J.P.Morgan

January 12, 2011

Mr. David A. Stawick
Secretary
Commodity Futures
Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange
Commission
100 F Street, N.E.
Washington, D.C. 29549-1090

Re: (1) CFTC Proposed Rule on Real Time Public Reporting of Swap Transaction Data 75 Fed Reg. 76140 (December 7, 2010) (the "CFTC Rule")

(2) SEC Proposed Regulation SBSR – Reporting and Dissemination of Security Based Swap Information 75 Fed Reg. 75008 (December 2, 2010) (the "SEC Rule") (collectively the "Rules")

J.P.Morgan ("JPM") welcomes the opportunity to provide comments to the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**") (each "**the Commission**" and together the "**Commissions**") with respect to the CFTC Rule and the SEC Rule regarding public reporting of swap information. We believe that the Rules generally promote the public policy objectives of promoting price transparency and enhancing price discovery while at the same time avoiding a material reduction in market liquidity. We believe however, that the Rules should be revised to minimize the risk of unintended consequences without compromising the achievement of these important public policy objectives.

JPM's Comments

We believe that there are two separate and distinct aspects to the impact of the Rules on the Swaps and Securities Based Swaps markets. This first aspect is the impact of a post trade transparency regime on the operation of those markets, including trading impact and impacts on market liquidity, as well as the effects of certain concepts such as block trades on other aspects of the implementation of the Wall Street Transparency and Accountability Act of 2010 ("Title VII"). Those concerns are the subject of this comment letter. The second

aspect is the operational burden and complexity of implementing a post trade transparency regime along the lines of those set forth in the Rules. This second aspect is currently being analyzed and does not form the subject matter of this letter. Attached to this letter is a powerpoint presentation which contains useful background information and which is incorporated by reference herein.

Impact on liquidity

JPM has two principal concerns with the Rules as proposed. The first is that corporate end users are likely to see a significant increase in costs for large, customized hedging transactions, particularly in Commodity, Interest Rate, Foreign Exchange and Equity markets. The second concern is a likely reduction in market depth in all derivatives markets. Both of these potential effects (increase in transaction costs and decrease in market depth) are aspects of liquidity.

In its Advance Notice of Public Rulemaking ("ANPR"), the CFTC states that although dealers have frequently argued that post-trade transparency may reduce liquidity in some settings, there is no empirical evidence of this. Both Commissions also state that the experience of implementing TRACE and the resulting academic studies support of the notion that transparency reduces transaction costs and does not decrease depth, and hence liquidity does not suffer. In light of the statutory requirement to consider the impact on liquidity of the Rules, these claims warrant especially close inspection.

First we must define liquidity. As Bessembinder et al note[1] in their discussion of TRACE[2]: "liquidity can include "tightness", which is the cost of completing a buy and sell transaction in a short period of time, "depth", which is the size of the buy or sell order required to move prices by a given amount, and "resiliency" which is the speed with which prices recover from a random shock in buy or sell orders." Bessembinder et al go on to point out that most of the studies of TRACE's effects have focused almost entirely on the tightness concept. Specifically, of the three major academic studies of TRACE's effects,[3] only Goldstein et al

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[1] Kyle, A., 1985, "Continuous auctions and insider trading", Econometrica, 53, 1315-1336.

[2] Maxwell, William F. and Bessembinder, Hendrik (Hank), Transparency and the Corporate Bond Market. Journal of Economic Perspectives, 2008.

[3] Amy K. Edwards, Lawrence Harris, & Michael S. Piwowar, Corporate Bond Market Transparency and Transaction Costs, J. of Fin., Vol. 62, at 1421-1451 (2007); Hendrik Bessembinder, William F. Maxwell, & Kumar Venkataraman, Market Transparency, Liquidity, Externalities and Institutional Trading Costs in Corporate Bonds, J. of Fin. Econ., Vol. 82, at 251-288 (2006); Michael A. Goldstein, Edith S. Hotchkiss, & Erik

attempt to address any aspect of liquidity other than tightness: they estimated the impact of TRACE on trading volumes[4]. As vividly demonstrated by the "flash crash" events of May 6, 2010 trading volume and depth are not the same, especially once markets become electronic and high frequency trading techniques become prevalent: much of the volume created by these techniques disappears when liquidity is most needed. So we are left with no empirical evidence for or against the impact of transparency on depth. But the statute does not limit its requirement to consider the impact of the Rules on liquidity to empirical evidence and the anecdotal evidence gathered independently by Bessembinder et al[5] is nearly universal in the conclusion that institutional customers experienced less deep markets as a result of TRACE. Finally, it's particularly important to note that TRACE was implemented contemporaneously with a period of rapid growth in the single name credit default swap ("CDS") market, which provided market participants with the means to trade block sizes of risk analogous to corporate bond risk outside of the TRACE framework. The existence of this "safety valve" means that the likely impact on depth may well have been much more substantial if, as will be the result under the Rules, trading in both bonds and CDS had been made subject to real-time public reporting simultaneously.

Furthermore, while the three studies showed decreases in transaction costs in the corporate bond market, we do not believe that result can be extrapolated to the Swap markets. The empirical evidence on this point is quite strong: Goldstein et al find no reduction at all in transaction costs on trade sizes above 1,000 bonds, or $1,000,000 par value. Similarly, Edwards, Harris and Piwowar find extremely weak effects at the 1,000 bond trade size and those for only part of the TRACE universe[6]. The average trade size for single name CDS -- the most direct Swaps analogue to corporate bonds -- is between $5 and $10 million. So the strongest evidence for transaction cost reduction is in a segment of the corporate bond that is completely non-existent in Swaps.

R. Sirri, Transparency and Liquidity: A Controlled Experiment on Corporate Bonds, Rev. of Fin. Stud., Vol. 20, Issue 4, at 235-273 (2007), at 269, 270.

[4] They did not observe a statistically significant effect on trading volumes.

[5] Bessembinder and Maxwell (2008).

[6] Bessembinder et al (2004) do study larger trade sizes by using the NAIC database of insurance company trades, and they find some reduction of transaction costs even for larger trade sizes. However, insurance company trading only represented 12.5% of the market volume in their study, and the trading style of insurance companies is sufficiently different from that of the rest of the corporate bond market that to generalize from that sample may not be justified. Certainly, to further extrapolate from that sample to all Swaps markets in light of major differences between asset classes and the generally higher level of average sophistication of Swaps market participants is, in our view, not supported by their results.

In summary, a review of the academic literature on the impact of transparency on liquidity indicates that:

(i) A majority of the studies found no effect on transaction costs even for small institutional trades ($1mm par value);

(ii) The impact on depth was not studied directly; and

(iii) Independently gathered anecdotal evidence from institutional buy-side customers was nearly universal in describing a decrease in depth after the implementation of TRACE.

If we apply these conclusions to the individual markets under the jurisdiction of each Commission, these results indicate that even in the case of single name CDS[7] the SEC cannot use the TRACE experience to satisfy the Congressional mandate to consider the impact on liquidity. But an even greater concern, and one that speaks directly to the impact on corporate end users, would be for the CFTC to incorrectly extrapolate the TRACE experience with corporate bonds to the Swaps markets over which it now has jurisdiction. The market for corporate bonds, even before the advent of TRACE, had a significantly different structure from the markets under the CFTC's jurisdiction. Corporate bonds are inherently much more idiosyncratic: there are tens of thousands of tradable instruments, compared to a few hundred significant ones in swaps, and their correlation to each other is lower. This meant that the frequency of large block trades was naturally lower, even before any impact that TRACE had on market depth. In addition, the secondary market for corporate bonds is entirely financial: there are no analogues to the corporate end user hedgers who are so active in FX, Commodities and Interest Rates. These observations strongly buttress the SEC's own cautions that structural differences between the securities markets and the Security-based Swap markets make extrapolation of the TRACE results problematic. In terms of these differences, our greatest concerns are in the following two areas:

(i) Customized Blocks: a material proportion of end-user hedging involves Customized Blocks, which in terms of size and customization are entirely absent from the corporate bond experience; and

[7] The market which is most directly analogous to corporate bonds.

