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February 7, 2010

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581
secretary@cftc.gov

RE: Proposed Rule 3038-AD08: Real-Time Public Reporting of Swap Transaction Data

Dear Mr. Stawick:

On behalf of Barclays Capital, I write to express our support for the Commission's efforts to implement the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and to thank you for the opportunity to meet with Commissioners and senior staff of the CFTC to comment on the proposed rule regarding Real-Time Public Reporting of Swap Transaction Data. Achieving robust market integrity and increased market transparency in the context of an effective regulatory environment benefits the entire market.

Our comments are intended to offer practical insights drawn from our perspective as a market participant and, more importantly, as a risk manager to our clients. Barclays Capital operates a global risk management business and we write as one of the very few large financial institutions that weathered the recent financial crisis without taking government funding in either the US or the UK. Strong banks support strong regulation and Barclays Capital welcomes regulation that gives regulators the tools they need to ensure strong, transparent, efficient and liquid markets.

We commend the Commission on this comprehensive rule-making, particularly given the tight time frame and limited access to data about the over-the-counter (OTC) markets that is currently available. Although we support the broad framework which has been proposed, we are concerned that the rule-making is not sufficiently nuanced with respect to different asset classes and products. US markets today are more liquid, longer term and lower cost than they were even 10 years ago. This has provided a service to the American public by facilitating lower cost risk management and greater capital investment in infrastructure leading to positive benefits such as those in the commodities markets, where investment in new exploration and production has generated a substantial decline in domestic natural gas prices. We fear that as currently contemplated, the block trade[1] thresholds are too high and the reporting time frames are too short, and we believe this could have serious unintended consequences on market liquidity, corporate risk management strategies, capital investment, funding costs and energy prices, particularly in less liquid markets.

With this background, Barclays Capital respectfully requests that the Commission considers the following recommendations:

- In order to ensure that liquidity is not compromised, the Commission's post-trade reporting requirements should be based on objective observations of comprehensive market data. Given the limited access to OTC market data that is currently available, we respectfully urge the Commission to

[1] Note that throughout this letter when reference is made to "block trades", our comments apply to "block trades" and "large notional swap transactions"

conduct an empirical study on the impact of post trade transparency requirements on the OTC markets prior to finalizing this rule-making.

- We respectfully recommend that the Commission consider a more flexible and tailored approach to its post-trade transparency requirements, with accommodations for certain markets that reflect differences between asset classes and between products and tenors within an asset class.
- We suggest that thresholds for block trade sizing be set dynamically and based on an analysis of a variety of factors including liquidity and transaction sizes in the specific OTC market.
- Certain products have characteristics that will require reporting timeframes which are flexible enough to accommodate meaningful hedging, particularly in less liquid markets. We suggest a reporting accommodation for these products based on average daily volume traded for the instrument and the size of the block and/or large notional swap transaction.
- We request that the Commission consider special accommodations to the post-trade reporting requirements for bespoke transactions and distress scenarios.
- We respectfully request that the Commission reconsider the manner in which the post-trade transparency requirements apply to end users to avoid compromising their ability to hedge the large, chunky and long dated risks that are often a necessary step to securing financing for large investments and infrastructure projects.

I. Liquidity Concerns and the Importance of OTC Market Data

As noted above, we are supportive of the broad framework of the real-time public reporting rulemaking, but we are concerned that the CFTC's lack of access to comprehensive data on the OTC markets means that this rule-making does not take into account the broad diversity of OTC markets. The rule-making appears to draw on intuitive analogy with existing exchange regimes for block trades. However, market dynamics in less liquid customized OTC markets often differ substantially from those seen in the more liquid standardized futures markets specifically because the OTC markets have evolved in response to the inability of the futures market to address certain industry needs.

