October 1, 2010

Mr. Richard Shilts
Director, CFTC Division of Market
Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Mr. Brian Bussey
Associate Director & Head of Title VII &
VIII Implementation
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Statutory Analysis of the Definition of “Swap Execution Facility” and the
Trading Determination

Dear Mr. Shilts and Mr. Bussey:

Pursuant to your request for our interpretation of the term swap execution facility ("SEF"),
contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act
(“Dodd-Frank Act” or “Act”), this letter considers what a SEF should be, and then
analyzes the determination as to which swaps are required to be executed on a SEF. ¹

The International Swaps and Derivatives Association, Inc. (“ISDA”) was chartered in 1985
and has over 830 member institutions from 57 countries on six continents. Our members
include most of the world’s major institutions that deal in privately negotiated derivatives,
as well as many of the businesses, governmental entities and other end users that rely on
over-the-counter derivatives to manage efficiently the risks inherent in their core economic
activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in
the derivatives and risk management business through documentation that is the
recognized standard throughout the global market, legal opinions that facilitate
enforceability of agreements, the development of sound risk management practices, and

¹ The analysis contained in this letter is premised upon the view that the references to “processing” in
Sections 733 and 763 of Dodd-Frank are indivisibly joined to and merely elaborative of the word “trading”,
and do not refer to any freestanding “processing” function.
The SEF Requirement

The Dodd-Frank Act creates a new category of registrant, a “swap execution facility” (and on the security-based swaps side, a “security-based swap execution facility,” collectively, “SEF”). Although the Dodd-Frank Act adds the definition of SEF to the Commodity Exchange Act (the “CEA”) and the Securities Exchange Act (the “‘34 Act”), that definition does not on its face suggest whether or how the term will apply to the many existing trading methods or platforms for swaps. We believe that the definition is to be read broadly to apply to a number of those methods or platforms, including “request for quote” (“RFQ”) platforms. Broad application will advance the Dodd-Frank Act’s purpose of promoting regulation of derivatives markets and the clearing of derivatives, while allowing heterogeneous derivatives markets to continue to innovate and serve individual customer needs. Indeed, a broad reading of the definition of “SEF” that allows for the coexistence of different types of facility will provide price transparency for participants which will become broadly available through the coexistence of multiple facilities reporting on either a pre-trade or real-time post-trade basis. A diversity of execution facilities will promote innovation in the markets for both homogeneous and idiosyncratic product.

Many OTC derivative products do not have the liquidity of typical exchange-traded futures. A one-size-fits-all vision of SEFs that is modeled on a futures or stock exchange will fail any markets that have insufficient trading activity to regularly attract participants and offer prices. In any event, had Congress intended swaps to be subject to the uniform requirements placed on the futures markets, it could simply have determined that swaps are futures. Similarly, had Congress intended security-based swaps to be subject to the uniform requirements placed on the national securities exchanges, it could have determined that security-based swaps are simply securities and nothing more. It did neither. More generally, had Congress wanted derivatives to be traded only on exchanges (futures exchanges and securities exchanges), it could have so decreed. It did otherwise. In fact, Congress’s intended flexibility is demonstrated in the new execution requirements in the Dodd-Frank Act itself. Pursuant to Section 723 of the Dodd-Frank Act, counterparties must execute applicable swaps on a board of trade designated as a contract market (a full-blown exchange in CEA parlance) or on a swap execution facility. Similarly, pursuant to Section 763 of the Dodd-Frank Act, counterparties must execute applicable security-based swaps on an exchange or on a security-based swap execution facility. Thus, SEFs are

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2 An electronic platform may allow a user of the platform to request quotes on a specified swap from a group of liquidity providers (typically dealers). Those quotes are only seen by the one participant and are typically executable by that participant, but other users of the system would not see the quotes and, accordingly, would not be able to execute on those quotes. Those other participants could, however, commence their own RFQ process at any time.

3 See Section 723 (new CEA section 2(h)(i)(A)).

4 See Section 763 (new ‘34 Act section 3C(h)).
included as an alternative to exchanges and must be something other than an exchange. A familiar presumption in statutory interpretation is that use of the disjunctive “or” creates mutually exclusive items or conditions.⁵ Consistently, it is reasonable to interpret this creation of an alternative means of execution as evidencing a desire to embrace existing execution platforms and methods that are not exchanges, as well as to provide for the possible introduction of new types of SEFs.

