

April 4, 2011

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: File No. S7-06-11 – Registration and Regulation of Security-Based Swap Execution Facilities (76 Fed. Reg. 10948)**

Dear Ms. Murphy,

The International Swaps and Derivatives Association<sup>1</sup> ("**ISDA**") and the Securities Industry and Financial Markets Association<sup>2</sup> ("**SIFMA**") (hereinafter referred to as the "**Associations**") appreciate this opportunity to provide comments to the Securities and Exchange Commission (the "**Commission**") regarding the recently released proposed rule concerning registration and regulation of security-based swap execution facilities ("**SB SEFs**").

We agree with the Commission's determination that a more flexible approach to rule-making will best serve to accomplish the goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"): migration of security-based ("**SB**") swaps to regulated markets, greater transparency and increased competition. We generally support the Commission's approach to interpreting the definition of SB SEFs and devising rules for SB SEF regulation. However, we raise specific concerns in our comments below.

Our comments below are organized as follows: (1) the organization and operation of SB SEFs; (2) trades exempt from mandatory execution on SB SEFs; (3) oversight and review of SB SEFs; and (4) other issues.

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<sup>1</sup> ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. ISDA's members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: [www.isda.org](http://www.isda.org).

<sup>2</sup> SIFMA brings together the shared interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, please visit: [www.sifma.org](http://www.sifma.org).

## **I. Organization and Operation of SB SEFs**

### **1. Definition of SB SEFs.**

- (a) We strongly endorse the Commission's flexible and inclusive approach in interpreting the definition of SB SEFs.**

We support the Commission's principles-based approach to defining SB SEFs. The Dodd-Frank Act does not require, and we see no benefit to, limiting SB SEFs to the specific platforms that currently exist. We commend the Commission's efforts to "facilitate competition and innovations in the SB swaps market."<sup>3</sup> We agree that this is best achieved by encouraging existing facilities to qualify as SB SEFs while promoting the development of new types of platforms. Existing facilities are more likely to try to become SB SEFs if the definition and regulation are flexible enough to allow existing facilities to qualify as SB SEFs by making modifications that are economically reasonable. Facilitating the evolution of existing platforms into SB SEFs will provide for a more fluid transition of SB swaps to regulated markets, will minimize market disruption and will promote greater liquidity and competition. As more trading migrates to SB SEFs, new types of platforms are likely to develop.

A flexible approach to trading facilities will harmonize with analogous proposals by regulators outside the United States. The European Commission stated that, in regard to a possible definition of "organised trading facilities": "[t]he definition would be broad and capable of applying to new organised trading facilities that may emerge in the future."<sup>4</sup> The International Organization of Securities Commissions, in its recent report on the trading of OTC derivatives, found that "[b]ased on the benefits to be gained from increased trading on organized platforms, the Task Force recommends that a flexible approach to defining 'exchanges or electronic trading platforms' for the purposes of addressing the G-20 objectives be taken in order to maximize the number of standardized derivative products that can be appropriately traded on organised platforms."<sup>5</sup>

- (b) Request For Quote ("RFQ") – we agree with allowing requesters to choose the number and identities of recipients, and in particular to allow RFQs to go to as few as one recipient.**

We agree with the Commission's proposal that the RFQ requester should determine how many recipients receive an RFQ. The statutory definition of a SB SEF is "a trading system or platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants . . . through any means of interstate commerce . . . ."<sup>6</sup> We agree with the Commission that a SB SEF will satisfy this definition if it provides the ability for multiple participants to trade SB swaps by accepting bids or offers made by multiple participants. In our view, an RFQ system that allows a participant to send an RFQ to

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<sup>3</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 21; 76 Fed. Reg. 10953.

<sup>4</sup> European Commission, "Public Consultation" on "Review of the Markets in Financial Instruments Directive (MiFiD)" (Dec. 8, 2010), p. 9.

<sup>5</sup> Technical Committee of the International Organization of Securities Commissions, "Report on Trading of OTC Derivatives" (Feb. 2011), p. 48.