Key distinctions between the OTC and futures markets include:

- Large OTC transactions can be significantly larger than large futures transactions: The largest over-the-counter swap transactions are often many times larger than the largest transactions executed in the futures markets, in part because the large intermediaries (such as Barclays) who provide customized products for end-user hedging use the futures markets to hedge their net portfolios. A popular misconception is that swap dealers merely hedge client risk "back-to-back" in the futures markets, but most client risks are not that simple. Futures are designed as a simple broad proxy to attract liquidity and transfer generic risks. They are intended to broadly mirror the physical market, but do not mirror the actual diverse and specific underlying risks of end-users.

- OTC instruments are tailored to fit the risk, while futures are always "off the rack": Sophisticated risk managers will use a wide variety of instruments and tools that may include transactions in the physical and OTC markets in addition to the futures markets. Where there is no precise hedge available that cleanly mirrors the risk, hedgers may choose to warehouse a portion of the risk and will look to correlated instruments (which may or may not include futures) to manage the risk, refining the hedge over time as better hedges become available. The result is a dynamic process that may involve multiple transactions and a variety of instruments. For larger transactions in less liquid markets, particularly niche commodities markets, this can be a lengthy process, taking days, weeks, or even months and occasionally years.

- Certain OTC markets are much less liquid than futures markets: Even some of the more liquid products in the rates, credit and commodities markets may trade only sporadically at certain times; trading volumes can fluctuate markedly from day to day. For example, in the credit markets, given the event-driven nature and default risk inherent in these markets, an instrument can migrate between being liquid and illiquid in a matter of weeks or months. In the FX market, available liquidity for certain currency pairs depends highly on whether the markets local to both currencies are open at the time of the trade. Liquidity providers therefore play a particularly important role in volatile and often one-sided markets to promote market stability. If a transaction is entered into during one of the less liquid periods, the intermediary's ability to hedge the risk (and therefore provide this service to end-users) will be significantly compromised if the transaction details are made public before the liquidity catches up to the hedging needs.

Given the different dynamics and nature of the OTC markets, it is, in our view, hasty to draw conclusions about the potential impact on liquidity of block trades in the OTC markets based largely on observations or data drawn from the futures markets. Similarly, there is insufficient evidence, in our view, to extrapolate that the time frames provided for hedging block trades in the futures markets will not compromise liquidity if applied to the OTC markets.

In our experience, clients carefully consider their options prior to transacting and act in their own best interests. Currently, clients are likely to choose to enter into an OTC transaction over a more public block trade only if they perceive some benefit to doing so. In many cases, the benefit is that these transactions are less risky and are priced accordingly. This is further discussed below in Section III.

In order to avoid the risk that liquidity is substantially compromised, the Commission's post-trade reporting requirements should be based on objective observations of empirical market data, rather than by analogy with the futures market. Indeed, the proposal notes that the Commission is lacking information and is not "…*aware of any academic literature that offers empirical evidence to support the claim of impaired liquidity given greater transparency or how block trades on swaps or large notional swaps are affected by a post-trade transparency regime*".[2] In our view, a lack of data on these critical issues and markets is an important reason not to move hastily forward in order to fulfill a statutory obligation. In addition, the Commission states that it "…*will continue to analyze and study the effects of increased transparency on post trade liquidity, particularly in the context of block trades on swaps and large notional swaps. The Commission expects that, as post-trade transparency is implemented in the context of the Dodd-Frank Act, new data will come to light that will inform the discussion and could cause subsequent revision of the proposed rules*".[3] We respectfully urge the Commission to conduct an empirical study on the impact of post trade transparency requirements on the OTC markets prior to finalizing this rule-making.

Taking the time to collect comprehensive data on OTC transactions and to fully analyze the underlying markets is critical to designing a tailored framework that is capable of dealing with the idiosyncrasies of each market. By contrast, a one-size-fits-all approach to block sizes and reporting time frames, which fails to accommodate the idiosyncrasies of different markets, will have large unintended consequences on market liquidity, especially for corporate end-users who depend on the ability to transact large volumes to support significant hedging programs and investment.