The definition of SEF even more strikingly shows a liberalizing intent, especially when compared with the pre-existing definition of “trading facility” that still remains in the CEA. First, pursuant to Sections 721 and 761 of the Dodd-Frank Act, the term SEF 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 (B) is not a designated contract market [or national securities exchange].” The definition of SEF thus encompasses all trading facilities as a subset of swap execution facilities, indicating that a greater variety of platforms and/or systems beyond trading facilities, boards of trade and exchanges, should be permissible for executing swaps.⁶

Second, the term “trading facility,” as previously and currently defined in Section 1a (34) of the Commodity Exchange Act, means “a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions (i) by accepting bids or offers made by other participants that are open to multiple participants in the facility or system; or (ii) through the interaction of multiple bids or multiple offers within a system with a pre-determined non-discretionary automated trade matching and execution algorithm.” [emphasis added.] Clause (i) of the definition of “trading facility” is almost identical to the entire definition of SEF, except for these additional words in the definition of trading facility: “that are open to multiple participants”.⁷ As these words are the only substantive material on which the two definitions diverge, it is clear that the deliberate removal of this phrase from “swap execution facility” was intended to allow for a broader interpretation of the new defined term.⁸ As such, the definition of a SEF itself

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⁶ Also note, as a clear indication that “swap execution facility” means other platforms and methods in addition to trading facilities, the language in Section 733 of the Dodd-Frank Act (new Sec. 5h(f)(6)(A)): “…a swap execution facility that is a trading facility shall adopt for each of the contracts of the facility, as is necessary and appropriate, position limitations or position accountability for speculators” (italics added for emphasis). Note also that the definition of “many-to-many” platforms in the CFTC glossary states that “many-to-many platforms are considered trading facilities under the Commodity Exchange Act.” Therefore, as trading facilities are a subset of swap execution facilities, it follows that many-to-many platforms are only a subset of a subset of swap execution facilities.

⁷ Clause (ii) seems to denote an automated version of clause (i) and its examination only underscores the difference discussed in the text above.

⁸ “It should be noted that intent can be expressed by omission as well as inclusion of language.” 2A Norman J. Singer & J.D. Shambie Singer, Statutes and Statutory Construction § 45:5 (7th ed. 2007).
contemplates that transactions will be permitted to be executed without all transactions being open to all market participants. As enacted, this definition contemplates only that multiple participants will be able to trade against multiple participants, not that each bid or offer must be open to all participants.

Earlier versions of the legislation referred to a SEF in essentially the same terms as the “trading facility” definition, including the “other participants that are open to multiple participants . . .” phrase. In the final version of the law, the phrase “other participants are open to” was deleted, leaving a definition referring only to a system in which “multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants.” As stated above, there is no requirement that each bid or offer be open to all, or any specific subset, of the participants in a SEF, provided that it is open to “multiple” participants. This leaves the CFTC, and SEFs, with substantial, and needed, flexibility to allow market participants to provide solicitations through a SEF to a targeted number of potential counterparties while still satisfying the objectives and requirements of the Dodd-Frank Act.

On the security-based swap side, there is less pre-existing definitional material as a basis for interpretation. However, in the absence of clear, current guidance under the ’34 Act (or guidance to which an analogy can be readily drawn), the SEC should coordinate its interpretation of the term “security-based swap execution facility” with the CFTC’s interpretation of “swap execution facility” under the CEA. The definition of “swap execution facility,” as added to the CEA by Section 721, and the definition of “security-based swap execution facility” in Section 761 are substantially the same. Accordingly, we believe that Congress intended the two definitions to be interpreted in similar fashions. Although the term “trading facility” is used in the new definition of “security-based swap execution facility” to be installed in the ’34 Act, the ’34 Act does not define the term “trading facility.” But again as previously noted, the term “trading facility” is defined in the CEA. We believe it would be prudent for the SEC to adopt the CEA definition of “trading facility” for these purposes, especially considering that other terms added to the ’34 Act by the Dodd-Frank Act, such as the definition of “eligible contract participant,” specifically refer to existing CEA definitions. If the SEC does so, our proposals for swap execution facilities would apply equally to security-based swap execution facilities.

According to the CFTC glossary, the statutory term “trading facility” includes “many-to-many” platforms and systems but excludes “one-to-many” platforms and systems. SEF
specifically includes, but is not limited to, all trading facilities, and at the same time does not include the phrase “that are open to multiple participants” that is embedded in the definition of “trading facility.” “Swap execution facility,” being more inclusive than “trading facility,” must include not just the many-to-many platforms already included in the definition of “trading facility,” but also other kinds of platforms admitted by the plain language of the definition, including, for example, RFQ platforms. This gives appropriate meaning to the language difference between the definitions of SEF and of trading facility.

