2 April 2011

To: Securities and Exchange Commission

By email only at: rule-comments@sec.gov

Re: Registration and Regulation of Security-Based Swap Execution Facilities (File No. S7-06-11)

In response to the publication for comment of the proposed rule on Security-Based Swap Execution Facilities ("SB SEFs"), we are pleased to provide some comments in our capacity as a leading research facility focusing on optimal securities market design. We welcome the opportunity to present the Securities Exchange Commission ("SEC", or "Commission") with a framework to monitor and assess the impact of its proposed rule and assist it as it carries out its mandate.

The activities of the Capital Markets Cooperative Research Centre ("CMCRC" or "the Centre") are founded on a combination of academic research and industry expertise that fosters innovative research and products designed to assist regulators in their mandates to protect the integrity and efficiency of financial markets. We understand that the Commission seeks to "facilitate competition and innovations in the SB swap market that could be used to promote more efficient trading in organized, transparent and regulated venues" and "that certain elements of equity market structure may be directly relevant to the SB swap market."[1] We further understand that the proposed regulation seeks to implement the relevant sections of the Dodd-Frank Act[2] "to reduce risk, increase transparency, and promote market integrity within the financial system…"[3]

We will focus our comments on these objectives and on the requirement for the Commission to "implement a process for a SB SEF to submit to the Commission proposed changes to the SB SEF's rules"[4], given that the Commission further states that it favors an approach allowing it "to monitor the market for SB swaps and propose adjustments, as necessary"[5]. The Commission is also seeking comment "on the impact of any differences between the Commission and CFTC approaches to the regulation of SB SEFS and SEFs"[6], gaps between the two regimes, and the impact of the proposed rule on "the incentives of market participants…" and "how the proposals compare with the existing or proposed regulations of other jurisdictions."[7] We note that some concerns have been voiced about the impact of the proposed rule on competition and efficiency, where the new regulatory structure designed to achieve price transparency might lead to decreases in efficiency, and

[1] Securities and Exchange Commission Release No. 34-63825; File No. S7-06-11, page 19.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010)

[3] Commodity Futures Trading Commission, Core Principles and Other Requirements for Swap Execution Facilities, in the Federal Register, Vol. 76, No. 5, January 7, 2011, page 1214

[4] Securities and Exchange Commission Release No. 34-63825; File No. S7-06-11, page 1

[5] Ibid, page 19

[6] Ibid, page 9

[7] Ibid, page 10

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consequently, a number of exemptions are available to these entities[8]. We aim to comment on this tradeoff between efficiency and integrity, to offer a framework designed to assess the impact of the proposed rule on both, and consequently equip the SEC with a decision-making framework based on evidence supporting its regulatory choices taking into consideration the impact on both efficiency and integrity. We also note that the proposed rule aims to reduce systemic risk and wish to comment on this aspect as well.

Objectives of regulation in the securities markets

We note that the proposed rule includes the requirement that a SB SEFs provide of a great number of attributes related to liquidity, transparency, ease of trading, access, risk controls, records and compliance. In our opinion, these attributes can be summarized into two concepts fundamental to the mandate of the SEC, namely to maintain and improve market efficiency and market integrity. Indeed, the proposed rule requires that a SB SEF establish rules providing for "fair treatment of all trading interest", that these rules should address "prohibited trading practices", permitting "trading only in security-based swaps that are not readily susceptible to manipulation" [9]. In addition, the SB SEF is required to review these periodically. We find that the Exchange Act also describes the mandate of the SEC in terms of providing fair and efficient securities markets[10].

We conclude that the process required of the Commission to allow the SB SEF to establish itself, and to subsequently submit proposed changes, must revolve around the twin notions of market efficiency and market integrity (also known as fairness), and that the assessment process must provide the SEC with the means to establish differences in efficiency and integrity and to compare them. This is exactly what the CMCRC framework can provide, and we explain it in the sections below.

The CMCRC Market Quality Framework

We begin by noting that virtually every major securities regulator in the world, including the umbrella International Organization of Securities Commissions (IOSCO), define their mandate in terms of fairness (or "integrity") and efficiency[11], together constituting "market quality". Surprisingly, however, market efficiency and market integrity are not defined and this lack of definition results in a lack of measures for the efficiency and integrity of a market. Likewise, the regulator is left unable to measure the impact of its regulatory framework and policy-making on market quality, the very outcome that the SEC's process of assessment is targeting. We believe that regulators need to define market fairness and market efficiency and seek operational measures of both. Market quality would then be defined as maximizing market fairness without detriment to market efficiency, and vice versa.

