March 1, 2013

Commissioner Mark Wetjen
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington DC 20581

Re: SEF Rules and RFQ-to-1

Dear Commissioner Wetjen:

Thank you for meeting with us recently to discuss the proposed SEF rules and the arguments to replace the RFQ-to-5 requirement with just an RFQ-to-1 (or some purported "compromise" like RFQ-to-2), recognizing that, as you stated repeatedly, you hadn't made up your mind and didn't have a position yet on the Proposed Rule. We want to reiterate here the compelling reasons discussed in our meeting demonstrating why those arguments should be rejected and the context in which they must be considered. Moreover, as discussed below, this is no time to "water down" or "weaken derivatives rules."[1]

First, it must always be remembered that the dark, unregulated over-the-counter ("OTC") derivatives market was a major component of the shadow banking system, where the last financial crisis was invisibly incubated, ignited the financial conflagration, and acted as a conveyor belt to transmit the crisis throughout the U.S. and global financial system. The proposed SEF rules, including in particular those related to RFQs, are critical steps in bringing long-overdue transparency, regulation, fair competition, and systemic stability to those markets.

Second, as I said in our meeting, too many of the discussions about specific rules are not only ripped from the context of the comprehensive Dodd-Frank law and its overriding objectives, but are also isolated, abstract, and bloodless, ignoring the very real human consequences, costs, and suffering. It must never be forgotten that that the recent financial collapse was the worst since the Great Crash of 1929 and has caused the worst economy since the Great Depression. The costs of that have been crippling, as an economic, fiscal, and human matter and that is what gave rise to the financial reform law in general and derivatives reform/Title VII in particular.

[1] "US Watchdog Set To Weaken Derivatives Rules," *available at* http://www.ft.com/intl/cms/s/0/e3fd4f66-81d0-11e2-b050-00144feabdc0.html#axzz2MCqBO1Ws.

1825 K Street, NW, Suite 1080, Washington, DC 20006 (1) 202.618-6464 (1) 202.618.6465 bettermarkets.com

Better Markets did an analysis that showed the dollar cost of the recent financial crisis and economic wreckage it caused will be more than $12.8 trillion.[2] Of course, dollar amounts, no matter how large, can never capture or reflect the incalculable and devastating human suffering from lost jobs, homes, retirements, educations, and so much more. On top of all that, local, state, and national budgets have been decimated because financial crises cause revenues to plummet at the same time the need for spending on urgent social needs skyrockets. Indeed, although never mentioned, much of the debate today about deficits and cutting critically important programs like Social Security results directly from the trillion dollar deficits inflicted on the country by the financial crisis.

That is what is at stake in properly and faithfully implementing the financial reform law. No amount of Wall Street lobbying, importuning, and talking their book to protect their business lines and profits should ever be allowed to eclipse those facts and the human suffering they have caused across the country, much of which continues to this day. That is why it is so overwhelmingly important to get reform right and not to "weaken" or "abandon" strong rules meant to protect the American people.

Third, as is well known, an oligopoly of the five largest U.S dealers controls 95 percent of the derivatives dealing in the U.S.[3] This oligopoly, referred to and documented as the "Derivatives Dealers Club,"[4] was not preordained; those dealers have used their substantial formal and informal means and methods of control to create and maintain that dealers club and its exclusivity.[5] Now, those dealers and their allies are doing everything possible to bend the new financial reform rules in a way that will enable them to replicate that oligopoly in the new, post-Dodd-Frank derivatives market structure. While that may be a legal, rational, profit maximizing thing for those dealer banks to do, it would be a total abdication of responsibility for regulators to let them do it, wittingly or unwittingly. It would defeat many of the most important provisions required by the financial reform law to protect investors, taxpayers, markets, and the economy from another devastating financial and economic crisis.

That is what is at stake in the SEF (and other derivatives) rules. As stated by the author of the article that brought the Derivatives Dealers' Club into the public eye:

> "...the main impediments to meaningful reform [are] the private actors who now control the trading of derivatives and all key elements of the infrastructure of derivatives trading, the major dealer banks. The importance of this 'Derivatives Dealers' Club'

---

[2] *See* Better Markets, "The Cost Of The Wall Street-Caused Financial Collapse and Ongoing Economic Crisis is More Than $12.8 Trillion," *available at* www.bettermarkets.com/cost-crisis.

[3] *See* OCC's Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2012, *available at* http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq312.pdf.

[4] *See* R. Litan, "The Derivatives Dealers' Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interested Parties," *available at* http://www.brookings.edu/research/papers/2010/04/07-derivatives-litan.