<sup>6</sup> Securities Exchange Act of 1934 ("**Exchange Act**"), Section 3(a)(77).

a single liquidity-providing participant would satisfy the requirements of the Dodd-Frank Act as long as the participant may also choose to send the RFQ to multiple liquidity-providing participants.

Setting a minimum number of recipients for an RFQ could harm market participants, particularly end-users, by requiring action that signals their trading interest. A pre-trade broadcast of the requester's intent to trade could enable other market participants to take action in anticipation of the trade, potentially affecting prices and moving the market against the requester. The danger is particularly significant for large trades that are too small to qualify as "block trades." This situation would be exacerbated if the definition of "block trade" were too restrictive. (See further discussion below.) The same concern would also arise for products that trade infrequently in illiquid markets, such as certain single-name corporate credit default swaps ("CDS"). A requirement to advertise a requester's interest to a broad portion of an illiquid market that may have few market-makers may effectively preclude confidentiality and may result in adverse price effects for the end-user. A wider broadcast of the RFQ provides pre-trade transparency for market-makers to the detriment of customers, who should be the primary beneficiaries of the regulations and the effort to increase pre-trade transparency. Each requester should be entitled to assess for themselves the balance between the available liquidity in the market and potential consequences of wide dissemination of the request. A restriction on customers' ability to choose RFQ recipients will not protect the customers and may potentially harm them.

**2. We are concerned about the proposal to require that SB SEFs disseminate composite indicative quotes and, if composite indicative quotes are required, they should not include responses to RFQs.**

We are concerned about the requirement in Proposed Rule 811(e) that a SB SEF that operates an RFQ platform must disseminate a composite indicative quote for SB swaps traded through the SB SEF and that this quote will be made available to all participants. The composite indicative quote is intended to provide "valuable pricing information"<sup>7</sup> and increase pre-trade price transparency. However, the composite indicative quote may not provide useful information because some indicative quotes may not be representative of execution prices and some indicative quotes may become stale over time and as markets move. Indicative quotes differ from execution prices for a number of reasons, including: first, execution price is often dependent upon a related hedge execution which is not determinable until the time of actual trade execution, and second, counterparty-specific and material agreement terms (which are of particular importance in the RFQ context) are not usually priced into indicative quotes. As a result, the composite indicative quote may not provide useful information, and may be misleading.

We are also concerned about the Commission's proposal that the composite indicative quote may also include responses to RFQs. Responses to RFQs are firm, not indicative, and RFQs are often used for trades with specific stipulations and the requests are made in a specific context, such as trades in large size and very illiquid SB swaps, and thus responses may not reflect the overall market for a given SB swap. The responder may provide a quote that is only meaningful for one particular RFQ and that the responder would not execute in the broader market. A responder

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<sup>7</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 94; 76 Fed. Reg. 10973.

may provide a non-competitive quote because it wants to be responsive even though it is not able to provide a competitive quote. Thus, the inclusion of responses to RFQs would not necessarily result in a composite quote that reflects the market.

Should the Commission require SB SEFs to disseminate composite indicative quotes, the Commission should clarify what is meant by such quotes and provide guidance or specify how such quotes are to be calculated. One calculation method is to source price information from a number of different price feeds and then determine the composite quote using a specified algorithm that excludes the highest and lowest prices, takes the average of the remaining prices and then incorporates a pre-determined bid-ask spread. We understand that this methodology is currently being employed to produce composite quotes on at least one platform. We would prefer this methodology over one that is simply constructed from the best bid and offer available to the SB SEF at any time.

**3. The Commission should provide that RFQ requesters may choose freely among existing firm interest and RFQ responses.**

**(a) The Commission should not impose any hierarchy or preference in execution on the requester.**

The release accompanying the proposed rules on SB SEFs (the "**Release**") states (footnote 163) that if a SB SEF has both an order book system and a separate RFQ mechanism, any trade in the RFQ system must interact with existing firm interest on the order book at the same or better price before interacting with interests on the RFQ platform. This requirement is not stated in the proposed rules and we strongly encourage the Commission not to impose such a requirement. The proposed rule should make it clear that the requester has full discretion to execute trades based on whatever factors the requester deems relevant. In addition to price, this may include size and factors affecting the "total price" of the transaction, such as execution efficiency, performance reliability and possible cross-product margining.