[8] Jickling, M. and Ruane, K. A., Congressional Research Service, The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title VII, Derivatives, August 30, 2010, pages 7 and 8.
[9] Ibid, pages 425, 427 and 428
[10] Securities Exchange Act of 1934, As Amended Through P.L. 111-257, Approved October 5, 2010, section 2.
[11] IOSCO, Objectives and Principles of Securities Regulation, June 2010. One of IOSCO's three objectives is "ensuring that markets are fair, efficient and transparent;"

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The CMCRC has spent the last 10 years building infrastructure (which includes an underlying theoretical framework, applications and data) designed to measure the impact on market quality of the choices made by regulators about the market design they implement or propose. The framework is described in the exhibits 1 and 2 below. Exhibit 1 characterizes the overall Market Quality framework. Under this framework, market design changes consisting of changes in five broad areas, namely, technology, regulation, information, participants and instruments, are required to pass tests of market quality. Market Quality in turn is divided into the two core concepts of market efficiency and market integrity, and to pass the tests one must provide empirical evidence that the changes (actual or proposed) will enhance both market efficiency and market integrity, or enhance one without detrimentally affecting the other. Exhibit 2 further develops the framework by defining the two key concepts and identifying empirical proxies to assist in measurement. Through this framework, we contend that a regulator is able to measure a market's efficiency and its integrity and to report changes in the measures pre and post important market design changes. These measurements can also be used to compare how well one market fares against other markets at a point and/or over time with the implication being that markets that have higher quality have more optimal designs.

Exhibit 1

Market Quality Framework

MARKET ELEMENTS and STRUCTURE

- Technology
- Regulation
- Information
- Participants
- Instruments

MARKET QUALITY

EFFICIENCY

- Transaction Costs
- Price Discovery

INTEGRITY

- Insider Trading
- Market Manipulation
- Broker/Client Conflict

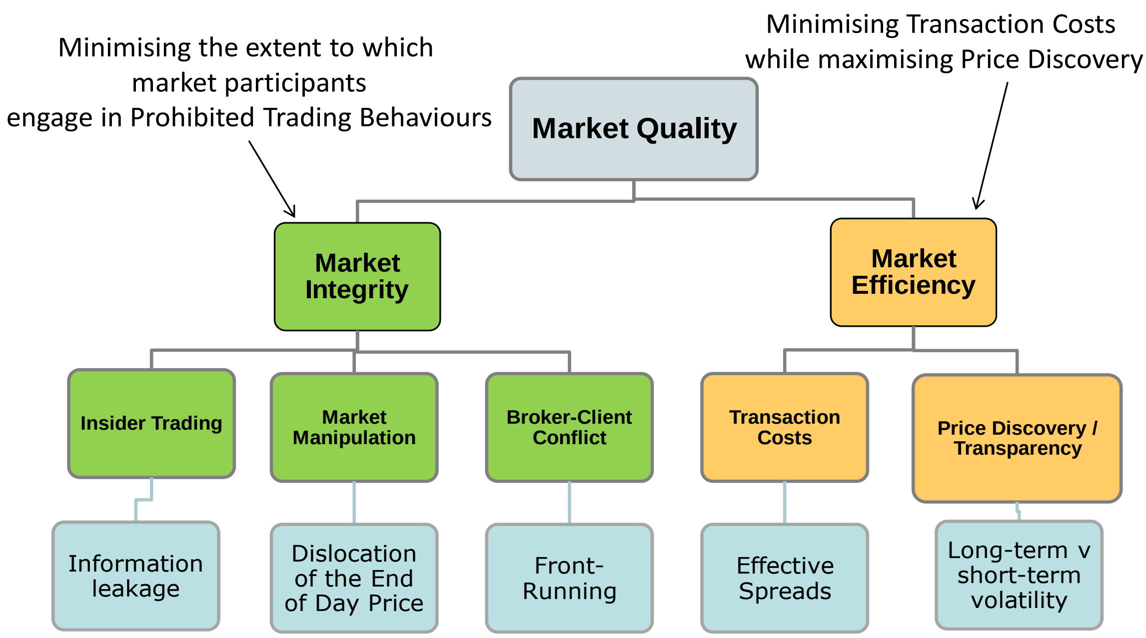
MARKET ADVANTAGE COMPARISON

Competitive Advantage is defined as having the appropriate combination of market elements that enhance efficiency and integrity, or not detract from either.

