BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

March 30, 2012

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

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

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the time that members of the Commission's staff have spent meeting with us to discuss the Commission's Proposed Rule on the registration and regulation of security-based swap execution facilities ("SEFs"). This letter is a follow-up to our meetings and to our comment letter submitted on April 4, 2011.[2] We respond here to two points discussed in the meetings on which additional comment was requested.

First, as referenced in our comment letter and as discussed in our meetings, some aspects of the Proposed Rule are very positive, notably the requirements regarding composite indicative quotes and the requirements regarding order interaction between limit order books and request-for-quote systems. These measures are essential to promote transparency and price competition in SEF trading, which are two extremely important policy objectives underlying the Dodd-Frank Act. Although our comment letter raised fundamental objections to the types of SEF trading platforms that the Proposed Rule would permit, we wish to emphasize that the measures cited above are nevertheless commendable and should not be weakened as the Proposed Rule is finalized. In general, any of the provisions in the Proposed Rule that promote transparency and competition; that establish strong, clear, and enforceable standards; and that otherwise help achieve the goals underlying the core principles governing SEFs, set forth in the Dodd-Frank Act,[3] should not be weakened.

Second, we remain concerned that the Proposed Rule does not establish sufficiently detailed requirements that SEFs must incorporate into their own rules governing access,

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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.

2 *See* Comment Letter from Better Markets, Inc. to the Commission, "Registration and Regulation of Security-Based Swap Execution Facilities, File No. S7-06-11, at 6-10 (Apr. 4, 2011).

3 Dodd-Frank Act § 763.

conflicts of interest, trading abuses, and chief compliance officers ("CCOs"). We recognize that, as envisioned by the Dodd-Frank Act, SEF rules will be subject to Commission review and approval. While this layer of oversight is certainly valuable as a general proposition, it cannot fulfill its intended purpose here because the Proposed Rule does not prescribe in sufficient detail what the SEF rules must contain and what the Commission must use as a yardstick in the SEF rule review process. To ensure that SEF rules include the provisions that are minimally necessary to achieve the core principles relating to SEFs in the Dodd-Frank Act, the Proposed Rule must include the requirements discussed in our comment letter and briefly reviewed below.

The Proposed Rule should retain provisions that maximize transparency and competition in the SEF environment, even if the Commission declines to impose a limit order book trading platform.

In our comment letter, we argued that the Proposed Rule should require SEFs to use a limit order book system. We further argued that if SEFs are permitted to use request-for-quote ("RFQ") platforms, then they must require participants to send their RFQs to more than just one participant.

In our view, this approach is mandated by the language of the Dodd-Frank Act. If a trading platform such as an RFQ system allowed a market participant to request a quote from only one liquidity provider, then the conditions mandated by the statutory definition of a SEF would not be met. Whenever an RFQ is directed to only one participant, "multiple market participants" simply do not have the "ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system," as required by the statutory language.[4] In short, the Commission erroneously interpreted the statutory language in terms of the theoretical ability of the **trading system** to meet certain criteria, not in terms of the actual ability of **market participants** to benefit from the conditions mandated by the statute.

Our position on trading platforms is not only a matter of statutory construction. Our recommendation would also better serve the policies underlying the Dodd-Frank Act. Requiring a limit order book system, or at least insisting that RFQs are transmitted to multiple participants, would maximize transparency and competition in trading on SEFs. As observed in the Release, these are two of the fundamental goals underlying the SEF trading requirement in the Dodd-Frank Act.[5]

If the Commission adheres to the approach set forth in the Release by allowing a SEF to employ an RFQ platform and by allowing market participants to disseminate RFQs to **only** one market participant, the Proposed Rule or the interpretive guidance must at least retain the provisions that maximize transparency and competition within that context. The Proposed Rule and the interpretive guidance do include some provisions that effectively advance these goals, and we strongly support them.

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[4] Dodd Frank Act § 761(a)(77).
[5] Release at 10953-55.

