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Morgan Stanley

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

Re: Further Notice of Proposed Rulemaking on Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade (RIN 3038-AD18)

Dear Mr. Stawick:

We are writing in response to the Commodity Futures Trading Commission's (the "**Commission**" or "**CFTC**") further notice of proposed rulemaking captioned "Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade,"[1] in which the Commission proposes rules (the "**Proposed Rules**") to implement the "available to trade" ("**MAT**") provision of the trade execution requirement set forth in new Section 2(h)(8) of the Commodity Exchange Act (the "**CEA**")[2] pursuant to Section 723(a)(3) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").[3]

Morgan Stanley believes it is critical to preserve liquidity in the swap markets. Our primary concern is that the Proposed Rules will make swap markets less liquid and more risky for our customers and ourselves.

The Proposed Rules do not stand alone. They will interact with other rules that have yet to be finalized. We would be less concerned about the MAT determination if the Commission's rules on permissible trading protocols and block sizes were liberal.

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1 Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade, RIN 3038-AD18, 76 Fed. Reg. 77728 (proposed Dec. 14, 2011) (to be codified at 17 C.F.R. pts. 37 and 38) (the "**Proposing Release**").

2 17 U.S.C. § 1 *et seq.*

3 Public Law 111-203, 124 Stat. 1376 (2010).

Unfortunately, we believe the opposite is likely to be true. Restrictive trading protocols and large block sizes, in combination with the Proposed Rules, will be even more harmful to liquidity, in our view.

The seven factors identified by CFTC are all helpful in a MAT determination, but only if there is further guidance. This could be in the form of objective criteria to be met (e.g., "trading frequency should be at least x"), or it could be principles-based (e.g., "liquidity should be sufficient to ensure that trades just below the block threshold would not be expected to move the market more than one price increment"). The Proposed Rules offer neither. They create a situation where two different SEFs or DCMs could reach different conclusions on the same swap, and there would be no basis for making a rational decision.

DCMs and SEFs, as for-profit entities, have strong incentives to force swaps—both liquid and illiquid—onto their trading platforms, and to be the first to do so. Because execution on a DCM or SEF becomes mandatory once a MAT determination is made, we expect many illiquid swaps could become subject to the trade execution requirement as a result of the Proposed Rules. Therefore DCMs and SEFs, because of these incentives, have clear and unavoidable conflicts of interest in making this determination. Mandatory execution of illiquid swaps on a DCM or SEF would substantially reduce liquidity in those products—by restricting over-the-counter ("**OTC**") trading without providing a viable platform alternative—and increase spreads and costs for our customers. These results are not consistent with—and indeed are directly contrary to—the intent of Congress in adopting the mandatory execution requirement of Dodd-Frank.

I. Only Liquid Swaps Should Be Subject To the Trade Execution Requirement

Execution of transactions on a DCM or SEF should only be mandatory for liquid swaps. In our view, this is the only feasible meaning of the phrase “available to trade.” Requiring counterparties to execute transactions involving illiquid swaps on a DCM or SEF will reduce liquidity, widen bid-offer spreads and increase transaction costs for all market participants. Prohibiting OTC trading and forcing already-illiquid swaps onto platforms with insufficient liquidity will significantly constrain liquidity. The reduction in liquidity, together with a disinclination on the part of market participants to reveal their interest to the entire market, will lead to a widening of bid-offer spreads. When liquidity is scarce, or transaction sizes large relative to the available liquidity, information about a market participant’s intention to trade becomes material to other market participants. If this information is required to be disseminated through a DCM or SEF, it will cause other market participants to modify their bids or offers, which will in turn affect the market price and increase the cost of the trade.

II. Congress Intended Only Liquid Swaps To Be Available To Trade

The drafters of Dodd-Frank understood the trade-offs between transparency and liquidity in the derivatives markets and designed the trade execution requirement to strike a balance between these competing objectives. Under Section 2(h)(8) of the CEA, any transaction involving a swap subject to the clearing requirement must be executed on a DCM or SEF, unless no DCM or SEF “makes the swap available to trade.” As Commissioner Sommers has observed, Congress used the phrases “list for trading” and “listing for trading” in other sections of the CEA, so, by using the phrase “makes available for trading” here, Congress must have meant something different.[4] A colloquy by Senator Lincoln on the floor of the U.S. Senate confirms the inference drawn by Commissioner Sommers and reveals that Congress intended “a minimum amount of liquidity” to be a prerequisite for a swap being made available to trade.