II. Accommodations for Less Mature and Less Liquid Markets

The Commission's rule-making proposes a one-size-fits-all approach to block trade sizing and reporting. We believe that the Commission's proposals may work very well for certain markets, but not for others. There are some OTC markets and products for which this proposal may be appropriate immediately, but there are others

[2] Federal Register /Vol. 75, No. 234 /Tuesday, December 7, 2010 / Proposed Rules, 76159

[3] Ibid, at footnote 67

for which this proposal may not be appropriate for a considerable period of time until markets mature and deepen.

We respectfully recommend that the Commission consider a more flexible approach to its post-trade transparency requirements, with accommodations for certain markets that reflect differences between asset classes and between products and tenors within an asset class. So as not to dilute the effectiveness of the Commission's regime, accommodations could be tailored to evolve as market and product liquidity evolves. Accommodations could then be removed entirely when nascent markets mature. Naturally less liquid markets could be accommodated in such a way as to protect the price discovery process, enhance liquidity and ensure market depth and resiliency.

A. Block Trade and Large Notional Swap Size Tests

We respectfully encourage the Commission to undertake further research and analysis on appropriate block trade accommodations tailored by market. The current threshold proposals for the "distribution test" and the "multiple test" seem arbitrary. We believe that placing an aggregate limit on what proportion of trades ought to be blocks is not appropriate as this is something that will fluctuate. The primary objective should be ensuring that market liquidity is not materially impacted. A comprehensive analysis of individual markets prior to setting this threshold will avoid unintended market disruption that will ensue if block trade thresholds are set too high.

The tests used by the Commission to determine block trade sizes should be calculated dynamically and granularly to capture diversity of liquidity within different markets (and to ensure that their effectiveness is not diluted). Look-back periods should be designed to ensure market-relevance, with some products having quarterly or semi-annual, rather than annual, look-backs. In addition to underlying asset and product, market definitions needs to take into account tenor and maturity buckets and locations. Also, as a technical point, a delta equivalent measure rather than a notional amount traded should be used in determining block sizes in relation to options, as notional size alone does not relate to the risk involved in non-linear products.

B. Reporting Time Frames

The proposed approach in the proposal for the 15 minute time frame for reporting block trades will be detrimental to less liquid markets. Distributing transaction information in less liquid markets without a reporting time frame adequate to allow for meaningful hedging and risk warehousing by intermediaries will reduce the socially useful productive liquidity provided by swap dealers to hedgers, and potentially aid very short term liquidity at the expense of end-users. This proposal has the potential to create a very unproductive dynamic in the markets whereby short-term traders are pit against long-term hedgers.

We would therefore suggest a reporting accommodation based on average daily volume traded for the instrument and the size of the block and/or large notional swap transaction. Importantly, such a mechanism would be quantifiable and verifiable by the CFTC. The larger the size of a block trade, the longer the time interval should be to report the trade to the public. In this way, hedging can be accommodated for large and/or illiquid transactions where liquidity providers take significantly longer than 15 minutes to disseminate risk. This would allow for more prudent and cleaner execution and reduce the risk of harm to the markets and to market participants, such as consumers and end-users as well as to the companies that rely on the markets to raise capital and manage risk. Open interest is not an appropriate measure in this instance because it does not reflect volume available to be traded on any given day.

C. Other Accommodations

Other accommodations may be required for bespoke transactions, distress scenarios, and implementation phasing.

- Bespoke Transactions: The transparency benefit of bespoke transaction public disclosure to the broader market is questionable to the broader market specifically because these transactions have no comparables. However the potential cost to participants engaging in these transactions if anonymity is not completely assured is potentially high.

