SDMA SWAPS & DERIVATIVES MARKET ASSOCIATION

May 14, 2012

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

Re: RIN 3038-AD08; In Consideration of Appropriate Block Trading Thresholds with Regard to Swaps Execution and Trade Reporting

Dear Mr. Stawick:

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "CFTC") on the CFTC's Notice of Proposed Rulemaking regarding **Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades (17 CFR Part 43).**

The SDMA is a non-profit financial trade group formed in 2010 to support the goals of the Dodd Frank Act. It believes that systemic risk of OTC derivatives can be mitigated through their regulation, the creation of central clearing, and by ensuring open and transparent access to ensure greater competition, lower transaction costs and greater liquidity. The SDMA is comprised of many US and internationally based broker-dealers, investment banks, futures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets.

The SMDA respectfully requests that the Commission additionally consider its earlier comment letter to the CFTC with regard to block trade thresholds, dated February 2, 2012.

Introduction

Setting block trade thresholds correctly for SEF trading is important to ensure increased transparency in the OTC swaps marketplace for a post Dodd Frank world. Too low a block threshold and fewer trades will be executed on SEFs as little structural change in swaps execution occurs, increased competition fails to manifest itself and more diverse liquidity is impaired. Too high a block threshold and the liquidity provider is legitimately put at risk as available market liquidity at time of trade fails to absorb

the block trader's offsetting trade or hedge completely, which in turn also has a negative impact on structural liquidity.

The block trade threshold rule then should be balanced, flexible and adjust as market conditions, in the long run, adjust. The SDMA asserts that the CFTC block trade threshold methodology for interest rate swaps and credit indices is appropriate in its approach of *percentage of notional traded* set at 67%, but respectfully recommends, that when considered in concert with *the market depth* and *breadth approach* (discussed below and in Question 35.a), such a threshold should be set higher at 75% of trade notional.[1]

Congressional Intent: 50%, 67% or 75%?

Sixty seven per cent of trade notional is consistent with Congressional intent. When debating the Dodd Frank Act in 2010, Congress argued that the guiding principle "… in setting appropriate block-trade levels should be that the vast majority of swap transactions should be exposed to the public market through exchange [or SEF] trading."[2] The SDMA submits that that the CFTC is correct to assert that "vast majority" *equates* with 67% per cent of trade notional. In fact, the SDMA believes that "vast majority"' should equate with the *more appropriate* 75% per cent of trade notional for the block trade threshold.

That Congress did not intend that "vast majority" equate with 50%, is clear— by definition, such a percentage is not even a simple majority. Simply put, had Congress intended that 50% of trade notional be the block trade threshold, it would have said so—it would have declared "half of swaps transactions should be exposed to the public market." The record plainly shows otherwise.

That Congress did intend a higher percentage of trades well above 50% is supported by the fact that Congress also intended that the trade reporting "tape" have value and meaning to the marketplace. Discussed below, such a percentage is low when compared with average trade size and suggested block thresholds from a market depth analysis. For example, for the three year interest rate swap, 50% would equate to a $240 Million notional block. This is only slightly higher than the average trade $221 million notional--a mere $19 million or 8.50% difference.

A tape that reported a block trade 15 - 30 minutes in arrears, where its true size is also shielded, and where the block trade was slightly above the average ticket size would have little practical significance and value to the market. Because a tape based on a 50% threshold would have little value to the market, it is contrary to Congressional intent and should not be permissible.

Market Depth Considered Relative to 50% of Notional –Question 35.a

But 50% of trade notional should be discounted because it's not a true reflection of liquidity conditions in the market—based on the *Market Depth* and *Breadth* test.

The Commission defines a block trade to be "large-sized transactions that would cause a *significant* price impact if required to be executed on the DCM's centralized market." In other words, a block trade is a trade whose size is so large that it cannot immediately be absorbed by all the current or *available* liquidity--bids or offers--in the marketplace during a given time period at the current price. Thus, it

[1] The SDMA supports the CFTC Block Trade Threshold for Commodities, Foreign Exchange and Equity based product. The focus of this comment letter is Interest Rate Swaps and Credit Derivative Indices.
[2] S5922 (Congressional Record, July 15, 2010).

follows; the block trade threshold should be *equal to sum of orders* available to the block market maker to trade against.