> In interpreting the phrase ‘makes the swap available to trade,’ it is intended that the CFTC should take a practical rather than a formal or legalistic approach…The mere ‘listing’ of the swap by a swap execution facility, in and of itself, without a minimum amount of liquidity, to make

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[4] Commissioner Jill E. Sommers, Opening Statement, Fourth Open Meeting to Consider Final Rules Pursuant to the Dodd-Frank Act (September 8, 2011).

> trading possible, should not be sufficient to trigger the Trade Execution Requirement.[5]

The purpose of the MAT provision was to limit the scope of the trade execution requirement to only those swaps for which there is sufficient liquidity to support trading on a DCM or SEF.

III. Prerequisites For Trading Are Different From Those For Clearing

We believe that a MAT determination requires a separate analysis from whether the swap should be subject to the clearing requirement. Not all swaps that are required to be cleared will necessarily be available to trade solely by the creation of a cleared market. To the contrary, we anticipate that many OTC products that cannot feasibly be centrally executed will nevertheless be cleared. However, the amount of liquidity necessary for MAT is different from that necessary to facilitate clearing of the swap. Central counterparties ("**CCPs**") can and do clear illiquid swaps. The focus for clearing is on an ability to value the swap and to apply appropriate risk management measures and margin requirements, which can be done with models and does not necessarily require active trading. It will not be possible for DCMs and SEFs to provide meaningful execution opportunities in all situations where clearing is mandated. As an example, NYMEX offers over 1,400 unique products for clearing on its ClearPort slate. While all of these products are offered for execution, the volume of executions is virtually nonexistent. Forcing some or many of these products to be executed certainly is contrary to the markets' interests and, we submit will in no way benefit market users.

IV. Proposed Rules Afford Too Much Latitude To DCMs and SEFs

Under the Proposed Rules, DCMs and SEFs, rather than the Commission, would make MAT determinations, and the DCMs or SEFs would be afforded great latitude in doing so. The Commission's role would be limited to reviewing determinations of DCMs and SEFs. In making its determination, a DCM or SEF would be required to consider, "as appropriate," seven enumerated factors or any other factor that the DCM or SEF may consider relevant. The DCM or SEF would be permitted to base its determination on any combination of the factors or on a single factor. The factors themselves, however, do not contain any objective criteria, nor does the Commission provide any principles-based guidance for their application. As a result, there are virtually no constraints on the power of a DCM or SEF to make swaps available to trade. As Commissioner Sommers notes, the lack of any parameters on how these factors should be considered will make it very difficult, if not impossible, for the Commission to reverse a

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[5] Statement of Senator Blanche Lincoln, Senate Consideration and Passage of the Conference Report on H.R. 4173, 156 Cong. Rec. S5870 (Daily Ed. July 15, 2010).

MAT determination. Moreover, the length of the Commission's review period—only 10 business days, if the DCM or SEF chooses to self-certify—is far too short to permit the Commission to undertake a meaningful review of the determinations. In addition, as a practical matter, once the MAT determination has been made, and market participants are required to cease the trading of the affected product outside of a DCM or a SEF, the reduction in liquidity and other negative effects will already be having an impact and it will be difficult, if not impossible, to reverse those effects.

Permitting a DCM or SEF such great discretion to make MAT determinations would also create a clear and insurmountable conflict of interest. Under Dodd-Frank, once a DCM or SEF makes a swap available to trade, that swap can no longer be executed bilaterally and can only be executed on a DCM or SEF. Consequently, DCMs and SEFs, which are for-profit entities, have strong incentives to see that as many swaps as possible are subject to the trade execution requirement—even those that are illiquid. Indeed, by making a MAT determination, a DCM or SEF could effectively block the operation of any OTC market, even if no active trading market developed for that swap on any DCM or SEF.

The incentive for a DCM or SEF to take such action, and the consequences of their doing so, are underscored by the history of central execution markets, which clearly reflects that a significant and, perhaps, insurmountable first-mover advantage exists for the trading facility that first brings a given product to market. Once a trading facility begins offering a new product, and establishes itself as the market for that product, it becomes very difficult for another facility to capture market share. Consequently, DCMs and SEFs will have powerful incentives to capture first-mover advantage by making MAT determinations before their competitors do. We believe that the Proposed Rules, which would allow DCMs and SEFs virtually unlimited discretion in this regard, would set off a race among DCMs and SEFs to move swaps—both liquid and illiquid—onto trading facilities. The result would be to eviscerate the MAT provision, undermine the existing OTC market and frustrate the clear intent of Congress to restrict the trade execution requirement to liquid swaps.

