MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

January 8, 2014

Via Electronic Submission: secretary@cftc.gov

The Hon. Mark P. Wetjen
Acting Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Request for Action by CFTC to Conduct Pre-MAT Compliance Reviews of SEF Onboarding Documentation and to Enforce SEF Rules and Related Guidance

Dear Acting Chairman Wetjen:

Managed Funds Association ("**MFA**")[1] wishes to bring to the attention of the Commodity Futures Trading Commission (the "**Commission**") certain issues related to the implementation of the Commission's framework for the trading of swaps on registered swap execution facilities ("**SEFs**"). We are supportive of the Commission's trading rules, and believe the Commission's SEF framework will benefit investors and the markets by increasing efficiencies, fostering market-based competition among providers, and promoting transparency. In preparing to comply with these rules, MFA's members have encountered material issues related to SEF rulebooks, SEF user agreements, and operational and documentation readiness for SEF trading of bunched orders that represent significant barriers to impartial access for buy-side firms to SEFs. We respectfully urge the Commission to address these issues prior to the effective date of the first "made available-to-trade" ("**MAT**") determination. We appreciate the recent guidance to SEFs and SEF registration applicants issued by Commission staff concerning the removal of restrictions to impartial access to SEFs,[2] and we respectfully urge the Commission to undertake a targeted compliance review of SEF documentation, and enforce its SEF rules and this guidance before the effective date of the first MAT determination.

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[1] Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] "Division of Clearing and Risk, Division of Market Oversight and Division of Swap Dealer and Intermediary Oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities", issued Nov. 14, 2013 (the "**Impartial Access Guidance**").

In Section I below, we outline what we view to be among the most problematic provisions in SEF rulebooks and user agreements for substantive compliance with the Commission's final SEF core principles and related staff guidance. If the Commission determines that non-compliant provisions exist, we respectfully ask the Commission to require the relevant SEF(s) to revise such non-compliant rulebook provisions before the effective date of the first MAT determination so that market participants are not required to adhere to and trade under non-compliant provisions. Although MFA members, as individual buy-side participants, have raised these concerns directly with SEFs, MFA strongly believes the Commission's intervention is crucial to enforce a baseline of compliance across all trading platforms before the trade execution requirement compels buy-side participants to adhere to SEF documentation and complete their onboarding to SEFs.

In Section II, with respect to our concerns over operational and documentation readiness for SEF trading of clearable bunched orders in credit default swaps ("**CDS**"), we respectfully request the Commission's assistance in seeing that facilities for pre-allocation and pre-execution checks at the allocated fund level are available before the effective date of the first CDS MAT determination.

Finally, in Section III we raise for the Commission's awareness certain further documentation and commercial challenges that buy-side firms have faced in negotiating access to SEFs.

For reference, MFA has also recommended a phased implementation of the MAT determinations in a separate letter.[3]

I. SEF Rulebook Provisions Remain that Impede Impartial Access for the Buy-Side

To date, SEF rulebooks and user agreements vary considerably as to their consistency with Commission regulations and guidance. Such Commission regulations and guidance include: (1) the Commission's final straight-through processing ("**STP**") rules;[4] the final SEF rules;[5] the staff's STP guidance;[6] the staff's No-Action Letter 13-66;[7] and the Impartial Access

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[3] *See* MFA letter in response to the Javelin, trueEX and TW SEF MAT determinations for certain interest rate swaps, filed with the Commission on November 21, 2013, available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59381.

[4] *See* Commission Final Rules on "Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management", 77 Fed. Reg. 21307 (Apr. 9, 2012).

[5] *See* Commission Final Rule on "Core Principles and Other Requirements for Swap Execution Facilities", 78 Fed. Reg. 33476 (June 4, 2013) (the "**SEF Core Principles Rule**").

[6] *See* "Staff Guidance on Swaps Straight-Through Processing", issued Sept. 26, 2013.

[7] *See* Commission Staff No-Action Letter No. 13-66, "Time-Limited No-Action Relief for Swap Execution Facilities from Compliance with Certain Requirements of Commission Regulation 37.9(a)(2) and 37.203(a)", issued Oct. 25, 2013 ("**NAL 13-66**").

