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

May 14, 2012

Via Electronic Submission: http://comments.cftc.gov

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, D.C. 20581

Re: CFTC Further Notice of Proposed Rulemaking on Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off Facility Swaps and Block Trades (RIN 3038-AD08)

Dear Mr. Stawick:

Managed Funds Association[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "**Commission**") on its further notice of proposed rulemaking related to "Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades" (the "**Re-Proposed Rules**")[2] under Title VII[3] of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**")[4]. The Re-Proposed Rules would: (i) define the criteria for grouping swaps into separate swap categories based on common risk and liquidity profiles; (ii) establish methodologies for setting appropriate minimum block sizes for each such swap category; and (iii) provide protective measures to prevent the public disclosure of the identities, business transactions and market positions of swap market participants.

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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 alternatives 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, North and South America, and all other regions where MFA members are market participants.

[2] Further Notice of Proposed Rulemaking on "Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades", 77 Fed. Reg. 15460 (Mar. 15, 2012) (the "**Re-Proposed Release**").

[3] Entitled "The Wall Street Transparency and Accountability Act."

[4] Pub. L. No. 111-203, § 701, 124 Stat. 1376 (2010).

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Executive Summary

MFA applauds the Commission's response to public comments in its re-proposed methodologies for determining the appropriate minimum block sizes in each swap category. MFA believes the re-proposed methodologies are a marked improvement over the previously proposed distribution test and multiple test to determine minimum block sizes.[5]

MFA recognizes that the Commission has a difficult task in balancing the twin statutory goals of enhancing pre- and post-trade transparency in the swaps market on the one hand, while also ensuring that market liquidity is not adversely impacted on the other hand. If minimum block sizes are set too low, we believe inadequate market transparency could harm price competition and lead to wider bid/ask spreads. Conversely, if minimum block sizes are set too high, market liquidity could be adversely affected if market-makers (i) become reluctant to transact in size for fear of being unable to hedge their risks before public disclosure causes adverse price movement in the market; or (ii) quote wider bid/ask spreads to offset this incremental risk. MFA's overarching concern is that the cost of erring in either direction will likely be borne by the end user.

Therefore, MFA respectfully offers a number of suggestions in this letter to assist the Commission in best striking the critical balance between swaps market transparency and liquidity. Our main views are:

I. The granularity of the swap categories can be improved by taking into account different product types within each asset class (*e.g.,* in the interest rate asset class, distinguishing between "vanilla" interest rate swaps ("**IRS**") and swaptions, caps, and floors, among others). Otherwise, MFA believes the Commission's proposed groupings by spread and tenor (for credit) and currency and tenor (for rates) is sufficient.

II. The proposed initial minimum block sizes should be calibrated against current market conditions, rather than based exclusively on a limited, three-month data set from 2010.[6] Selected adjustments to initial minimum block sizes may be warranted due to a combination of: (a) the noted granularity concerns in swap categories; and (b) limitations related to the size, composition, and timeliness of the data set that the Commission used to set its proposed initial minimum block sizes for swap categories in the interest rate and credit asset classes.

III. The Commission should retain the flexibility and discretion to update the post-initial minimum block sizes on a case-by-case where appropriate, for example, by narrowing the look-back window if needed due to material changes in the trading activity in a given swap category.

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[5] Real-Time Public Reporting of Swap Transaction Data; Proposed Rule, 75 Fed. Reg. 76139 (Dec. 7, 2010) at 76175.

[6] Re-Proposed Release at 15468. For clarity, this recommendation pertains to the initial period only, not the post-initial period.

IV. The cap sizes for public reporting purposes should mirror the minimum block sizes for each swap category.

Broadly speaking, if swap categories are properly distinguished in the final rulemaking, we believe the Commission's proposed 67% notional amount calculation provides a viable methodology to calculate post-initial minimum block sizes. However, if swap categories are not properly distinguished, and the Commission cannot ensure a calibration of the initial minimum block sizes to current market conditions, we hesitate to endorse the 67% notional amount calculation in the final rulemaking, and prefer instead that the Commission use a 50% notional amount calculation, particularly in the initial period, with a phase-in to a 67% notional amount calculation over time.

