BETTER MARKETS
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April 4, 2011

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

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

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Securities and Exchange Commission ("Commission"). The Proposed Rules establish a framework for the registration and regulation of security-based swap execution facilities ("SEFs"), in accordance with Section 763(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

Developing rules governing the operation of SEFs is one of the most important challenges facing the Commission as it implements the Dodd-Frank Act. SEFs are a critical element of the derivatives market infrastructure envisioned by the Dodd-Frank Act, as they are one of the primary means for bringing the shadow market into the open.

It is painfully obvious that the financial crisis, which brought us to the brink of international economic collapse, was in large part the result of a "shadow," or non-transparent, financial market. This shadow market emerged largely because of off-exchange trading. The ability of counterparties to meet and match without the use of conventional exchanges grew exponentially.

1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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There were two unfortunate consequences of this "innovation." First, direct counterparty credit exposure, arising because derivatives were not cleared, spawned a tangled web of inter-counterparty obligations, often mismanaged by even the most sophisticated trading operations.[2] Mechanisms for clearing off-exchange trades were later added to some direct matching systems in response to the mushrooming levels of exposures and a series of disruptive bankruptcies. But large volumes of bi-lateral, uncleared transactions continue to dominate the market.[3]

Second, the shadow market, in which uncleared derivatives were transacted, omitted the price transparency and price discovery provided by regulated exchanges. Deprived of critical information concerning the magnitude of positions and exposures, market participants and regulators alike struggled, and ultimately failed, to accurately assess the dire conditions in the market.

It is inevitable that some of these shadow market systems and practices will not be able to adapt to regulatory reform and will not survive. It is apparent from various comments provided by the financial industry and their supporters that they do not yet accept that this financial crisis was an "**extinction event**" for some of these practices. Their starting point is that the Dodd-Frank Act and the rules promulgated thereunder must be conformed to pre-existing market structures.

This view is wrong, but not surprising. Considering the massive profitability of non-transparent and unregulated derivatives trading in the decades before the financial crisis, denial is a predictable response. And for those industry commenters not in denial, framing the issue so that it is premised on doing no harm to pre-existing businesses and outsized profits is a clever tactic. However, this strategy, whatever its origins, simply ignores that the Dodd-Frank Act requires "business as usual" to change.

Against this backdrop, it is apparent that the definition of a SEF in the Proposed Rules is critical to the realization of the transparent market mandated by the Dodd-Frank Act. Equally important are rules governing trading practices allowed on SEFs.

However, there is yet another major challenge. In the past, rules and procedures to preserve the orderly operation of markets with minimal disruptions were focused on individual exchanges. That approach is clearly problematic and, in fact, systemically dangerous in the modern environment. Today, electronic and algorithmic trading enables market participants to roam across a landscape populated by multiple SEFs and exchanges. They are able to almost instantly manipulate the relationships among disparate markets, taking advantage of differences in the rules of the road at various trading facilities or platforms. Even ICE Chairman and CEO Jeffrey Sprecher has recently warned of the

[2] For a remarkable example, *see* Forbes, August 12, 2008, Ruthie Ackerman, "Constellation's Collateral Damage;" and The Baltimore Sun, September 19, 2008, Robert Little, "Collateral, Credit Crunch Took Down Constellation."

[3] Some evidence of this is found in the vocal and well-publicized efforts to maximize the scope of the end-user exception to clearing, asserting enormous losses in profits from a narrow interpretation of the exception.

"regulatory arbitrage" among exchanges (i.e., the exploitation of different rules applied by different exchanges) that may develop in the new environment.[4] Therefore, it is particularly important for the Commission and its fellow regulator, the Commodity Futures Trading Commission ("CFTC"), to strive for clarity and uniformity as they establish the rules governing SEFs.

SUMMARY OF COMMENTS

In our comment letter, we address the following issues:

Definition of Swap Execution Facility

- To maximize transparency as intended by the Dodd-Frank Act, the Commission should require the use of a limit order book system as the SEF platform for trade execution, and it should incorporate this provision in the Proposed Rules rather than offering only interpretive guidance. In addition, order book systems must be required to use a "best price/first-in-time" rule to sequence the matching of orders.

- If the Commission decides to allow SEFs to use request for quote ("RFQ") trading systems, then the Proposed Rules must be changed to conform to the law's express requirements. First and foremost, RFQs must be disseminated to all participants in the SEF, not just to one participant or some other limited number. Giving market participants the discretion to direct RFQs to just one other participant essentially preserves the private, bi-lateral mode of executing SBS trades that Congress repudiated in the Dodd-Frank Act. In addition—

    - Responses to RFQs for firm quotes must be firm as to quantity as well as price.

    - Responses to RFQs must be made available to all participants of a SEF.

    - When RFQs are used for large trades, block trading rules should apply.