(ii) Standardized Blocks: these are much more commonly used by professional asset managers in the CFTC's markets than they are in corporate bond or single name CDS markets, so the risks of an incorrectly applied analogy are also high here.

Translating these concerns into specific elements of the proposed Rules, we note three specific areas where the potential effect on end-users is greatest, and where history is of very limited use as a guide: (1) the determination of block size thresholds, (2) the time delays for block reporting, and (3) the use of size masking. We address each in turn.

Determination of the Appropriate Minimum Block Size

The determination of the Appropriate Minimum Block Size is among the most important elements of Title VII. If too many trades are treated as blocks, then the objective of increased transparency and greater organization of the price formation process may be undermined. On the other hand, if too few trades are eligible to be blocks, implementation of Title VII could significantly reduce liquidity. The latter is true not only because the block size definition affects the time for reporting the trade, but also because the block size definition affects whether a transaction must be executed on a SEF. When considering the significance of the SEF mandate, it is important to note that although Congress wisely exempted corporate end-users from the requirement to execute on a SEF, most financial end-users of Swaps, because they qualify as "financial entities", are not exempt from the SEF trading requirement. This means that professional, highly sophisticated users of the OTC derivatives market are losing the ability to negotiate prices for their transactions in the way that they believe maximizes the returns to their shareholders and other investors. Title VII gives significant discretion to regulators to ensure that in the process of adding transparency to the Swaps market the Commissions do not undermine the effective functioning of a critical part of the American capital markets. Using that flexibility wisely in defining the Appropriate Minimum Block Size is critical to a successful implementation of Title VII.

JPM commends the CFTC for its proposal of a flexible and sophisticated framework for determining the Appropriate Minimum Block Size. By referencing the transaction data collected for each Swap instrument and applying non-asset–class-specific mathematical formulae to the data, the proposed Rule minimizes the chances that a rule that works well in one asset class would not work effectively in a different one. Further, we recognize that the Commissions have a legitimate interest in not characterizing a large proportion of the Swap transactions as block trades. We believe, however that the CFTC has calibrated its

framework to produce Appropriate Minimum Block Sizes that are excessive, and that the proposal will reduce liquidity materially.

Before discussing the formulae themselves, we would like to address the CFTC's analysis of three futures contracts in footnote 84 of the CFTC Rule[8]. From this analysis, the CFTC concludes that the "natural" state of futures markets is for a miniscule proportion of transactions to be blocks, and therefore that the minimum of 95% established in the proposed rule provides adequate flexibility for less liquid Swaps markets. We strongly disagree with the analysis employed in footnote 84 because its logic is fatally flawed by the failure to capture economically equivalent transactions that occur in the OTC market. A thought experiment is useful to clarify the point: imagine a market consisting of a regulated central order book marketplace with very high block limits and very short delays for reporting the blocks after execution. Then imagine that a parallel marketplace exists for the economically equivalent risk in which all transactions are privately negotiated and there is no real time post-trade reporting required. Further, imagine that market participants occasionally believe that certain large transactions need to be negotiated privately to obtain the best price, and that pricing for these transactions will improve if the trade is not reported, or at least is reported with a delay. Clearly, market participants wishing to negotiate privately will choose to transact in the parallel OTC market. This will result in the block trade percentages reported in the regulated central market being vanishingly small, which is, in fact, what the CFTC observes. However, this is not equivalent to saying that there is no natural desire among market participants for private negotiation. In fact, what it suggests is that the preference of market participants for privacy in negotiation as well as delays in reporting is so strong that they simply do not bother to make use of the block trading provisions of the central market because despite allowing for private negotiation, the extremely short delay in reporting the block transaction is sufficiently damaging to liquidity (as defined by the ability to obtain the best price for size the customer wants to transact) that customers almost always choose to transact their larger sized trades in economically equivalent form through the fully private OTC market.

Now bringing back this thought experiment to the actual markets observed, we note that the Eurodollar market has an entire suite of economically similar OTC products in the form of FRAs, OIS Swaps, short-dated interest rate swaps, and other similar instruments that allow market participants to obtain very similar risk profiles to that provided by Eurodollar contracts without accessing the central market. Similarly, in the WTI and RBOB futures markets, there is a parallel OTC swap market. Not considering these markets in the analysis results in an

[8] 75 Fed Reg. 76162

incorrect conclusion -- analogous to concluding that demand for rapid travel between New York and Chicago is low because the fastest trains are not always full, without noting that travelers have the option to take a plane which is faster and cheaper. Following this analogy, the Commission is proposing to severely curtail the availability of plane travel without making any allowances for the resulting increase in demand for speedy train travel—by simultaneously bringing the OTC market under its jurisdiction and failing to make adequate provisions for the need for private negotiation.

Fortunately, the energy options markets provide an opportunity to look at the totality of the marketplace across regulated central order books and privately negotiated OTC markets. This is because these markets have opted to centrally clear transactions executed OTC through submission to CME ClearPort. Once submitted, the volumes are visible and reported by the CME Group. Natural Gas European-style options (contract code "LN") provide a useful example to study. The CME reports that for the month of November, the average daily trading volume of LN was 93,525 contracts. On the randomly chosen day of Tuesday, December 7th, the CME reports trading volume of 81,015 contracts across 194 unique contracts, which indicates that this date is representative of a typical trading day. Of this total volume, 73,148 contracts, or 90.3% of the total, were privately negotiated. This is a striking conclusion: in the market for options on one of the most significant commodities for the US economy,[9] market participants choose private negotiation over 90% of the time. This real world evidence simply cannot be reconciled with the assertion in the proposed rule that even in less liquid markets, only a tiny proportion of transactions are executed through the block exemption.[10] When the analysis includes all economically equivalent risk in a fully competitive market devoid of any capital- or operationally-based barriers to entry[11], not only are privately negotiated transactions a material proportion of the overall market, they are in many cases a large majority of the market. As a result, the proposed Rule, which assumes that such activity is not material, will severely curtail it, reducing liquidity and increasing costs for market participants.

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[9] Natural gas is the third most important fuel source in the US.

[10] The CFTC also fails to distinguish between trades and orders. As markets have electronified, orders are increasingly broken up into extremely small individual trades. This will tend to further artificially depress the reported percentage of block trades.

[11] Because the clearing venue is ClearPort and these contracts are treated as futures for clearing purposes, market participants have access to the full slate of FCMs, many of which are lightly capitalized, as well as self-clearing startup market-markers.

A secondary flaw in the CFTC's analysis is its comparison of the liquidity in futures to that in OTC markets. The CFTC chooses three futures contracts (Eurodollars, WTI and RBOB) and characterizes them as representing a range of liquidity. In particular, it describes the RBOB market as representing the less liquid end of the spectrum. According to CME Group's Monthly Energy Update, in November 2010 the RBOB contract had an average daily notional traded volume of $11.06 billion, with an annualized volatility of 27%. This results in daily risk-adjusted[12] volume of $190 Million. By the same measure, the most liquid OTC derivative, the 10 year plain vanilla fixed floating interest rate swap, has risk-adjusted volume of $137 Million; and the most liquid credit index, the on-the-run high grade CDX index, trades only $18 Million of risk-adjusted daily volume. From this analysis, we can see that the CFTC's description of RBOB as a less liquid contract, through nominally accurate compared to the most liquid and successful futures contracts (which themselves represent only a tiny fraction of all listed futures), is profoundly misleading when compared against the liquidity spectrum in the OTC market.

With regard to the specific formulae the CFTC proposes, we believe they contain three specific elements which will produce block trade thresholds that are much too high, resulting in a significant negative impact on liquidity.

The first is that in determining the social size, the rule requires taking the greatest of three different measures of the average: mean, median and mode. The meaning of the term "social size" is the size that is the "standard", "default" or "most typical" trade size in the Swap Dealer community. Following the common sense interpretation of this term argues for defining it as the mode trade size among swap dealers. To take the maximum of three measures is simply an arbitrary device to ensure the number is higher than it otherwise would be; and in the case of the mean, it's a particularly ill-suited measure of the typical social size since it's already skewed upwards by the block trades themselves.