MFA also notes that minimum block sizes are important not only with respect to the reporting delays provided in the Commission's final rules on real-time public reporting, but equally, if not more importantly, with respect to the Commission's yet to be finalized rules on swap execution facilities ("**SEFs**"). Until we know with certainty which modes of execution will be permitted under the final SEF rules, MFA is unable to express a definitive view on the appropriateness of a 67% or 50% notional amount calculation threshold. If the Commission's final SEF rules remain as proposed, MFA believes the Commission should set lower initial minimum block sizes in order to afford greater flexibility in modes of execution (*i.e.*, at the outset, it would be preferable to use the 50%, rather than the 67%, notional amount calculation in the initial period).[7]

I. Swap Categories in the Interest Rate and Credit Asset Classes Should Also Include Granularity by Product Type

MFA strongly believes that the granularity of the swap categories in the interest rate and credit asset classes can be improved by taking into account the different product types within each asset class. Improved granularity is important to avoid "mixing apples and oranges" (metaphorically referring to product types with very different liquidity profiles), both when selecting the appropriate data to calculate minimum block sizes for a given category of swaps, and then, when applying such minimum block sizes to specific categories of swaps within each asset class.

In our view, further granularity is warranted since, as proposed, swaps with materially different trading profiles (*e.g.,* average notional size, number of trades, frequency of trades, number of counterparties, *etc.*) would be grouped together in a single swap category.

[7] *See also* MFA's comment letter to the Commission dated March 8, 2011, in response to the Commission's proposed rulemaking on "Core Principles and Other Requirements for Swap Execution Facilities", 76 Fed. Reg. 1214 (Jan. 7, 2011) (noting on page 8 of our letter the significant impact of a restrictive definition of block trade on transaction liquidity, which would be further decreased if quote-requesting participants have to send a request for quote ("**RFQ**") to more than one recipient). For example, if under the final SEF rules, a counterparty is obliged to send an RFQ to five other market participants, MFA would generally seek a lower initial minimum block size than in the execution scenario where a counterparty were only obliged to send an RFQ to one other market participant.

If swap categories are set too broadly and capture dissimilar product types, the resulting blended data set, when subjected to the notional amount calculation, would yield a minimum block size that is theoretically too low for certain swaps in the category, and too high for others. MFA appreciates that the Commission has taken care to address such results by proposing groupings by spread and tenor (for credit) and currency and tenor (for rates), which sufficiently address this issue along those differentiating factors. However, we believe the Commission's approach would be enhanced if it also took into consideration the fact that there are a limited, though materially important, number of distinct product types within each asset class that could be used to further distinguish categories for setting minimum block sizes.

By introducing this additional granularity by product type within an asset class, we strongly believe the Commission would obtain better tailored initial and post-initial minimum block sizes, irrespective of whether the notional amount calculation is based on a 67% or 50% figure. In fact, with this refinement, the Commission may well obtain an appropriately higher minimum block size for more standardized, liquid, or on-the-run swap categories, and similarly, an appropriately lower minimum block size for less standardized, liquid, or off-the-run swap categories.

If the Commission improves the level of granularity by product type for categorizing swaps in the interest rate and credit asset classes, the 67% notional amount calculation may well be the appropriate calculation for initial or post-initial minimum block sizes. But without such improvements, we fear the 67% threshold could set certain minimum block sizes in the interest rate and credit asset classes too high (or even too low), at least in the initial period.

Interest Rate Asset Class

For swap categories in the interest rate asset class, MFA generally supports the Commission's use of tenor groups and currency groups for establishing swap categories, and does not call for any further granularity within these two factors. In addition, MFA appreciates that the Commission does have the notional amounts calibrated properly relative to each other by tenor (*i.e.,* such that notional amounts are comparable across the curve on a risk-adjusted basis).