The Meaning of "Available to Trade"

- The requirement that all SBS subject to clearing must also be traded on SEFs or exchanges hinges on whether a SEF or exchange has made the SBS "available to trade." The Commission should interpret this concept broadly and in accordance with the plain and simple meaning of the Dodd-Frank Act: an SBS should be considered "available to trade" if a SEF or exchange has, in fact, made it available to trade. Superimposing other tests or conditions, such as trade volume thresholds, is unwarranted. Such an approach will only reduce the number of SBS that must be

[4] Reuters, March 1, 2011, Ann Saphir, "ICE Chief Plans to Upend Rival CME's Business."

traded openly on SEFs or exchanges, and relegate more SBS to the shadows of the OTC market.

Access Requirements

- The Proposed Rules must require SEFs to prohibit purchased preferential access to rapid data feeds. Such access essentially legalizes front-running, and it is fundamentally unfair to other market participants.

Conflicts of Interest

- The Proposed Rules must require SEFs to prohibit revenue sharing, volume discounts, rebates, and other similar arrangements used by SEFs to attract business and establish dominance in a given market. If allowed, these practices will enable SEFs to exact unfair prices from captive market participants. They will also distort market prices and impose hidden costs on those who are not favored with preferential pricing arrangements.

Abusive Trading Practices

- The Proposed Rules should identify specific trading practices that SEFs must address in their rules, including front-running, wash trading, pre-arranged trading, fraudulent trading, and other manipulative or disruptive trading practices.

- In addition, the Proposed Rules must require SEFs to address a variety of new abusive trading practices that HFTs may bring to the SBS market, including front-running large trades, price spraying, rebate harvesting, and layering the market. Even if these abuses do not immediately infect the SEF environment, their appearance is only a matter of time as the SBS market grows. It is far better to preempt them now in the Proposed Rules than to address them only after they have become entrenched and market participants have suffered harm. To limit the possibility of abusive trading by HFTs, the Proposed rules should also require SEFs to—

    - Institute "speed limits" requiring bids and positions to be held for minimum durations on the order of 5 to 10 seconds.

    - Implement surveillance and audit trail systems that are capable of tracking and monitoring orders and cancellations in the extremely short time intervals that HFTs and other traders rely upon in their trading strategies.

Chief Compliance Officers

- The Proposed Rules must require SEFs to implement additional measures that will protect Chief Compliance Officers ("CCOs") from attempts by boards and senior management to undermine their independent judgment and effectiveness. Those measures should include—

    - Appointment of a senior CCO with overall responsibility for compliance by a group of affiliated or controlled entities.

    - Competency standards to ensure that CCOs have the background and skills to fulfill their responsibilities.

    - Vesting exclusive authority in the independent board members to oversee the hiring, compensation, and termination of the CCO.

    - Requiring the CCO to report to the board as opposed to senior management.

    - Requiring the CCO to meet quarterly with the Audit Committee, in addition to annual meetings with the board and senior management.

    - Explicit prohibitions against attempts by officers, directors, or employees to coerce, mislead, or otherwise interfere with the CCO.

    - Requiring the board to review and comment on, but not edit, the CCO's annual report to the Commission.

THE DEFINITION OF SWAP EXECUTION FACILITY

The definition of a SEF is critically important because it will largely determine the degree of transparency that the new regulatory framework will bring to the SBS marketplace. Under the Dodd-Frank Act, any SBS subject to mandatory clearing *must* be executed on a SEF or exchange, subject to certain exceptions. The statute thus forces the vast majority of SBS transactions onto regulated markets. The intent, of course, is to create orderly and efficient markets that provide transparency and competition. However, the degree to which these goals are achieved will depend upon the exact nature of the trading environments that the Commission requires SEFs to provide in its rules.

The Statutory Standard

The statutory definition of a SEF is focused squarely on promoting price transparency and competition. It provides as follows:

> The term 'swap execution facility' means a trading system or platform in which **multiple participants have the ability to execute or trade swaps by accepting**

> **bids and offers made by multiple participants** in the facility or system, through any means of interstate commerce, including any trading facility that—
>
> (A) facilitates the execution of swaps between persons; and
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> (B) is not a national securities exchange.[5]

The thrust of this definition is that market participants must interact with multiple market participants when executing trades in SBS.

Interpretive Guidance Instead of a Proposed Rule

The Proposed Rules do not apply this definition in accordance with the language or intent of the statute. As a threshold matter, the Commission has determined not to establish a "prescribed configuration" for SEFs, but instead to offer interpretive guidance in place of a definition. The rationale stated in the Release is that guidance, as opposed to a rule, will provide flexibility to trading venues that may seek to become registered as SEFs and will permit the continued evolution of organized markets for trading SBS.[6]

The Commission should abandon this flexible, wait-and-see approach, and should instead promulgate a definition of SEF that clearly stipulates the types of trading systems or platforms that will satisfy the requirements of the Dodd-Frank definition. The concept of allowing for flexibility or evolution in the industry has value, but only to the extent it is permitted **within** the statutory and regulatory boundaries that are necessary to achieve transparent, fair, and systemically stable SBS markets. Without an enforceable rule in place that sets those boundaries, the industry will have too much incentive and latitude to contrive trading systems that may fit within the Commission's guidance but which actually defeat the goals of transparency and competition embodied in the Dodd-Frank Act.

