May 14, 2012

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: CFTC RIN 3038–AD08 – Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades

Dear Mr. Stawick,

The International Swaps and Derivatives Association[1] ("ISDA") and the Securities Industry and Financial Markets Association[2] ("SIFMA") appreciate this opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") regarding the recently released further notice of proposed rulemaking and request for comments ("NPRM") concerning the criteria for grouping swaps into separate swap categories, the methodology for setting appropriate minimum block sizes, and measures to prevent the public disclosure of the identities, business transactions and market positions of swap market participants in order to implement certain statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which amends the Commodity Exchange Act (the "CEA").

Executive Summary

We consider the development of appropriate minimum block sizes to be of critical importance to the successful implementation of the real-time public reporting obligation in the Dodd-Frank Act and rules recently adopted by the Commission.[3] Below is a brief summary of our key points regarding the NPRM:

[1] ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, visit www.isda.org.

[2] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, please visit: www.sifma.org.

[3] On January 9, 2012, the Commission issued a final rule regarding the real-time public reporting of swap transaction data, which prescribed time delays for block trades. 77 FR 1182 In adopting the final rule, the

- Achieving the appropriate relationship between reporting delay and frequency and volume of swap trading in a specific swap product is critical to achieving the statutorily-required balance between transparency and liquidity.[4] In all swap markets, there are clearly definable categories of swaps that trade with significantly lower frequency and volume than more liquid categories of swaps.

- Treating more liquid and less liquid categories of swaps equivalently for the purposes of real-time public reporting is likely to widen bid/offer spreads and reduce liquidity for lower-frequency/lower-volume categories. Unless the dissimilarities between distinct categories of swaps are acknowledged and considered in setting appropriate block thresholds, liquidity providers in less liquid instruments will have an extremely low probability of hedging their risk before information about the swap transaction is broadly disseminated, and will therefore be forced to adjust their pricing.

In consideration of the above realities, we believe that:

1. The appropriate minimum block size framework set forth in proposed section 43.6(b) at the asset class, category, and currency grouping levels is not sufficiently granular to consider vast differences in the trading frequency and volume of different swap products within those categories.

2. In product categories or currencies that trade below a certain frequency threshold, all transactions should be treated as block transactions.

3. The Commission should revise its proposed methodology for determining appropriate minimum block sizes from a 67% notional amount calculation to a 50% notional amount calculation in order to align the ratio of block size to daily volume in the swaps market to a level more similar to that of futures markets.

4. The Commission should revise its trimmed data set mechanism, which is currently calibrated such that it would fail to exclude even the largest transactions done in swaps markets, thus failing to preclude a very large transaction from substantially skewing the block threshold.

5. The Commission should set the initial cap size as the lower of the relevant block size or interim cap size, and set the cap size equivalent to the relevant block size during the post-initial phase.

Our comments below are organized as follows: in Part I, we discuss the importance of ensuring that the final rule protects market liquidity; in Part II, we discuss the proposed approach to the grouping of swaps in each of the asset classes; in Part III, we discuss the proposed methodology used to determine appropriate minimum block sizes for each swap category; and in Part IV, we discuss the proposed approach to determining cap sizes for each swap category.

Commission noted that it "intends to issue a separate notice of proposed rulemaking that will specifically address the appropriate criteria for determining appropriate minimum block trade sizes in light of data and comments received." 77 FR 1182, 1185

[4] 7 U.S.C. 2(a)(13)(E).

I. The proposed rule does not adequately protect liquidity for swaps, particularly for swaps in smaller, illiquid markets.

The proposed rule does not achieve the statutorily-mandated objective of protecting liquidity, particularly with respect to swap markets with limited trading activity. As the Commission points out, Congress intended that the Commission consider both the benefits of enhanced market transparency and the effects such transparency would have on market liquidity.[5] Section 2(a)(13)(E) of the CEA, as amended by the Dodd-Frank Act, requires that the Commission's rules for the public availability of swap transaction and pricing data contain provisions that take into account whether public disclosure will materially reduce market liquidity.[6] The proposed rule, however, does not adequately consider liquidity, because it groups together swaps that trade with very different levels of liquidity. In addition, the proposed methodology fails to adequately recognize swaps that do not trade in a liquid manner. In illiquid swaps, real-time disclosure may compromise the ability of participants to hedge their position because publication of the prices will enable other participants to anticipate one party's need to hedge and thus result in adverse price movement. In addition, in illiquid markets, disclosure of a particular trade would not meaningfully increase price transparency for other market participants.[7]

Accordingly, we would like to draw the Commission's attention to a central concept that is useful in assessing the difference between a liquid and illiquid swap as it relates to establishing block thresholds:

Does the swap trade frequently enough, and in enough volume, to permit full risk hedging in a relatively immediate time period, and prevent wider bid/offer spreads due to rapid, discontinuous price movement subsequent to reporting? If it does, then only reporting of particularly large-sized transactions needs to be delayed because it is likely that risk can be offset quickly for smaller transactions. If it does not, then the Commission should not group it in with higher-liquidity swap products for the purposes of block size determination.