For the swap seller, therefore, if the block trade amount that it wishes to sell is higher than the *sum of available bids* in the marketplace at the *current price*, then it is clear that the entire trade size cannot be absorbed by the market and that trade is certainly a "block". But if the block trade amount that the seller wishes to sell is below the *sum of all bids* in the marketplace at the *current price*, then it is also true that such a trade cannot be a block—because it is readily absorbed by the market's available liquidity and does not "move the market".

To better illustrate this example consider *Exhibit A* attached from Bloomberg's ALLQ trading system from February 24, 2012. Barclays quotes the two year interest rate swap at Bid: 0.603 / Offer: 0.613, both bid and offer for $400 MM notional in size. That means that Barclays, a dealer, will buy $400MM at 0.603 yield and sell to you $400MM at 0.613 yield. For the lay person, these are large notionals to be sure, but not atypical in the swaps market where the average two year trade size is $344 million.

For the two year swap, to set the block trade threshold *equal* to $460MM would be to set the threshold only marginally higher that the quoted size of $400MM that Barclays, one out of several dealers, was willing to trade with a customer. Presumably, the other listed dealers showing quotes at the current price for $750MM would be willing to buy the remaining $60MM.

It is fair to conclude that setting the block threshold *equal* to $460MM is not the optimal threshold because the market can readily absorb such size. In this case – one dealer can absorb $400MM alone, with the remaining $60MM absorbed by the other quoting dealers. As a result, the *50% of trade notional approach*--that suggests exactly $460MM as its block trade threshold --is too low relative to available liquidity in the marketplace. In this instance, it is difficult to see how the liquidity provider would be harmed and consequently need the protection of a block rule—when its trade size is readily absorbed by the market.

But is the Barclays quote an anomaly or truly reflective of one quote from one dealer out of many? To answer this, we consider Market Depth and Market Breadth.

Market Depth Test

We argue that rule makers should set the block threshold at least equal to the Market Depth discussed in Question 35.a.

Discussed in more detail in our earlier letter, the SDMA defines Market Depth ("MD") as the sum of Observed Liquidity ("OL") at *time of trade*.[3] For the seller, available liquidity is the sum of all bids at the current price for a given swap. For the buyer, it is the sum of all offers at the current price for a given swap.

$$\text{Market Depth} = \sum \text{OL}$$

[3] See page 2 of the *SDMA Letter to CFTC RIN 3038-AD08: Real-Time Public Reporting of Swap Transaction Data*, dated 2/2/12.

Figure 1 (below) considers Market Depth, which is equal to Observed Liquidity for the largest and most liquid US interest rate swap market: dollar denominated, 3 month Libor indexed swaps.[4] The first column is the swap maturity. The second column shows the "screen size" or the standard size increment in which the swap price is customarily quoted by market practitioners. The third column displays average trade size. The fourth column displays swap sizes as a function of the 50% of trade notional approach. The fifth column displays notional swaps sizes as a function of the 67% of trade notional approach. The sixth column considers the Observed Liquidity ("OL").

Swap Maturity	*Screen Size (MM)*	*Average Trade Size**	*50% Block Size*	*67% Block Size*	*Observed Liquidity*	*MD Block Size*	*Multiple of MD*	
							50%	*67%*
2yr	200	344	460	750	1,493	1,493	0.3	0.5
3yr	150	221	240	380	1,131	1,131	0.2	0.3
5yr	100	126	240	380	762	762	0.3	0.5
7yr	75	113	170	290	524	524	0.3	0.6
10yr	50	85	170	170	392	392	0.4	0.4
30yr	25	52	120	210	168	168	0.7	1.3

** LCH Data from1/25/2012*

Figure 1. Market Depth, 50% & 67% Considered

Market Depth Method Discussed

To arrive at Observed Liquidity, we sampled six dealers' live actionable prices for each of the following: 2 year, 3 year, 5 year, 7 year, 10 year and 30 year. This is a conservative approach because we assumed that only six dealers exist in the market. Daily, we sampled dealer's bid size and offer size at the current price. We defined *current price* to equal the *highest* bid or *lowest* offer in addition to quotes captured within a *quarter basis point* of the highest bid and lowest offer. Likewise, we ignored order size when it was associated with bids *lower than* or offers *higher than* the acceptable current price.

We then took the average of each daily observation for a given swap over the given time series[5] to arrive at Observed Liquidity for the particular swap ("OL").[6] With regard to the suggested Market Depth method in Question 35.a, the SDMA believes that the Commission's approach is consistent in terms of approach. The SDMA sampled six dealers consistently, which is conservative, but agrees that sampling the entire marketplace through SEFs, as suggested in Question 35.a is a more scalable test and more representative of the market.[7]

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[4] For convenience purposes such a test is interest rate swap based. The same test can be run for credit indices or indeed any traded product.