Misapplication of the Statutory Standard

The interpretive guidance offered in the Release is far too permissive. The Dodd-Frank Act defines a SEF to mean a trading system "in which **multiple** participants have the ability to execute or trade swaps by accepting bids and offers made by **multiple** participants."[7] The unmistakable and explicit intent of this language is that market participants must interact with multiple market participants when executing trades in SBS. Congress recognized that real transparency and competition could only arise from these types of open trading platforms, and that the secretive, bilateral mode of executing SBS transactions could not be allowed to persist, at least in the SEF environment.

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[5] Dodd-Frank Act, § 761(a)(6) (emphasis added).
[6] Release at 10953.
[7] Dodd-Frank Act, § 761(a)(6) (emphasis added).

The Release takes a different approach, however, which is much weaker and which does not adhere to the statutory language or its purposes. Under the guidance provided in the Release, a trading system would satisfy the SEF definition even if it enabled a market participant to send a single RFQ to "**any number** of specific liquidity providing participants on the SB SEF, including just a **single** liquidity provider."[8] This constitutes, literally and substantively, a bilateral mode of trade execution, and it is unequivocally impermissible under the express requirements of the Dodd-Frank Act.

The Commission's interpretation would allow one-to-one bids and offers on the theory that the statutory definition only requires that participants have the **ability** to request bids or offers from multiple participants, not that they must do so.[9] But this cannot possibly be what Congress intended. Under this interpretation, the regulatory requirement that SBS be traded on SEFs or exchanges becomes essentially optional, while the traditional and failed mode of doing business through bilateral, private interactions is allowed to continue.

If this view is accepted, then market participants *may* choose to engage in an open and transparent bid/ask system, but they need not do so. Reform is left to the discretion of market participants. This outcome would be antithetical to the Dodd-Frank Act, undermining the letter and spirit of the law. The Commission does not have the authority to disregard the law on this point or to purport to implement it in a way that is inconsistent with the statute's express provisions.

The Release itself reveals the contradictions inherent in this approach. It acknowledges that "the traditional bilateral negotiation model . . . would not fall within the definition of SB SEF because there would be only **one** party able to seek a quote and only **one** party able to provide a quote in response."[10] Yet the Commission's guidance would allow precisely this traditional, one-to-one system to persist, by giving participants the option to restrict the scope of their requests for bids and offers. In fact, under this system, two parties could agree on the price and terms for an SBS and then arrange for one party to direct a single-recipient RFQ to the other, frustrating the competitive pricing function of the SEF trade execution requirement.

The Release further states that giving participants the ability to disseminate bids and offers to all other market participants "would allow for increased transparency beyond what would be found in the bilateral OTC market," but at the same time, the Release concedes that this benefit will accrue only "**if** a market participant chooses to utilize the functionality to display a bid or offer."[11]

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8 Release at 10953 (emphasis added).
9 *Id.*
10 Release at 10954 (emphasis added).
11 *Id.*

The Proposed Rules must establish a definition that will unequivocally promote transparency and competition, not one that conditions it on the desires of market participants. Everyone already knows where those market desires will lead: outsized profits in markets without transparency and competition, where risks will build up unseen and lead to another market failure.

Unpersuasive Justifications

The justifications in the Release for this approach are not persuasive. The Release explains that the Commission is attempting to balance the need to promote transparency with the need to provide incentives for market participants to trade SBS on regulated markets rather than in the OTC market.[12] The specific concern is that if the terms of a trade, especially a block trade, must be disseminated broadly prior to execution, then other market participants could attempt to profit from this information, to the detriment of the party initiating the trade.[13] This, in turn, might discourage market participants from using SEFs as opposed to OTC mechanisms for executing trades.

The supposed tension between the dual goals of promoting trading on SEFs and enhancing pre-trade price transparency is more imagined than real. They are, in fact, complementary goals. To the extent they do conflict as suggested in the Release, Congress has already resolved the conflict by **mandating** that SBS be traded on SEFs or exchanges, subject to certain conditions and exceptions. Therefore, there is very little need to **incentivize** the use of SEFs or exchanges. This factor simply cannot be regarded as a compelling rationale for severely limiting the transparency of the trading platforms that SEFs must provide.

To the extent the Commission is focused on the impact of block trades, the remedy is to carve out a narrow exception for them, not to define all acceptable trading platforms based on those unique challenges. Rules applicable to block trades can and should draw on the definitions and threshold formulas that the Commission has developed for post-trade reporting. Establishing discrete rules for block trades would at least maximize the amount of competition and price transparency for the majority of trades to be executed on SEFs.

As a practical matter, the benefits of requiring bids and offers to be communicated to all SEF participants outweigh any drawbacks. Among those benefits are price competition and lower prices. As noted in the Release, requiring RFQs to be sent to multiple dealers will foster greater competition, which is likely to lower spreads as dealers compete with each other as to price.[14] The resulting lower prices would counteract the effect of inflated prices that are feared to arise if RFQs are required to be disseminated to multiple dealers.