Any requirement to accept existing firm interest for less than the full RFQ amount may have adverse consequences for the RFQ requesters. These consequences are likely to be worse in the SB swaps markets than in existing securities and futures markets because of the relatively lower level of liquidity in the SB swaps markets. If the customer is required to accept existing firm interest for less than the total amount of the RFQ, this may harm the price that the RFQ requester will receive. For example: an RFQ is made for offers of 50MM in an SB swap; there are existing firm offers for 5MM each at 191, 192, 193, 194; and the best response to the RFQ is an offer for 50MM at 195. Under a preference regime as suggested by the Commission, the requester would have to execute the smaller trades for a total of 20MM and a trade with the RFQ responder for 30MM (assuming the responder will sell only 30MM at that price), resulting in five trades with five different liquidity providers. The weighted average price of the trade is then 194, but the price differential may not compensate the requester for other "costs" related to having to trade with four additional and unknown parties. If the response to the RFQ of 50MM at 195 is "all or none" and the best RFQ response that will fill 30MM is at 198, then the requester will be forced to execute with the four partial offers and the one offer at 198, for a weighted average price of 195.8, resulting in a worse price for the requester than if the requester been able to buy all 50MM at 195 from the best RFQ responder.

Imposing a hierarchy and execution requirement is also likely to generate a larger number of transactions for a given notional amount if the requester is required to execute trades with existing firm interest in amounts smaller than that of the RFQ. Unnecessarily high trading volume is contrary to the aim of established regulatory and industry initiatives such as tear-ups and compression. Also, as multiple market-makers simultaneously attempt to execute the same hedge, other market participants may interpret the action as an indication of a directional shift in market sentiment and cause the market price for the related SB swap to move in an adverse direction to the RFQ requester.

The requester of an RFQ should be able to choose the bids and offers with which it wishes to execute a trade. There is no policy reason and no directive in the Dodd-Frank Act that requires trade prioritization and execution with existing firm interest.

**(b) "Interaction" between RFQs and existing firm interest should be limited to the communication of such bids/offers to the requester.**

As stated above, the Release requires that an RFQ must "interact" with existing firm interest. The Release does not define "interact." We request that the Commission provide that the only requirement for RFQs and existing quotes is that SB SEFs communicate relevant existing quotes to RFQ requesters.

SB SEFs should be given discretion to determine what quotes qualify as existing firm interest and what criteria will apply, such as term to expiration and size restrictions. Otherwise, requesters may be inundated with stale or possibly misleading information. Also, the information flow between the requester and the SB SEF should be one-way: the SB SEF should inform the RFQ requester of the relevant existing quotes but should not inform the participants giving the quotes of the relevant RFQs. This will prevent possible abuse by market participants seeking disclosure of relevant market information by submitting quotes for small transactions or off-market stub quotes.

In our view, only firm interest for a size of transaction that is at least equal to the quote size requested by the RFQ should be communicated to the requester. Without this limitation, an RFQ may result in quotes being reported to the RFQ requester that are for transaction sizes smaller than being sought by the requester. In addition to not meeting the requester's desire to execute a particular transaction size, the smaller quotes may provide the requester with misleading information if the sizes are too disparate. Communication of smaller quotes also would likely result in a higher volume of trades, which would be contrary to the outcome favored by long-standing regulatory and industry initiatives.