Consider some examples of differing liquidity across swap categories from the credit and interest rate markets:

> *Example 1:* A review of recent data from the Depository Trust & Clearing Corporation ("DTCC") shows the wide range of liquidities within the four- to six-year tenor bucket for credit indexes with similar spread levels.[8] For the North American Investment Grade index, five year swaps on a recently issued index, CDX.NA.IG.17, traded, on average, 268 times a day (with an average daily notional value of $16.819 billion) during the six month period from September 20, 2011 through March 19, 2012; yet swaps on the prior

[5] 77 FR 15460, 15466.

[6] 7 U.S.C. 2(a)(13)(E).

[7] See discussion in the comment letter from ISDA and SIFMA to the Commission regarding: real-time public reporting of swap transaction data; swap data recordkeeping and reporting requirements; and reporting, recordkeeping, and daily trading records requirements for Swap Dealers and Major Swap Participants, February 7, 2011 at 3, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27581.

[8] Market Liquidity – Untranched On-the-run Index Trading Report, DTCC, DTCC Deriv/SERV, April 16, 2012, *available at* http://dtcc.com/products/derivserv/data_table_snap0018.php. For further information regarding the data included in the DTCC report, *see* http://dtcc.com/downloads/products/derivserv/CSC_ICC_Index_Study_0412_draft_v3.pdf.

index, CDX.NA.IG.16, after it had been outstanding for six months, traded, on average, 49 times a day (with an average daily notional value of $3.046 billion) during the same period. Furthermore, other indexes with similar tenor and spread levels may trade much less frequently.

Example 2: A review of recent data from the Federal Reserve Bank of New York ("NY Fed Study")[9] illustrates the vast difference in liquidity across different interest rate swap classes. During the period covered by the NY Fed Study, an average of 621 swaps of fixed rates for 3 month USD LIBOR traded per day. During the same period, an average of only 38 swaps referencing inflation rates as the floating rate index traded per day across all four "super-major" currencies (an average of 9.5 swaps per currency, per day).

Under the Commission's proposal, block sizes on such swaps would be set by a single calculation. The block criteria for IG.16 and IG.17 would be exactly the same despite a trading frequency ratio of 5.5 to 1. The block criteria for USD 3 month LIBOR swaps and inflation swaps would be exactly the same despite a trading frequency ratio of 64 to 1. Clearly, the reporting of a large trade in a low frequency/low volume product would have a disproportionately higher propensity to widen bid/offer spreads subsequent to reporting than a comparably sized trade in a much more liquid market. The rule for establishing reporting delays and block size thresholds should consider this distinction so as not to violate the statutorily-mandated objective of protecting liquidity.

II. Swap Categories

A. We urge the Commission to divide each swap asset class (i.e., interest rate, credit, equity, foreign exchange and other commodity swaps) into additional swap categories so that the swap categories reflect the varying levels of liquidity across the marketplace.

In the NPRM, the Commission states that the criteria under proposed section 43.6(b) would result in swaps with common risk and liquidity profiles being grouped together.[10] We do not believe the proposed rule achieves this objective. Recent market data illustrates that a more granular approach is required, whereby each swap asset class is divided into additional swap categories to take into account the liquidity differences across the swaps market.[11] Generally, a highly liquid instrument should not be grouped together with an instrument that is traded much less frequently. Further, swap categories should be representative of the fungibility of instruments in each category. Trading in one swap instrument will not necessarily represent liquidity in another swap instrument. Failing to account for this will result in swaps with differing liquidity levels being subject to a single block size that is unlikely to be appropriate for all of the instruments in each category.

---

[9] Staff Report No. 557, Federal Reserve Bank of New York, An Analysis of OTC Interest Rate Derivatives Transactions: Implications for Public Reporting, March 2012.

[10] 77 FR 15460, 15467, fn. 95.

[11] As discussed above, data from DTCC regarding 5 year CDS indexes illustrates the striking disparity in liquidity between on-the-run and off-the-run versions of an index, which the proposed rule would not separately categorize. *See supra*, note 8.

B. Credit default swaps should be separately categorized based on index series, narrower periods, and product type.

i. Individual CDS index series should be separately categorized.