Guidance (collectively, the "**CFTC SEF Legal Standards**"). We believe that inconsistencies with the CFTC SEF Legal Standards are due, in part, to the Commission's granting temporary SEF registration based only on a completeness review of SEF application documentation, pending the completion of the Commission's substantive review of such documentation.[8] While some SEFs have revised their rulebooks and other documentation in response to the Commission's guidance, MFA members continue to see non-compliant provisions in SEF rulebooks and other documentation, including certain aspects of SEF trading protocols that are not reflected in SEF rulebooks. Such provisions competitively disadvantage the buy-side and impede the buy-side's impartial access to direct participation on SEFs. Each of the following bullet issues highlights inconsistencies with the CFTC SEF Legal Standards:

- Participant Representation re FCM Clearing Guarantee: Some SEFs require a Participant on the SEF to represent either that it is self-clearing, or that the Participant's clearing futures commission merchant ("**FCM**") unconditionally guarantees all of the Participant's trades. Only a dealer participant can make such a representation: (1) while certain dealers are self-clearing, virtually no buy-side firms are in such a position; and (2) FCMs will provide an unconditional clearing guarantee only to their dealer affiliates, never to a buy-side clearing customer. Therefore, such a requirement will exclude buy-side participants from gaining access to the platform.

  To ensure impartial access in accordance with the CFTC SEF Legal Standards, we submit that SEF rulebooks should simply provide that each customer should have a clearing agreement with an FCM and if a trade is within the credit limit for the customer, as determined pursuant to the SEF-mandated pre-trade credit check, then the FCM will accept it for clearing. To achieve full compliance with the CFTC SEF Legal Standards, we understand that this requirement should be supported by: (1) the SEF's provision of facilities for the FCM to perform order-by-order pre-execution credit checks; (2) an explicit rule in the SEF rulebook that requires each FCM to perform such check on each order; and (3) an explicit rule in the SEF rulebook that the FCM then guarantees that it will accept for clearing each order that passes such credit check. We believe these provisions are essential to removing any barrier to participation in a SEF for any market participant that qualifies as an eligible contract participant and that has an FCM willing to guarantee its pre-checked swap trades for clearing.

- RFQ Requests: For the avoidance of doubt, SEF rulebooks should be required to clarify that requests for quotes ("**RFQs**") are "orders" that are also subject to pre-execution credit checks and corresponding FCM guarantees. Some SEF rulebooks exclude RFQ requests from orders subject to such checks.

[8] The Commission noted in its final SEF rule that "it will review a SEF applicant's Form SEF to ensure that it is complete, and will not conduct any substantive review of the form before granting or denying temporary registration". *See* SEF Core Principles Rule at 33487.

- Voice and Block Trades: We understand that orders entered and/or negotiated by voice on a SEF, as well as block trades (as defined in Commission regulation 43.2)[9], are all trades "subject to the rules of a SEF" and therefore must undergo pre-execution credit checks and receive associated FCM guarantees. Because SEF rulebooks are frequently unclear on this point, there is resulting confusion that persists among market participants. SEFs should be required to clarify through their rulebooks how their workflows for voice and block trades comply with these requirements.

- Express Prohibition of Breakage Agreements: We understand the CFTC SEF Legal Standards to prohibit the applicability of so-called "breakage agreements" to trades executed on, or subject to the rules of, a SEF.[10] However, SEF rulebooks vary considerably on this topic: some continue to have breakage provisions; others allow bilateral breakage agreements to override the *void ab initio* rule of the SEF; others incorrectly reflect the provisions of NAL 13-66 by contemplating that a re-executed trade that fails to clear could expose a Participant to breakage, which is contrary to the Commission's conditional "new trade/old terms" relief; and others are silent. To avoid market confusion and material barriers to access, we request that the Commission further clarify that SEF rulebooks, in accordance with the CFTC SEF Legal Standards, must (1) affirmatively and expressly bar the enforcement of any breakage arrangement in respect of trades executed on or subject to the rules of a SEF and (2) prohibit any such bilateral agreement from overriding the rules of the SEF.

- Enablement Mechanisms: Consistent with the Impartial Access Guidance, it is our view that there is no basis for "enablement mechanisms"[11] in respect of clearable swaps on a SEF given that transacting parties will never be exposed to each other's counterparty credit risk. Nonetheless, certain SEFs continue to impose

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[9] "Block trade" is defined in Commission regulation 43.2, as a "publicly reportable swap transaction that: (1) Involves a swap that is listed on a registered [SEF] or [DCM]; (2) Occurs away from the registered [SEF's] or [DCM's] trading system or platform and is executed pursuant to the registered [SEF's] or [DCM's] rules and procedures; (3) Has a notional or principal amount at or above the appropriate minimum block size applicable to such swap; and (4) Is reported subject to the rules and procedures of the registered [SEF] or [DCM] and the rules described in [part 43] . . .". Further, as stated in the preamble to the SEF Core Principles Rule: "With respect to the treatment of block transactions, the Commission notes that the definition of block trade in part 43 of the Commission's regulations applies to such transactions involving swaps that are listed on a SEF. The Commission also notes that the definition of block trade states, in part, that block trades occur away from the registered SEF's or DCM's trading system or platform and [are] executed pursuant to the registered SEF's or DCM's rules and procedures." SEF Core Principles Rule at 33494.

