1585 Broadway
New York, NY 10036

Morgan Stanley

March 2, 2011

Via Electronic Submission: http://comments.cftc.gov
David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: CTFC Notice of Proposed Rulemaking on Core Principles and Other Requirements for Swap Execution Facilities (RIN 3038–AD18)

Dear Mr. Stawick:

We are responding to the Commodity Futures Trading Commission ("**CFTC**") regarding its Notice of Proposed Rulemaking on Core Principles and Other Requirements for Swap Execution Facilities ("**SEFs**") (the "**CFTC Proposed Rules**")[1] in which the CFTC proposed rules establishing a comprehensive new regulatory framework for the trading and execution of swaps under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

On behalf of ourselves and our large and diverse group of clients and customers, we wish to express the following serious concerns about the potential negative impact of the CFTC Proposed Rules on the swaps markets and the availability of liquidity in those markets. We have grave concerns with certain elements of the CFTC Proposed Rules, but our greatest concern is with how those rules will interact with other proposed rules, including block trade criteria and real time reporting. We believe that these rules, in combination, will severely adversely affect market liquidity and the effective functioning of SEFs. In summary:

- First, we submit that the Request for Quote ("**RFQ**") trading protocol, as outlined in the CFTC Proposed Rules, will reduce liquidity and widen bid-ask spreads for large non-block trades, as well as for a number of other types of trades, thereby increasing transaction costs for all market participants. We recommend that the determination of the number of market participants to which an RFQ should be sent be left to the discretion of market participants;

- Second, we strongly urge the CFTC to adopt objective criteria for the determination that swaps are "made available for trade" on a SEF. An individual SEF's determination to list an illiquid swap, combined with the mandatory execution requirement, could result in

[1] CFTC Notice of Proposed Rulemaking on "Core Principles and Other Requirements for Swap Execution Facilities", RIN 3038-AD18, 76 Fed. Reg. 1214 (Jan. 7, 2011, with a comment deadline of March 8, 2011) (the "**Proposing Release**").

that SEF having a monopoly in the trading of that instrument to the detriment of market liquidity and functionality. We make recommendations for such objective, CFTC-approved criteria; and

- Third, we submit that the CFTC Proposed Rules, along with other proposed rules, will critically undermine the ability of market participants to efficiently execute large non-block trades at reasonable price. The restrictive definition of block size, which makes a very limited number of transactions potentially eligible for treatment as block trades, combined with the requirement that large non-block trades be reported immediately after execution, will undermine market efficiency and liquidity. The CFTC's proposed RFQ protocol would further exacerbate this problem.

I. Request-For-Quote Protocol

The CFTC's proposed model, requiring that an RFQ be sent to at least five market participants, will increase transaction costs for our customers and effectively take away their right to transact in the way that they deem in their best interest. The shortcomings of this model become especially apparent when this execution method is applied to large non-block trades. To the extent that a customer's intention to execute a large trade is "signaled" to more than one market participant, the price of the relevant instrument will likely move adversely to the customer. Expecting that an adverse price movement will occur, market participants responding to the RFQ will need to reflect the potential adverse market movement in the price of the swap, thereby transferring the cost of pre-trade transparency onto the customer. We note that the Dodd-Frank Act exempts blocks from the SEF trading requirement. However, the marketplace trades swaps in all sizes, from very small to very large, and under the CFTC's proposed block size criteria, very few trades would qualify as blocks.[2] Specifically, we believe that there would be many trades large enough to trigger this signaling effect but which would not qualify as blocks under the CFTC definition.

As a related point, and as more fully explained in Part III below, we note that the proposed requirement that large, non-block trades be reported to the public as soon as technologically practicable will have a similarly significant adverse effect on liquidity.

The swaps markets are comprised of institutions who understand the trade-offs between transparency and liquidity, and in particular, the impact of signaling large transactions to multiple market makers. Our customers recognize that as trade size grows, best execution results from including fewer market makers in the RFQ. Customers today sometimes choose to include only one market maker in an RFQ, even though they are free to include more. They do so because they know from experience that it leads to better execution.