V. Determinations Should Be Made By the Commission

While DCMs and SEFs should be allowed to propose swaps for designation, we submit that all MAT determinations should be made by the Commission and should not become effective until the Commission has made its determination. The timeframe for the Commission to review a proposal and make its determination should be at least 60 days from the date of formal submission, with 30 days for notice and comment. In light of the conflicts of interest identified above, we believe that a notice and comment period, which would afford the Commission an opportunity to consider the views of market participants with interests in the proper functioning and liquidity of a

market for a particular swap that might not align with the interests of the DCMs and SEFs, would be an essential addition to the MAT determination process.

VI. Determinations Should Be Based On Objective Criteria

We favor an objective interpretation of the MAT requirement and encourage the Commission to establish objective, required criteria in its adopting release. It is imperative, and consistent with manifest congressional intent, that the criteria include sufficient liquidity as a prerequisite and not merely one of several factors to be considered. The Commission should reject any exercise of discretion on the part of any platform in making MAT determinations and instead require the adoption by all platforms of, at a minimum, the following two objective criteria:

1. For a swap to be available to trade on a DCM or SEF, there should be resting bids and offers for that instrument on that platform[6] for at least half of the relevant trading hours for a ninety-day period prior to the determination; and

2. Each swap must have been traded an average of at least five times per day during the same time period.

While these criteria are subject to debate, we believe most market participants would agree that they are easily satisfied by liquid swaps, and not satisfied by illiquid swaps. However, they are not the only criteria that matter, so we recommend that the Commission design additional objective criteria to take into account the uniqueness of each swap market.[7]

This approach would be consistent with the Securities and Exchange Commission's (the "**SEC**") preliminary interpretation of the "available to trade" provision applicable to security-based swaps ("**SB swaps**").[8] The SEC has stated its preliminary belief that, in light of the potential for conflicts of interest that security-based swap execution facilities ("**SB SEF**s") have, the decision as to when a SB swap would be

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[6] This requirement could be relaxed to permit a DCM or SEF to determine that a swap satisfies the minimum liquidity threshold based on trading on other platforms or in the OTC market. However, a DCM or SEF should not be permitted to seek a MAT determination with respect to any swap unless it has experience trading that swap. Importantly, there should not and has not been any restrictions on SEFs or DCMs listing contracts to voluntarily trade. Our concern only focuses on the restrictive impact of mandatory execution.

[7] These points were also addressed in our SEF Comment Letter.

[8] See Section 3C(h) of the Securities Exchange Act of 1934, which was added by Section 763(a) of the Dodd-Frank Act.

considered to be made available to trade should be made pursuant to objective measures established by the SEC, rather than by one or a group of SB SEFs.[9] Congress directed the CFTC and the SEC to harmonize their implementations of Title VII of Dodd-Frank, and they should be consistent in this respect as well.[10]

Furthermore, the CFTC has employed quantitative thresholds to aid in making similar determinations in the past. For example, the CFTC's rules for identifying "significant price discovery contracts" under the CFTC Reauthorization Act of 2009 prescribe quantitative thresholds with respect to trading volumes and other metrics. The Commission stated that it would view "the average of five trades per day or more threshold as the level of activity that would potentially meet the material volume criterion," which is one of the four factors that the Commission must consider in identifying significant price discovery contracts.[11]

VII. Rules Should Address Timing Considerations

The CFTC's final rules should also recognize that the MAT determination cannot be made at a single point in time and then become binding indefinitely, or at least until the next annual review. Under the proposed rules, a swap with a MAT determination will thereafter have that status at all times and in all contexts. This situation, however, can change dramatically over time, including within very short periods of time. It is therefore unrealistic to label a particular product as MAT and have it maintain that status even if it later becomes illiquid or effectively stops trading. Moreover, there are other dimensions to the timing of this determination that must be taken into account and reflected in the final rules. For example, most swaps are actively traded only during a portion of the business day and not overnight or on weekends. Certain swaps may be liquid only during certain hours of the day or only on certain days of the week or month. For example, certain physical swaps only actively trade during "bid week." For interest rate swaps, settlement dates and tenors are important. For example, five-year spot-starting interest rate swaps are highly liquid and available to trade, but four-year-and-364-day swaps are not, nor are five-year-and-one-day swaps. Similarly, certain types of swaps have a high degree of seasonality, with liquidity only during specified periods of the year, based on energy usage, crop cycles or other factors. These swaps may be sufficiently

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9 SEC, Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948, 10969 (February 28, 2011).