In other words, the limited “multiple participants” references in the definition of “swap execution facility” can easily encompass any platform with multiple participants regardless of whether on each individual trade on the platform there are multiple potential bidders and/or offerors. The SEF definition simply requires that a facility provide multiple participants with trading opportunities, as an RFQ facility does.

That substantial variation is intended within the definitions of “swap execution facility” and “security-based swap execution facility” is borne out by the statement heading the statutory list of core principles applicable to each of these types of facilities. This statement declares that each such facility “shall have reasonable discretion in establishing the manner in which the . . . facility complies with the core principles . . .” In other words, the core principles, which otherwise could be read to impose a rigid, exchange-like regime, instead are to be applied by each facility (not the regulatory agency) in reasonable relation to the attributes of the facility. The Dodd-Frank Act grants the regulatory agencies great latitude to write regulations that will promote trading on swap execution facilities and that will support the reasonable discretion of each facility in dealing with the core principles requirement. As the statute makes clear, there is a statutory purpose of promoting trading on swap execution facilities, along with promoting pre-trade price transparency. Consistently, RFQ facilities are already established in the market today, enabling multiple end-users, each acting individually, to solicit prices from multiple dealers. These facilities inherently offer pre-trade price transparency and also serve all other goals stated above.

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12 The CFTC glossary defines a “many to many” platform as “a trading platform in which multiple participants have the ability to execute or trade commodities, derivatives, or other instruments by accepting bids and offers made by multiple other participants. The definition specifically states that, “In contrast to one-to-many platforms, many-to-many platforms are considered trading facilities under the Commodity Exchange Act. Traditional exchanges are many-to-many platforms.

13 A familiar presumption in statutory interpretation is that an “including…” reference in a statute is illustrative, not exclusionary. See 2A Norman J. Singer & J.D. Shambie Singer, Statutes and Statutory Construction § 21:14 (7th ed. 2007).

14 Section 733 (new CEA section 5h(f)(1)(B)); Section 763 (new ’34 Act section 3D(d)(1)(B)).

15 This type of variability is essential to principles-based regulation. See, for example, Section 725 (new CEA section 5b(c)(2)(A)(ii)) with respect to Derivatives Clearing Organizations. The variability permitted by the core principles may not be taken lightly.

16 See Section 733 (new CEA sections 5h(d) and 5h(f)(1)(B)); Section 763 (new ’34 Act sections 3D(d)(1)(B) and 3D(f)).

17 Section 733 (new CEA section 5h(e)).
Additionally, the core principles applicable to SEFs do not include core principle 9 for designated contract markets, which states that a designated contract market “shall provide a competitive, open and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade.” Because the core principles for SEFs otherwise largely track the core principles for designated contract markets, the omission of core principle 9 with respect to SEFs clearly means that SEFs need not provide the same type of “competitive” and “open” bidding market required of designated contract markets, but can instead vary the manner of execution and the extent to which bids and offers are open to all market participants, as necessary to accommodate the needs of particular markets and participants. This supports the conclusion that a SEF need not require participants to make bids and offers available to all other participants.

An expansive view of what may be a swap execution facility is consistent with broad Congressional purposes beyond those discussed above. A legislative purpose of Title VII has been to preserve a distinct “swaps market.” This has been done out of regard for the innovation that has sprung from an endlessly diverse marketplace. As Treasury Secretary Geithner said in his March 13, 2009 letter to various legislators regarding the then-forthcoming legislative program, “[T]hese amendments…will allow market participants to continue to realize the benefits of using both standardized and customized derivatives…”. Recognizing a wide variety of SEF “types” will reflect and embrace that diversity. Indeed, restricting the flexibility afforded to SEFs and market participants with respect to the manner of execution, or mandating a “one-size-fits-all” approach, will undermine the realization of these objectives, by preventing many market participants from entering into necessary transactions because they will be required to be processed through an inappropriate trading mechanism. This will constrain liquidity in the markets, reduce competition and impair transparency. We therefore believe that an expansive approach to the execution of transactions on SEFs is not only permitted but also required under the Dodd-Frank Act. Close examination of the execution requirement itself supports this approach.

