SDMA SWAPS & DERIVATIVES MARKET ASSOCIATION

February 2, 2012

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

Re: **RIN 3038-AD08: Real-Time Public Reporting of Swap Transaction Data (17 CFR Part 43)**

In Consideration of Appropriate Block Trading Thresholds with Regard to Swaps Execution and Trade Reporting

Dear Mr. Stawick:

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "CFTC") on the CFTC's Notice of Proposed Rulemaking regarding **Real-Time Public Reporting of Swap Transaction Data (17 CFR Part 43).**

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

Introduction

It is well established that there exists certain considerations for block trades in most liquid markets. Congress was quick to recognize that such rules would also exist for swap trades as it drafted the *Dodd Frank Act* (the "DFA"). With the DFA, however, the clear intent of Congress was that, while block trade rules for different contracts and markets might be different, "the guiding principle in setting appropriate block-trade levels should be that the *vast majority* of swap transactions should be exposed to the public market through exchange [or SEF] trading... (emphasis added).[1] To be sure, Congress intended that

[1] S5922 (Congressional Record, July 15, 2010).

most trades are *non-block* and thus must trade on transparent SEFs or DCMs if true transparency and market integrity is to be achieved.

Block trades are positive to the marketplace because they promote trading in large increments that in turn promotes liquidity. To encourage trading in large size increments, it is typical to protect liquidity providers from external forces that might otherwise abuse the information of a large trade and its immediate impact on prices and market equilibrium. As such, market makers are typically granted a time delay before they must report the block trade to the open market. In this time period, the trader may either trade hedge its block trade position or trade out of it altogether.

But a tension exists between the market maker's right to protect itself and the market's right to know trades as they occur. Too little time in the delay interval and the trader fails to set its hedge and is harmed. Too much time, however, and the trader is now in possession of market 'moving' or price sensitive information that can be used to harm the market. Thus, the role of the rule maker is to set the *optimal* balance between protecting the dealer and protecting the market from any possible abuse.

Block rules typically are defined by three determinants: 1) the time delay before the trader must report; 2) what trade information is reported; and 3) the trade size threshold that determines a block trade. On January 2012, the CFTC addressed the first and second items. It set the time delay for swaps to 30 minutes for the first year, and 15 minutes for each year thereafter. The CFTC also set the block reporting size to "250MM+" for all trades equal to and greater than 250 million. This paper therefore focuses solely third determinant—what is the optimal block trade size threshold for an interest rate swap?

Moreover, what is a correct and practical method for threshold determinations such that market liquidity is not harmed and the vast majority of swaps trade on SEFs or DCMs consistent with Congressional intent?

To answer these questions, the SDMA proposes a multi-pronged approach where three tests are considered to determine and measure optimal block trade thresholds: 1) a market 'depth' test; 2) a market 'breadth' test and 3) a *multiples* of average trade size test. Discussed in greater detail below, this paper not only proposes actual block sizes that should be adopted by the CFTC, but suggests that such a practical approach may continue to be used with increasing accuracy over time by regulators as SEFs become their real time data providers of pre trade price information.

What is a Block Threshold?

To consider our approach, it is first necessary to define the block threshold. The CFTC defines swap block trades to be "large-sized transactions that would cause a *significant* price impact if required to be executed on the DCM's centralized market." In other words, a block trade is a trade whose size is so large that it cannot immediately be absorbed by all the current bids or offers in the marketplace during a given time period.

Market Depth Test: Set Threshold Equal to Market Depth

To consider appropriate block trade thresholds, it is necessary to consider the liquidity in the market place at any point in time for a given swap.

Theoretically, it is true that if a market were perfectly liquid, no block trade exception would be needed because there would always be a *bid* for every seller and an *offer* for every buyer at the current market price. Thus, the available liquidity in the market at any time during the trading day would instantly

absorb *an*y trade at *any* size. In reality of course, this is not the case. There is not infinite liquidity at a given price but there is some; and thus one must consider how much liquidity is actually available or how much 'depth' exists at the current price.

We argue that rule makers should set the block threshold <u>at least equal</u> to the Market Depth.

Market Depth ("MD") is defined as the sum of Available Liquidity ("AL") at the time of trade. For the seller, available liquidity is the sum of all bids at the current price for a given swap. For the buyer, it is the sum of all offers at the current price for a given swap.