The second is the arbitrary setting of the social size multiplier at 5. In general, Swap market trade sizes are characterized by a large proportion of all transactions being grouped around the social size. Put differently, the dispersion of trade size is quite low. As a result, setting a social size multiplier of 5 will typically have the effect of making privately negotiated transactions much less than 5% of the market. Since we propose that social size be defined as the mode size between Swap Dealers, it is already inherently a "wholesale" size.

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[12] Throughout this comment letter, we use the approach of normalizing risk across contracts by using the historical volatility of the contract to compute a 1 day, 1 standard deviation economic fluctuation range, as a means of normalizing the amount of risk transfer across different contracts and asset classes.

Consequently, setting the social size multiplier anywhere higher than 1 already ensures that all transactions involving less sophisticated participants receive the maximum level of scrutiny[13].

The third is the use of the distribution test minimum threshold of 95% together with the requirement that the final block threshold is the greater of this measure and the social size measure. We believe that the multiple test is the one that most directly relates to the natural dynamics of the marketplace and which, when modified as we propose, should be the central driver of the block size determination. The distribution test should function solely as a "failsafe" to ensure that a majority of trades are not blocks.

Interestingly, we note that the CFTC has, in fact, previously recognized the importance of flexibility in allowing for private negotiation. In its September 28, 2008 resubmission of amendments to its Regulation 1.38 concerning trading off the centralized market and its guidance and acceptable practices concerning Core Principle 9, the CFTC moved away from setting a 90% threshold (itself already lower than what it is proposing in this ANPR) and instead adopted principles-based language that emphasized the primacy of obtaining best execution, whether in the central market or outside of it.

Thus, following the CFTC's own previous guidance on the matter, we propose:
1. Defining Social Size as the mode of trade sizes among Swap Dealers.
2. Setting the Social Size Multiplier no higher than 2.
3. Lowering the "distribution test" minimum threshold from 95% to 50%.

Making these changes would restore appropriate flexibility to the execution mandate while retaining the elegant cross-asset class adaptability of the Commission's construct and ensuring that a large majority of transactions still occur on a SEF or DCM and are reported as soon as technologically practicable[14].

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[13] Section 43.5(b)(1) of the proposed rule provides that only ECPs may execute block trade and large notional swaps, but it permits DCMs to allow asset managers having more than $25 million of total assets under management to transact block trades for customers who are not ECPs. This rule seems to reflect a concern that private negotiation offers less protection to unsophisticated investors than trading through the central market. It is presumably for this reason that only ECPs are allowed to transact blocks. Since all entities that transact in the OTC market already must be ECPs, we believe the analogous concern about customer protection in the Swaps market is already addressed.

[14] We note Commissioner Dunn's references to the importance of frequently revisiting rules. We of course agree with the importance of this, and we would add that when comparing two paths to the same end rule, one

Time Delays for Swaps That Trade on SEFs-"Standardized Block Trades".

As mentioned above, one of the clear Congressional mandates in granting to the Commissions the authority to promulgate rules to enhance post trade transparency was to avoid public disclosure that would materially reduce market liquidity. The reason that public disclosure entails this risk is straightforward: if providers of liquidity know that when they take on a risk position the market will know that they have taken it, it will be difficult to trade out of that risk position without significant loss, because other market participants will know their market position. From this it follows that the time delay for reporting should be linked not to an arbitrary period of time but instead a period of time that reasonably relates to how long it takes to trade out of a risk position without distorting the market in a particular asset class, since each asset class has different liquidity characteristics. Specifically, we suggest that the time delay should vary by different types of swaps and should be a function of the amount of time it would take on a trading day to trade out of the risk taken on in a Block Trade. This would result in shorter time delays in markets which trade very actively, such as the 5 year interest rate swap market, and for longer time delays in which trading is not as active, such as the market for jet fuel swaps.

This approach to time delays for post trade reporting is currently taken by the London Stock Exchange (LSE). Under the LSE post-trade transparency regime a dealer may request a delay in the post-trade reporting of a trade according to the relative size of the trade compared to the average daily trading volume. This is to allow the dealer to cover the position. The maximum time delays are a function of the Average Daily Trading Volume (ADTV) and apply as follows:-

60 minute delay for a trade that exceeds 10% of the ADT V
180 minute delay for a trade that exceeds 20% of the ADTV
End of day reporting for a trade that exceeds 30% of the ADTV (or noon next day reporting if trade is executed in the last 2 hours of the trading day)
End of next day reporting for a trade that exceeds 100% of the ADTV
End of second day reporting for a trade that exceeds 250% of the ADTV

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which starts out flexibly and is tightened later after further analysis of market impact, and one which starts more rigidly and is then loosened, the latter path tends to lead to irreversible adaptations in the market structure and so the putative loosening of the rule that might occur as a result of identifying excessive market impact may be pointless by the time it's implemented.

A simple example of how this concept would work for interest rate swaps is as follows: a customer pays fixed on $200 million of a plain vanilla 10 year Fixed/Floating interest rate swap. The ADTV of that instrument over the previous quarter might have been $10 billion, but the Swap Dealer will not be able to consume more than a certain percentage of the daily trading volume without distorting the market. Assume that in this case that's 10% of the $10 billion ADTV i.e. $1 billion. That $1 billion would be the daily liquidity in our example. Thus, to exit the $200 million position (i.e. 20% of the daily liquidity of $1 billion) will take 20% of the trading day, or about 96 minutes. The rule could therefore require the reporting to take place 96 minutes after the trade is executed, where we assume the market to open at 8 and close at 5, such that if transaction were consummated at 4 PM, it would be reported 36 minutes after the next day's open, or at 9:36 AM.

Although at first glance such a framework may seem complex, it is no more complex than the process that the CFTC is proposing to compute the Block Trade size thresholds, and in fact the delay "grid" per instrument could be produced by the Swap Data Repositories as part of that same process.

Time Delays for Swaps that Do not Trade on SEFs-"Customized Block Trades"

Unlike the proposed standardized 15 minute delay applicable to Standardized Block Trades, the CFTC has asked for comments on the time delay applicable to Customized Block Trades, i.e. swaps in large size that do not trade on a SEF. We believe that the approach that we advocate for Standardized Block Trades should also be followed for Customized Block Trades and that the logic is even more compelling for Customized Block Trades. This is so for two reasons: Customized Block Trades, by definition, play a less significant price discovery function than Standardized Block Trades; and Customized Block Trades often leave liquidity providers with complex basis risks that are very difficult to trade out of. Thus, in terms of the competing public policy objectives of the Rule, the fact that not much useful information is given to market participants while there is a higher risk of an adverse impact on market liquidity argues for a more flexible application of time delays for these transactions.

We also note that, by their nature, Customized Block Trades are quite likely to involve end users, such as airlines, who are hedging their commercial risks in a customized and hand tailored way. Congress was vigilant in its drafting of Title VII to ensure that end users would not lose access to these important risk management tools, and the Commissions should avoid promulgating rules which might have the effect of limiting access of end users to customized risk management products. It is particularly ironic in this regard that the SEC's

proposed block reporting delays are so much longer than the CFTC's, when the likely impact on end-user hedging is so much greater in the markets under the CFTC's jurisdiction.

One practical challenge to using the ADTV to calibrate the required delays for Customized Blocks is the non-standard nature of the transactions, since the ADTV for such a transaction may be extremely low, or zero. One solution to this problem that would achieve the Congressional objective of preserving liquidity for end-users would be for the Commissions to defer implementation of reporting requirements for Customized Blocks for a period of time, e.g. one year, that would allow the Commissions to examine the data on these transactions that are reported to the swap data repositories and obtain a thorough understanding of their liquidity and risk profiles. The Commissions could use the results of this examination to identify standardized instruments to which more frequently traded Customized Blocks are most similar in terms of their risk and then to determine a multiple of the standardized instruments' delay times that would be applied for purposes of calculating the corresponding Customized Blocks' reporting times (the multiple would account for the lower ADTV of the Customized Block vs. the corresponding standardized instrument). For infrequently traded Customized Blocks, the Commissions could require that the Swap Dealer identify the corresponding standardized instrument and apply a multiple that is reasonable in relation to the multiples for other Customized Blocks then traded. The accuracy of those choices would be subject to audit and review by the Commissions in order to avoid artificially extending reporting times.