[5] *See* L. Story, " A Secretive Banking Elite Rules Trading in Derivatives," *available at* http://www.nytimes.com/2010/12/12/business/12advantage.html.

> cannot be overstated. All end-users who want derivatives products ... must transact with dealer banks. The dealer banks, in turn, transact heavily with each other, to hedge the risks from their customer trades and somewhat less frequently, to trade for their own accounts."
>
> "... the major dealer banks have strong financial incentives and the ability to delay or impede changes from the status quo - even if the legislative reforms that are now being widely discussed are adopted [as they were]- that would make the ... derivatives markets safer and more transparent for all concerned."[6]

We will not address here all the claims made by those promoting RFQ-to-1 (or something other than RFQ-to-all or RFQ-to-5), but wanted to address the key issues raised in our meeting:

1. The definition of a SEF in Section 721(a) of the Dodd-Frank Act is **not** consistent with an RFQ-to-1 model.

2. An RFQ-to-1 model would only offer the illusion of greater "flexibility," allowing the Commission to capture a broader swath of swaps under the execution mandate but only at the unacceptable cost of transparency, competition, stability, and a level playing field.

3. For actual illiquid markets (for which the industry has provided no data), an RFQ-to-all or RFQ-to-5 model would **not** raise costs for customers and would **not** disclose too much information to other market participants.

4. The Rule of Construction in Section 733 of the Dodd-Frank Act contains two goals that are **not** in "tension": increasing pre-trade transparency and promoting the trading of swaps on SEFs, both of which are required and achievable.

5. Even if there was tension between these two goals, an RFQ-to-1 would **not** be an appropriate way to resolve this tension.

[6] The Derivatives Dealers' Club and Derivatives Market Reform, *available at* http://www.brookings.edu/research/papers/2010/04/07-derivatives-litan .

1. *Claim: the definition of a SEF in Section 721(a) of the Dodd-Frank Act is consistent with an RFQ-to-1 model*

Response:

The definition of a SEF in Section 721(a) requires a many-to-many model. An RFQ-to-1 system violates this requirement:

> 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, though any means of interstate commerce, including any trading facility.[7]

An RFQ-to-1 system that does not interact on a pre-trade basis with the central limit order book ("CLOB") is a distinct parallel system, since the quotes provided on the RFQ system are invisible to the rest of the market, and not executable by any market participant other than the requestor. Simply because a system runs a CLOB and an RFQ system in parallel does not mean that the RFQ platform can be considered as meeting the SEF requirements just because the CLOB platform does.

In essence, a SEF that allows RFQ-to-1 is a SEF platform running in tandem with a bilateral, OTC marketplace. Title VII of the Dodd-Frank Act clearly mandates moving the OTC market onto SEFs – **not** creating SEFs that preserve the substance if not the precise form of the old OTC market. Indeed, the Principle of Construction for the rules relating to SEFs explicitly requires the CFTC to promote SEF trading – not to promote OTC trading by turning SEFs into *de facto* OTC markets, which is what in substance RFQ-to-1 or -2 will do. While a long way from the optimal RFQ-to-all, which should be required, at least an RFQ-to-5 model as set forth in the Proposed Rule sets a reasonable floor that should largely achieve the statutory goals (assuming the other provisions of the Proposed Rule and other rules are not weakened, abandoned or gutted).

The definition of a SEF closely mirrors, and was deliberately based on, the CFMA definition of a trading facility. Just as one-to-one platforms (and even one-to-many, single-dealer platforms) are not considered trading facilities, RFQ-to-1 systems cannot be considered SEFs. The definition of a SEF differs from that of a trading facility in that it explicitly includes "by any means of interstate commerce." This indicates that Congress was willing to grant the CFTC authority to include voice brokered trades within the SEF framework. However, in no way does it dilute the many-to-many requirement of the statutory definition.[8]

---

[7] Dodd-Frank Act Section 721.

[8] Thus, while the recent letter from Rep. Scott Garrett is right that the statute permits voice trades, this in no way implies that bilateral voice trades are permitted. That would be, again, the OTC market.

2. *Claim: an RFQ-to-1 model would enable greater "flexibility," thus allowing the Commission to capture a broader swath of swaps under the execution mandate.*

Response:

The sole reason an RFQ-to-1 model might enable SEF trading to capture "97 percent of swaps," as claimed during our meeting, is that it requires virtually no change from the existing OTC practices of the pre-crisis derivatives markets.

