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Morgan Stanley

May 11, 2012

Via Electronic Submission: http://comments.cftc.gov
Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
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,

Morgan Stanley appreciates the opportunity to comment to the Commodity Futures Trading Commission (the "***Commission***") regarding its proposed Block Size Rules. In this letter, we focus primarily on the macro-economic issues involving Block Size Rules and their interaction with certain other proposed and final rules. In particular, we are concerned that the Block Size Rules will result in reduced liquidity in the swaps market for all market participants.

As we noted in our letter of February 7, 2012 regarding the "Made Available to Trade" ("***MAT***") Rule, individual proposed rules do not stand alone. There are four rules that interact with one another and which in combination can be either helpful or harmful to liquidity. All involve trade-offs between transparency and liquidity. These are:

1. the proposed MAT Rules;[1]
2. the finalized Swaps Reporting Rules;[2]
3. the yet-to-be-proposed Permissible Trading Protocols Rules;[3] and
4. the proposed Block Size Rules.

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[1] "Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade", 76 Fed. Reg. 77728 (proposed Dec. 14, 2011).

[2] "Real-Time Public Reporting of Swap Transaction Data", 77 Fed. Reg. 1182 (adopted Jan. 9, 2012).

[3] Proposed Section 37.9 provides for "permitted transactions" which includes block trades. Permitted transactions are not required to only be transacted through an Order Book System or a Request for Quote System.

As these rules continue to increase transparency, liquidity provided by market makers to medium and large size non-block trades will diminish. Liquidity providers will find that the market, knowing the details of a transaction that is about to take place, or which has recently taken place, moves in such a way that the cost of offsetting the trade rises.[4] Liquidity providers will compensate by showing smaller sizes and/or by widening their bid-offer spreads – i.e., by reducing available liquidity. It is for this reason that the Dodd-Frank Act mandates longer time delays for public reporting of block trades. Now the question is whether the proposed rules will effectively preserve liquidity. We believe they will not.

The Commodity Exchange Act (the "***CEA***"), as amended by the Dodd-Frank Act, requires the Commission to take into account the effect these rules will have on liquidity. Section 2(a)(13)(E) of the CEA mandates that the Commission adopt the Swaps Reporting Rules but also requires that the Commission "take into account whether the public disclosure [of transaction and pricing data of swaps] will materially reduce market liquidity" in doing so. Given the linkages between the various rules, this requirement is equally pertinent to the Block Size Rules.

When the Commission first proposed potential block size rules in its Notice of Proposed Rulemaking on January 7, 2011, it received numerous criticisms around its block size proposals. Commenters found the proposed sizes to be too large to protect liquidity from the "signaling" problem mentioned above, and also criticized the proposal as being "one size fits all" for a broad variety of OTC swaps. The current proposal is certainly no longer "one size fits all." Indeed, there are now 24 proposed "buckets" for interest rate swaps based on currency and tenor, and 18 more for credit default index swaps. Unfortunately, two key problems remain if liquidity is to be preserved.

1. By the Commission's own analysis, the current proposal would permit approximately 6% of swap transactions in interest rate and credit products to be blocks. This compares to 5% in the original proposal. The difference is not enough to alleviate the problems originally described by ourselves and others.[5]

2. The many buckets take no account of whether a swap is "vanilla." There are many swaps that are or will be clearable and likely made available to trade but which have substantially less liquidity than on-the-run vanilla swaps. These include swaps with non-integral years to maturity, broken-dated swaps, floating to floating swaps, callable swaps and swaptions. But the proposed rules make no provision for these, because their lower liquidity is not a result of currency or tenor alone.

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[4] The Commission recognized the specific issue of "moving the market" in the proposing release. The Commission explained that it believed "that the publication of detailed information regarding 'outsized swap transactions' could expose swap counterparties to higher trading costs." 77 Fed. Reg. 15466.