[10] *See, e.g.*, Impartial Access Guidance, at p. 2, fn. 3.

[11] As defined in the Impartial Access Guidance, the term "enablement mechanism" refers to any mechanism, scheme, functionality, counterparty filter, or other arrangement that prevents a participant in a SEF from interacting or trading with, or viewing the bids and offers (firm or indicative) displayed by, any other participant in such SEF. *Id.* at p. 1.

such enablement mechanisms by providing market participants with the ability to enable/disable counterparties in cleared swap markets on SEFs, or to prevent certain parties from seeing streaming prices. Eliminating "enablement mechanisms" on SEFs is a necessary precondition to ensuring impartial access to SEFs in accordance with the CFTC SEF Legal Standards.

- Caps on RFQ Requests: Certain SEFs continue to impose limits on the maximum number of counterparties to whom a given RFQ can be sent. Such caps are inconsistent with Commission regulation 37.9(a)(3) and the Impartial Access Guidance (*see* p. 3).

- Indirect Access: All SEFs should have rules in their rulebooks regarding accessing their platforms through an agent or intermediary as required by the SEF Core Principles Rule. Market participants must have the option to connect to SEFs indirectly, as they do in futures trading. Without explicit authorization of indirect or intermediated access, we believe the SEF rulebooks are inconsistent with the Impartial Access Guidance (*see* p. 4).

II. Concerns with Operational and Documentation Readiness for SEF Trading of Bunched Orders

MFA members also remain troubled by operational readiness for SEF trading of clearable bunched orders in CDS that are traded in blocks and then allocated to underlying funds, which is currently a common way for buy-side firms to trade swaps, including CDS. For such bunched CDS orders, the only available execution-to-clearing trade flow requires buy-side participants to enter into a standby or "super" FCM arrangement to guarantee the bunched order at the time of SEF execution, clear the bunched order based on a credit limit at the fund manager level, and then allocate the order to individual funds post-execution. In certain instances, the legal documentation for such an arrangement is not yet resolved. In addition, the execution-to-clearing trade flow remains untested by certain SEFs and FCMs. We also understand that FCMs may limit their offering of such standby FCM arrangements to certain clients, such as larger funds, thus preventing SEF access by smaller funds to trade bunched CDS orders.

The solution for clients that have difficulty implementing standby arrangements is for the relevant SEF and registered derivatives clearing organization to make it possible for the client's investment manager to pre-allocate the bunched order and then for the relevant FCM(s) to perform pre-execution checks of such allocations (*i.e.*, at the fund level) before such bunched order is entered. In this way the bunched order will be pre-execution guaranteed in compliance with Commission requirements, but without the need for a standby clearing arrangement. This approach is already available for cleared interest rate swaps, but not for CDS. To allow such clients to continue to execute bunched CDS orders, therefore, we respectfully request the Commission's assistance in seeing that facilities for pre-allocation and pre-execution checks at the allocated fund level are available before the effective date of the first CDS MAT determination.

III. Concerns with Business and Liability Provisions in SEF Documentation

To date, a principal impediment to funds completing the SEF onboarding process has been the problematic business and liability provisions of certain SEF documents that require extensive review and negotiation. For example, many SEF user agreements and rulebooks provide that, for hedge fund customers, the investment manager shall be the "Participant" and shall be the party responsible for transaction liability and the indemnity provisions. In certain cases, individual traders are also treated directly as the agents of the fund (rather than, more accurately, as employees of the agent of the fund). Such provisions (which fail to distinguish among funds, their managers, and the employees of such managers) are not only inconsistent with existing hedge fund structures, but are also at odds with trading mechanics in the futures and OTC derivatives markets. By contrast, SEF documents typically limit liability for SEFs' actions without any customary exception for their negligence or misconduct. Because all of these provisions are inconsistent with existing hedge fund structures and well-established trading documents and protocols in other, more familiar markets, they require not only a thorough review of the SEF documents, but also a re-examination of existing fund documents. This process is cumbersome and time-consuming, and MFA members have reported varying levels of negotiation success with SEFs in securing changes to the SEF documents.

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We would welcome the opportunity to discuss our concerns in greater detail. Please do not hesitate to contact the undersigned or Laura Harper at (202) 730-2600 with any questions the Commission or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director & General Counsel

cc:

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