We are concerned nonetheless that the Commission has not adequately accounted for differences among product types in the interest rate asset class. Specifically, the proposal combines "plain vanilla" fixed vs. floating IRS with other IRS, including swaptions, caps, floors, inflation swaps, or constant maturity swaps. However, the trading characteristics and liquidity profiles of these products exhibit material differences, the most important of which in this context is their average notional trade size. Based on a recent study of interest rate derivatives by the Federal Reserve Bank of New York**,** the average notional size of trades varies widely by product type, from over $1 billion for overnight indexed swaps (OIS) and forward rate

agreements (FRAs), to between $100-$150 million for "vanilla" IRS and cross-currency basis swaps, to as low as $18 million for inflation swaps.[8]

Accordingly, MFA strongly recommends that the Commission establish separate swap categories for each product type, in addition to the existing groupings by currency and tenor. This change will result in better tailored minimum block sizes. If distinguishing among five to ten product types appears too complex, the Commission should consider distinguishing between those products that are cleared today by LCH and CME (or become clearing-eligible), and those that are not, which we believe, at a minimum, provides a more viable delineation among products.

Such an approach should not cause any concern from a transparency perspective since: (a) the material trading volumes in the market are in the "vanilla" products; (b) there are few, if any, "unsophisticated" users of the more exotic and customized products; and (c) there is little threat of counterparties moving from the "vanilla" to other product types to avoid disclosure requirements (and any risk could be addressed by existing anti-evasion powers to prevent, for example, counterparties from trading deep in-the-money swaptions as a substitute for "vanilla" IRS).

Credit Asset Class

For swap categories in the credit asset class, MFA generally supports the Commission's proposed grouping by tenor and spread to categorize credit default swaps ("**CDS**"). We believe the categories that the Commission has proposed are sufficiently granular, and we do not suggest that any further segmentation within spread or tenor is needed or warranted.[9]

However, we do believe it is important to distinguish between different types of swaps in the credit asset class. Specifically, we believe that the Commission's final rulemaking should establish:

- a separate stand-alone minimum block size applicable to the then current 5-year ("**5YR**") on-the-run CDS index for CDX.NA.IG, CDX.NA.HY, iTraxx Europe, and iTraxx Europe Crossover; and
- separate categories of swaps for indexes, options, and tranches.

Grouping indexes and tranches, which the Commission defines as particular segments of the loss distribution of the underlying CDS indexes, within the same swap category does not adequately account for the differences in trading characteristics among these CDS product

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[8] Staff Report No. 557, Federal Reserve Bank of New York, An Analysis of OTC Interest Rate Derivatives Transactions: Implications for Public Reporting, March 2012. Available at http://www.newyorkfed.org/research/staff_reports/sr557.pdf. *See* specifically Table 1 on page 7.

[9] We are assuming that spread refers to "traded spread" as set forth in proposed sec. 43.6(b)(2)(i) in the Re-Proposed Rules.

types.[10] Data from The Depository Trust & Clearing Corporation ("**DTCC**") shows that the average notional size of transactions for these different products differs materially enough to justify separate swap categories. According to DTCC data for the week ending May 4, 2012, the average notional volume of a new untranched CDS index trade was $199 million, while the average notional volume of a new untranched CDS index trade was $35 million.[11]

Further, as the Commission noted, even within credit default index swaps, for example, more recently issued "on-the-run" indexes trade much more frequently than "off-the-run" indexes.[12] As such, we strongly recommend creating a separate category dedicated to each of the then-current 5YR on-the-run CDS indexes for each of CDX.NA.IG, CDX.NA.HY, iTraxx Europe, and iTraxx Europe Crossover. These dedicated swap categories would only apply to each such then-current 5YR on-the-run index, such that when a new series is issued, the prior series that has "rolled" would then fall into the general 4-6 year swap category.