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[2] CFTC Notice of Proposed Rulemaking on Real-Time Public Reporting of Swap Transaction Data, RIN 3038-AD08, 75 Fed. Reg. 76140 (December 7, 2010, with a comment deadline of February 7, 2011) (the "**CFTC Real-Time Reporting Proposed Rule**") at 76172, 76176.

We strongly advocate a regime under which swap participants may use their experience and judgment to determine how many market participants an RFQ should be sent to in order to achieve best execution of a trade. Moreover, we respectfully note that a quote requester's obligation to send an RFQ to no less than five market participants is not rooted in the Dodd-Frank Act.[3] Rather, the rationale underlying the creation of SEFs appears to be the desire to provide quote requesters with "the ability"[4] to accept bids and offers made by multiple market participants if they so wish. As a related point, the Dodd-Frank Act provides that a SEF shall have reasonable discretion in establishing the manner in which it complies with the core principles set forth in the Dodd-Frank Act, including trade order execution procedures.[5] The CFTC Proposed Rules, as they relate to the RFQ execution protocol, are inconsistent with this grant of discretion.

II. "Available to Trade" Determination and Mandatory Execution Requirement

The CFTC Proposed Rules implement a mandatory trade execution requirement, whereby swaps that are required to be cleared must be executed on a SEF or Designated Contract Market ("**DCM**"). However, a transaction need not be executed on a SEF or DCM if no SEF or DCM makes the swap "available to trade".[6]

The determination of availability to trade is of critical importance to ensure competition among trading venues. We begin by noting that many more swaps will be clearable than will be traded with any regularity. A SEF's decision as to which instruments to list cannot be the sole determinant of when a swap could no longer, absent an exception (e.g., non-financial end-user hedging), trade in the over-the-counter ("**OTC**") market. If the "made available to trade" requirement were interpreted as satisfied merely by the listing of a contract for trading, any DCM or SEF could list an illiquid (but clearable) swap, thereby declaring it available to trade and triggering the mandatory execution requirement. This could result in several unintended consequences.

The first effect would be the establishment of an overnight platform monopoly in the trading of certain instruments. Because the determination that an instrument has been made available to trade essentially removes it from the OTC market, a significant segment of Morgan Stanley's customers and market makers without connectivity to that particular platform would effectively be precluded from entering the market in that instrument until they established connectivity to that platform or until another platform made that instrument available to trade. Market participants would be required to seek connectivity with the platform listing a particular instrument in order to trade the instrument. As a second effect, market participants with greater resources to devote to IT connectivity, operations and document negotiation would gain faster

[3] *See* Commissioner Sommers' dissent in the approval process, in Proposing Release at 1259.

[4] Dodd-Frank Act Section 721(a)(21), amending the Commodity Exchange Act ("**CEA**") to introduce new Section 1a(50), which defines SEFs.

[5] Dodd-Frank Act, Section 733, amending the CEA to introduce Section 5h(f)(1)(B).

[6] Dodd-Frank Act, Section 723(a)(2), amending the CEA to introduce Section 2(h)(8) of the CEA.

access to trading. Third, the operators of the platform would be in a position of deciding which market participants would be given connectivity, and in which order. Finally, once connectivity to the platform was established, a customer would be forced to deal with those market makers who happened to be present on that platform.

We favor an objective interpretation of the "made available to trade" requirement under Section 2(h)(8) of the CEA and encourage the CFTC to memorialize objective criteria in its adopting release.[7] The CFTC should reject any exercise of discretion on the part of any platform in making periodic determinations of whether a swap is available for trading and instead require the adoption by all platforms of, at a minimum, the following two objective criteria. First, note that each platform should have trading hours for particular instruments. For a swap to be available to trade on a SEF, there should be resting bids and offers for that instrument on that platform for at least half of the relevant trading hours for a ninety-day period prior to the determination of availability to trade. Second, each swap – or instruments with substantially the same characteristics – must have been traded an average of at least five times per day during the same time period. The CFTC should independently evaluate each platform's compliance with these criteria and design other criteria to take into account the uniqueness of each swap market.