While it is true that a SEF rule which adheres strictly to the statutory definition will result in some of the swaps that are currently transacted OTC to fall out of its clearing and trading mandate, that is simply an inescapable outcome of what Congress has directed the CFTC to do. The swaps that would be (and the only swaps that **should** be) excluded under a strict SEF rule are precisely the sorts of transactions that Congress envisaged falling outside of the SEF model: the most illiquid, customized and exotic derivatives which cannot be cleared, and which constitute a tiny minority of the swaps market even today.[9] For all other transactions, a robust SEF regime based on a CLOB and RFQ-to-all must be preserved.[10]

Structuring the rule to maximize the amount of swaps subject to the clearing and trading mandate at the expense of pre-trade transparency, a level playing field, fair competition, investor protection, market stability, and risk reduction is inconsistent with the statute and the cataclysmic reasons that gave rise to the statute. Moreover, it is the ultimate tail wagging the dog: structure a rule so that it accommodates the tiny percentage of illiquid, customized, and exotic swaps rather than for the overwhelming majority is to turn rulemaking on its head and allow what should be an exception to become the rule.

Thus, the claimed "flexibility" that purportedly arises from an RFQ-to-1 model that might enable maximizing the trading and clearing mandate would be, at best, a hollow victory and come at a very, very high and unacceptable price.

---

[9] For instance, the latest ISDA figures show that the majority of OTC IR swaps and FRAs were already centrally cleared well before the clearing mandate went into effect. *See* http://www2.isda.org/news/isda-publishes-mid-year-2012-market-analysis.

[10] That Congress recognized this fact is evident. *See* Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010, S. Rep. No. 111-176 at 34 (stating that "Some parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, uncleared contracts while **bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible**." (emphasis added)

3. *Claim: for illiquid markets, an RFQ-to-5 model would raise costs for customers by disclosing too much information to other market participants.*

Response:

The mistaken idea that RFQ-to-1 would lead to better pricing than RFQ-to-all or even RFQ-to-5 lies in direct contradiction to the principle embedded in the statute: that more transparency leads to better pricing.

An RFQ-to-1 model is just the old bilateral OTC market but with some increased post-trade transparency. While post-trade transparency (publishing of completed trades) can help ensure fairer pricing, its effectiveness is dramatically reduced if it is not also accompanied by pre-trade transparency (publishing of available bids and offers). Because of its overwhelming importance, promoting pre-trade transparency is not only an explicitly stated goal of Title VII as a whole, but also a Rule of Construction for regulations implementing Section 733. In enacting this requirement expressly into the law, Congress recognized that wide access, competition, a level playing field, **and** transparent pricing would bring down costs for customers while simultaneously creating a more efficient, more stable, and less risky market place.

The specific argument set out during our meeting for why RFQ-to-1 would in some instances provide better pricing than RFQ-to-5 or RFQ-to-all is that in illiquid markets dealers quoting would have to take into consideration the number of other dealers who would know about the intent to trade. Since the other dealers might move the markets in which the winning dealer would need to hedge the quoted trade (described as the "winner's curse"), the winning dealer would take this into account when quoting his price – raising it to cover the additional risk he would be exposed to.

This scenario is unlikely in the extreme for virtually all of the trading that will take place on SEFs for a number of reasons. First, the block trade rule exists precisely to shield cases where disclosing the intent to trade at a given volume would move the market (or the hedging market). To allow virtually universal bilateral trading over a concern that a few market-moving trades **might** slip under the block trade threshold is to allow a very small risk applicable to a very few trades to dictate the rule applicable to all trades. Moreover, the fact that Congress mandated a block trade rule which spells out the situations in which bilateral trading on SEFs is permitted demonstrates clearly that it thought about the issue and chose not to authorize bilateral trading in instances outside of block trades as set forth in the statute.

Second, even in illiquid markets, dealers do not hedge with equally illiquid instruments. Indeed, the only reason a market for illiquid swaps contracts can exist at all is that dealers are able to hedge with more liquid equivalents, capturing the spread between the two markets in exchange for adopting the counterparty and liquidity risk on the illiquid portion of the trade. Therefore, even for illiquid contracts it is not the case that the instruments dealers would use to hedge their trades could be artificially squeezed by rival dealers in an RFQ-to-many situation.

Third, a market participant can also shield key elements of a trade, which if disclosed might theoretically provide other market participants an advantage: name, direction, and size can all be shielded, thereby reducing, if not eliminating, the purported concerns.