Each individual CDS index series should be separately categorized in order to reflect differences in the level of trading in each index. A CDS index series demonstrates a markedly lower level of trading 6 months after issuance, when a new version of the index series is issued. Trading is generally most active in the most current version of an index. As an example, in each of three previously issued versions of the CDX.NA.IG (North American Investment Grade) index, the average number of contracts traded per day in the on-the-run version of an index was 5-7 times the number of transactions from an off-the-run version.[12]

We agree with the Commission that the underlying index helps "explain average notional size in the CDS data set", but disagree with the Commission's assertion that the use of indexes to separately categorize swaps would impose unnecessary complexity on market participants.[13] We disagree because it will be relatively easy to collect data for swaps on any given index series and, once the relevant methodology is established, it should not be excessively complex to apply that methodology to the relevant data set. In addition, the Commission has proposed to list block sizes for each swap category on its web site, so it will also be a simple matter for participants to get access to such information.[14] Further, we believe it is more important for the Commission to group together swaps in a logical manner that reflects market liquidity rather than to strive to create as few swap categories as possible. For the above reasons, we believe the Commission should separately categorize each individual CDS index series.

ii. Different CDS product types should be separately categorized.

Different types of CDS products, including options and tranche swaps, have widely varying liquidity levels. This range of liquidity levels can be seen in the tranched index swap trading that is reported by DTCC.[15] For example, the average daily notional amount and number of trades for (1) the 3 year 10-15 CDX.NA.HY.11 (i.e., the three year tranche of the North American High Yield series 11, with an attachment point of 10 and an exhaustion point of 15) is $41 million and trades on average 3 times per day, while (2) the 3 year 15-25, 25-35, and 35-100 CDX.NA.HY.11 had average daily notional amounts of $3.5 million, $655,000, and $4.2 million, respectively, and each traded less than once per day.[16] They are also not fungible with each other so that liquidity in, for example, the swap on a particular index will not result in liquidity on an option on another index. We disagree with the Commission's view that using tranche level and other criteria to separately categorize CDS instruments "may not be practicable because it may produce too many swap categories and as a result would impose unnecessary

[12] Market Liquidity – Untranched On-the-run Index Trading, DTCC, DTCC Deriv/SERV, April 16, 2012, *available at* http://dtcc.com/products/derivserv/data_table_snap0018.php.
[13] 77 FR 15460, 15475, fn. 144.
[14] Proposed section 43.6(f)(3).
[15] Market Liquidity – Tranched On-the-run Index Trading, DTCC, DTCC Deriv/SERV, *available* at http://dtcc.com/products/derivserv/data_table_snap0019.php.
[16] *Supra*, note 15.

complexity on market participants".[17] As mentioned above, we do not believe that a significant burden will be imposed on market participants by more sensibly grouping swaps into additional swap categories, as appropriate. The level of trading varies across different product types (i.e., tranche, options) in the CDS market, and we believe the swap categories should account for these differences, particularly where to do otherwise would result in an inappropriately high block trading threshold for less liquid products. We urge the Commission to separately categorize each CDS product type to reflect the specific liquidity of trading in each product.

iii. Tenor categories should be narrower than proposed, to more accurately reflect trading activity.

We support the Commission's proposal to use tenor to separately categorize credit swaps. However, the tenor categories should be narrower than proposed, in order to more accurately reflect the varying levels of trading across the market. In particular, we believe the proposed 4 to 6 year tenor category should be further divided into a 4-4.5 year category, 4.5-5 year category, 5-5.5 year category, and 5.5-6 year category. These additional categories would more accurately reflect the high volume of trading in swaps with five year maturities linked to CDS indexes and the fact that new CDS index series are issued every six months.[18]

iv. We support the use of the traded spread of a CDS index to set swap categories.

We agree that the spread for a CDS transaction should be used to group credit swaps. The Commission should clarify that the spread for a CDS transaction for purposes of determining the relevant swap category will be based on the traded spread, rather than on the fixed coupon, as suggested in the NPRM.[19]

The traded spread for a particular CDS transaction is indicative of the level of risk inherent in the index, and therefore, the expected liquidity of the swap. As market conditions change, the creditworthiness of underlying reference entities may also change, affecting the liquidity of a particular index. We believe, therefore, that the swap categories should be based on the current spread of a transaction in order to reflect such changes in liquidity. We believe it would be too rigid if a final rule were to fix an index to be of a particular quality on a particular date, based on conditions at the time that the index was created, and not allow for adjustment of the applicable block size if the creditworthiness of an underlying reference entity subsequently deteriorates (or improves) and the index becomes less (or more) liquid. Therefore, we suggest that the block threshold should be based on the spread (calculated according to standard industry practice (e.g., Bloomberg Code CDSW)) at the time of each trade. This has the advantage of incorporating the actual riskiness of the instrument into the block determination. This approach would not add significant additional complexity because standard market calculations would be used and the differing block thresholds would be known to participants prior to the trade.