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[12] Release at 10955.
[13] Release at 10954.
[14] *Id.*

Price discovery also would be enhanced if the "multiple to multiple" test in the statute were implemented in the Proposed Rules as Congress intended. This would follow not only from the dissemination of bids and asks to multiple dealers, but also from a "more robust" composite indicative quote, which would incorporate a greater number of responses.[15]

Excessive Concern with Accommodating Existing Business Models

The Release also makes clear that the interpretive guidance has been heavily influenced by concerns over the impact of the SEF definition on the existing platforms that are currently used for trading SBS. The Release invites comment, for example, on the consequences of the definition for "those platforms that would not be able to meet the proposed interpretation of the definition of SB SEF."[16] It further asks whether there are "any types of trading venues so critical to the proper functioning of the SBS swap market that the Commission should consider expanding the proposed interpretation of the definition of SB SEF so that such entities could qualify as SB SEFs?"[17]

These issues should not sway the Commission as it formulates the rules defining and regulating SEFs. Accommodating these concerns would mean tailoring the rules to meet the needs of existing market participants, rather than requiring market participants to conform to the new rules that are necessary to implement the legally mandated regime for SBS. In the Dodd-Frank Act, Congress meant to revolutionize the SBS market to make it more transparent, fairer, and more resistant to systemic risk. If some market participants must incur costs or change their modes of operation to achieve these objectives, then so be it. While the rules should avoid imposing unnecessary costs, they should certainly not be diluted to spare industry the unavoidable consequences of regulatory reform.

Specific Recommendations

The optimal way to implement the statutory definition of a SEF is to require the use of a limit order book system, which is currently operated in the futures and securities markets. The Release correctly observes that the limit order book system generally provides greater pre-trade transparency than other systems, such as single-dealer and multi-dealer RFQ platforms.[18] The Commission should also ensure that execution preferences under a limit order system are fair. Preference within a price level in an order book system must be based on a "best price/first-in-time" rule.

RFQs should not be a permitted trading system or platform under the SEF definition. They do not maximize transparency and price competition. If allowed, they should be subject to a number of restrictions. Above all, RFQs for firm quotes must be disseminated

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15 Release at 10954.
16 Release at 10956.
17 *Id.*.
18 Release at 10952.

to all participants in the SEF, not just to one participant or some other limited number. For a quote to be considered firm, it must be firm as to quantity as well as price, to reduce the potential for manipulation and deception. In addition, all firm responses to an RFQ should be made available to all participants of the SEF to ensure trading transparency.

Finally, narrowly tailored block trade rules should apply, where necessary, to address concerns regarding the potential impact of signaling that a large trade may be forthcoming. The Proposed Rules require SEFs to establish and enforce rules regarding "the manner in which block trades will be handled."[19] As indicated in the Release, the definition should be the same as the one suggested in the Commission's proposed rule governing the dissemination of SBS transaction data.[20]

THE MEANING OF "AVAILABLE TO TRADE"

Another issue that is central to the regulation of the SBS markets is determining when a SEF has made an SBS "available to trade." This determination has two important consequences. Under the Dodd-Frank Act, SBS that must be cleared must also be executed on an exchange or a SEF, unless no exchange or SEF makes the SBS "available to trade."[21] Hence, the statute conditions the mandatory execution requirement on whether or not a SEF or exchange has made the SBS available to trade. In addition, once an SBS is made available to trade by any exchange or SEF, it can no longer be traded in the OTC market.

In the Release, the Commission recognizes two possible regulatory approaches to this issue. The first would define "available to trade" in accordance with its plain meaning: A SBS would be deemed available to trade if a SEF or an exchange has listed the SBS for trading. The second would define the phrase according to objective criteria that center on factors such as the trading volume or liquidity associated with the SBS.[22]

The Commission prefers the second approach, as a means of preventing SEFs from exercising unilateral control over whether an SBS is available to trade. The Release expresses a particular concern that SEFs dominated by a small number of dealers may have competitive incentives either to prevent or to encourage the migration of SBS to the exchange or SEF venue.[23] The Proposed Rules do not address the issue, and the Release indicates that the Commission does not yet have sufficient information to propose objective standards governing the determination.[24]

In general, we strongly support attempts by the Commission to prevent market participants from exercising excessive control over issues, such as whether an SBS should be deemed available to trade and therefore subject to mandatory SEF or exchange

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[19] Proposed Rule 811(d)(9).
[20] Release at 10973.
[21] Dodd-Frank Act, § 763(a).
[22] Release at 10969.
[23] Release at 10968-69.
[24] Release at 10969.

execution. However, in this case, and for the reasons explained below, we believe the Commission should refrain from imposing additional tests in this area. Instead, the Commission should adopt the first, straightforward method for determining whether an SBS has been made available to trade, and should incorporate it into the Proposed Rules. That standard should be simply whether an exchange or a SEF has in fact made the SBS available to trade.

One virtue of this approach is that it follows the plain language of the Dodd-Frank Act. The phraseology in the statute suggests that the test should be taken at face value: it states that mandatory exchange trading or SEF trading of SBS "shall not apply if no exchange or SEF makes the SBS available to trade."[25] Availability is cast simply in terms of actions by exchanges or SEFs, not in terms of independent criteria. In addition, the Dodd-Frank Act elsewhere clearly states that "a security-based swap execution facility that is registered under [the subsection governing registration] **may make available for trading any security-based swap**."[26] Here again, the language of the statute vests the decision to make SBS available for trading in the hands of the SEFs[27].