Note that our first proposed criterion potentially leads to only certain hours in which some swaps are available to trade on SEFs (or DCMs). This is intentional and, in our view, appropriate. Customers wishing to trade swaps outside of the hours when they are available to trade on SEFs should be free to use the OTC market and not be forced to wait for a SEF to open.

Once the objective criteria have been met, we propose that the CFTC provide public notice that a swap will be deemed available to trade, and on which platform(s), and allow at least thirty days before the mandatory execution requirement becomes effective. This provides time for other SEFs or DCMs to list the instrument, and reduces the likelihood of the monopoly scenario described above.

Finally, the CFTC should regularly review their determinations and, where a swap no longer meets the requirements, remove that swap from the list of instruments "available to trade."

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[7] We endorse the Securities and Exchange Commission ("**SEC**")'s preliminary interpretation of the determination of "made available to trade" in Section 3C(h) of the Securities Exchange Act (the "**SEA**") as meaning something more than the decision to simply trade, or essentially list, a security-based swap on a security-based SEF or an exchange. *See* SEC Notice of Proposed Rule and Interpretation on Registration and Regulation of Security-Based Swap Execution Facilities, Release No. 34-63825, File No. S7-06-11, RIN 3235-AK93, 76 Fed. Reg. 10948 (February 18, 2011, with comment deadline of April 4, 2011), at 10969. This determination should be made pursuant to objective criteria established by the SEC, rather than by one or a group of security-based SEFs or the proposed swap review committees of such entities.

III. The Combination of the RFQ Protocol and the Reporting and Block Size Requirements Will be Adverse to Market Liquidity and Functionality

The Dodd-Frank Act explicitly recognized the need to deal with block trades separately in its public reporting and SEF / DCM provisions.[8] Under the current regime proposed by the CFTC, non-block transactions are to be reported as soon as technologically practicable following execution, whereas block trades in standardized swaps are to be reported within fifteen minutes.[9]

The degree of premature dissemination of pre-trade information inherent in the CFTC's requirement that a SEF send an RFQ to no less than five market participants, as described above, would, in and of itself, severely compromise market liquidity and make most large transactions very costly to execute. In addition, the degree of post-trade transparency afforded by the immediate reporting requirement for large, non-block trades would compromise the viability of certain market participants' hedging strategies. The combined negative impact of these two factors on market liquidity is greater than the individual effect of either factor. Even if an RFQ for a large, non-block transaction were sent to only one market participant, once the entire market becomes aware of the trade, it would know that the market maker will soon be liquidating or hedging its large position, causing bids and offers to adjust accordingly. Immediate trade reporting thereby results in adverse price movements for the market maker. As a result, market makers would reflect this in their prices, thus transferring the cost of post-trade transparency to customers.[10]

The proposed unduly restrictive definition of block, only makes matters worse. The provisions in the Dodd-Frank Act relating to public reporting of swap transaction data require that the rules promulgated by the CFTC take into account whether public disclosure will materially affect market liquidity.[11] We respectfully submit that the rules as currently proposed

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[8] Dodd-Frank Act, Section 727, amending the CEA to introduce Section 2(a)(13)(E)(ii-iii) and Dodd-Frank Act, Section 733, amending the SEA to introduce Section 5h(f)(2)(C).

[9] CFTC Real-Time Reporting Proposed Rule, at 76172, 76176.

[10] We also believe that a fifteen-minute delay in reporting for block trades is insufficient. The issues relating to signaling that a market maker is, or will be, liquidating or hedging a block position are not alleviated by a fifteen-minute delay when such positions may take a much longer time to liquidate or hedge. This is especially the case given the large block sizes resulting from CFTC's proposed block definition. We refer the CFTC to the comment letter submitted to the CFTC by the International Swap and Derivatives Association, Inc. ("**ISDA**") and the Securities Industry and Financial Markets Association ("**SIFMA**") on February 7, 2011 with respect to real-time reporting requirements for swap transactions, commenting, among other things, on why significant additional research is necessary before appropriate delays can be determined and that new rules for reporting should be introduced cautiously. *See* ISDA/SIFMA comment letter re: (1) RIN 3038-AD08 – Real-Time Public Reporting of Swap Transaction Data; (2) RIN 3038-AD19 – Swap Data Recordkeeping and Reporting Requirements; and (3) RIN 3038-AC96 – Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, February 7, 2011, (the "**ISDA/SIFMA Comment Letter**").