---

[17] 77 FR 15460, 15475, fn. 145 & question 10.

[18] Market Liquidity–On-the-Run Index Trading, DTCC, May 11, 2012, p. 2, *available at* http://dtcc.com/downloads/products/derivserv/CSC_ICC_Index_Study_final.pdf.

[19] 77 FR 15460, 15468, fn. 102. In the NPRM, the Commission notes that the "conventional spread" represents the equivalent of a swap dealer's quoted spread, which includes a fee based on a fixed coupon. *Id*.

C. Interest rate swaps should be separately categorized based on individual currency, product type, and narrower periods.

i. Interest rate swaps should be separately categorized by individual currency.

We believe that only single-currency fixed versus benchmark LIBOR interest rate swaps in USD and EUR currencies (i.e., in USD, fixed versus 3 month LIBOR, and in EUR, fixed versus 6 month EURIBOR) are liquid enough so that public reporting of block transactions may not affect liquidity, depending on the final block determination rules.

Some justification for this argument may be drawn from a recent study from the Federal Reserve Bank of New York[20] ("NY Fed Study") on interest rate swap transaction data over a 3 month period. The NY Fed Study argues that in the 30 minutes following G4 currency fixed/float swap transactions similar in size to the set of block thresholds in the Commission's proposed rule, dealers are able to hedge between 50% and 70% of their DV01 risk. When we further parse the data, however, it becomes clear that the ability to offset unique risk in a short time span degrades as currency departs from single-currency fixed versus benchmark LIBOR interest rate swaps in USD and EUR.

The reason for the degradation is that the frequency and volume of transactions becomes too low to make it likely that a dealer can truly hedge risk in such a short time span. Focusing first on the simple number of transactions that take place in any 30-minute window, using an extension of the NY Fed Study's data:

- On average, about 621 USD-denominated fixed versus 3 month USD LIBOR swaps traded every day during the study period.
    - Representative data illustrates that roughly 85% of that trade count transacts in the primary business center for any individual currency between roughly 7 a.m. and 5 p.m. EST.
    - This means that, on average, about 26 3 month USD LIBOR swaps trade during the delay period set by the Commission.
- If we extend that logic to fixed versus 6 month EURIBOR swaps:
    - On average, about 18 EUR-denominated 6 month EURIBOR swaps trade during the delay period set by the Commission during the period from 7 a.m. to 5 p.m. GMT.
- But, if we move on to JPY and GBP we find that:
    - On average, only about 9 JPY-denominated 6 month JPY LIBOR swaps trade during the delay period set by the Commission during the period from 7 a.m. to 5 p.m. Tokyo time.

[20] Staff Report No. 557, Federal Reserve Bank of New York, An Analysis of OTC Interest Rate Derivatives Transactions: Implications for Public Reporting, March 2012.

- On average, only about 6 GBP-denominated 6 month GBP LIBOR swaps trade during the delay period set by the Commission during the period from 7 a.m. to 5 p.m. GMT.

There is a very low likelihood that enough GBP fixed/float swaps, for example, occur in a tenor that is a reasonable hedge for a block transaction, during the 30 minute delay period. If we extend the NY Fed Study's findings, it becomes clear that anything other than USD and EUR fixed for benchmark floating swap block transactions is unlikely to be directly hedged during a 30 minute delay, and thus should be subject to separate treatment for the purposes of block threshold determination and reported size capping.

- Both the NY Fed Study and the Commission divide the interest rate swaps market into about 8 tenor buckets representing "like" DV01 risk.

- Further, the NY Fed Study shows the mean size of swaps and percentage of total flow transacted for each bucket in the G4 currencies.

- Using the 30 year swap bucket as a block trade example:

  - Assume a dealer accommodates a $224mm (GBP139) 30 year fixed versus 6 month GBP LIBOR swap (current block size for this bucket is $210mm).

  - The mean size of a G4 currency 10 year – 30 year tenor swap is $56mm.

  - According to the aforementioned 6 trades per 30 minute average frequency, in order to fully hedge the $224mm block trade, 67% of all trades occurring (4 out of 6) would have to be 10 year – 30 year swaps. From the actual observed distribution of transactions across tenors, we know that this is unlikely.

Failing to treat JPY and GBP denominated swaps differently from USD and EUR swaps ignores the significant difference in the frequency and volume of swaps in those currencies. We believe that the simplest way to address this issue so as not to affect liquidity, would be to treat each of the G4 currencies as their own unique grouping for the purposes of calculating block metrics.

ii. Interest rate swaps should be separately categorized by product type.