This interpretation will also maximize the trading of SBS on exchanges and SEFs, as Congress intended. Applying independent standards such as a minimum level of trading volume would only have the effect of reducing the number of SBS that must be traded on an exchange or SEF. This result would follow whenever a SEF sought to list an SBS for trading but the Commission's test could not be met and the SBS could not be deemed available for trading. It is difficult to see how superimposing an additional set of requirements could ever increase the likelihood that an SBS would be "available for trading." If no SEF elected to list an SBS for trading, no set of standards could make it, in fact, "available."

In addition, contrary to the Commission's suggestion, there is no need to establish a test for ensuring that an SBS has sufficient liquidity before it is deemed available to trade. The mandatory **execution** requirement in the Dodd-Frank Act applies only to SBS that are already subject to the mandatory **clearing** requirement.[28] SBS that have been accepted for clearing have sufficient liquidity to enable a clearinghouse to measure the risks associated with them. Hence, to the extent a screening mechanism is necessary with respect to execution of SBS on SEFs or exchanges, the clearing requirement provides it. That clearing requirement is, in turn, subject to close oversight by the Commission.

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25 Dodd-Frank Act, § 763(a).

26 Dodd-Frank Act, § 763(c) (emphasis added).

27 With respect to **swaps**, the Dodd-Frank Act authorizes the Commission and the CFTC to promulgate rules defining the universe of swaps that can be executed on a swap execution facility. Dodd-Frank Act, § 733. These provisions do not alter our view of the "available to trade" test discussed above. They do not apply to SBS; the rulemaking authority is permissive, not mandatory; and these provisions expressly require any rules to reflect the ultimate goals of promoting SEF-execution and price transparency. The way to achieve those objectives is to interpret "available to trade" according to its plain meaning, not in light of additional criteria.

28 Dodd-Frank Act, § 763(a).

In short, the Commission's proposal would sometimes prevent, but never promote, the mandatory execution of SBS on exchanges or SEFs. The undesirable consequence would be that more SBS trading would remain in the shadows of the OTC market.[29] Accordingly, the Propose Rules must not incorporate additional standards that would encumber the simple "available to trade" test set forth in the Dodd-Frank Act.

ACCESS REQUIREMENTS

The Dodd-Frank Act requires SEFs to comply with 14 core principles, and among those core principles is the duty "to provide market participants with impartial access to the markets."[30] The Proposed Rules implement this requirement in two provisions, which are intended to strike a balance between ensuring impartial access to SEFs and ensuring the financial integrity of transactions.[31]

Given these objectives, the focus of the Proposed Rules is largely on the types of entities that a SEF may allow as a participant and the conditions that a SEF may impose on those entities to ensure that they are financially responsible. For example, Proposed Rule 809(c) requires all participants to be members of a registered clearing agency, and Proposed Rule 809(d) requires eligible contract participants that are not registrants to establish special risk management controls.

These provisions are reasonable but they fail to address an increasingly important problem involving preferential access to the markets via data channels. The key issue here is not who may participate in the market, but on what terms.

Privileged access to data feeds is a practice that profoundly disrupts fair and equitable trading. It is the modern-day version of front-running and it is on the rise. Unless anticipated and addressed in the Proposed Rules, this phenomenon will afflict SBS markets as well.

An even greater concern in the SBS market is the lack of fair access to valuation indices on which some SBS are based. The dealers that control a SEF may seek to gain competitive advantage by ensuring that the indices used to price various SBS are *not* widely available. This disparity in access to critical information clearly favors some market participants at the expense of others.

Any form of unequal access constitutes an anti-competitive advantage passed from SEFs and exchanges to selected market participants that are in a position to use preferential access to secure a trading advantage. The value of this advantage is enhanced by the fragmented nature of derivatives markets and the likelihood of multiple, market-specific SEFs. Given the extraordinary concentration of trading volumes in a narrow set of

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[30] Dodd-Frank Act, § 763(c).
[31] Release at 10961.

large firms in the derivatives market, the potential for conflicts of interest and predatory behavior is great.

To address this growing problem, the Proposed Rules must expressly prohibit purchased preferential access to rapid data feeds. In addition, the Proposed Rules must require SEFs to ensure that valuation indices are made available to all participants in the SEF.

The Dodd-Frank Act clearly requires SEFs to establish and enforce "participation rules," and those rules must include "means to provide market participants with impartial access to the market." This reference to the market is a broad formulation. It encompasses not only traditional notions of inclusion and participation but also access to data, which is the life blood of our modern day markets. The goal of ensuring impartial market access cannot be achieved if data flows to and from SEFs and exchanges are sold to the highest bidder or otherwise granted to a favored few at the expense of all others.