From the most recent DTCC liquidity study of CDS indexes,[13] it is clear that the trading characteristics of the 5YR on-the-run indexes are markedly different from other tenors and from the off-the-run indexes (*i.e.*, after an index has rolled). Thus, creating a separate minimum block size for the current 5YR on-the-run CDS contract for select indexes would not only result in a more appropriately tailored threshold for that CDS contract, but also would ensure that the block sizes being calculated for the other swaps remaining in, for example, the 4-6 year & < 175 bps category, are not skewed by the on-the-run activity. We respectfully request that the Commission set this minimum block size by creating a stand-alone swap category, since the bulk of current trading activity occurs in the then-current 5YR on-the-run index. Therefore, we believe this is a high-priority item which could benefit most from properly calibrating pre- and post-trade transparency and poses the greater risk of adversely impacting market liquidity if not addressed.

II. Initial Minimum Block Sizes Should be Better Calibrated

MFA is concerned that as proposed, the Commission's 67% notional amount calculation, as applied to a limited, 3-month data set from 2010, provided to the Commission with assistance of the Over-the-Counter Derivatives Supervisors Group ("**ODSG**"),[14] has yielded some anomalous results in setting certain initial minimum block sizes. We think these anomalies could be partially addressed by re-calculating the initial minimum block sizes after improving

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[10] Re-Proposed Release at 15475, fn. 145.

[11] For DTCC data comparing tranched and untranched indexes, *see* http://www.dtcc.com/products/derivserv/data_table_iv.php?tbid=1, http://dtcc.com/products/derivserv/data_table_iii.php?tbid=3 and http://dtcc.com/products/derivserv/data_table_snap0019.php

[12] Re-Proposed Release at 15475, fn. 146. *See also* Staff Report no. 517, Federal Reserve Bank of New York, An Analysis of CDS Transactions: Implications for Public Reporting, September 2011.

[13] 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.

[14] Re-Proposed Release at 15468.

the granularity by product type suggested above. However, in addition, given limitations related to the size, composition, and timeliness of the data set that the Commission used for the initial period,[15] we believe that it would also be worth calibrating the initial minimum block sizes against current market conditions and, where warranted, making adjustments.

For example, we observe that a $250 million notional trade in the on-the-run 5YR CDX.NA.IG Index is not a market-moving event (*i.e.*, that if disclosed in real-time would have a market-moving impact or an adverse impact on liquidity). In fact, multiple dealers regularly quote two-way markets on Bloomberg's ALLQ for this product in $250 million or greater notional sizes. Thus, it is not readily apparent to us how disclosure of such a trade in real-time would inhibit a counterparty from hedging its risk, cause bid-ask spreads to widen, or otherwise adversely affect market liquidity. Nonetheless, based on appendix F in the Re-Proposed Rules, we note that the initial minimum block size for such a swap would be $190 million.

Likewise, for the on-the-run 5YR CDX.NA.HY index, the Commission has proposed an initial minimum block size of $51 million, which is very similar to the size typically quoted on ALLQ by multiple dealers of $50 million.

MFA acknowledges that historical trading data is not the only indicator of liquidity in a product. Current market depth, as evidenced for example by the number of dealers quoting two-way markets in a product, and the notional sizes of the quoted bids and offers, is an equally instructive liquidity indicator. If the threshold to measure the liquidity impact of a given product is whether or not a market-maker has the ability to readily replace its risk before any potential adverse price movements in the market occur, then we submit that examining the relationship between the proposed initial minimum block sizes and current market depth appears to be a good check-and balance mechanism.

To be clear, MFA is not suggesting that the Commission move to one of the alternative approaches outlined in the Re-Proposed Release that sets the minimum block sizes based on current market activity[16] (which we acknowledge can vary over time, and can potentially be manipulated, among other factors that introduce data unreliability). Rather, for the initial minimum block sizes <u>only</u>, since they are being established based on a limited non-current data set, we urge the Commission to undertake a comparison of its proposed initial minimum block sizes with current market conditions, where possible, and make selected calibrations, where appropriate. Such changes would be well-reasoned, justified, and welcomed by the market, and we submit, would not be perceived as arbitrary.