It is clear that all swap products are not equal. Interest rate swaps can be broken down into product types by like risk as follows:

- Fixed versus non-benchmark floating rate indexes and basis swaps

  - Non-benchmark fixed/float swaps like 1 month, 6 month, and 12 month LIBOR in USD or 1 month, 3 month, and 12 month EURIBOR in EUR

  - Basis swaps such as benchmark versus non-benchmark LIBOR indexes, overnight index swap basis (OIS), Fed Funds versus LIBOR basis, and less common indexes like CMT, T-bills, SIFMA, and CMM

- Inflation Swaps – a specified inflation rate index

- Options – usually the swaption and cap/floor markets

- Cross-currency Swaps – where each leg of the swap is denominated in a different currency

- Exotics – multiple categories of risk, including but not limited to volatility, correlation, path-dependency, event, and cross-asset risks

To be clear, none of the above risks are effectively hedged by transacting single-currency fixed versus benchmark LIBOR interest rate swaps, and so should be categorized separately.

The frequency, volumes, and/or currencies traded in such products are often an order of magnitude smaller than in vanilla fixed/float swaps. Drawing from the NY Fed Study, we illustrate that the number of transactions during an average 30-minute primary business hour period is often less than one:

- Basis Swaps – 49 transactions per day in all G4 currencies, or 0.61 trades per 30 minutes per currency.

- OIS Swaps – 165 per day in all G4 currencies, or 2.06 trades per 30 minutes per currency.

- Inflation Swaps – 38 per day in all G4 currencies, or 0.48 trades per 30 minutes per currency.

- Swaptions and Caps/Floors – 181 per day in all G4 currencies, or 2.26 trades per 30 minutes per currency.

- Cross-currency Swaps – 23 per day in all G4 currencies, or 0.28 trades per 30 minutes per currency.

- Exotic Swaps – not contemplated in the NY Fed Study, but from representative data, certain product types trade less than once per day.

It is abundantly clear that the above products should not be treated the same as vanilla fixed versus floating swaps for block rule-setting purposes, if the intent is to preserve any reasonable ability to find hedges before public dissemination.

Despite the Commission's contention that further increasing granularity would impose an additional compliance burden on market participants, we believe that a counterparty to an interest rate swap will be aware of the class of the transaction and will not have difficulty in confirming the appropriate block size by, for example, looking up the relevant information on the Commission's web site, as proposed.[21]

[21] Proposed section 43.6(f)(3).

The Commission also notes that using the floating rate index of a swap to categorize interest rate swaps could result in certain swap categories with relatively few transactions.[22] We do not believe it is appropriate for the Commission to reject the use of a specific criterion for this reason. Determinations of categories for block trades should be based on concerns about liquidity and price discovery, not about the size of each category. Ensuring that swaps in which there are few transactions, for which there is markedly low liquidity, are separately categorized from swaps with a higher trading frequency reinforces the integrity of the overall methodology for establishing categories.

iii. Tenor categories for interest rate swaps should be narrower than proposed.

We support the use of tenor as a criterion for categorizing interest rate swaps. However, as noted above for credit swaps, the broad tenor categories as proposed will result in swaps with notably distinct levels of liquidity being grouped into a single tenor category. We propose that the Commission set tenor categories that straddle the relevant benchmark points as follows: 0-3 months, 3-6 months, 6-18 months, 1.5-3 years, 3-7 years, 7-12 years, 12-20 years, 20-30 years, and greater than 30 years. In addition, with respect to back-dated swaps, we urge the Commission to determine the tenor of a back dated swap as the time from the date of execution of the swap (as opposed to the start date) to the maturity date of the swap.[23]

D. The Commission should divide the equity swap asset class into swap categories based on liquidity.

We respectfully request that the Commission reconsider its proposal to disallow equity swaps from being eligible for treatment as a block trade or large notional off-facility swap. The arguments throughout this letter with respect to the adverse effects on liquidity and spreads are just as applicable to equity swaps as they are to swaps in other asset classes. We also request that the Commission adopt multiple categories for equity swaps based on the underlying index or basket, product type (e.g., total return versus price return swaps), notional size, and tenor.

Just like in other asset classes, in equity swaps there are swaps that trade with significantly lower frequency and volume than more liquid categories of swaps. The adverse effects on spreads and liquidity that would accompany a final rule that disallows block treatment for equity swaps will be particularly acute for equity swaps that are less frequently traded. Examples include equity swaps linked to custom baskets, which do not have publicly traded index products, and equity swaps linked to international indexes, which often have much lower liquidity than swaps linked to very liquid underlying indices, such as the S&P500. Equity swap transactions are generally not regarded as having been executed until the dealer sets the price terms for the relevant transaction; however, to the extent that hedging activity occurs after information about the swap transaction is broadly disseminated, spreads on swaps are likely to increase, particularly for swaps linked to less liquid indexes or custom baskets.