CONFLICTS OF INTEREST

The Dodd-Frank Act requires each SEF to "establish and enforce rules to minimize conflicts of interest in its decision-making process."[32] The Proposed Rules implement this core principle by supplementing the rules that the Commission previously proposed in Regulation MC, which establish ownership and governance limitations on SEFs, national exchanges, and clearing agencies. The supplementary provisions in the Proposed Rules (1) ensure fair representation of SEF participants on the Board, (2) require at least one Board member to be an investor representative, and (3) enhance the role of participants in the nomination of Board candidates.[33]

Although these provisions are a useful complement to Regulation MC, they do not go far enough. The Proposed Rules must address the volumetric and profit-based incentives that SEFs use to attract business. The influence of these arrangements is so powerful that they can overwhelm otherwise sound corporate governance and ownership limitations. As explained below, their harmful impact is evident in price gouging of captive market participants, unfair and opaque cost allocation, and distorted price discovery,

Compensation incentives can be used to capture and exploit market participants. An obvious business plan for a SEF targeting a specific market is to strike a volume-for-cash deal with the market makers in the sector. Market participants must have access to market makers to reliably execute transactions and to discover bid/ask spreads. In fact, market participants depend on the reliable price quotes provided only by market makers. Therefore, if the SEF can capture the volume of all or a substantial portion of the market makers, the rest of the market will be compelled to use the SEF regardless of the quality of service or cost.

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32 Dodd-Frank Act, § 763(c).
33 Proposed Rule 820.

In this circumstance, the control of a SEF by its shareholders is illusory. Quality and cost of service are far less important to the success of a SEF than the secure posting of transactable bid/ask prices. This enables market makers to dominate and control without equity or ownership investments.

These incentives also burden other market participants by imposing unfair and undisclosed costs. When a SEF provides financial incentives based on trade volume to a participant, the cost is shifted onto other participants. The SEF is merely buying volume and arranging for a subclass of its customers to pay for it.

Finally, rebates and discounts for trading liquidity or volume cause variations in transaction value based on the particular fee concession that applies. The inevitable result is distorted prices. In addition, market participants will game the system to take advantage of rebates and discounts to the detriment of the greater marketplace. These behaviors and their consequences have already been experienced in the equity markets, which provide fair warning of potential problems as derivatives markets mature.[34] Equity markets have experienced activities such as fake quotes to take advantage of credits-for-quotes schemes and programmed direction of volume to various trading platforms to take advantage of liquidity rebates.

The only way to address these problems is to prohibit revenue sharing, volume discounts, rebates, and other similar arrangements entered into by SEFs. The Commission must take this step in the Proposed Rules to minimize conflicts of interest in accordance with the Dodd-Frank Act.

ABUSIVE TRADING PRACTICES

The Dodd-Frank Act requires SEFs to establish and enforce trading rules that will "deter abuses." The Release and the Proposed Rules devote very little attention to the implementation of this statutory requirement, even though preventing abusive trading practices remains one of the most important tasks in the effort to establish and sustain confidence in the integrity of the SEF marketplace.

Proposed Rule 811(a) simply mirrors the statute by requiring SEFs to establish and enforce rules that "deter abuses," and Proposed Rule 811(d)(6) simply requires SEFS to establish and enforce rules concerning "prohibited trading practices." The Release offers no specific guidance.[35]

This is woefully inadequate. It essentially outsources to private market participants both the identification of "abuses" and the remedy for them. This is unrealistic in a market

[34] *See* New York Stock Exchange discussion of payment for order flow by the CBOE in comment letter on SEC Release No. 34-62445, *available at*: http://sec.gov/comments/s7-21-09/s72109-163.pdf.

[35] Release at 10972.

environment where maximizing profits is the priority. Not to suggest anyone would necessarily intentionally commit wrongdoing, but when there is a conflict between what many might see as an abuse and an opportunity to make substantial profits, judgments are inevitably clouded, at best.

Thus, the Propose Rules must identify specific abusive trading practices that SEFs are required to address in their rules. These rules must include front-running, wash trading, pre-arranged trading, fraudulent trading, and any other manipulative or disruptive trading practice. The consequences for engaging in those practices must also be spelled out.

The Proposed Rules must also address a variety of emerging trading practices, deployed by high frequency traders ("HFTs"), which are really traditional forms of abusive trading in a modern, electronic guise. These are traders who use high-frequency and algorithmic practices in automated trading systems that respond to objective market conditions in a pre-programmed way and at lightning speed.

It may be that trading abuses associated with HFTs will grow incrementally as the SBS markets mature, but it is inevitable that, unless preempted, they will take root and ultimately become a significant problem. It is imperative, therefore, that the Commission address the threat of this emerging phenomenon in the Proposed Rules now.

A major goal of HFTs is to take advantage of trading rules of SEFs and exchanges, often using order and cancellation strategies to detect the motivations of other market participants and gaming the rules based on this knowledge. If an HFT can detect a large position being piecemealed into the market, it can position itself in front of the trade, buy and immediately sell to the market, all within a very short period of time.