**4. SB SEFs should not be required to provide a mechanism to disseminate firm quotes from participants.**

Although the proposed rules themselves do not include this requirement, the Release states that a SB SEF "must provide a mechanism for the dissemination of firm quotes, if any, submitted by participants."<sup>8</sup> The commentary indicates that this would "allow a 'limit order-book' model to

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<sup>8</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 36; 76 Fed. Reg. 10957.

emerge in parallel with other trading models on the SB SEF."<sup>9</sup> We disagree with this requirement. We agree with Commissioner Sommers, who objected to a requirement in the Commodity Futures Trading Commission (the "CFTC") proposed rules that SEFs provide a centralized electronic screen on the basis that, "this provision is not mandated by the Dodd-Frank Act and may limit competition by shutting out applicants who wish to offer request for quote services without this functionality."<sup>10</sup> We respectfully recommend that the proposed rules allow SB SEFs to provide a mechanism for the dissemination of firm quotes submitted by participants on the SB SEF, but not require them to do so.

We are concerned about the statement in the Release that "if a SB SEF displays firm, executable trading interest, it must display such interest to all parties."<sup>11</sup> If a market participant posts quotes on a centralized screen, it should be able to do so only to a limited group of recipients. A requirement that all executable trading interests displayed on a SB SEF be displayed to all parties will deter market participants from submitting information and executing trades and thereby reduce transparency and liquidity. This will be particularly true for trading interest in illiquid SB swaps and SB swaps in large size. Market participants will be concerned that broad exposure of such interest may cause the market to move against them. As a result, market participants may decide to forgo execution, which would result in less liquidity.

**5. We agree with the Commission's view that a SB SEF may determine access based on objective and non-discriminatory standards.**

We support the Commission's proposal to allow SB SEFs to establish impartial requirements for access and to permit SB SEFs not to grant access to eligible contract participants that are not registered SB swap dealers, major SB swap participants or brokers. We believe this will help SB SEFs meet their obligations under Core Principle 6, which calls for procedures to ensure the financial integrity of SB SEFs. Core Principle 2 requires SB SEFs to "provide market participants with impartial access (emphasis added) to the market . . . ."<sup>12</sup> In light of Core Principle 6, impartial access need not and should not be interpreted to mean access to any and all possible participants.

**6. The SB SEF regulations should permit a SB SEF to develop protocols for swaps that cannot be cleared and should permit differential pricing for swaps using different SB swap clearing agencies ("SB SCAs").**

Parties that execute SB swaps through a SB SEF will do so in the expectation that the SB swap will settle through a particular SB SCA. The proposed rules do not address what will happen if a SB swap fails to clear through the relevant SB SCA after the SB swap is executed on a SB SEF. We recommend that the Commission allow a SB SEF, together with its participants, to develop protocols to address the failure of a SB swap to clear after execution. These protocols should address the processes to be used if a SB swap fails to clear, including legally sufficient

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<sup>9</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 36; 76 Fed. Reg. 10957; see also Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 25; 76 Fed. Reg. 10954.

<sup>10</sup> 76 Fed. Reg. 1259, col. 2.

<sup>11</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 89; 76 Fed. Reg. 10972.

<sup>12</sup> Securities Exchange Act of 1934, Section 3D(d)(2)(B)(i).

documentation (such as confirmations) and credit requirements. The Commission should also explicitly permit bilateral trading for SB swaps that fail to clear.

Also, if a SB swap can clear on more than one SB SCA, the market value of the SB swap may vary depending on the SB SCA that will be used. This variation could occur because of differences in costs of clearing, in execution capabilities, or in creditworthiness of different SB SCAs. Therefore, the Commission should permit SB SEFs to allow differential pricing for SB swaps using different SB SCAs.

## **II. Exemptions from mandatory execution requirement**

### **1. Block Trades.**

#### **(a) The Commission should exempt block trades from SB SEF requirements.**

The Exchange Act has not been modified by the Dodd-Frank Act in the same way as the Commodity Exchange Act ("CEA"): the Commission was not given the same authority with respect to SB SEFs as the CFTC was given with respect to SEFs to "promulgate rules defining the universe of swaps that can be executed on a swap execution facility."<sup>13</sup> We see no reason for a difference and think a technical correction would be appropriate. The Commission should have the same authority and, along with the CFTC, should exclude block trades from the mandatory execution requirement. If block trades are not excluded from the execution requirement then the requirements should be kept to a minimum, as discussed further below.