[5] While commenting on the CFTC's real-time reporting proposal, many users of swaps expressed concerns regarding the potential adverse impact on market liquidity of unduly high or insufficiently tailored block thresholds. See e.g., comment letters by Blackrock, PIMCO, Vanguard, the Association of Institutional Investors, the Coalition for Derivatives End-Users, the Investment Company Institute and Managed Funds Association and the Air Transport Association of America.

By way of example, in the first four months of 2012, Morgan Stanley traded the 5-year plain vanilla spot start USD swap over a dozen times per day on average, indicating the high degree of liquidity for this swap. The proposed block size of $380 million equates to a DV01[6] of about $188,000, which is reasonably large by market standards. We believe a trade of $300 million (i.e., large but not a block), if known to the market, would move interest rates by perhaps 1/4 basis point, or about half of the typical bid-offer spread in today's bilateral market. This expected cost would be passed on to customers via the prices made by liquidity providers.

The impact is much greater for a GBP-denominated swap with a 3-year tenor beginning 2 years forward. This swap is much less liquid, trading perhaps a few times a week. The Commission is proposing that its minimum block size should also be $380 million. We believe that a $300 million trade in this swap – also a non-block under the proposed rule – would have a market impact of 3 basis points if seen by the market. To cover this cost, swap dealers would need to double or triple the current bid-offer spread, which renders the cost of accessing immediate liquidity prohibitive for our customers.

Without meaningful relief with regard to block size, market participants will expose themselves to costs and/or risks that are not intended consequences of the Dodd-Frank Act:

1. If liquidity is needed immediately, investors and end users may be forced to accept less competitive prices than what is available currently;

2. Market participants may instead elect to segment their swap trades into pieces small enough to avoid incurring a liquidity premium. It will take longer to transact large trades, and market risk will have been substituted for liquidity risk;

3. Investors and end users may leave the swaps market altogether and find different financial products to hedge their risks. This will result in less effective hedges for them and will reduce available liquidity even further for swap participants that remain;

4. End-users may not hedge their risk positions at all.

All four situations would result in reduced liquidity in swap markets. Furthermore, situations 3 and 4 would result in increased systemic risk.

We believe that there are two potential approaches to solving the problems with the proposed Block Size Rule.

1. The Commission could allow DCMs and SEFs to set appropriate block sizes, subject to the Commission's approval. This is the most straightforward approach, and it would align swaps with the way futures markets work today. We believe it would be effective because DCMs and SEFs would benefit by setting block sizes in a way that maximizes liquidity, since this would result in more frequent, larger trades.

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[6] DV01 is the change in the value of a swap for a 1 basis point change in interest rates.

2. Alternatively, the Commission could lower the proposed block sizes in general and apply them only to vanilla structures with standard maturities – i.e., all non-vanilla swaps would be blocks initially. An anti-evasion rule would ensure that swap dealers do not tweak swap structures merely to receive block treatment. In one year's time, the Commission would have sufficient transaction data available to determine whether changes to the rule were warranted.

We wish to point out that the swap markets are comprised of institutions rather than individuals. Our customers and competitors, as well as the potential DCMs and SEFs, are knowledgeable participants who know how to achieve good execution. If the Commission sets initial block sizes that are low, our customers still have the option to execute on DCMs or SEFs if that leads to better execution. However, if the initial block sizes are too big, as we believe they are under the proposal, there would be no simple remedy for the subsequent drop in liquidity.

In summary, we believe that the Block Size Rule is critical to the future success of OTC swap markets. It is the "final check" that ensures an appropriate balance between transparency and liquidity. Unfortunately, we believe that the rule as proposed will not get the job done.

We appreciate the opportunity to comment to the Commission on the proposed Block Size Rules, and we would be pleased to discuss any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to Dexter Senft (212-761-2466).

Respectfully submitted,

Dexter Senft
Managing Director

cc: The Hon. Gary Gensler, CFTC Chairman
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Scott O'Malia, CFTC Commissioner
The Hon. Mark P. Wetjen, CFTC Commissioner
The Hon. Mary Schapiro, SEC Chairman
The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner
The Hon. Daniel M. Gallagher, SEC Commissioner