A recent study describes the interaction of high-frequency and algorithmic trading in the marketplace.[36] The study observes that high-frequency trading intermediates between market makers and liquidity traders. It increases the price paid by liquidity traders when they buy and decreases the price received when they sell. High-frequency trading increases price volatility. As a result, market makers enjoy higher liquidity premiums. High-frequency trading also increases volume, but is neither driven by fundamentals nor does it constitute noise trading. High-frequency trading is an anathema to the efficient markets paradigm because it actually increases volume, but does not provide liquidity or decrease volatility.

Abusive HFT Trading Practices

Listed below are four HFT practices that must be considered "abuses" within the meaning of the Dodd-Frank Act. Each of these is facilitated by market intelligence tactics

[36] Cartea, A. and Penalva, J., "Where is the Value in High Frequency Trading," Universidad Carlos II de Madrid, November 2, 2010.

commonly used by HFTs to discover hidden liquidity, primarily the intent of market participants to execute plans to acquire or dispose of large positions by a series of smaller trades. For example, a liquidity trader ("LT") wishing to transact a large position may well want to effect the trade in tranches to avoid moving market prices against it. One way that an HFT can detect this is to simply watch for orders that are filled and then re-emerge. The speed of their systems can enable them to perceive this situation and act on it extremely quickly.

These and other intelligence gathering tactics are designed to set the stage for HFTs to extract value by using a miniscule speed advantage based on the rules of the trading road, specifically priority given to the first-in-time best bid or offer.

- Exploiting a Large Quantity or Block Trade. If an HFT has detected an LT that seeks to transact a large position in small increments, then the HFT can exploit its speed to alter market conditions in a way that encourages buyers to accept a slightly higher price and sellers a slightly lower price. This tactic is an analog to traditional front-running. In the past, front-running was enabled by information regarding a market participant's order which was misused by a trader to position itself in front of the order. The difference here is that the HFT gathers the information by poking and pinging the market to estimate the motivation of the LT rather than getting a tip from a broker or other market participant. The results are the same: the LT and the market maker have received less from their trading than they might have because of the HFT's manipulation of the market's dynamics and trading rules, with no concern for fundamental values.

- Price Spraying. HFTs sometimes use a more aggressive tactic based on information regarding large trades that are transacted in smaller orders. If the HFT detects a series of buy orders, for instance, it may simply buy the market. It then uses a series of sell-or-cancel orders to discover the LT's upper price limits. The HFT then positions itself at the front of the queue at the LT's price limit and simply sells at that price realizing profit between its purchase prices and the LT's price limit. This is also just a form of front-running. The advantages to the HFT are the information on motivation derived from early acquisition of information on the LT's buy orders, the ability to rapidly buy the market before others can react to the information, and the use of a spray of sell and cancel orders to find the optimal price level to re-establish the bid side of the market at the point it can then dominate.

  Front-running, buying the board, and spoofing, among other tactics, would all be prohibited if individuals were doing them. **The fact that computers (pre-programmed by individual human beings) engage in these practices should not change the legal standard.**

- Rebate Harvesting. SEFs offer rebates based on transacted volume to attract market makers. HFTs are able to instantaneously transact buy and sell orders at the same all-in price, or even at a loss which is less than the value of the rebate. The HFT earns the rebate by simply turning over the trade in a round-trip transaction. The exchange or SEF has unintentionally paid for volume, but not liquidity. The ultimate buyer and seller would have transacted but for the intervention of the HFT, which was able to execute the two trades in "real-time."

- Layering the Market. This involves the placement of multiple bids and offers at different prices and quantities. It generates an enormous volume of orders but has cancellation rates as high as 90 percent. While it can facilitate rebate harvesting, it can also be used to generate phantom depth and liquidity of the market, which can induce a belief by other market participants that there is price momentum. Some of the other participants may draw this conclusion based on algorithms of their own. Once trading behavior is induced, the HFT can use other tactics similar to those used in the case of large positions transacted in a series of orders to buy or sell ahead of the direction of the momentum. The HFT's advantages are: to be able to place and cancel multiple orders quickly and to position itself as first in the queue at a strategic price level ahead of the momentum. This is a direct analog to spoofing. The HFT has no intent or desire to transact on the multiple bids and offers. It is very certain that most (approximately 90 percent) will be cancelled. The purpose is to induce price momentum and suggest a depth of liquidity which simply does not exist.

Risk Controls for Trading

The Proposed Rules require SEFs to establish rules concerning trading halts.[37] In addition, the Proposed Rules include provisions requiring SEFs to provide for the exercise of emergency authority, including the authority to impose a variety of trading limits and operational restrictions.[38] Such measures are designed to address extraordinary circumstances, such as instances when trading in the security underlying an SBS has been suspended.

Although useful, trading halts are insufficient to address the more chronic disruptions that HFTs may cause. The addition of "speed limits," in addition to stop lights, is required to serve as a buffer against the potential for disruption fueled by HFT.

The Commission should require that bids and positions be held for minimum durations. For instance, although the rules might vary depending on asset class and market structure, the time periods should range between 5 and 10 seconds at a minimum. Legitimate, algorithmically-driven trading strategies can then be implemented in this environment, but high-frequency volume—which benefits only the trader and subjects the market to tremendous risks—would be curbed.