Reporting of Notional Amounts

We note that the SEC Rule and the CFTC Rule take significantly different approaches to the reporting of Notional Amounts of Swaps and Security Based Swaps. Under the SEC Rule, the exact Notional Amounts of Security Based Swaps are reported, with a time delay for Block Trades. Under the CFTC Rule, the exact Notional Amounts of Swaps are reported up to a maximum of $250 Million; above $250 Million, Notional Amounts are reported as "$250+". This is commonly referred to as the "masking rule".

We believe that the SEC Rule should adopt a masking rule, and that the masking rule in the CFTC Rule should be revised downward to mitigate adverse impacts on market liquidity. The masking rule is similar in concept to the so-called "5+ rule" in TRACE. Under TRACE, transactions involving bonds in excess of $5 Million are reported as "5+" if they are investment grade ("HG") and "1+" if they are high yield ("HY").

As Bessembinder et al note, despite the anecdotal evidence of decreased depth as a result of TRACE, the corporate bond market continues to function; and JPM believes that although depth has decreased, the cost of this decrease is offset by the benefit from the reduction in transaction costs for retail investors. However, this net benefit is obviously sensitive to the reduction of depth being small, especially since most of the institutional investors who experience this cost are ultimately managing money on behalf of individuals. We believe that the use of masking in TRACE together with the setting of the thresholds at 1+ and 5+ is the key reason that the balance between increased transparency for small tickets and reduced depth for large tickets is positive. We also note that TRACE reporting, which was initially applicable only to transactions in corporate bonds, has recently been extended to transactions in Agency Securities as well. In doing so, FINRA has adopted the same "5+" masking rule as has been used for corporate bond reporting, even though the Agency Securities market is larger and more liquid than the corporate bond market and the typical trade size among institutional counterparties is significantly larger than in corporate bonds. This supports the notion that masking thresholds should be set near the level that represents the dividing line between retail and institutional trades, and highlights how the CFTC's proposed threshold of 250+ is significantly higher than it should be, especially in light of the much greater significance of block depth for end-users in the CFTC's markets when compared to corporate bonds.

As an alternative that would both improve and unify the proposals of each Commission, we would suggest extending the TRACE size masking framework to all Swaps and Security Based Swaps. This could be easily done by simply computing how much market risk is represented by the TRACE masking thresholds and using those numbers to map the masking thresholds into other asset classes. For example, by making certain assumptions[15] we can see that the scaling of the HG masking threshold to be 5 times larger than the HY one (5+ vs. 1+) renders the two thresholds roughly equivalent in risk terms: they represent approximately $8,100 of one-day price risk. Mapping this into plain vanilla fixed-floating IRS results in the following proposed masking thresholds for some representative benchmarks: for 2 year interest rate swaps, $8 million; for 5 year interest rate swaps, $3 million; and for 10 and 30 year interest rate swaps, $1 million. These thresholds are lower than those proposed by the CFTC, and despite being economically equivalent to those employed in TRACE, the Commissions may be uncomfortable with a threshold that results in a majority of transactions being reported under the masking rule[16]. In this case, we would propose

[15] Average duration of 4 years; daily basis-point volatility of HY credit of 21 bps and HG of 4 bps (which equates to an annualized lognormal spread volatility of 75% and a spread of 435 for HY and 85 for HG)

[16] This would be the natural result because of the absence of retail-sized transactions in the Swaps markets.

simply setting the masking threshold at the Social Size. This will be a higher number than the TRACE-equivalent thresholds, and will result in a majority of transactions being reported with fully disclosed notional amounts, while still leveraging the TRACE experience to minimize the impact on market depth.

Finally, we do agree that accurate aggregate trade volumes by instrument should be computed and disseminated at the end of the day[17] independently of the choice of masking threshold, and that "un-masked" trade-by-trade notional amounts should eventually be disseminated after the application of both masking rules and reporting delays in order to facilitate analysis of market trends by market participants and the academic community[18].

Regulatory Coordination

Although the CFTC Rule and the SEC Rule are similar, there are many differences between them, many of them minor. For example, both Rules require the capture at point of trade of many trade details for eventual reporting, but the trade details to be captured are not the same under each Rule. These differences will make implementation of post trade reporting very difficult for market participants subject to the Rules. These differences will require different systems and workflows and largely duplicative but separate training and compliance regimes, all of which will result in widespread confusion among trading, operations and compliance personnel within those market participants. For example, at JPM there are traders who enter into both credit default swap index transactions, which are Swaps and thus would be subject to the CFTC Rule, and single name credit default swap transactions, which are Security Based Swaps and thus would be subject to the SEC Rule. The existence of two separate post trade transparency regimes which will need to be implemented differently at the trader level will make such implementation extraordinarily difficult and will make the information that is ultimately reported much less useful to the public. The result is likely to frustrate the post trade transparency public policy objectives of the Rules. We strongly urge the Commissions, to the maximum extent possible, to conform their Rules and eliminate any differences which are not absolutely necessary in order to eliminate these negative consequences.

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[17] As long as the number of transactions is above a threshold that would ensure that no person's position is made public, as the statute requires.

[18] Of course, the regulatory community will have this information under all circumstances.

Conclusion

We believe that the proposed Rules are an important first step in devising an appropriate post-trade transparency regime for the Swaps and Security Based Swaps markets. As noted, however, we believe that several changes to the proposal are necessary to prevent them from unnecessarily reducing market liquidity, and thereby impairing the efficiency of U.S. financial markets.

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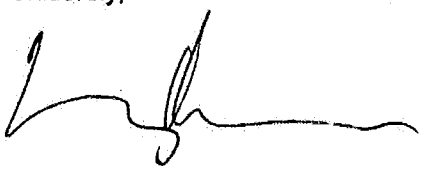
Thank you for the opportunity to comment publicly on these important matters.

Sincerely,



Jeremy Barnum
Managing Director
J.P. Morgan

Sincerely,

Don Thompson
Managing Director and
Associate General Counsel
J.P.Morgan

cc:
Honorable Gary Gensler, Chairman
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Honorable Scott O'Malia, Commissioner

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Honorable Kathleen L. Casey, Commissioner
Honorable Luis A. Aguilar, Commissioner
Honorable Troy A. Paredes, Commissioner