Although the Release permits SB SEFs to establish different trading rules for block trades generally, it states that block trades would be subject to various minimum requirements with respect to pre-trade transparency and interaction with other trading interests.<sup>14</sup> We are concerned that such requirements may not be appropriately calibrated to block trades and may restrict customer choice. Because block trades are large and illiquid, as the Commission has recognized, reporting these trades does not contribute to the transparency of the market. For example, including the response to an RFQ for a block trade in a composite quote may produce a misleading result because the terms, including price and size, of the block trade may not reflect market volumes or prices that are generally available.

As discussed above, we strongly recommend that the Commission not impose any execution hierarchy or preference with respect to the interaction with other trading interests. We are particularly concerned about the imposition of an execution hierarchy on block trades. The parties to block trades may reach a price after negotiations over very specific terms, including size. If one of the parties was required to accept existing firm quotes rather than the quote of its counterparty, there would be no negotiation. It is particularly troublesome to impose a partial execution requirement for block trades because they are specifically structured in relation to the size of the trade. We urge the Commission to avoid establishing any execution priorities for block trades.

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<sup>13</sup> 7 U.S.C. §5h(d). We note that the CEA permits the Commission (as well as the CFTC) to "promulgate rules defining the universe of swaps that can be executed on a swap execution facility."

<sup>14</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 97; 76 Fed. Reg. 10974.

We request that the rules provide an appropriate reporting delay for block trades and provide that trade size need not be disclosed. As noted in the ISDA/SIFMA Block Trading Study, reporting exemptions are often employed by market regulators to preserve a high level of liquidity.<sup>15</sup> A reporting delay should provide enough time to allow market participants to hedge the market risk of a block trade. We reiterate the position stated in our letter regarding proposed Regulation SBSR, that the size of a block trade (other than the fact that it is a block trade) should not be disclosed at any time. Such treatment of block trades would be similar to the treatment under FINRA's TRACE system.<sup>16</sup>

**(b) The definition of "block trade" should not be too restrictive.**

We commend the Commission for acknowledging the significance of large-size trades in the SB swaps market and soliciting input from market participants on how block trades should be defined and the potential ramifications of the definition. We urge the Commission to define "block trade" in a manner that does not overly restrict qualifying trades and that would result in a consistent definition across the relevant rules.

Trading in the swaps market is fragmented, product-specific and concentrated in larger transaction sizes, as shown in the ISDA/SIFMA Block Trading Study.<sup>17</sup> A definition that is overly restrictive has great potential to adversely affect the ability of end-users and others to execute and hedge large transactions because informing the market of a potential large transaction may move the market against the person seeking the transaction. Market-based research and analysis should be employed to provide the basis for the determination of well-calibrated block trading exemption rules, and these rules should be updated quarterly. We are happy to provide assistance, having performed a similar study.

**2. Available to Trade.**

**(a) We strongly agree with the Commission's view that "available to trade" requires more than mere listing or trading on a SB SEF and we ask that "available to trade" be defined to reflect minimum liquidity levels.**

We strongly support the statement in the Release that the Commission would in effect interpret the phrase "made available to trade" as something more than the decision to simply trade the swap on a SB SEF or exchange.<sup>18</sup> In the absence of liquidity, a SB SEF listing does not enable participants to trade a SB swap. For example, even if equity or CDS swaps of different types become traded on a SB SEF, the liquidity of any single equity or CDS swap may be very limited. The ISDA/SIFMA Block Trading Study determined that "[l]iquidity in OTC derivative markets is fragmented and varies considerably depending on the specific product and terms of the

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<sup>15</sup> ISDA/SIFMA Block Trading Study, attached to ISDA and SIFMA joint comment letter on Proposed Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information (75 Fed. Reg. 75208), dated January 18, 2011, Annex 2, p. 5.