[5] We took collated data from each dealer over the time interval from January 2012 to April 2012.

[6] Since dealers typically quoted the same size for both the bid and the offer for a particular swap, the Observed Liquidity only captures one side—either all bids or all offers. This properly accounts for observed liquidity available to either the swap seller or swap buyer.

[7] The SDMA recommends that to better "trim" the data set in Question 35 (a), the Commission trim bids and offers with a similar definition of SDMA "current price". To achieve this, it is recommended that the Commission take half the bid-offer spread and capture such orders within the bid and this range value and likewise the offer and this range value.

Block Thresholds Determined

Setting Observed Liquidity equal to Market Depth, we argue that this is the *optimal* notional amount at which block trade threshold should be set. To set the block threshold below the Market Depth would mean that the block trade is readily absorbed by the market, with some residual liquidity remaining — this by definition is not a market moving trade. Such a trade would not result in harm to the block trade liquidity provider.

Conversely, to set the block threshold above the Market Depth would mean that the block trade is not readily absorbed by the market, because some residual amount would still remain—this by definition is a *market moving* trade or 'block trade.' Such a trade *would* result in harm to the block trade liquidity provider.

Consider *Figure 1* above for the two year swap. The Observed Liquidity and Market Depth indicated is $1.493 billion in notional size. That means that the market could absorb $1.493 Billion at the current price without moving the market. When considered relative to the suggested block threshold of 50% of trade notional of $460MM, which is 30% of the Market Depth amount, it is clear that the 50% block threshold number is *too low* and should not be adopted.

When considered relative to the suggested block threshold of 67% of trade notional of $750MM, which is 50% of the Market Depth amount, it is clear that even the 67% Block threshold number is also too low and should be rejected in favor of a large percentage of trade notional. The SDMA recommends 75%.

Such a finding is also consistent across the yield curve: 3 year, 5 year, 7 year, 10 year and even 30 year swaps. Only at the 67% of trade notional threshold for 30 year swaps does the suggested threshold amount, $210MM, exceed the suggested Market Depth block threshold of $168MM.

But our Observed Liquidity only considers six dealers. What about the liquidity that another 20-25 market makers may provide?

Thus, based on our first test — the Market Depth test — we suggest that block thresholds for dollar denominated, Libor indexed swaps be the following: 2 year ($1,493 MM), three year ($1,131 MM), five year ($762 MM), seven year ($524MM), ten year ($392 MM) and thirty year ($168MM).

Market Depth Test & Time Considerations

The Market Depth test is conservative also because it ignores additional available liquidity within the delayed reporting window set by the CFTC. The CFTC has recently mandated that such a time period shall be 30 minutes for the first year and then 15 minutes thereafter.

As previously discussed, a block trade is a trade whose size is so large that it cannot immediately be absorbed by all the current bids or offers in the marketplace *during a given time period*. If the market maker has 30 minutes in which to hedge its position or trade out of the position completely—what is the likelihood that new bids and offers appear in the market within that time frame?

The Market Depth test only captures the Observed Liquidity that is immediately available to be swept by the block market maker. It does not capture the subsequent prices that would enter the market in the 30 minute hedging window that follows. Because it is highly likely that several new bids and offers

would enter the market place within the 30 minute window post immediate liquidity being swept by a block trade, the Market Depth test and its resultant block trade thresholds suggested here should be viewed as the conservative low end of where thresholds should be set by the rule maker.

Market Breadth Test

But what about off coupon and off maturity swaps? Can you measure the Market Depth for each individual swap?

Analyzing well established trading and hedging techniques of less liquid swaps, we find it is not necessary.

The SDMA agrees with the Market Breadth test as suggested in Question 35.a. Such a test recognizes that swaps are traded, hedged and risk managed on a *portfolio basis* by market makers. Simply put, current trading practice and risk management techniques recognize that market makers rarely hedge or trade out of *off-market* block positions using the exact swap in question—the "focus swap".

Instead, market makers synthetically create an opposing or hedge position that replicates the risk characteristics of the focus swap. Hedgers create such a synthetic position by use of a basket of swaps within the same category. For example, to hedge a $500 Million 8.10 year, US Dollar denominated, 3 month Libor swap, the trader could create a synthetic opposing position with a basket of 7, 8 and 10 year US dollar denominated interest swaps.