OBSERVATIONS ON THE OTC DERIVATIVES MARKET

J.P.Morgan

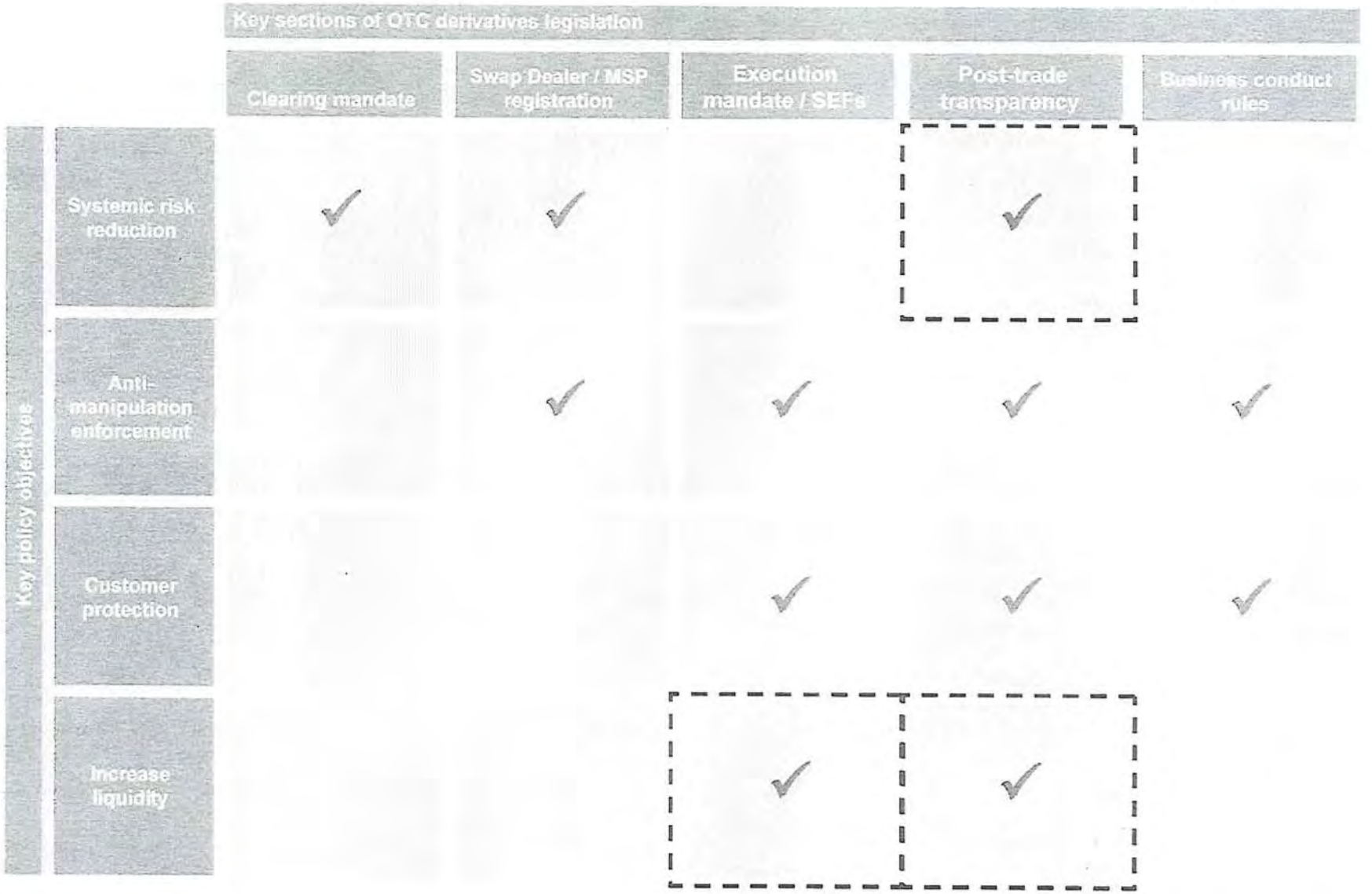
Introduction

- OTC markets benefit from certainty
- Ensuring an efficient and liquid market under the new framework a shared goal
- Meaningful data will inform better policy outcomes

Policy Map: Key policy objectives and how the legislation addresses them

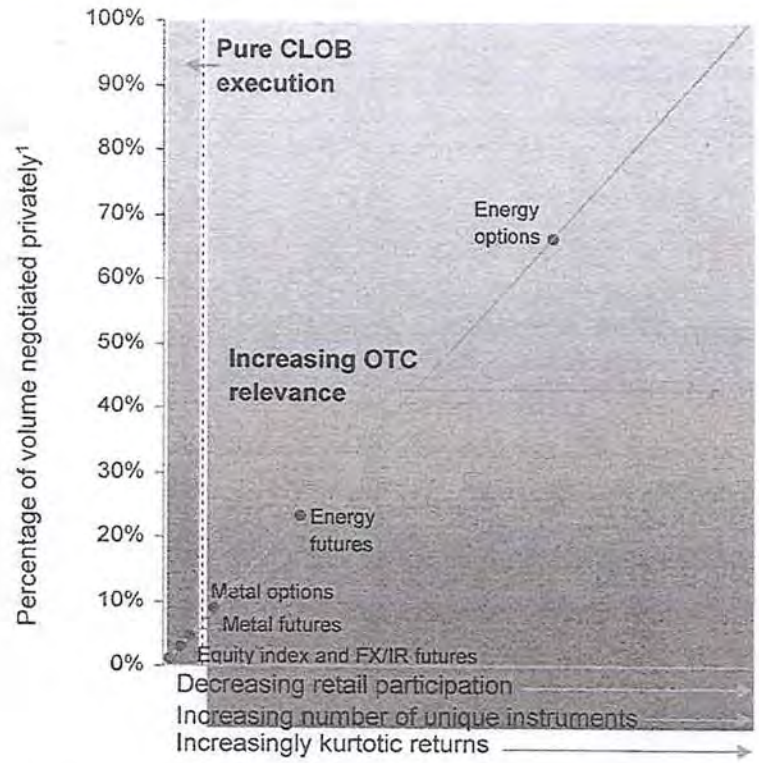
✓ Policy addressed by section

Key rulemakings

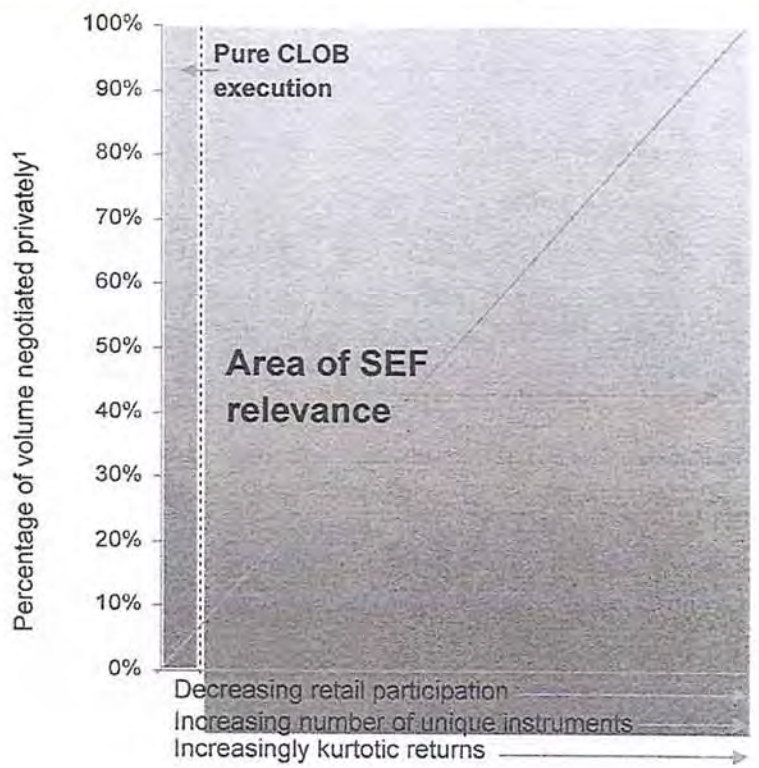


Existing futures rules supply useful insights

Current futures market construct



End-state derivatives construct *(illustrative)*



Source: CME Group data adjusted per JPMC analysis
[1] Includes Blocks, EFPs and ClearPort

- The more idiosyncratic and customized and less retail flow a product has, the higher the % of privately negotiated volume
- In the current market, if the natural state of execution is to have a material percentage of flow be privately negotiated, the OTC market provides an escape valve to provide execution flexibility. So within exchanges, we don't observe many contracts with very high % of privately negotiated volume, because those products will tend to gravitate towards OTC trading
- There is significant scope to define a SEF to fill this "continuum gap", yet still allowing for a liquidity "outlet" when private negotiations are optimal

Current futures market "privately negotiated transaction" construct useful guide for OTC market

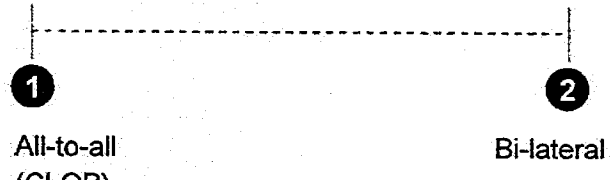
Evolution of block trade definition in futures markets

- **In 2004** the Commission proposed that an acceptable minimum size for block trades would be at a level larger than 90% of the transactions in a relevant market **("90% threshold")**
  - Some exchanges disagreed with the proposed minimum size of the 90% threshold suggesting the numbers were unresponsive to market needs and that there may be instances where 90% could be too high or not high enough
  - CBOT suggested that an acceptable minimum block trade size be at the point where the block would move the market or where the customer would not be able to obtain a fair price or fill the order on the centralized market
- In response **the Commission changed the proposed guidance and acceptable practices on this topic**
- Block trades are allowed to be transacted off the centralized market for two reasons
  - Prices attendant to the execution of large transactions on the centralized market may diverge from prevailing market prices that reflect supply and demand of the commodity as the centralized market may not provide sufficient liquidity to execute large transactions[1]
  - Block trading facilitates hedging by providing a means for commercial firms to transact large orders without the need for significant price concessions and resulting price uncertainty
- As such, the proposed guidance notes that minimum block trade sizes should be larger than the size at which a single buy or sell order is customarily able to be filled in its entirety at a single price (though not necessarily with a single counterparty) in that contract's centralized market, and exchanges should determine a fixed minimum number of contracts needed to meet this threshold
- The Commission proposes as an acceptable practice that **DCMs review the minimum size thresholds for block trades no less frequently than on a quarterly basis** to ensure that the minimum sizes remain appropriate for each contract (i.e., for each asset class and specific product)
- The **importance of data, and specifically "adequate" data,** is highlighted as a key input for making informed decisions on what constitutes a block trade