<sup>16</sup> ISDA and SIFMA joint comment letter on Proposed Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information (75 Fed. Reg. 75208), dated January 18, 2011, p. 5.

<sup>17</sup> ISDA/SIFMA Block Trading Study, (See fn. 15), Annex 2.

<sup>18</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 79; 76 Fed. Reg. 10969.

contract . . . traded . . . ." <sup>19</sup> The study found that the markets for interest rate and credit derivatives are characterized by low volumes concentrated in large transaction sizes, across a large number of available instruments. <sup>20</sup> Accordingly, a SB swap of a type that is listed may actually rarely be traded.

We request that the Commission clarify the parameters of what is "available to trade" to reflect measures of liquidity on a SB swap-specific basis. At a minimum, a particular SB swap should trade multiple times daily with multiple distinct swap counterparties in order to be considered "available to trade." We urge the Commission to perform an in-depth study of the markets on a SB swap-specific basis, in conjunction with market participants, to determine other appropriate criteria for "available to trade." The study and resultant criteria should be appropriately tailored at the SB swap product level. For example, a study of aggregate trading volumes of all IBM CDS across all tenors and coupons would not provide useful data from which individual thresholds for IBM 3 month CDS and IBM 5 year CDS could be derived. The study should capture relevant SB swap-specific characteristics, such as cycles in trading volumes. For example, a study encompassing one month of trading data would be insufficient for a product that experiences volume spikes on roll months that occur quarterly.

Initial criteria for "available to trade" should be set at a high level of liquidity to ensure that SB swaps that generally trade infrequently would not initially be "available to trade." The Commission should provide for ongoing monitoring and periodic review and allow for dynamic modifications to the criteria for "available to trade" as appropriate, to minimize the possible harmful effects of a mistake in the initial criteria. Application of the initial criteria over different economic cycles and market environments will generate information that will enable the Commission to determine how the criteria should be adjusted. This applies to designating new products that are "available to trade" as well as identifying products that are no longer "available to trade." Products and trading volumes on the SB swaps market are not static and regulation must be flexible to respond to trends that signal fundamental changes at the product level.

- (b) We agree that the Commission should define criteria that determine whether a SB swap is "available to trade" and we ask that the Commission make the determination as to whether a SB swap is "available to trade."**

We support the proposal in the Release that the Commission should determine the objective measures that will be used to determine what is "available to trade." <sup>21</sup> The Release is not entirely clear, however, as to who will make the actual determination whether a particular SB swap is available to trade or not. We believe the Commission should make that determination because the SB SEF itself will have an economic incentive to encourage trading on the SB SEF. An approach under which SB SEFs are allowed to determine what is "available to trade" could encourage SB SEFs, for competitive reasons, to prematurely determine that a SB swap is "available to trade" even though that determination would not be supported by the actual trading volume, in order to gain market share. This is not in keeping with the intent of the Dodd-Frank

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<sup>19</sup> ISDA/SIFMA Block Trading Study, (see fn. 15), Annex 2, p. 2.

<sup>20</sup> ISDA/SIFMA Block Trading Study, (see fn. 15), Annex 2, pp. 15-22.

<sup>21</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p.78; 76 Fed. Reg. 10969.

Act provisions applicable to SB SEFs to foster a marketplace where SB SEFs compete with one another. As a result, and in view of the broad significance of this determination, we believe the Commission, rather than the SB SEFs, should make the determination, subject to requirements of notice, public comment and opportunity for a hearing. The Commission should also make the determination of what is no longer "available to trade," again based on objective measures determined by the Commission. However, the Commission must be able to make determinations of what is no longer "available to trade" rapidly, in order to address markets in which liquidity rapidly declines. As a result, in determining whether a SB swap is no longer "available to trade," the Commission should not be required to provide for notice, public comment and opportunity for a hearing.