4. *Claim: the Rule of Construction in Section 733 of the Dodd-Frank Act contains two goals that are in "tension": increasing pre-trade transparency vs. promoting the trading of swaps on SEFs.*

Response:

There is no tension between the two goals articulated in the Principle of Construction. Had Congress intended these two goals to be considered as conflicting, they would have clearly noted this, as they specifically did in other cases, some proximate to this very provision. For example, Section 737, which mandates speculative position limits, requires the Commission to consider the liquidity effects on hedgers when setting the level of limits. It is conclusively telling that no such modifier is present in 733.

Rather, Congress intended that the CFTC promote the complementary goals of bringing as much swaps trading as possible onto transparent, well-regulated venues. To suggest that transparency should be sacrificed to incentivize dealers who prefer to trade in the shadows to use SEFs is to entirely invert the order of precedence. SEFs must be designed in a transparent way, consistent with the statute. They must also be designed in a user-friendly way that promotes broad trading on SEFs and avoids evasion of SEFs through loopholes.

This is what Congress meant – not that SEFs should be so weakened that they merely place a regulatory stamp of approval on the old OTC way of transacting swaps.

5. *RFQ-to-1 may be an appropriate way to resolve the claimed tension described above.*

Response:

As stated above, there is no tension between the two goals of broad SEF trading and transparent SEFs.

However, even if there were, an RFQ-to-1 model would not be an appropriate way to resolve the conflict. RFQ-to-1 undermines the pre-trade transparency requirement entirely. It cannot be the case that in setting twin goals – even if these goals were in "tension" – that Congress intended for one of the goals to be completely subordinated to the other. By rendering large swathes of many markets invisible and unexecutable to the majority of participants, RFQ-to-1 would entirely ignore the mandate to increase pre-trade transparency. The post-trade transparency that would be created by printing RFQ-based trades to the CLOB screen **after the fact** would be no substitute for the **pre**-trade transparency that Congress mandated.

Indeed, an RFQ-to-1 or -2 would create two markets: the one on the CLOB and the bilateral RFQ one. Those who participate in the RFQ market would have the advantage of seeing the bids and offers on the CLOB, while those trading on the CLOB would not have access to the RFQ quotes. This will inevitably result in the RFQ market undermining the CLOB market because market participants are not going to want to remain at risk in the CLOB knowing that the RFQ market has, could, or will move away from the CLOB market. No interpretation of the law, "Talmudic" or otherwise, permits such a result.

CONCLUSION

Our comments here are focused on an RFQ-to-1 model because that was virtually the entire focus of our hour-plus meeting, but nothing materially changes if the discussion focused on an RFQ-to-2 model. An RFQ-to-1 (or RFQ-to-2) model will be substantively indistinguishable from the prevailing systemically significant, non-transparent, and unstable OTC market, which financial reform in general and Title VII in particular was intended to eliminate.

At stake in the SEF rules is a central pillar of Title VII: pre-trade transparency. The Title itself is named the "Wall Street Transparency and Accountability Act," and – as mentioned above – Section 733 explicitly states pre-trade transparency as a rule of construction.[11] This is based on recognition that well-functioning derivatives markets are key to protecting the U.S. taxpayer from another financial collapse and from more massive taxpayer-funded bailouts.

The opaque practices and anti-competitive activities of the "Derivatives Dealers Club" in the run-up to the crisis were a central cause of the financial crisis. Those practices and behaviors are still ongoing.[12] The SEF rules are key to breaking this oligopoly, thereby creating a safer, fairer, more transparent derivatives market that works for Main Street instead of just Wall Street. To do this successfully, they must preserve the appropriate standard of RFQ-to-all. Under no circumstances should they be weakened below RFQ-to-5.

Lastly, not all arguments, however tenuously tethered back to the text of the statute, are deserving of equal weight because they can somehow claim to be based on something set forth in the statute. Moreover, the particular provision of the statute under discussion cannot be divorced from the overriding goals of the statute and the facts and circumstances giving rise to the statute. All must be considered when coming to an informed, reasonable application of the statute via a rule. Not to use too many clichés, but the forest simply cannot be lost for the trees when passing interrelated rules designed to implement a comprehensive statute, particularly when those arguing for cutting down the trees are the very same firms that set the forest on fire, requiring a law to be passed to protect the country from them.

---

[11] HR 4173.

[12] *See* L. Story, "A Secretive Banking Elite Rules Trading in Derivatives," *available at* http://www.nytimes.com/2010/12/12/business/12advantage.html.

Thank you again for your time in the meeting and considering these arguments.

Sincerely,

Dennis M. Kelleher
President & CEO

David Frenk
Director of Research

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
dfrenk@bettermarkets.com

www.bettermarkets.com

cc: Chairman Gensler
Commissioners Chilton, Sommers, O'Malia