[1] In this sense block trading also provides execution certainty for investors (i.e., they know liquidity will not disappear)
Source: http://www.cftc.gov/LawRegulation/FederalRegister/e8-21865.html

OTC market currently serves as "outlet" for products not suited to exchange trading

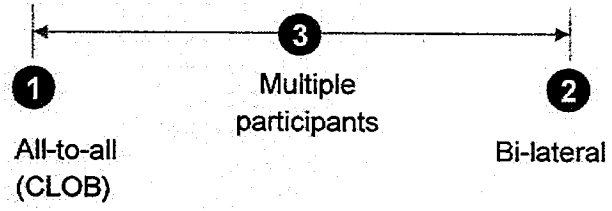
Exchange paradigm



Binary system: *either all-to-all or purely bi-lateral execution*

Products natural tend towards optimal execution paradigm

OTC paradigm



Choice along the contiuum: *participants can choose execution mode*

Execution continuum *(pre-legislation)*

Description

- In the exchange execution paradigm there are **2 options**
  1. Participants must trade on exchange (all-to-all CLOB), unless
  2. Trade qualifies as a block trade and bi-lateral (privately negotiated) execution is possible
- **Participants can choose** execution mode along the continuum
  - Either all-to-all (1) or bi-lateral (2) as above, or
  3. Orders shown to and negotiated with multiple participants, but not all-to-all

Key observations

- OTC market is not just about customization, it also provides an execution mode "outlet"
- If a product is standardized trading on an exchange does not necessarily maximize liquidity
  - Legislation recognizes this by creating the concept of a SEF
- Pre-legislation the question of "causality" (does a product trade on exchange because its liquid or is it liquid because it trades on exchange) was less important, because exchange and bilateral trading co-existed

- Pre-legislation, an exchange could list a new product for trading, and it would attract liquidity if the exchange mode of execution was optimal. If bilateral execution was preferred by market participants, an "outlet" existed to optimize liquidity
- Examples: (1) Treasury futures trade on exchange, but treasuries themselves continue to trade bilaterally, although some increasingly trade in SEF-like platforms. (2) Stocks trade on exchanges, but corporate bonds trade OTC. (3) Short-dated Libor-based derivatives trade almost entirely on exchange, long-dated ones trade primarily OTC

Preliminary data shows a low number of active participants in OTC derivatives, implying there can be less than one participant per instrument

EXAMPLES

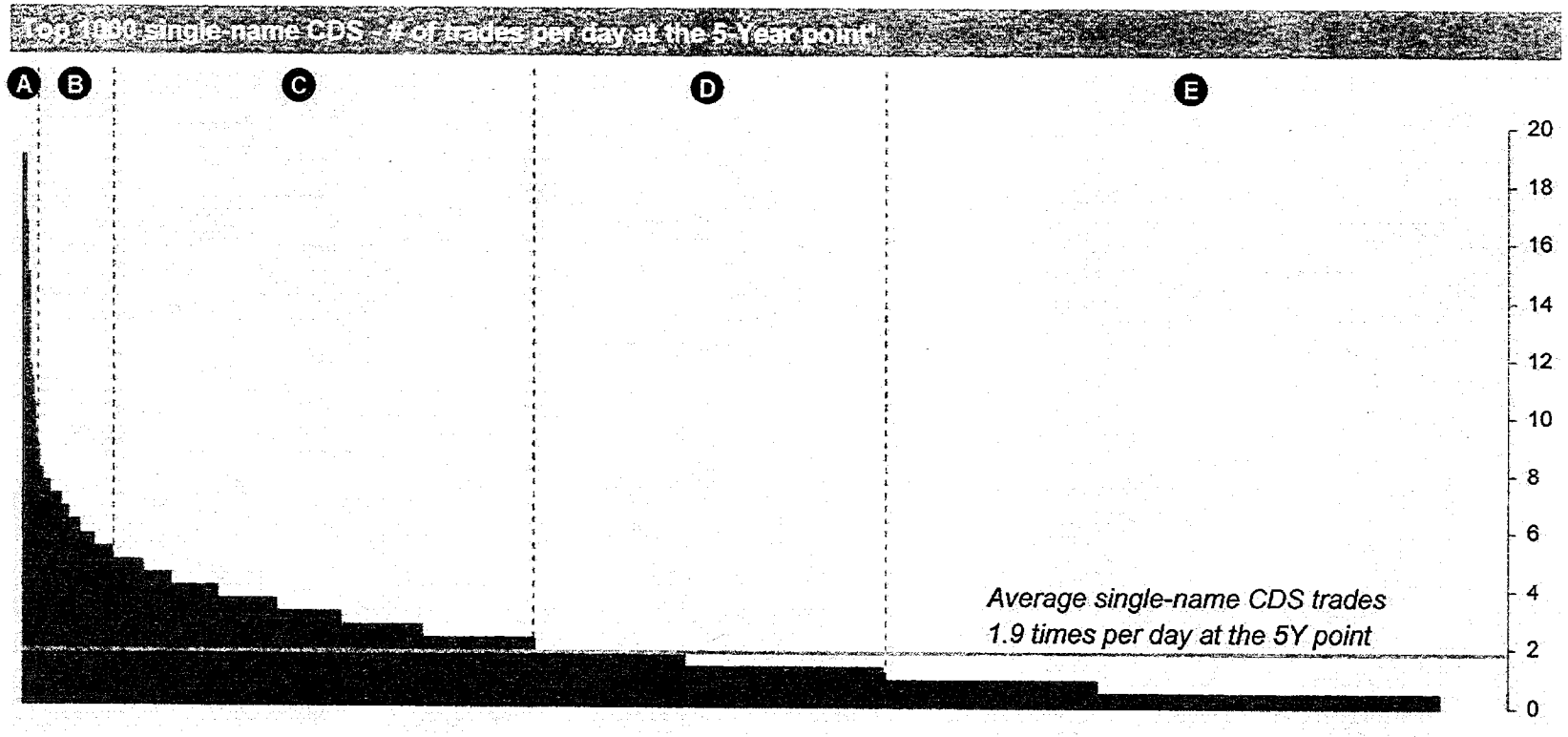
	Number of active[1] participants	Approximate # of "benchmark" instruments	Number of total instruments	Participant to "benchmark" instrument ratio	Participant to total instrument ratio	Average number of benchmark trades per day	Average number of total trades per day
Single-name CDS	220	225	83,000	0.98	0.003	1.9	4.3
Index CDS	180	4	80	45	2.250	~200	~250
Vanilla IR Swaps	510	>25	>100,000	<20.4	<0.005	~700	~1000
WTI Futures	>20,000	1	70	>20,000	>285	150,000	>250,000
S&P e-Minis	>1,000,000	1	5	>1,000,000	>200,000	>160,000	>200,000

Note: For methodology and key assumptions please refer to appendix

Source: DTCC data, E*Trade public information, preliminary Markit data, Internal JPMC data and interviews
[1]Defined as trading at least 5 times per year

In OTC derivative markets, number of trades per day is significantly lower than in the most liquid futures markets

Note: We have focused the analysis on Credit as: (1) more data was available and (2) this will likely be the first area of focus