**3. Combination/package trades and inter-affiliate SB swaps should be excluded from mandatory execution on a SB SEF.**

**(a) Combination trades.**

Combination trades are transactions in which parties concurrently trade, on an integrated basis, a SB swap that must be executed on a SB SEF or exchange and another transaction that is not a SB swap that must be executed on a SB SEF or exchange. For example, two parties may trade a total return swap and an underlying equity security as part of one unified package with a single price. After the Dodd-Frank Act becomes effective, some trades may also involve combinations of two swaps, one of which is subject to the execution requirement, and the other of which is not subject to the execution requirement.

Because the price and execution for each leg of such a trade is dependent on the other leg, requiring the SB swap to be traded on a SB SEF would effectively prevent these trades. To avoid this result, SB swaps involved in these combination trades should not have to be executed through a SB SEF. Such combinations could be executed as packages, similar to exchanges of futures for related positions, with the SB swap leg submitted to a SB SEF post-trade, thereby satisfying clearing, reporting and other related regulatory obligations.

**(b) Inter-affiliate swaps.**

We urge the Commission to exempt SB swaps between affiliates from the mandatory execution requirement for SB SEFs. First, ISDA has separately requested the Commission to determine that inter-affiliate swaps are exempt from mandatory clearing.<sup>22</sup> If the Commission makes such a determination, then under Section 3C(h) of the Exchange Act, an inter-affiliate SB swap would not be required to be executed through a SB SEF because it is not subject to the clearing requirement. Thus, if the Commission determines that inter-affiliate SB swaps are not subject to the clearing requirement, we request that the Commission recognize that inter-affiliate SB swaps need not be executed on a SB SEF.

Second, inter-affiliate SB swaps should not, in any event, be required to be executed on SB SEFs. SB swaps between persons under common control simply represent allocations of risk

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<sup>22</sup> See ISDA comment letter on Notice of Proposed Rulemaking: Process for Review of Security-Based Swaps for Mandatory Clearing (75 Fed. Reg. 82490), dated February 14, 2011, p. 10.

within a corporate group.<sup>23</sup> The size, frequency, and in certain instances, pricing levels, of inter-affiliate SB swaps will likely have no informational value for the broader market and the reporting of such SB swaps could have the unintended result of confusing market participants as to the true depth and liquidity of the market. As a result, executing these SB swaps through a SB SEF will not improve pre-trade price transparency and could be misleading. Requiring SB SEF execution of inter-affiliate trades will reduce a company's ability to accomplish risk management objectives on a cost-effective basis. In the futures markets, despite the general rule that futures contracts must be executed through a designated contract market ("DCM"), there is a longstanding practice of affiliates trading among themselves outside DCMs.

### **III. Oversight and Review**

#### **1. We support the proposal to require a swap review committee and the required composition of the committee.**

We support the Commission's concept of a swap review committee to monitor the trading of SB swaps on the SB SEF, and the proposal that the committee should be constituted with a fair representation of market participants. However, the Commission should also provide that membership on the swap review committee requires appropriate market expertise for each member. We reiterate the concern set out in ISDA's previous letter on proposed Regulation MC that a rule that mandates certain percentages of public director representation on a committee is less effective than focusing on the expertise of each director.<sup>24</sup> We also recommend that the swap review committee determine which trades are block trades, based on criteria established and set by the Commission.

Proposed rule §811(c) provides that the swap review committee must periodically "determine whether the trading characteristics of each security-based swap justify a change to the trading platform for each security-based swap."<sup>25</sup> We recommend that the Commission allow the swap review committee to make such determinations, but not require it to have such a periodic review. SB SEFs and their participants should have procedural flexibility in determining when and if trading platforms are no longer appropriate for certain SB swaps.

#### **2. Proposed Regulation MC.**

The proposed rules regarding conflict of interest refer to the prior proposed rules on ownership and governance for SB SEFs (Regulation MC).<sup>26</sup> ISDA has previously expressed its concerns about certain requirements under Regulation MC, including the requirement that at least 51% of the directors of a SB SEF be public directors.<sup>27</sup> We disagree with this requirement for public

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<sup>23</sup> See "Further Definition of 'Swap Dealer', 'Security-Based Swap Dealer', 'Major Swap Participant', 'Major Security-Based Swap Participant' and 'Eligible Contract Participant'", 75 Fed. Reg. 80183.