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

Figure 1 (below) considers Market Depth, which is equal to Available Liquidity for the largest and most liquid US interest rate swap market: dollar denominated, 3 month Libor indexed swaps. The first column is the swap maturity. The second column shows the 'Screen Size' or the standard size increment in which the swap price is customarily quoted by market practitioners. The third column displays Observed Liquidity ("OL").

To arrive at Observed Liquidity, we sampled six dealers' live actionable prices for each of the following: 2 year, 3 year, 5 year, 7 year, 10 year and 30 year. Daily, we sampled dealer's bid size and offer size at the current or near current price. For the near current price we included order size that was within a *quarter basis point* difference of the highest bid or lowest offer. Likewise, we ignored order size when it was associated with bids lower than or offers higher than the acceptable tight range. We then took the average of each observation for a given swap over the given time series to arrive at Observed Liquidity for the particular swap ("OL").[2] [3]

Swap Maturity	***Screen Size (MM)***	***Observed Liquidity***	***Available Liquidity "AL"***	***Block Thresold***
2yr	200	1,492	1,492	1,492
3yr	150	1,132	1,132	1,132
5yr	100	792	792	792
7yr	75	546	546	546
10yr	50	408	408	408
30yr	25	176	176	176

Figure 1. Market Depth Test

For the two year dollar Libor swap, the observed liquidity from six dealers is $1.492 billion in notional size. From considering Observed Liquidity, we may conclude that the market may instantly absorb *at least* the purchase or sale $1.492 Billion in notional two year swaps before liquidity is directly impacted.

[2] See Exhibit A for collated data taken from each dealer over the time interval.

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

Likewise, for the 10 year swap, the market could absorb *at least* the purchase or sale $408 million in notional, before liquidity is directly impacted.

But our Observed Liquidity only considers six dealers. What about the liquidity that the other 24 dealers may provide?

Clearly this broader dealer community does actually provide considerable liquidity to the swaps market place in addition the six dealers we observed. But, because only a small number of dealers offer live screens, it is presently difficult to quantify the liquid contributions of the non-electronic market makers. It is hoped that by encouraging more transparency through SEF trading, more prices will become available in the future. But for now we have set Available Liquidity *equal* to Observed Liquidity. Thus in an effort to be quite conservative, we assume that the marketplace for the purposes of this study is only comprised of the six dealers polled.[4]

Thus, based on our first test--Market Depth test--we suggest that block thresholds for dollar denominated, Libor indexed swaps be the following: 2 year ($1,492 MM), three year ($1,132 MM), five year ($792 MM), seven year ($546MM), ten year ($408 MM) and thirty year ($176MM).

Market Depth Test & Time Considerations

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

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

The Market Depth test only captures the Available Liquidity that is immediately available to be swept by the block market maker. It does not capture the subsequent prices that would enter the market in the 30 minute hedging window that follows. Because it is highly likely that several new bids and offers would enter the market place within the 30 minute window post immediate liquidity being swept by a block trade, the Market Depth test and its resultant block trade thresholds suggested here should be viewed as the conservative low end of where thresholds should be set by the rule maker.

Market Breadth Test

The second test that should be considered to determine optimal Block size trade thresholds is the Market Breadth test. This test recognizes that swaps are traded, hedged and risk managed on a portfolio basis by market makers.

Simply put, a given swap (a 'focus swap') may be routinely hedged by another swap of like maturity or by a basket of swaps of different maturities. As such, because the market maker may hedge a block trade with swaps of different maturities, it is necessary to consider the total available liquidity of those additional hedging swaps most likely used when setting optimal block size thresholds.

[4] It is important to note that Available Liquidity (AL) also does not consider the impact of new liquidity providers. Several non-traditional liquidity providers, such as electronic or 'algorithmic' market makers have already indicated their intention to enter the swaps marketplace.

$$\text{Market Breadth} = \sum \text{AL}_{\text{focus swap, adjacent swaps}}$$

Market Breadth is defined as the total sum of available liquidity of the focus swap in addition to the available liquidity of the adjacent swap point to its right and to its left on the swap curve.