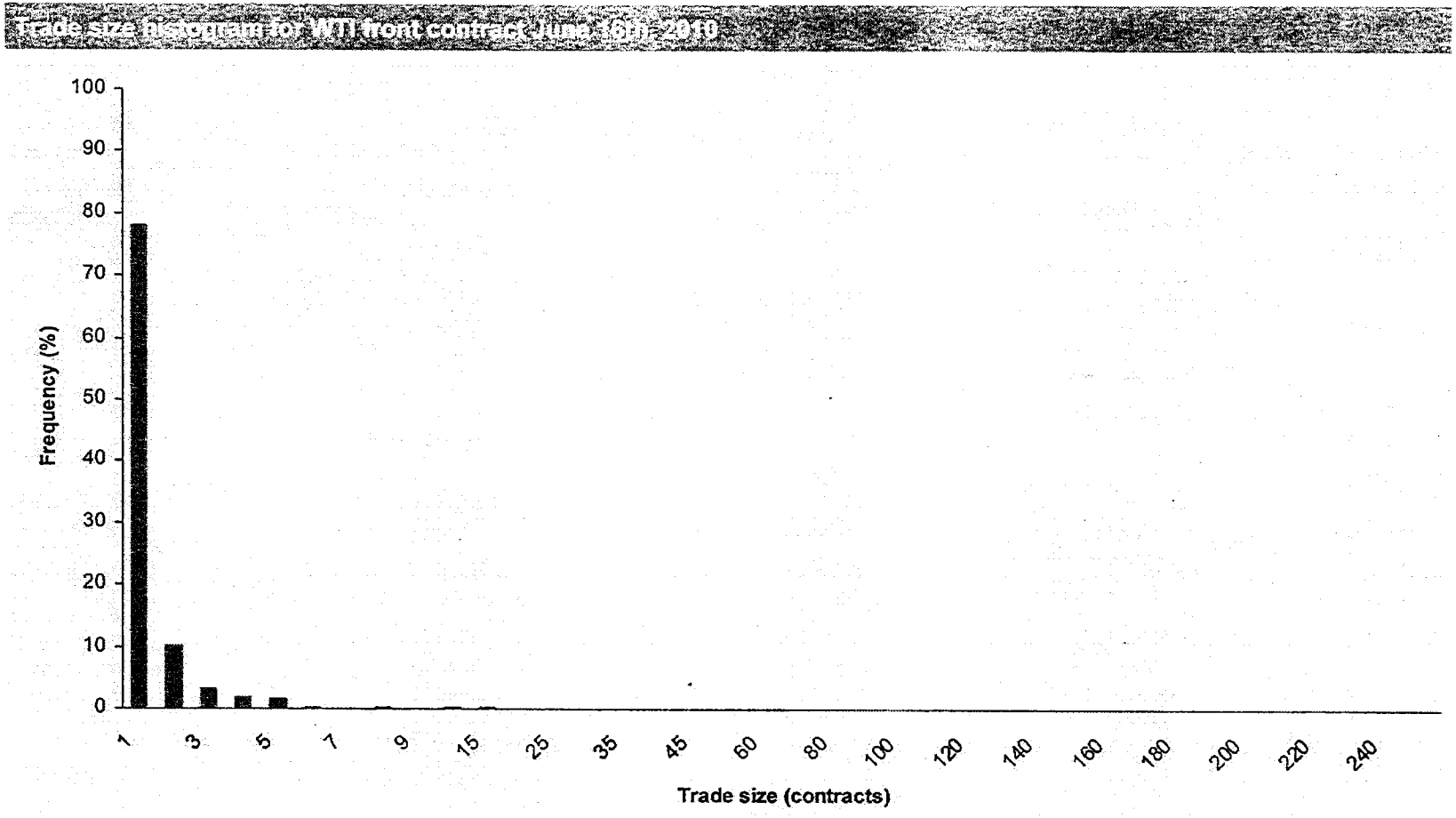


Source: DTCC data adjusted per JPMC internal analysis

- **A** 7 names trade more than 10 times per day
- **B** 52 names trade more than 5 times per day, but less than 10
- **C** 282 names trade more than 2 times per day, but less than 5
- **D** 234 names trade more than 1 time per day, but less than 2
- **E** 425 names trade less than 1 time per day

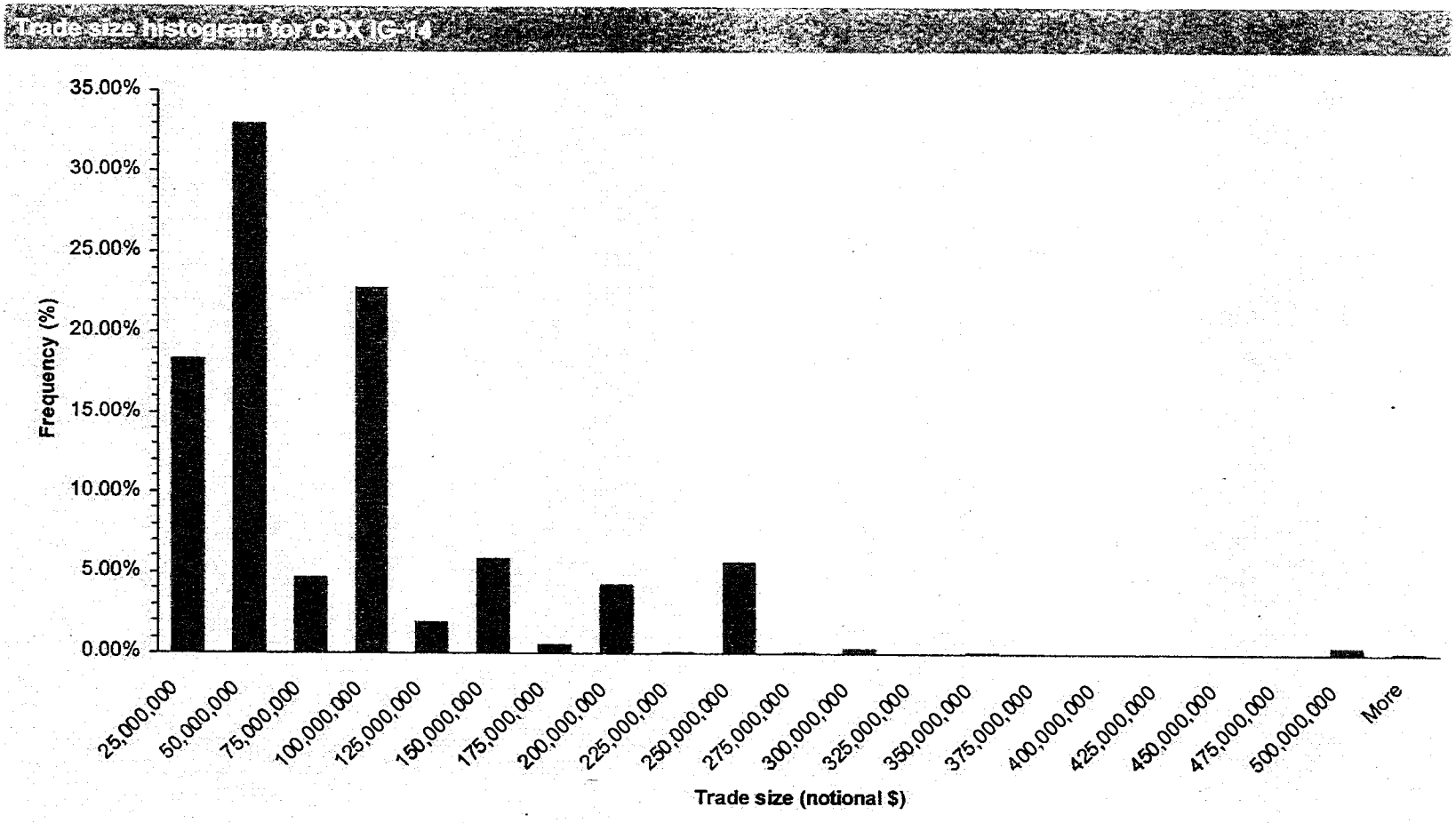
[1] Assumes that 45% of volume is concentrated on the 5 year point (as per previous JPMC analysis)

~90% of trades in liquid futures contracts are small (i.e., of 2 or less contracts)



Source: Nymex data

In CDS index trades, however, indicate higher percentage of "larger" trades



Source: JPMC internal data

Normalizing by volatility shows that typical trade sizes in OTC markets are comparable to block minimums for futures