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37 Proposed Rule 811(d)(8).

38 Proposed Rule 816.

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Surveillance and Audit Trail

The Proposed Rules include a number of provisions requiring SEFs to establish rules governing surveillance and recordkeeping.[39] To enable SEFs and the Commission to address the challenges posed not only by HFTs, but by electronic trading more generally, the Proposed Rules should ensure that each of these monitoring provisions are capable of tracking and recording events in the extraordinarily short time intervals that characterize the rapidly evolving marketplace.

For example, automated trade surveillance systems must allow time-stamping at intervals consistent with the capabilities of traders that use the SEF's systems. Orders and cancellations must be time-stamped at intervals consistent with the capabilities of such traders. This will enable SEFs to monitor the implementation of trading strategies that are abusive.

Similarly, records of customer orders and their disposition, whether filled, unfilled, or cancelled, must be time-stamped at intervals consistent with the capabilities of traders. This is especially important for reconstruction of problematic episodes, like the recent "flash crash." It is critical that all of these reports can be quickly and easily compiled into a format allowing analysis by regulators.

CHIEF COMPLIANCE OFFICERS

The Dodd-Frank Act requires each SEF to designate a chief compliance officer who is responsible for establishing a compliance policy, monitoring the SEF's compliance with applicable laws and regulations, and remediating compliance problems as they arise.[40] The CCO also must file an annual report with Commission, including a financial report, and must present the report to the SEF's Board before submitting it to the Commission.[41]

Rules governing the appointment, responsibilities, and supervision of the CCO are a vital component of the new regulatory framework governing SEFs. While rules addressing conflicts of interest help minimize inequitable and predatory behaviors, rules relating to the CCO help minimize actual violations of applicable laws and regulations. For many years, market participants operated in an environment in which regulation was viewed as an obstacle to doing business. Changing this corporate culture requires the involvement of a CCO who has the authority and independence to function effectively and without interference.

The Proposed Rules will help fortify the role of the CCO as an effective force in achieving SEF compliance, but they should be strengthened in a number of ways.

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[39] Proposed Rules 813, 814, and 817.
[40] Dodd-Frank Act, § 763(c).
[41] *Id.*

Affiliates. The Proposed Rules must address the issue of affiliates and controlled groups. Compliance should be addressed with respect to the entire group. An affiliated organization should not be allowed to serve as a vehicle for avoiding compliance. A single, senior CCO should have overall responsibility for the entire group of affiliated and controlled entities, even if individual entities within the group have CCOs. The annual report on compliance should likewise address both individual and group entity compliance.

Qualifications. The Proposed Rules should require the CCO to meet competency standards to ensure that the person has the background and skills appropriate for fulfilling the responsibilities of the position. These standards should include a lack of disciplinary history, in addition to criteria demonstrating relevant knowledge and experience. Furthermore, the CCO must not be the SEF's general counsel or a member of its legal department.

The Role of Boards of Directors and Conflicts of Interest. The business realities of SEFs are unique. Their business model depends on capturing volume-for-fee income. Inherently, they will be subject to the influences of their major customers, the large financial institutions generating essential trading volume. The duties of a CCO will often conflict with the interests of these powerful participants. One duty specified in the Proposed Rules is resolution of conflicts of interest, which will be particularly contentious. In these businesses, the barriers to independent judgment related to compliance are unusually large.

The independent members of the boards of directors are, by design, independent from senior management. Compliance is less likely to be viewed by them as an obstacle and more likely to be viewed as an important goal.

In light of these pressures that are exerted on CCOs, the Proposed Rules must include the following provisions to help ensure the independence of the CCO:

- Decisions relating to the designation of the CCO, their compensation, material changes in their responsibilities, and their termination should be the sole responsibility of the independent members of the board of directors acting by majority vote.

- The CCO should report to the Board and must also have a direct reporting line to the independent directors or Audit Committee.

- The Proposed Rules must require that the CCO meet with the board of directors *and* the senior officer to discuss the effectiveness of compliance policies at least once each year. In addition, the CCO should meet at least quarterly with the Audit Committee. This will provide the foundation for the independent members of the board of directors to become truly effective allies of the CCO and it will make it much less likely that the CCO will succumb to the pressure to permit risky and inappropriate practices that serve the interests of powerful customers.

Prevention of Coercion. As suggested in the Release, the Proposed Rules should include a provision "explicitly prohibiting any officers, directors, or employees of a SEF from, directly or indirectly, taking any action to coerce, manipulate, mislead, or fraudulently influence the CCO in the performance of his responsibilities."[42]

Annual Report. The duty of the CCO to prepare an annual report on compliance issues, certify the report, and furnish the report to the Commission is central to the efficacy of the Proposed Rules. Under the Proposed Rules, the report must be furnished to the board of directors prior to submission to the Commission. We propose that the independent directors and/or the Audit Committee as well as the entire Board be required to review and approve the report in its entirety and to detail any disagreements they may have with the report. The CCO should be required to then file the report with the Commission, either as approved or with statements of disagreement, but without edits.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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