[11] Dodd-Frank Act, Sections 727, amending the CEA to introduce Section 2(a)(13)(E)(iv). *See also* Dodd-Frank Act, Section 763(i), amending the SEA to introduce Section 13(m)(1)(E)(iv), requiring that the SEC account for the same consideration.

would have a material adverse impact on liquidity. The signaling problem created by both the proposed RFQ protocol and the immediate reporting requirement would be mitigated if more trades qualified as blocks. Indeed, the whole purpose of having separate rules for block trades is to avoid such problems. Unfortunately, the CFTC's proposed definition for block size leads to very few trades qualifying as blocks, thus magnifying, rather than diminishing, the problem.[12]

The consequences of the proposed rules on market access and diversity of participation would be momentous and unfortunate. Some market participants would likely attempt to avoid the excessive costs of executing large illiquid swap transactions by segmenting them into several smaller ones, thus inevitably exposing themselves to market risk rather than liquidity risk. Other market participants, however, would probably prefer to exit the swap market altogether and would either choose to utilize less efficient vehicles to hedge their positions, thereby exposing themselves to additional risks including basis risk, or choose not to hedge their positions at all. These decisions would only serve to increase systemic risk, which is clearly not what was intended.

Therefore, we urge the CFTC to adopt a definition of block size that is related to the size that would move the market for a particular asset class, and to preserve participants' choice for RFQ execution. We further urge the CFTC to adopt an interpretation of "available to trade" that avoids the unintended consequence of providing some SEFs with monopoly power and shutting some of our customers out of the market.

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[12] We refer to our comment letter relating to the CFTC Real-Time Reporting Proposed Rule stating our belief that trades in illiquid markets should be subject to different reporting requirements than those applicable to trades in more liquid markets in order to prevent situations where information disseminated to the market might impact the effectiveness of hedging strategies, create potential "front running" and ultimately adversely affect the depth and breadth of the markets. Morgan Stanley comment letter re: Treatment of Illiquid Products under CFTC Proposed Rule under Section 763 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (File No. S7-34-10), February 7, 2011. Our concern is particularly focused on the limited number of transactions eligible for treatment as block trades and on the comparatively much greater number of illiquid, non-block transactions that the CFTC will require be reported immediately after execution. *See* CFTC Real-Time Reporting Proposed Rule at 76172, 76176.

We also endorse the ISDA/SIFMA Comment Letter referred to in footnote 10 above, which recommended that any final rules relating to block trades be constructed so that block trades can be both executed and hedged without negatively impacting liquidity or end-user funding and issuance costs. The letter also warned that that the risks of adopting block trading rules that are not proportionate to the available liquidity of an OTC derivatives market include a reduction in end users' ability to hedge their risk and an increase in the cost of that hedging activity.

Finally, we would also point the CFTC to comment letters from the end-user and asset manager community that endorse similar views, such as: Vanguard, Pacific Investment Management Company LLC (PIMCO), Air Transport Association of America, Inc., Chesapeake Energy Corp., Blackrock Inc. and Encana Marketing (USA) Inc.

We appreciate the opportunity to comment to the CFTC on these proposed rules and would be pleased to discuss any questions the CFTC may have with respect to this letter. Any questions about this letter may be directed to Dexter Senft (212-761-2466).

Respectfully submitted,

Dexter Senft
Managing Director

cc: The Hon. Gary Gensler, CFTC Chairman
The Hon. Michael Dunn, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner

The Hon. Mary Schapiro, SEC Chairman
The Hon. Kathleen L. Casey, SEC Commissioner
The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner

Elizabeth M. Murphy, Secretary, SEC