To determine the block trade threshold then for an off market swap, hedgers concern themselves not with the liquidity of specific focus swap traded, but with the sum of the available liquidity that exists for the swaps of the same category from which the trader uses to hedge. Thus for the 8.10 swap, the block trade threshold should equal the sum of Market Depth for a possible liquid swaps within the same category.

$$\text{Market Breadth} = \sum OL_{\text{focus swap, liquid swaps (same category)}}$$

The SDMA submits that the categories suggested by the Commission are generally consistent with market practice in determinants: currency, index, callable/non-callable, maturity or tenor.

The Market Breadth test is conservative because it only considers liquidity of liquid swaps within the same hedging category. It is possible to use non category swaps for hedging purposes to avail of their liquidity if desired or necessary. For example, you could hedge a five year swap with a two year and thirty year swap.

The Market Breadth test is conservative because it ignores availing hedging tools such as US Treasuries or Euro Dollar Futures. Using Eurodollar futures, which are highly liquid, can prove to be quite an efficient hedge especially in the shorter swap maturities. Thus, it could be argued that the liquidity of such tools be included in each respective swap category.

Data Availability For Market Depth and Breadth Tests

The SDMA sampled six dealers and assumed them to be the complete pool of liquidity providers. For a more complete data set, however, the SDMA agrees with the Commission approach to capture data

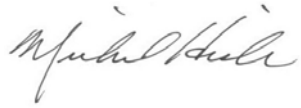
directly from SEFs and DCMs. The CFTC has authority to capture such data and providing such data to the Commission should not prove difficult for SEFs. Most SEFs typically capture this data already.

The SDMA recommends that the Commission adopt such an approach at its earliest convenience, perhaps after six months of data capture from SEFs and DCMs.

Conclusion
The SDMA submits that the CFTC block trade threshold methodology for interest rate swaps and credit indices is appropriate in its approach of *percentage of notional traded* set at 67%, but respectfully recommends, that when considered in concert with *the market depth* and *breadth approach* discussed in Question 35.a, such a threshold should be set *higher* at 75% of trade notional.

Both the *market depth* test and the *per cent of notional traded* test should be taken together for the first year until data gathered becomes significant. In the long run, the *market depth* test properly considers liquidity as a function of *orders* not just *trades* and properly sets the optimal block trade threshold not only for OTC derivatives, but also for other asset classes. Such a test is scalable, easy to administer and would be cheap to create. In today's technology environment, data capture and accessibility has also become less challenging.

Respectfully Submitted,



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

RULE QUESTIONS ANSWERED

Should the Commission provide for special swap categories and appropriate minimum block size methodologies for bilateral versus cleared swap transactions? If so why? (Question Number 1 (p. 15468))

The Commission should apply one test for each swap category, regardless of cleared versus bilateral.

Are the proposed criteria, by tenor and currency type, the correct approach for determining swap categories in the interest rate asset class? Should any other characteristic be considered to create categories? (Question Numbers 2 - 8 (p. 15472 - 73))

Swaps are traded and risk managed on a portfolio basis. For illiquid *off-tenor* or *off-coupon* swaps, market practitioners generally do not seek to trade out the block position immediately. Instead, market makers replicate the swap synthetically using a basket of liquid swaps around such a position. The liquidity provider then executes the opposing synthetic swap to hedge the off market position. Thus, the guiding principle for categorization should be what hedging tools will most likely be used by the hedger –and from these instrument clusters, categories should be formed. The CFTC categories are therefore appropriate and accurate in terms of currency, index, and tenor.

Is the 67% notional amount calculation the appropriate methodology for calculating minimum block size for IRS and credit assets classes? Question Number 32 (p. 15480) Is there any part of the swaps market for which a 50% notional amount methodology would be appropriate? (Question Number 33 (p. 15480 – 81))

Considered relative to a *market depth* and *market breadth* analysis, discussed above, the SDMA believes that 75% of notional is a more accurate and suitable capture of true block trade thresholds.