**The SEF Execution Requirement**

The requirement to execute swaps on a SEF or exchange (the “SEF execution requirement”) under the Dodd-Frank Act is designed to promote the use of SEFs to accomplish several principal objectives: (i) ensure that swap transactions are subject to transparency through centralized reporting systems; (ii) allow participants to observe market prices and activity; and (iii) provide for regulatory oversight of the execution of transactions. In order for these objectives to be realized, however, Congress and the regulators recognized that it is essential that the markets for swaps traded on SEFs maintain adequate liquidity and that, in order to achieve this goal, each market would need to analyze and structure its SEFs independently, and multiple forms of execution would need to be permitted. For these reasons, the Dodd-Frank Act implies that the applicable regulator should make an independent assessment as to whether a swap should be executed
on a SEF, separate from its clearing determination with respect to the same swap. Indeed, as set forth below, Congress and the regulators clearly acknowledged the importance of developing liquid markets, and not just listed markets, in the swaps traded on a SEF. Accordingly, the execution determination can only be made based on an assessment of the liquidity of the trading (as opposed to clearing) market for a swap.

In addition, the statute makes it clear that swaps executed on a SEF should be eligible for block trading exemptions, subject to size thresholds that reflect market liquidity and the needs of market participants. Given the emphasis on the need for liquidity, and promoting use of SEFs, block trading thresholds must be set at levels that accommodate the level of trading activity, the liquidity and size of the market, and the needs of market participants, in the relevant market. In order for block trading to be a viable option, all trades that are of a certain size or that are characterized by lower liquidity must benefit from appropriate delays before being made public to enable the liquidity provider or risk intermediary to lay-off the associated risk without being ambushed in the market.¹⁸

The SEF execution requirement is subject to new Section 5h of the CEA, which states that “The Securities and Exchange Commission and the Commodity Futures Trading Commission may promulgate rules defining the universe of swaps that can be executed on a swap execution facility. These rules shall take into account the price and nonprice requirements of counterparties to a swap and the goal of this section as set forth in subsection (e).” As a result, the SEF requirement itself, by its terms, is not absolute and affords the applicable regulator significant discretion in determining the swaps required to be centrally executed. The fact that a swap is required to be cleared is not dispositive of the SEF determination.

This conclusion is further underscored by the fact that a swap will be exempt from the SEF execution requirement if no SEF “makes the swap available to trade.” First, this language differs from the requirement that a derivatives clearing organization “accept” a swap for clearing. While the applicable regulator must consider the liquidity of a market in evaluating whether it should be cleared, it is theoretically possible (although perhaps not economically viable) for a derivatives clearing organization to “accept” both sides of a single swap for clearing. In contrast, a single swap that does not generate any trading activity beyond the one transaction cannot be said to be “available to trade” on a SEF. The exemption from the execution requirement, in other words, is more expansive and is premised on Congress’s expectation that not all cleared transactions will necessarily be traded on a SEF. Second, the exemption from SEF execution applies to swaps that are not made “available to trade,” regardless of whether they are “listed” on a SEF. In our view, the phrase “available to trade” connotes a SEF that has created an actual trading market, with market liquidity that can accommodate the needs of market participants, and not merely listed a swap for which there is no liquidity and no trading activity. As a result, the listing of a swap, standing alone, is insufficient to bring it within the execution requirement, unless the applicable regulator has made a separate determination that

¹⁸ See, e.g., new CEA sections 2(a)(13)(E) and 5(h)(f)(2)(C).
liquidity is at a level that makes the swap “available to trade.” The phrase available “to trade,” in our view, can only be interpreted to mean that the SEF has taken steps to facilitate the development of an actual trading market with adequate liquidity to accommodate the needs of market participants.

These considerations mandate that the applicable regulator undertake an analysis of a particular swap, separate from its analysis with respect to clearing, to determine if the swap can and should be subject to a SEF execution requirement. The Dodd-Frank Act affords the applicable regulator considerable latitude with respect to such determination. Further, the Dodd-Frank Act allows the use of a flexible concept of SEFs intended to promote both the clearing and execution requirements. Permitting a multiplicity of SEF types will substantially advance the dominant principles of the Dodd-Frank Act without sacrifice of its legislative goals.19

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ISDA appreciates the opportunity to comment on the definition of “swap execution facility.” We trust this submission is helpful to you in your consideration of the role of SEFs under the Dodd-Frank Act in forwarding innovation and transparency in the markets. Please feel free to contact me or ISDA’s staff at your convenience.

Sincerely,

Robert Pickel
Executive Vice Chairman

19 Arguably, the only way to fully satisfy the goals of the execution requirement would be to have standard contracts trading on exchanges. Trading through SEFs, however, must be viewed in the market context created by the Dodd-Frank Act; thus any customer will have access to numerous public sources of market information, even if using a system that necessarily has less “transparency” than an exchange.