For example, the Proposed Rule requires a SEF operating an RFQ system to create and disseminate a composite indicative quote for SBS traded on or through the system.[6] Further, the composite indicative quote must include both composite indicative bids and composite indicative offers, and it must be made available to all participants of the SEF.[7] The Release also indicates that any response to an RFQ that is provided to a participant submitting an RFQ must be included in the composite indicative quote.[8]

The Release further explains that if a SEF operates a central limit order book as well as a separate RFQ mechanism, then the SEF's system will have to ensure that any trade to be executed in the RFQ mechanism interacts with any existing interest on the limit order book.[9]

These provisions are very positive, and we commend the Commission for including them. They will prove to be especially important if the final rule otherwise limits transparency and competition by allowing just one-to-one interaction on an RFQ system, and they should not be weakened as the Proposed Rule is finalized.

The Proposed Rule must impose more specific requirements on the SEFs to achieve the core principles set forth in the Dodd-Frank Act.

Our comment letter made clear that the Proposed Rule must incorporate a number of more specific provisions, including language that will more effectively ensure fair access to SEFs, limit conflicts of interest, prevent abusive trading, and allow CCOs to play a meaningful role. That is all the more true in light of the mechanism for SEF rule review that the Commission would implement under the Proposed Rule.

The general approach taken in the Proposed Rule, and in the Dodd-Frank Act, is that every SEF must establish and enforce rules that will achieve the broadly framed goals embodied in the 14 core principles set forth in the Dodd-Frank Act. The Commission in turn will review those SEF rules and will approve them unless they are inconsistent with the Dodd-Frank Act or the Commission's own rules.

While the process of rule review is beneficial, and will help the Commission ensure that SEFs establish adequate rules and procedures, the Proposed Rule and the Release provide too little concrete guidance as to the provisions that SEFs must include in their rules. This creates several distinct problems:

- First, the lack of specific guidance will foster inconsistent standards among the SEFs, since SEF rules may vary widely yet still comply with the general terms of the Proposed Rule and the interpretive guidance in the Release.

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6 Proposed Rule 242.811(e).
7 *Id.*
8 Release at 10972.
9 Release at 10974 & n. 163.

- Second, the Commission itself will not have clear, concrete, and consistent standards against which to judge the rules submitted by SEFs.

- Third, without guidance and more specific standards, SEFs are likely to draft rules that are too weak to achieve the important objectives embodied in the core principles.

- Fourth and finally, without more specific standards in the Proposed Rule or at least in the interpretive guidance, the public cannot know how effectively the SEF environment will be regulated and policed.

This overly general approach to SEF regulation will unnecessarily weaken the ability of the Proposed Rule to eliminate potential abuses and systemic risks in the security-based swaps markets. In addition, this approach will undermine confidence among market participants and the public as to the fairness and integrity of the SBS marketplace. This lack of confidence will only hamper the robust development of SEF trading—something the Release identifies as a major objective of the Proposed Rule.[10]

As important, the SEC will never have sufficient resources to police the entire industry. It is therefore imperative that the SEC adopt rules that the industry can follow easily—hence the need for clear and specific minimal standards—and that the SEC can enforce with a minimum of effort. If the Proposed Rule is adopted in its current form, then the SEC will find itself struggling to review innumerable versions of SEF rules, to determine which are or are not consistent with the core principles, to require the SEFs to redraft their rules accordingly, and, failing all that, to seek clarity and uniform application through enforcement actions. This process would be highly inefficient and ineffective, and it would ultimately hurt the industry, the public, and the SEC. Unless strengthened, the Proposed Rule will lead to this result.

Therefore, in all of the areas cited above—including fair access, trading abuses, conflicts of interest, and CCO's—the Proposed Rule needs to specify with more particularity what behaviors each SEF must, at a minimum, require or prohibit. At the same time, of course, the Proposed Rule and the interpretive guidance should make clear, through catchall provisions, that these requirements are minimums, and that SEF rules must also include whatever other measures are necessary to fulfill the core principles. The key points are briefly reviewed here.