While we agree that as a general matter the underlying equity cash market is highly liquid, we do not think that leads to a conclusion that equity swaps should not be eligible for treatment as

[22] 77 FR 15460, 15471, fn. 119.

[23] In question 7 of the NPRM, the Commission specifically seeks comment on calculating the tenor of back-dated swaps (i.e., those swaps in which the start date is prior to the execution date). (77 FR 15460, 15473)

block trades or large notional off-facility swaps. Liquidity in the underlyer does not necessarily translate into liquidity in swaps linked to that underlyer, particularly in the case of less liquid indexes or custom basket swaps. For example, a customer may ask a dealer to trade a custom basket swap, the components of which could be the shares of a number of issuers each with highly liquid equity securities, but there may be very few or no other swaps that are linked to that same basket. With that in mind, we would propose that the Commission establish minimum block sizes for equity swaps based on consideration of the total trading volume of swaps linked to the relevant underlying index or basket of equity securities. Our comments elsewhere in this letter on methodology would also apply to equity swaps. This approach would have the advantage of being consistent across asset classes and of being consistent with many currently existing block trade rules for futures products linked to equity indexes, where minimum block sizes are typically determined by exchanges based on trading volume in the contracts linked to the underlying index.

The Commission explains that the proposed absence of block rules for equity swaps is due in part to the liquid underlying cash market.[24] Yet even in the cash market, the Securities and Exchange Commission ("SEC") has adopted a rule specifying block trade sizes. *See* SEC Rule 3b-8.[25]

III. Methodology

A. The Commission's methodology does not address the basic issues of liquidity and price discovery.

The methodology proposed by the Commission focuses on sorting swaps in a particular market by their notional amount and providing that some percentage of the largest notional trades will be blocks. This approach fails to consider that, in different markets, different sizes of trades will have characteristics that should make them eligible to be block trades. These characteristics are: (i) that the trade can move the market in a rapid, discontinuous way, and (ii) that widespread publication of the trade in and of itself will result in a significant market movement to or through the price of the reported transaction so that the party to the original trade will not be able to hedge its position without suffering a nearly instantaneous loss. Another feature of a block trade is that, because of its size, specificity, or for other reasons, the price of the trade is not a good indicator of prices that may reasonably be available to other market participants in the same market. In addition, we believe the block size thresholds should be more flexible in order to account for variations in liquidity across time zones as is the case for block sizes in futures contracts.[26] These concerns apply not only to credit, interest rate and equity swaps, as discussed above, but to swaps in the foreign exchange and other commodity asset classes as well. For oil and gas swaps in particular, we note that there are periodically relatively large transactions for which hedging would become difficult if real-time public reporting, without a delay, is required. For all swap asset classes, the Commission should use criteria to determine block sizes that take into account the relationship between volume, frequency, and liquidity, rather than imposing a

[24] 77 FR 15460, 15484.
[25] 17 C.F.R. §240.3b-8(c).
[26] We note that the CME Group establishes varying block sizes for the same futures contract depending on whether the trade occurs during regular trading hours, evening hours, or overnight. *See* Market Regulation Advisory Notice, CME & CBOT, Block trades, Advisory number RA1110-3, December 5, 2011.

mechanical test based on notional sizes. Specifically, we would recommend metrics like block threshold size compared to total average daily trading volume for each swap category and currency. This could be done as its own criteria method, or by adjusting the percentile input (e.g., 67%, 50%, etc.) to best describe a consistent block-to-volume ratio.

B. The Commission should permit block treatment for all transactions in markets with the least liquidity.

Block treatment should be permitted for any swap transaction, regardless of size, in swap categories for which trade frequency is particularly low. In such highly illiquid markets, a single transaction is especially likely to move the market (i.e., change the prices that market participants would demand or accept for a particular swap transaction). As noted in the NY Fed Study, low trading frequency, customization and high degree of trade dispersion demonstrated by certain illiquid swap instruments may limit value investors derive from the reporting of trades in such instruments.[27] Further, in an illiquid market, real-time public reporting without a delay will have a material negative impact on the incentives for market makers to provide liquidity, as will the restrictions in execution style that will be imposed by the execution mandate. Therefore, we urge the Commission to establish a clear rule permitting block treatment for every transaction (regardless of size) in a swap category for which there are no more than fourteen swaps traded per business day (roughly one trade per 30 primary business minutes, a period equal to the year one block delay for Swap Dealers and Major Swap Participants). For most illiquid products, we believe that that allowing a 15 minute delay for price dissemination is insufficient protection for liquidity providers to hedge sensitive risk. However, it is the maximum allowed under Part 43, and therefore, we are asking that it be afforded where applicable. Without such protection, liquidity providers will build into their prices the likelihood (in fact the near certainty) that the market in the infrequently traded instrument will move against them following the release of the trade information to the public. The result will be higher hedging costs for the dealer and less liquidity and higher transaction costs for investors.