- Distress Scenarios: As evidenced by the recent financial crisis, there will inevitably be distress scenarios which will require accommodation under this proposal. The futures clearing system successfully weathered the recent financial crisis, but it did not do so on its own. The clearinghouses received considerable assistance from some of the larger intermediaries, who stepped in to manage risks that were triggered when other market participants fell. These situations are extremely time sensitive because the clearinghouses must off-load the bankrupt portfolio's risk before its value deviates significantly from that of the collateral held by the clearinghouse in reference to the portfolio. This is a complex process and accommodations will be required to ensure clearinghouses are able to achieve rapid closure and to minimize market volatility and price impacts. In order for intermediaries of scale to assist in taking on what are typically very large and time-sensitive risks, accommodations will be required for both block size and, critically, reporting time frames.
- Implementation Phasing: Products may be arranged on a spectrum which ranges from (i) relatively liquid and easy to standardize, at one end to (ii) relatively illiquid and highly customized, at the other end. To help ensure that the data that is collected is consistent, accurate and fit for purpose, the Commission should consider providing an extended voluntary testing phase. We urge the Commission to consider a phased introduction of post-trade transparency requirements, based on empirical data and starting with the most liquid markets, with accommodations given as required to products that may pose special or different risks. Additionally, in order to aid meaningful analysis, it is important to avoid a fragmented market picture, and as such we believe that phasing of reporting requirements should be done by asset class and product rather than trading venue or market participant.

III. Competitive Markets can have Low Margins, but High Risk Premiums

A common theme that we have noticed in the policy dialogue appears to be the idea that increased transparency in a market automatically translates into greater liquidity provision and lower prices. We wanted to address this theme because we do not believe that this is always the case. Economies of scale (large portfolios in which to diversify risk) are often necessary to prudently offer products to help end-users manage fragmented and diverse risks. Further, markets exist across the whole spectrum of liquidity for a variety of different reasons. Some markets are less liquid because they are less mature. Some markets, however, are less liquid for inherent reasons.

This is probably best illustrated by commodity markets where producers and consumers of commodities face very specific underlying risks due to the nature of the physical product, including risks based on the commodity's specifications, volume, and location. These markets are extremely fragmented and there is a natural asymmetry in the size of producer and consumer hedging at any one time. Producers require large volume hedges because they are typically hedging to support sizeable investments in exploration, production, or infrastructure, which cannot be funded without a hedge on forward prices of anticipated production. The average transaction size of a consumer is much smaller. Producers and consumers are also often using different specific grades of underlying commodities, and are often not in the market at the same time or managing risk over the same time periods. Swap dealers perform a critical function by warehousing and diversifying risk in these markets to remedy the structural mismatches between buyers and sellers, providing long-term liquidity where there would otherwise be none, even for very standard products such as oil and natural gas.

The natural number of market participants in a niche commodity market may therefore be small, which increases the difficulty of hedging for market makers (and therefore increases the risk of these markets), but that does not mean that these markets are uncompetitive. A niche commodity market, particularly for less liquid longer-dated tenors, may function very efficiently with 3 buyers and 5 sellers, with low margins, but naturally high risk premiums.

The current proposal, with its one-size-fits-all approach to 15 minute reporting time frames for block trades, may substantially increase risk premia in markets like these. Reduced liquidity and anticipatory trading are real risks, and thus will generate real costs, but no material benefit, for end-users. The Commission has recognized some of these challenges, and we applaud the efforts to address anonymity in the proposal. However, we are concerned that the <u>anonymity protections will not be enough in less liquid markets – it is not necessary to know who is selling or buying; the mere knowledge that someone is doing so in size will move the market.</u>

<u>The resulting increased uncertainty and volatility may lead to market intermediaries actually exiting these markets, either temporarily or permanently, as they evaluate whether their risk capital can be deployed prudently in these markets. A decrease in the provision of risk capital would be extremely detrimental for end-users; these markets rely on intermediaries of scale that can provide meaningful and effective non-standard hedging for complex and long dated requirements.</u> In one such example, Barclays provided financing and hedging to a US-based refinery to support its expansion and efficiency improvements. The hedge provided was tailored to the very specific oil and product grade mix and tenor requirements of the project. It was the financial security provided by the hedge that allowed the company to prudently undertake this expensive capital investment, and without the hedge, the capital investment would not have been made. The risk to an intermediary like Barclays in a transaction such as this is exacerbated due to the niche and regional nature of the market for these specific refined product grades. In this example, the OTC markets have naturally less liquidity because of the product specificity, and even generic proxy hedges using futures contracts would not have provided enough liquidity for years in order to hedge this long-dated transaction completely.