Swap Maturity	*PV01 per Million*	*PV01 Block (MD)*	*Depth PV01*	*Breadth PVO1*	*Market Depth* Threshold*	*Market Depth* Adj (300K)*	*Market Breadth* diff*	*Market Breadth* Threshold*
2yr	$ 179	$266,322	$ 300,000	$ 600,000	1,492	1,681	189	3,361
3yr	$ 279	$315,602	$ 300,000	$ 900,000	1,132	1,076	(56)	3,228
5yr	$ 489	$387,050	$ 300,000	$ 900,000	792	614	(178)	1,842
7yr	$ 659	$359,541	$ 300,000	$ 900,000	546	456	(90)	1,367
10yr	$ 875	$357,122	$ 300,000	$ 900,000	408	343	(65)	1,028
30yr	$ 1,611	$283,536	$ 300,000	$ 600,000	176	186	10	372

** Notional expressed in millions*

Figure 2. Market Breadth Test

In Figure 2, we consider the Market Breadth test. There are certain steps that we must take to properly determine the correct block thresholds for swaps across the curve based on the Market Breadth test.

First, to consider liquidity expressed in notional sizes on an equivalent basis, we consider their Available Liquidity expressed on a risk adjusted basis or on a PV01 basis. Thus, we divide the Market Depth Thresholds in column six (determined by the Market Depth test) by the PV01 per million in column two. Column three lists the resultant PV01 for Market Depth Blocks which range from a value $266,322 to a value of $387,050 per basis point. For convenience purposes, we assume them all equal and set to equivalent to $300,000 per basis point. As evidenced in column eight, this is an acceptable assumption because it ratchets the suggested Block Threshold notionals downward in most cases as listed in the column entitled “Market Depth Threshold Adjusted”. For example, the five year swap block threshold notional is now $614 million, down from $792 million as originally determined by the Market Depth test.

Next, to properly consider the Available Liquidity across adjacent swap points, we first add the Depth PV01 of the focus swap to Depth PVO1 of the points adjacent to it to arrive at Breadth PV01, listed in column five.

For example, to determine two year swap Breadth PV01, we add the two year swap Depth PV01 equivalent ($300,000) and the three year swap Depth PV01 equivalent ($300,000) to equal $600,000 per basis point. Likewise, to determine the five year point Breadth PV01, we add the five year swap Depth PV01 equivalent ($300,000) to the three year swap Depth PV01 equivalent ($300,000) and the seven year swap Depth PV01 equivalent ($300,000) to equal Breadth PV01 of $900,000 per basis point. For the five year swap, this resultant PV01 properly accounts for the fact that a five year swap can be hedged with a combination of three year and seven year swaps.

To determine the suggested Market Breadth Threshold notionals for each maturity, we divide the Breadth PV01 by the simple PV01 per million for the relevant swap. For example, to determine the

block threshold for the five year swap we divide the Breadth PV01 ($900,000) by the PV01 per million ($489) to get $1.842 Billion. Thus, the $1.842 Billion is the suggested block threshold based on Market Depth and Market Breadth.

The resultant Market Breadth Threshold notionals (column nine) properly consider Available Liquidity not only in the focus swap that needs to be hedged, but also considers the Available Liquidity in the swaps around it. It is these adjacent swaps that swaps traders typically use as hedging vehicles if liquidity in the focus swap ever becomes suboptimal.

Thus, according to this conservative Market Breadth test, we suggest that block thresholds for dollar denominated, Libor indexed swaps be the following: two year ($3,361 MM), three year ($3,228 MM), five year ($1,842 MM), seven year ($1,367 MM), ten year ($1,028 MM) and thirty year ($372MM).

Market Breadth Test Considerations

This Market Breadth test builds upon Observed and Available Liquidity considered in the Market Depth Test. The Market Breadth test properly considers not only the liquidity in a particular swap, but also sees all swaps of a given class as economically equivalent.

The test recognizes that swaps are traded, hedged and risk managed on a portfolio basis by market makers. It recognizes that because a given swap may be routinely hedged by another swap of like maturity or by a basket of swaps of different maturities, rule makers should consider the liquidity of those swaps in making the Block Threshold determination.

The Market Breadth test is conservative because it *only* considers additional liquidity of swaps adjacent to the focus swap for hedging. It is of course possible to use non adjacent swaps for hedging purposes to avail of their liquidity if desired or necessary. For example, you could hedge a five year swap with a two year and ten year swap. For our test however, we decided against including this method because if the swap curve 'pivots' or moves in a non-parallel manner the hedge result would be suboptimal.