Investors have a clearly demonstrated preference for discretion over publicity when executing illiquid instruments. The Commission's own study of 570 futures products established that "almost all" of the trading occurred off exchange in 410 of them.[28] These are all products for which DCM execution is currently available, but not mandated. Many of them have significant amounts of open interest, but may trade infrequently. In those cases, market participants (both investors and dealers) determined that the quality of execution (across all measures of "quality" including, but not limited to, price for the particular transaction in question) was best served by executing the trade bilaterally and not in the public forum of the exchange. In our view, this clearly demonstrates that liquidity is a critical consideration when market participants decide how to execute a trade. Forcing the same transparency standards on market participants for both liquid and illiquid products will be detrimental. Instantaneous trade disclosure for highly illiquid products, combined with the potential for SEF or DCM execution, is likely to erode their liquidity further and to do severe damage to the safety and soundness of the system as a whole.

[27] Staff Report No. 557, Federal Reserve Bank of New York, An Analysis of OTC Interest Rate Derivatives Transactions: Implications for Public Reporting, March 2012, at 21.

[28] 75 FR 80572, 80589, Notice of Proposed Rulemaking, Core Principles and Other Requirements for Designated Contract Markets, Dec. 22, 2010.

C. Using a 50% notional amount calculation to determine appropriate minimum block sizes would be an improvement from the proposed approach.

The Commission states that the proposed 67% notional amount calculation is intended to ensure that two-thirds of the sum total of all notional amounts in each swap category are reported on a real-time basis.[29] The rationale for choosing 67% is not clear. Commentators have suggested that using the 67% notional amount calculation was selected in order to achieve a result that is similar to the 95% distribution test previously proposed by the Commission.[30] This view is supported by the Commission's own review of data in the NPRM, which found that applying the 67% notional amount calculation to data provided to the Commission by the OTC Derivatives Supervisors' Group ("ODSG") would result in 94% of interest rate swap and CDS trades being reported in real-time.[31]

If the Commission determines that it will use a notional amount test, a 50% notional amount calculation would be an improvement from the proposed 67% notional amount calculation as it would be less likely to cause market disruptions. One way to evaluate whether the proposed block threshold rule is appropriately calibrated is to test for consistency with other established block thresholds. An interesting comparison is the ratio of block trade size to total daily notional volume. In the 10 year Treasury Note futures contract for example, the block size is 5,000 contracts during primary business hours and the average daily volume is on the order of 900,000 contracts. The block size to daily volume ratio is about 5.6%. The NY Fed Study suggests that $84bn notional of USD fixed vs. 3 month LIBOR swaps trade per day. Representative transaction data over a 1 year period suggests that 35% of its notional volume transacts in "Tenor group 6" (greater than 5 years and less than or equal to 10 years). Combining those data, roughly $29bn of swaps trade every day in Tenor group 6. Using $290mm as the block size for that grouping (as proposed by the 67% method), the block to volume ratio is 10%, or nearly double that of the similar-duration futures contract. If we use the same ratio as the 10 year Treasury Note futures contract, the suggested block size for Tenor group 6 would be 5.6% of $29bn, or $163mm; very close to the $170mm level suggested by a 50% notional method.

D. The Commission should phase in the block size threshold to permit the market to adjust and consider the costs of implementing the proposal.

In order to allow the liquidity of trading on SEFs and DCMs to build, the Commission should phase in the block size threshold. For instance, if the Commission were to adopt a notional amount test, the threshold could be set using a 25% notional amount calculation in the first year, and thereafter be gradually raised until reaching the threshold chosen by the Commission. We note that there is a precedent for using a phased-in approach in TRACE and in the futures market. We believe the Commission should also gradually phase-in block size thresholds for bilateral swaps. In addition, we urge the Commission to conduct a rigorous cost-benefit analysis that addresses the costs of compliance with the proposed rule.

E. The Commission should determine block sizes using only recent data, to ensure that block sizes are reflective of existing market conditions.