Access

The Proposed Rule very generally requires that SEFs establish standards for granting "impartial access" to trading on the SEF, as well as "access to the services offered"

[10] Release at 10954 (a flexible approach to the trading platform may encourage the development of trading on SEF platforms, even with respect to SBS swaps that are not required to be traded on a SEF or exchange).

by the SEF.[11] However, these general standards may not cover certain conduct that would hinder truly fair access to a SEF and the services it provides. For example, preferential access to data defeats impartial access and must be prohibited, but the general requirements regarding access in the Proposed Rule do nothing to ensure that SEF rules will preclude such arrangements. Furthermore, there is no indication that the Commission will withhold its approval of a SEF rule that allows for such preferential data access. Thus, the Proposed Rule must be more prescriptive and explicitly prohibit preferential data access, whether purchased or not.

Conflicts of Interest

With respect to conflicts of interest, the Proposed Rule includes some valuable quantitative requirements regarding board composition that SEFs will have to adopt. However, the Proposed Rule fails to address a broader range of conduct that can generate harmful conflicts of interest. These practices include 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 would enable SEFs to exact unfair prices from captive market participants. They would also distort market prices and impose hidden costs on those who are not favored with preferential pricing arrangements. The Proposed Rule should address these concerns explicitly in the provisions on conflicts of interest.

Abusive Trading Practices

The Proposed Rule is very general with respect to abusive trading practices, simply requiring SEFs to establish rules that "deter abuses" and rules concerning "prohibited trading practices."[12] These are useful provisions in that they broadly prohibit abusive conduct, thus enabling the Commission some leeway in reaching new forms of abuse that will undoubtedly emerge as the security-based swap market evolves. At the same time however, the Proposed Rule must identify specific trading practices that SEFs must address in their rules, including front-running, wash trading, pre-arranged trading, and fraudulent trading, along with a catchall that covers other fraudulent, manipulative, unfair, or disruptive trading practices.

In addition, the Proposed Rule 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—and it is all but guaranteed if the final rule does not explicitly prohibit them, along with a catchall provision. It is far better to preempt these abuses now, with explicit prohibitions in the Proposed Rule, than to address them only after they have become entrenched and market participants have suffered harm.

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[11] Proposed Rule § 242.811(b)(1), (2).
[12] Proposed Rule § 242.811(a)(2) and (d)(6).

Chief Compliance Officers

The Proposed Rule provisions concerning CCOs are relatively detailed as far as they go, but they still fail to impose a significant number of additional requirements that are essential if CCOs are to have the genuine autonomy they will require to function effectively. Those measures 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 necessary 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; and
- Requiring the board to review and comment on, but not edit, the CCO's annual report to the Commission.

Ensuring that market participants have CCOs with real authority and autonomy to police a firm from within is one of the most efficient and effective tools available to regulators. But without these additional measures, the CCOs at SEFs are at risk of becoming the relatively insignificant placeholders that have characterized the financial services industry for too long. That cannot be allowed to continue, especially in an environment where the SEC lacks sufficient resources. The SEC must use the rules to increase the likelihood that the industry will effectively police itself.

It became clear **after** the financial collapse of 2008 that compliance and self-policing had become virtually non-existent. Compliance is not a "revenue generator" and the industry often views it as an impediment to all sorts of highly profitable business activities that are risky and abusive—precisely the conduct that must be stopped. To help eliminate this conduct, CCOs must be empowered and protected so that they can fulfill their critical role. The fundamental problem is highlighted in a telling observation from Raghuram Rajan's award-winning book, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*:

> I remember a meeting between risk managers of the major banks and academics in the spring of 2007 at which we academics were

> surprised that the managers were not more worried about the risks stemming from the plunging housing market. After our questions elicited few satisfactory replies, one astute veteran risk manager took me aside during the break and said: 'You must understand, **anyone who was worried was fired long ago** and is not in this room.' Top management had removed all those who could have restrained the risk taking precisely at the point of maximum danger.[13]

This outright hostility to compliance **will** become dominant again unless the Proposed Rules are strengthened when finalized. This is a key test of whether or not one of the clearest and most important lessons of the last crisis has been learned and acted upon.

Conclusion

We again thank the Commission's staff for their time and attention to our comments on the Proposed Rule. We hope that this supplemental letter is helpful.

Sincerely,

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[13] Page 141 (emphasis added).