In the Context of accepted Regulatory Mandates a market design change must enhance (and certainly not detract from) either Efficiency or Integrity

Exhibit 2

COMPONENTS OF MARKET QUALITY



Notwithstanding the difficulties associated with measurement, we contend that the proxies for fairness and efficiency make it possible to compare and contrast markets at a point in time. We note that the rule proposed by the CFTC[12] addresses the abusive trading practices that are directly reflected in the framework's proxies. In our opinion, the framework fulfills the regulatory requirement for a process to assess the impact of the changes proposed by SB SEFs to the SEC, to monitor the impact of the regulatory framework for SB SEFs, and in particular the impact of differences between the CFTC's approach and the SEC's approach. The proxies and the framework could also help the Commission and SE SBFs to assess the impact of the changes they make to their own markets' design on the quality of their markets through time. Markets which have higher efficiency and fairness measures are markets which by definition have more optimal market designs and better quality, and vice versa.

The issue of systemic risk has taken on greater importance for regulators around the world in the wake of the global financial crisis, in the securities industry as well as in the banking and insurance industries. This is a difficult task for securities regulators because it involves them making assessments about contagion effects that threaten the viability of markets. As markets have become more globally

[12] Commodity Futures Trading Commission, Core Principles and Other Requirements for Swap Execution Facilities, in the Federal Register, Vol. 76, No. 5, January 7, 2011, page 1223.

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connected, there is a perceived threat arising from their inter-connection, namely, that factors affecting one market (e.g. the possibility of a major intermediary failing) may adversely affect another[13], especially given that most of the major financial intermediaries are the same names in each marketplace. This has presumably motivated IOSCO's principles 11 to 13 on Cooperation in Regulation. We note that a recent judgment by a higher court in Canada[14] sheds some light on the expectations that may flow from the mandates of securities regulators about the management of systemic risk. The object of securities legislation is described:

"…Its general objects, like that of all securities legislation, are the protection of the investing public, and the establishment and support of vibrant yet stable public markets for capital… The legislation is not primarily focused on the types of irresponsible investment decisions or products that might create systemic risk. Some provisions directed at systemic risk can be postulated. For example, … financial enterprises are required to have capital reserves of different types and magnitude…(the) level of margin purchasing of securities is limited…, because it has been suggested that some crises … were contributed to by the purchase of securities on excessive margins. Likewise, the sale of uncovered options is regulated. It might be thought to be contrary to public policy to allow the sale of highly speculative securities… (but securities legislation) is primarily aimed at the selling of securities, not bad investment product or practices. … (Any) regulation of …"systemic risk", like all securities regulation, comes down to regulating particular types of contracts …. (where) the focus is still on protecting individual investors, by providing them with the information they need to make rational investment decisions. .. There are existing federal institutions that (regulate systemic risk), for example the Canadian Deposit Insurance Corporation and the Office of Superintendent of Financial Institutions. Systemic risk at best is the tail in this Reference, not the dog. … No securities legislation manages capital flows... No securities commission buys or sells shares to influence the market, or increases or manages the gross amounts of capital available in the economy."

The objective of fair and efficient markets is related to systemic risk to the extent that contagion adds volatility, and therefore risk to markets, increases costs and reduces efficiency. In turn, to the extent that increased costs reduce liquidity, there is also a link to integrity because there is a direct negative correlation between liquidity and the ability to manipulate, namely, the lower the liquidity in a stock/market the higher the ability to manipulate. We respectfully submit that systemic risk in securities markets is an attribute resulting from market design as opposed to a fundamental objective and that it is possible that the market design changes authorised by regulators, such as the one contemplated by the SEC, may enhance contagion effects which could, in turn, undermine the fairness and efficiency of markets. Systemic risk is therefore more an attribute of a market's design than it is an output from a market design. Alternatively, it is a means to an end rather than an end it itself.

[13] The same issue exists within a market.

[14] Court of Appeal of Alberta, Reference re Securities Act (Canada), 2011 ABCA 77, March 8, 2011.

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The CMCRC is experienced in providing estimates of market quality metrics and changes therein for every major securities market in the world. We trust you will find our framework useful and look forward to further assisting the Commission.

Thanking you for the opportunity to comment, we remain,

Yours faithfully.
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