Current futures market (liquid contracts) - *examples*

	Block Trade minimum (# contracts)	**Block Trade minimum size** ($mm)	**Daily volatility** (2 Standard Deviations)[1]	**$ - equivalent 2 standard deviation range**
10 year note (futures)	5,000	615	0.78%	4,810,000
30 Day Fed Funds (futures)	2,000	9,980[2]	3.10%	50,000
HH Natural Gas (futures)	100	5	5.31%	260,000
Gold (futures)	200	25	2.06%	490,000
EUR/USD FX (futures)	150	25	1.50%	370,000

Current OTC derivative market (typical trades) - *examples*

	Typical trade size[3] ($mm)	**Daily volatility** (2 Standard Deviations)[1]	**$ - equivalent 2 standard deviation range**
NA HG Index	125	0.29%	390,000
NA HY Index	25	1.25%	320,000
5Y IRS	100	0.59%	590,000
1Y EUR Straddles	100	0.19%	190,000
Spot EUR/USD	25	1,50%	370,000
1Y 10Y Swaption Straddles	100	0.07%	70,000
1Y S&P Variance	300,000 (vega)		230,000

Source: Bloomberg, CME Group, JPMC analysis
Note: all calculations are based on observed data for 08/02/2010 and numbers are rounded to nearest $10,000
[1] 2 standard deviations used to calculate risk with a 95% confidence level
[2] Each contract is based on $5mm of notional. Please note the volatility number shown is that of the interest rate as value at risk is a function of the volatility on the rate rather than on the notional
[3] Typical trade size refers to the most common trade size in the professional dealer community

Comparing size and liquidity across futures and OTC markets

		Trade sizes		
		Retail market size	Futures block or institutional OTC typical size	Institutional OTC block
Current Futures construct	**Applicability**	✓	✓	✗
	Typical trade as % of ADV	n/a	<10%	
End-state derivatives construct *(currently OTC)*	**Applicability**	✗	✓	✓
	Typical trade as % of ADV		20-100%	5-10x
	Important observations	▪ *There is no retail participation[1] in OTC derivative markets* ▪ This suggests OTC markets have a lower number of participants at any given time than exchange traded markets	▪ Pre-trade negotiation flexibility becomes increasingly important	▪ In addition to pre-trade negotiation flexibility, post-trade reporting delays become important for these trade sizes. This type of transaction is exceptionally uncommon in futures

[1] Although there is minimal participation by sophisticated high–net worth investors (well in excess of the QIB minimums)

Important post-trade reporting considerations

- There is a clear need and for post-trade reporting
- Market participants can assist in helping define templates to facilitate data gathering that can be useful in rule drafting

Important differences between OTC derivatives and Futures market to consider for post-trade reporting rules

- Even for block trades in the current futures construct, the post-trade reporting delay is only five minutes
  - For the category of institutional block trades representing several days or weeks of trading volume, a five minute reporting delay is insufficient and would likely lead to certain products not trading and clients not being able to offset risk
- Worth noting that even in the products where there is significant on-exchange liquidity and where the block minimums are material even from an institutional risk perspective (eg 10y Note futures[1]) these minimums are a small % of the ADV
- In certain OTC markets, block trades can represent weeks if not months of trading volume
  - This concept does not exist in exchange world
  - **New post-trade regime should contemplate appropriate block trades as well as appropriate reporting delays for risk management purposes to make information meaningful without disrupting market liquidity**

International coordination: CESR recommendations to EC on post-trade transparency

- **Liquidity as key input to post-trade regime:** "CESR is of the view that the calibration of thresholds and time delays for the proposed regime should ideally be based on liquidity of the asset in question"
- **Post-implementation review:** "At the core of CESR's recommendations to the Commission is the need to undertake a post-implementation review (for all asset classes) with a view to reaching conclusions one year after introducing the new transparency obligations"

[1] Block trade minimum as a % of ADV (2010 YTD) can be <5% depending on the contract

Potential risks where SEF rules could reduce liquidity rather than increase it

It is broadly accepted that SEFs will…

- Supply post-trade transparency and reporting to data repositories
- Provide an orderly, rules-based means of execution
- Guarantee electronic confirmation and STP
- Enforce anti-manipulation rules (and escalate/support to CFTC enforcement as appropriate)
- Enforce customer protection rules (and escalate/support to CFTC enforcement as appropriate)
- Supply pre-trade transparency as appropriate to increase liquidity

…but there are risks that could impact liquidity

- Current execution paradigm in futures construct is binary
  - SEFs should be fluid, flexible and allow for the types of execution models that ensure competitive markets while maximizing liquidity
  - Post-trade reporting should generate a data set to verify that customers aren't consistently behaving contrarily to their best interests and should support future rule making
- The relationship between size and permissibility of "RFQ-like" negotiation: in a non-retail market with limited potential liquidity, the framework should take into account RFQ-like negotiation

General considerations

- Consider developing **templates for post-trade reporting** in cooperation with service providers and market participants to supply the Commission with meaningful data to inform rule making

- In drafting liquidity-sensitive rules --primarily post-trade transparency and "block trade/private/less than all negotiation"-- consider **making rules dynamically refer to the underlying liquidity data** to ensure efficient responsiveness to evolving market conditions

- Consider that the **OTC market** is not only a means of customizing, but also an **"outlet" for risk transfer on less liquid assets**; restricting participants' ability to move institutional amounts of risk will impact overall liquidity and market efficiency

- Consider the **key distinction characterizing products currently traded OTC**

  - Small number of participants relative to the universe of tradable instruments

  - Participants are almost exclusively large, sophisticated institutions

Appendix

Methodology and key assumptions for Slide 6

	Methodology and key assumptions		
	Number of participants	**Number of instruments**	**Number of trades/day**
Single-name CDS	▪ Used internal JPMC client trading data to estimate number of active participants in US (defined as trading at least ~5 times per year) ▪ Assumes JPMC trades with all active participants	▪ Included all 100 names in HY index and 125 names in HG index for "benchmark instruments" ▪ For total instruments assumed 1038 entities (JPMC internal data), with 40 maturities and 2 coupons each	▪ Used data for top 1000 single-names CDSs (globally) from DTCC report "Market Activity Snapshot" ▪ Assumed 45% of trades happen at 5Y point (benchmark) as per previous JPMC analysis
Index CDS	▪ Used internal JPMC client trading data to estimate number of active participants in US (defined as trading at least ~5 times per year) ▪ Assumes JPMC trades with all active participants	▪ Assumes benchmark products are "on the run" and previous index series both for HY and HG ▪ Assumes 10 active series and average of 4 maturities per series for total products for each of HY and HG	▪ Estimate total number of trades per day in US at ~250 based on interviews ▪ Assumed 70% of trades happen at 5Y point (benchmark) as per previous JPMC analysis
Vanilla IRS	▪ Used internal JPMC client trading data to estimate number of active participants in US (defined as trading at least ~5 times per year) ▪ Assumes JPMC trades with all active participants	▪ Assumes 10+ short term benchmarks (<1Y), another 10 (1Y – 10Y) and at least 5 in over 10Y maturities ▪ For total instruments number shown is a lower bound since in reality each trade is a unique instrument	▪ Used preliminary MarkitSERV May data, applied a correction factor of 0.85 to account for post-trade allocations ▪ Assumes 75% of trades reported through MarkitSERV
WTI Futures	▪ High-level estimates based on JPMC internal interviews with Oil Trading team	▪ Contracts for every month in this year (Sep-Dec), every month until end 2015, and then 2 contracts per year until end 2018 ▪ Front-month is "benchmark" contract	▪ Tick data for front contract on June 16th shows >150,000 trades ▪ Assumes 60% of trades are in the front month "benchmark" contract ▪ Triangulated with ADV July 2010 data
S&P e-Minis	▪ Assumes that 1/3 of E*Trade's ~3mm accounts are active participants in S&P e-Minis trading ▪ Actual number of total active participants likely to be higher	▪ For total instruments, counted all 5 outstanding quarterly contracts (Sep '10 – Sep'11) as per CME product specification information	▪ July 2010 ADV is 2.1mm contracts, assumes average trade is of ~10 contracts (potentially lower) ▪ Assumes 80% of trades are in short-dated "benchmark" contract