10 See Section 712(a)(1) of the Dodd-Frank Act, which directs the CFTC to consult and coordinate with the SEC for the purpose of assuring regulatory comparability and consistency to the extent possible.

11 CFTC, Significant Price Discovery Contracts on Exempt Commercial Markets, 74 Fed. Reg. 12178, 12197 (March 23, 2009).

liquid during their active periods and but largely illiquid—and not "available to trade"—at other times. This means that the MAT determination process should be flexible enough to recognize swap tenor, time of day and other critical factors, and not just the swap identifier. If a market participant wishes to enter into a swap outside of the times when the swap actually is available to trade on a DCM or SEF, the market participant should be permitted to do so in the OTC market.

Although the proposed rules require annual review of MAT determinations, experience has shown that liquidity in the swap markets can be significantly reduced, or even disappear entirely, abruptly and unexpectedly. If a swap ceases to be liquid on a DCM or SEF, even for a short period of time, market participants should be able to petition the Commission for an expedited MAT determination, and the rules should permit market participants to trade bilaterally. While we support annual review of available to trade determinations, we believe that annual review alone would be too infrequent to adequately address this concern. In addition, the annual review does not in any way address the other timing issues noted above—swaps with liquidity only at certain times or during certain periods—and these issues as well must be addressed in the final rules.

VIII. "Economically Equivalent Swap" Concept Is Problematic And Unnecessary

We also have substantial concerns with the concept of "economically equivalent swaps" and the effect this standard will have on the markets. First, as with the MAT determination criteria, the Commission has provided neither objective criteria nor principles to employ. It is unclear how DCMs and SEFs would be able to consider and compare "material pricing terms" to determine whether one swap is economically equivalent with another swap. The conflict of interest discussed above applies just as much to the determination of economic equivalence as it does to the MAT determination, since both result in a mandatory execution requirement. A clearly defined, objective test for an "economically equivalent" swap would mitigate this concern. Without such a test, market participants will have difficulty determining which swaps must be executed on DCMs and SEFs, and this will create confusion and uncertainty in the market.

However, our concerns with the term "economically equivalent" are more fundamental, and we question whether this approach is viable at all or on any terms. In our view, the concept of "economic equivalence" is inherently elusive and subjective. Even two swaps with identical contractual terms, cash flows and credit risks will not be economically equivalent in the eyes of market participants unless they are cleared through the same CCP. SEFs listing the same swap for clearing on different CCPs will have different order books—one for each CCP—with potentially different prices, bid-offer spreads, volumes and open interest. In other words, the swaps would have different market risk and liquidity characteristics at the two CCPs even though the cash flows and

credit risks are the same. Thus, one of the swaps might appropriately be MAT while others, even with the same terms, are not. Other differences between otherwise equivalent swaps (dates, quantities, delivery points, etc.) will exacerbate these distinctions further.

Because we believe liquidity is what really matters, economic equivalence does not. We advocate replacing the economically equivalent swap concept with an anti-evasion rule. The rule would prohibit swap dealers from trading customized swaps outside of a DCM or SEF if the primary purpose is to circumvent the trade execution requirement. Trading in such swaps would only be permitted in response to customer demand for a purpose other than evading the trade execution requirement.

IX. Group, Category, Type, or Class of Swaps

Finally, the Commission requested comment on whether the rules should permit MAT determinations to be made with respect to a "group, category, type, or class" of swaps and how those terms should be defined. In our view, and that of the drafters of the "available to trade" provision, a swap should only be subject to the trade execution requirement if there is sufficient liquidity available to support trading of the swap on a DCM or SEF. It follows, therefore, for the same reasons discussed above with respect to "economically equivalent swaps" that a "group, category, type, or class" of swaps should not be determined to be available to trade unless every swap in such "group, category, type, or class" is available to trade. But this would require the definitions of group, category, type and class to consider swap liquidity, effectively rendering the definitions moot. To define them otherwise would be harmful to the derivatives markets and would run counter to the legislative intent.

In summary, the proposed definition of "available to trade" is not a definition at all. It essentially says that "available to trade" is what any of several conflicted parties says it is. Morgan Stanley advocates having an actual definition with objective criteria, consistent with Congressional intent, which can be applied by the Commission in a uniform way. Anything else will result in a race to the bottom, which a place none of us wants to be.

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. Jill E. Sommers, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner
The Hon. Mark P. Wetjen, CFTC Commissioner