[29] 77 FR 15460, 15480.
[30] Risk.net, "New CFTC block trade proposals spark row over 67% threshold", April 5, 2012.
[31] 77 FR 15460, 15481, fn. 198.

The Commission should use a 6-month window of data as part of its methodology for determining appropriate minimum block sizes for each swap category. Using a three-year rolling window of data, as proposed in the NPRM, is over-inclusive, and could result in applying block sizes that are no longer reflective of notional sizes in the market. This is particularly true in the case of CDS indexes, where the composition of an index series is typically selected every six months to create a new "on-the-run" series. For any transaction in a new interest rate swap product, the Commission should permit block treatment regardless of the notional size of the transaction until sufficient data is available to determine an appropriate block size.

In addition, we believe that the real-time public reporting rules, including the block size rule, will quickly cause the market to trade swaps in smaller average trade sizes. Accordingly, using a rolling three-year period would improperly skew block sizes upwards.

F. The proposed methodology to exclude extraordinarily large transactions is flawed.

We support the Commission's use of a "trimmed data set" to calculate block sizes for each swap category. As the Commission noted, the exclusion of "extraordinarily large transactions" will serve to achieve appropriate minimum block sizes that are not skewed away from a representative value of notional sizes.[32] However, the methodology for excluding transactions from the "trimmed data set" in proposed section 43.2 would result in a threshold that is far too high to exclude any transactions. As proposed, a "trimmed data set" is a data set that has had extraordinarily large notional transactions removed by transforming the data into a logarithm with a base of 10, computing the mean, and excluding transactions that are beyond four standard deviations above the mean.

Instead of using the proposed approach to the trimmed data set, we recommend looking at the raw block size (calculated based on all transactions in the relevant swap category) and eliminating any trades that are more than five times larger than the block threshold as an alternative to using the standard deviation approach. In the alternative, we believe the Commission should at the very least use a methodology that would exclude transactions that are three (rather than four) standard deviations beyond the mean. Four standard deviations would include extraordinarily large transactions, and that will skew the data, making the statistic (whether 67% or 50% is used) very noisy and not meaningful. Three standard deviations of a normal distribution covers 99.865% of the distribution (99.9% roughly), while four standard deviations corresponds to 99.9968% (99.999% roughly), which is a standard we consider polluted with idiosyncratic, non-representative observations when doing statistical analysis.

G. The Commission should set block sizes for equity swaps using similar methodology used for other asset classes, and coordinate its approach with the SEC.

As discussed above, we believe the Commission should consider the varying levels of liquidity within different segments of the equity swap asset class, and establish swap categories accordingly. A similar methodology should be applied to determine block sizes for equity swaps as will be used to determine block sizes in other swap asset classes. As discussed above, any transaction in an illiquid equity swap should be treated as a block, regardless of notional size.

[32] 77 FR 15460, 15480.

Further, the Commission should coordinate its approach with the SEC to minimize the incentive for participants in the equity swaps market to engage in regulatory arbitrage.

H. The Commission should clarify that a swap transaction will be deemed "executed" once the price and quantity terms are known.

A swap transaction is generally not regarded as having been executed until the material terms, including the price, have been established. We seek clarification from the Commission that a trade will be deemed executed for real-time public reporting purposes only once the price and quantity terms are known for the swap.

IV. Cap Size: we urge the Commission to adopt post-initial cap sizes that are equivalent to the block size for the relevant swap category, and in the initial phase to set cap sizes equal to the lower of the initial block size or interim cap size.

The same reasoning that determines that a certain level is the appropriate minimum block size should also determine that such a level is the cap size. We do not believe that the added market transparency from reporting transaction sizes between the 67% notional threshold for block sizes and the proposed 75% notional threshold for cap sizes would outweigh the harm to liquidity from this additional disclosure. We urge the Commission to ensure that the post-initial cap size applicable to each swap category is always equal to the relevant block size for the swap category.[33] In the initial period, the cap size should be equal to the lower of the initial block size in proposed Appendix F or the interim cap size as provided in proposed section 43.4(h)(1). If the block size for a swap category is zero, the Commission should use the interim cap size in proposed section 43.4(h)(1) as the cap size for that swap category.

* * *

ISDA and SIFMA appreciate the opportunity to comment on the proposed procedures to establish appropriate minimum block sizes. Please feel free to contact the undersigned or our staff at your convenience.

Sincerely,

Robert Pickel
Chief Executive Officer
ISDA

Kenneth E. Bentsen, Jr.
Executive Vice President,
Public Policy and Advocacy
SIFMA

[33] In question 73 of the NPRM, the Commission specifically seeks comment on whether the initial and post-initial cap sizes should always be equal to the appropriate minimum block size for a particular swap category. 77 FR 15460, 15493