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[15] *Id.* (noting that the interest rate swap data set covered transactions confirmed on the MarkitWire platform between June 1, 2010 and August 31, 2010; the CDS data set from the Warehouse Trust Company LLC covered allocation-level data on CDS transactions for a three-month period beginning on May 1, 2010 and ending on July 31, 2010).

[16] As contemplated in Question 35 of the Re-Proposed Release at 15482.

III. The Commission Should Provide for Flexibility in the Observed Data Set for Calculating Post-Initial Minimum Block Sizes

We are concerned that the Commission's proposed use of a rolling three-year window of data for calculating post-initial minimum block sizes would unnecessarily constrain the Commission's ability to shorten that look-back period if material changes in market conditions were to warrant looking at a smaller set of more recent data.[17] MFA believes that over the next few years there will be substantial evolution in the trading characteristics of the swaps market. For example, the number of market participants may increase, the average trade size may be lower, *etc*. In addition, there could also be one-off, long-term changes or shorter-term shocks that altered the trading patterns for a specific swap contract or category of swaps that would warrant targeted adjustments to the look-back period for one or more swap categories.

MFA believes that the Commission's statutorily-mandated objectives of enhancing pre- and post-trade transparency while protecting market liquidity would be better served if the Commission has the regulatory flexibility to adjust more responsively to any such material market changes. Thus, in the post-initial period, we recommend that the Commission should, as it receives and reviews data collected by registered swap data repositories ("**SDRs**"), and where warranted on a case-by-case basis for individual swap categories or across multiple swap categories, retain the option to:

(i) make more frequent updates to the minimum block sizes, and

(ii) shorten the look-back window for the observed data set.

In these instances, we suggest that the Commission would continue to rely on its overall notional amount calculation methodology. However, for a relevant swap category, we suggest that the Commission would narrow the historical data set as needed, and re-run its analysis outside of any regular annual update process that is applied to all other swap categories.

We respectfully urge the Commission to retain the flexibility to be nimble in updating post-initial minimum block sizes in such extraordinary circumstances, based as always on reliable data from SDRs, so as not to be overly constrained by its own regulations to annual adjustments for all swap categories.[18]

IV. Cap Sizes Should Match Minimum Block Sizes

MFA believes that it is unnecessary for the Commission to establish cap sizes for public reporting purposes that differ from the minimum block sizes for each swap category. We appreciate and support the Commission's efforts to protect the disclosure of the true notional amount of market-moving block trades. We are concerned, however, that the Commission

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[17] Re-Proposed Release at 15517.

[18] *Id*. at 15518 (Proposed sec. 43.6(f)(1) would constrain the Commission's flexibility after the post-initial period by stating that: "No less than once each calendar year thereafter, the Commission shall update the post-initial minimum block sizes.")

would be burdening itself with extra calculations, ongoing maintenance responsibility of separate cap size data on its website, and other administrative work that will likely result from market participants seeking exemptive relief or interpretive guidance based on any anomalies between post-initial cap sizes determined by a 75% notional amount calculation and post-initial minimum block sizes determined by a 67% notional amount calculation for each swap category. We believe this additional resource burden on the Commission, as well as the corresponding compliance duties for SDRs, SEFs and other market participants to report trades in accordance with different cap size levels, is not justified by the marginal increase in transparency that results from higher cap sizes for public reporting purposes. Moreover, we do not see any meaningful price transparency benefit resulting from higher cap sizes that would outweigh these burdens.

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MFA appreciates the opportunity to comment on the Commission's Re-Proposed Rules. If the Commission or its staff has questions, please do not hesitate to call Laura Harper or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

cc: The Hon. Gary Gensler, Chairman
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Scott D. O'Malia, Commissioner
The Hon. Mark P. Wetjen, Commissioner