The ability for intermediaries to warehouse risks like these in the context of the proposed framework for block transactions is a real risk that intermediaries will need to consider. Assuming intermediaries remain willing to enter into these types of transactions, these risks will need to be priced accordingly, thus increasing the cost of risk management to everyone's detriment, particularly the end-user's. These types of transactions provide important economic benefits including job creation, and in this example, the refinery expansion contributes to US energy security by maximizing the different crude qualities that can be refined domestically. <u>Robust competition is critical for markets and it is possible to have this without introducing artificial constraints that might hamper the ability of intermediaries to meet the legitimate needs of market participants</u>.

<u>IV. Application of Rule-Making to End-Users</u>

We respectfully request that the Commission consider the application of post-trade transparency requirements to end-users, in the light of Dodd-Frank legislative intent. The Dodd-Frank Act makes clear that end-users qualify for special treatment regarding the regulation of swap transactions, particularly with respect to (i) transaction execution, (ii) pre-trade transparency requirements, (iii) clearing, and (iv) position limits.

It is also clear that the Dodd-Frank Act did not clearly address every aspect of end-user swap transaction regulation. As a result of a lack of clarity as to whether or not end-users are obliged to margin swap transactions, Senators Dodd and Lincoln wrote a letter to Representatives Frank and Peterson clarifying that the bill was not intended to impose margin requirements on end-users.[4] Senators Dodd and Lincoln wrote that "*[j]ust as Congress has heard the end user community, regulators must carefully take into consideration the impact of regulation… on these entities*".[5] Their letter concludes: "*Regulators must carefully follow Congressional intent in implementing this bill. While Congress may not have the expertise to set specific standards, we have laid out our criteria and guidelines for implementing reform. It is imperative that these standards are not punitive to end users, that we encourage the management of commercial risk, and that we build a strong but responsive framework for regulating the derivatives market*".[6]

Specifically, the Dodd-Frank Act requires that, notwithstanding the fact that an end-user is using swap transactions to hedge or mitigate commercial risk, the post-trade transparency requirements apply to such swap transactions. In our view, the post-trade transparency requirements for end-users must be considered in the light of Congress' clear legislative intent and it is our view that the Commission has the authority and the discretion

[4] June 30, 2010 letter written by Senators Dodd and Lincoln and the colloquy that occurred that same day between Representatives Frank and Peterson
[5] Ibid. page 3
[6] Ibid. page 4

to extend special treatment to end-users in this regard. <u>If special treatment is not afforded to end-users, it is, in our view, likely that swap dealers will be less capable (and therefore less likely) to enter into the types of substantial hedging transactions that end-users depend upon for financing investments. Swap dealers can not assume less liquid market risk when the ability to efficiently syndicate risk cannot be relied upon.</u>

V. Conclusion

The Commission's continued thoughtful leadership will ensure that US markets remain a robust and attractive option for participants globally, allowing for more comprehensive supervision of what are increasingly interconnected global markets. We encourage the Commission to preserve its own flexibility to react to real-time market conditions and to draw new conclusions as more data becomes available.

Ensuring consistency across regulators, both domestically and internationally, is critical for all rule-makings, but particularly rule-makings like this one which have the potential to so dramatically impact market liquidity. <u>The important objectives of comprehensive regulation and increased transparency can be achieved without jeopardizing the robust, liquid markets that facilitate effective hedging for Corporate America's *legitimate* risk management needs.</u>

Barclays Capital appreciates the opportunity to comment on this proposal, and to participate in this important dialogue. All participants have a vested interest in ensuring the health of the markets through an effective regulatory regime which maintains market integrity, and supports and encourages efficiency. As you further evaluate this proposal, please do not hesitate to contact us. We would be happy to elaborate on any of these points and provide any data available to us which may be required to thoroughly evaluate the implications of this proposal.

Sincerely,

Gerald Donini
Managing Director
Barclays Capital Inc.