<sup>24</sup> ISDA comment letter on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC (75 Fed. Reg. 65882), dated November 23, 2010, p. 7.

<sup>25</sup> Securities and Exchange Commission release No. 34-63825; File No. S7-06-11, p. 424; 76 Fed. Reg. 11061.

<sup>26</sup> See SEC Release No. 34-63107, File No. S7-27-10, 75 Fed. Reg. 65882, (October 26, 2010).

<sup>27</sup> ISDA comment letter on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC (75 Fed. Reg. 65882), dated November 23, 2010, p. 7.

directors. Governance requirements for SB SEFs should be consistent with those adopted for SB SCAs.

We also are concerned about the requirement that SB SEFs have a Regulatory Oversight Committee comprised solely of independent public directors. (Proposed 242.702(e), 75 FR 65932). As ISDA has previously stated, we think that requiring SB SEFs to establish a Regulatory Oversight Committee risks a duplication of functions between the committee and the Chief Compliance Officer, who has specific and extensive duties under the proposed rules.<sup>28</sup>

#### **IV. Other**

##### **1. The Commission should adopt a staged implementation of the proposed rules.**

Many of the proposed rules will pose significant operational and administrative hurdles for market participants and SB SEFs. For example, the proposed rules have requirements for system safeguards that will require time and systems expertise to implement fully. We strongly suggest that SB SEFs be allowed to adopt the rules on a staged basis so that the basic functioning of the SB SEF and the market can be established before all requirements are imposed.

##### **2. The Commission should indicate what treatment will be given to foreign SB SEFs.**

Some SB SEFs will need to operate on a cross-border basis and the Dodd-Frank Act does not give the same exemptive authority to the Commission with regard to foreign SB SEFs as it has given to the CFTC with regard to foreign SEFs.<sup>29</sup> This inconsistency needs to be rationalized and the Commission should be given broader exemptive authority. Without such authority, the Commission will need to consider how it will regulate non-U.S. SB SEFs that wish to include U.S. participants. In particular, the Commission should provide specialized treatment with regard to registration and supervision for a SB SEF that is adequately regulated by its home country.

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<sup>28</sup> ISDA comment letter on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC (75 Fed. Reg. 65882), dated November 23, 2010, p. 6.

<sup>29</sup> The Exchange Act, in §3D(e) provides that "[t]he Commission may exempt, conditionally or unconditionally, a security-based swap execution facility from registration under this section if the Commission finds that the facility is subject to comparable, comprehensive supervision and regulation on a consolidated basis by the Commodity Futures Trading Commission." The Commodity Exchange Act, in §5h(g) provides that the CFTC "may exempt, conditionally or unconditionally, a swap execution facility from registration under this section if the [CFTC] finds that the facility is subject to comparable, comprehensive supervision and regulation on a consolidated basis by the Securities and Exchange Commission, a prudential regulator, or the appropriate governmental authorities in the home country of the facility."

**3. The Commission, the CFTC and foreign regulators should ensure harmonization and flexibility amongst their rules.**

The Dodd-Frank Act puts the Commission, the CFTC and foreign regulators in the position of designing the structure and regulation of significant and novel market architecture in the swap markets. For this reason, we urge the Commission, the CFTC and foreign regulators to coordinate their efforts in devising the new market rules. Because swaps in one market are often hedged in or linked to other markets, it is critical that SB SEFs (or their equivalents) in different jurisdictions operate in a compatible manner.

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The Associations appreciate the opportunity to comment on the proposed requirements for SB SEFs. We trust this submission is helpful to you. Please feel free to contact us or our staff at your convenience.

Sincerely,



Robert Pickel  
Executive Vice Chairman  
ISDA



Kenneth E. Bentsen, Jr.  
Executive Vice President  
Public Policy and Advocacy  
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