Instead of the 67% notional amount calculation the appropriate methodology should the Commission based minimum block size on alternatives tests such as: (a) market depth and breadth Question Number 35.a (p. 15482), (b) average volume in a given time period, Question Number 35.e (p. 15483) (c) the volume of a portion of trades, Question Number 35.f (p. 15483) (d) impact of trade sizes on price? Question Number 35.h (p. 15484) Is the proposed method of using a "trimmed data set" (i.e.; a data set in which extraordinarily large notional transactions are removed) appropriate for calculating minimum block size? (Question Numbers 34.a and 34.b (p. 15482))

The SDMA supports the *market depth* & *market breadth* methodologies discussed in Question 35.a. Such an order driven approach taken in tandem with the trade notional approach will return a more complete analysis from which block trade thresholds may be set. The SDMA recommends that the CFTC adopts the *market depth* & *market breadth* approach as the data becomes available from execution venues.

The SDMA does believe that *average volume in a given time period* method is an accurate or reliable test. Please see earlier SDMA analysis of ISDA average volume test in SDMA comment letter to CFTC with regard to block trade thresholds, dated February 2, 2012.

Is the Commission's approach that it determines minimum block size correct? Question Number 61 (p. 15489) Alternatively, should a SEF or DCM determine minimum block size? Question Number 62 (p. 15489) If the Commission were to permit SEF and DCM to determine minimum block size, what would be appropriate parameters to give to SEF and DCM to ensure that there are standard minimum block sizes? (Question Number 62b (p. 15489))

The SDMA recommends that the CFTC set the block trade threshold for trading. It is not uncommon for OTC derivative execution venues to experience and/or succumb to external pressures from its largest liquidity providers in exchange for increased order flow. Thus, SEFs could opt to lower block trade

thresholds for their own financial gain, but at the expense of transparency, competition and more democratized market liquidity. With few liquidity providers still today, and pre trade transparency not guaranteed, such pressures will persist until regulators ensure a level playing field that in turn attracts more liquidity providers, greater competition and lessened incumbent influence.

Is the method for setting initial cap size – the maximum notional amount that is reported on a block trade -- appropriate? Question Number 71 (p. 15493) The initial cap size is the greater of block size set in Appendix F and those stated in 43.4(1) (i) (for interest rate swaps - $250 million for IRS with tenor of up to two years, $100 for IRS with tenor between two and 10 years, and $75 million for IRS with tenor of over 10 years) and 43.4(h)(1)(ii) (for credits asset class - $100 million). Is the use of 75% of notional amount calculation appropriate for determining post initial cap sizes? Question Number 72 (p. 15493)

The SDMA supports the proposed Cap Size rule for interest rate and credit default indices. Such a cap size (75% of notional size) is appropriate and consistent with the SDMA's recommendation that, when considering per of notional traded, block thresholds should be set equal to 75%, and not 67% of notional traded. Discussed above, the SDMA believes that, when considered in concert with market depth and breadth methodologies, 75% of notional is more representative of actual block trade thresholds in the swaps market. Given that the liquidity provider also has 30 minutes in year one, and 15 minutes in each year thereafter, to report the trade to the market, the SDMA believes that the liquidity provider is appropriately protected from market forces that might otherwise act against it.

Exhibit A: Bloomberg All Q, 2/24/2012

USSWAP2 Index ALLQ — CurncyALLQ

USD SWAP SEMI 30/360 2YR | 93) Launchpad | All Quotes

10:37:10 | 94 Suspend Sorting | 97) Settings

PCS	Firm Name	Bid	Ask	BSz(MM)	ASz(MM)	Time
CMPN	Composite(NY)	0.6075	0.6110	0.04 x	0.04	10:36
CBBT	SwapTrader Comp	0.6070	0.6110	x		10:37
CSSW	CREDIT SUISSE INTL	0.60600	0.61300	250 x	250	10:36
WLSW	WLB Swaps	0.6100	0.6160	250 x	250	10:35
HSBC	HSBC Bank	0.60500	0.61500	250 x	250	10:35
BXSU	BARCLAYS CAPITAL	0.60300	0.61300	400 x	400	10:33
BGN	Bloomberg BGN	0.6056	0.6125	x		10:37
CMPN	Composite(NY)	0.6075	0.6110	0.04 x	0.04	10:36
LAST	Last Update	0.6070	0.6120	x		10:36
BMOD	Nesbitt Burns	0.5970	0.6310	x		10:36
BLC	Bloomberg (Calc)	0.5984	0.5984	x		10:34
TPRA	TP Rates	0.5950	0.6350	x		10:34
ICUS	ICAP PLC US	0.5920	0.6320	x		10:32
TIRS	TRADITION NA	0.6010	0.6150	x		10:31
PREB	TP US	0.5890	0.6290	x		10:29