It is important to note, that the Market Breadth Test also ignores hedging or availing of liquidity using hedging tools such as US Treasuries or Euro Dollar Futures. Using Eurodollar futures, which are highly liquid, can prove to be quite an efficient hedge especially in the shorter swap maturities. But again, to be conservative, we decided against including them in the Market Breadth test.

Average Trade Size and Multiples Test.

A straightforward method to cross check the suggested block thresholds of the Market Depth and Breadth test is to consider them relative to a '*multiples of the average*' trade size of a swap of a given maturity.

Simply put, trades of an *average* trade size should be required to trade on SEFs, if rule makers wish that all *average* trades and those of *smaller than average* trade size should trade on transparent trade venues such that the transparency and liquidity goals of the DFA are met. To set them lower than the average, would logically mean that only very few swaps trades (those below the average size) would ever take occur on a SEF or DCM.

As a result, rule makers should chose a block trade threshold that is at least equal or indeed some fair multiple of average trade size.

Such a 'multiples of average trade size' approach is consistent with Congressional intent. As previously noted, Congress desired that the 'vast majority' of swaps should trade on SEFs or DCMs in considering Block trade thresholds for the DFA. Congress did not say only those trades 'of less than average size.' Thus, rule makers cannot set Block Trade Thresholds *less than or equal to the average* trade size. Rule makers are required to set such a threshold at some *fair* multiple of average trade size.

Appropriately, the CFTC considers such a *multiples of average test* as part of its two pronged block threshold approach. It suggests that the Block Threshold should be the higher of 1) five times the higher of the mean, median or mode of trade size; or 2) the 95 per centile distribution test. But is a multiple of five times the mean, median or mode --the correct and *fair* multiple?

Swap	*Screen*	*Average*	*Mrk Depth*	*Mrk Breadth*	*Average as Multiples of:*		
Maturity	*Size (MM)*	*Trade Size**	*Block*	*Block*	*Screen*	*M. Depth*	*M.Breadth*
2yr	200	344	1,492	3,361	0.6	4.3	9.8
3yr	150	221	1,132	3,228	0.7	5.1	14.6
5yr	100	126	792	1,842	0.8	6.3	14.6
7yr	75	113	546	1,367	0.7	4.8	12.1
10yr	50	85	408	1,028	0.6	4.8	12.1
30yr	25	52	176	372	0.5	3.4	7.2
** LCH Data from 1/25/12 (www.swapsclear.com)*				*Average*	0.6	4.8	11.7

Figure 3. Mutiples of Average Trade Size

In Figure 3, we consider the Average Trade Size relative to the Block Thresholds determined by the Market Depth Test and the Market Breadth Test. In column three, we display the average swap trade size. In column four and five we display the suggested Block Thresholds as determined by our Market Depth and Market Breadth Tests respectively.

First, observing average trade size by itself or a one times (1 x) multiple, we see following trades sizes: $344 million (two year), $221 million (three year), $126 million (five year), $113 million (seven year), $85 million (ten year) and $52 million (30 year). As discussed above, rule makers should not set required Block Thresholds equal or below these minimum trade sizes.

Second, to consider the fair multiple of average trade size, we consider Market Depth and Market Breadth relative to average trade size. We consider the Market Depth and Market Breadth Thresholds from our earlier tests as multiples of Average Trade Size in columns eight and nine respectively.

Considering average trade size relative to Market Depth, we observe that Block Thresholds suggested by our Market Depth test are on average a 4.8 multiple of the average trade size with a minimum of 3.4 multiple (30 year) and a maximum multiple of 6.3 (five year).

Considering average trade size relative to Market Breadth, we observe that Block Thresholds suggested by our Market Breadth test are on average a 11.7 multiple of the average trade size with a minimum of 7.2 multiple (30 year) and maximum multiple of 14.6 (three year and five year).

Assuming the CFTC fives times multiple test to be a multiple of the *average* trade size, we see that the CFTC five times multiple is sufficiently approximate to the 4.8 average multiple from the Market Depth test.

Moreover, because the Market Depth test captures only Available Liquidity, that is the total bids or offers available at the current price at any point in time taken from only six dealers, and because the Market Depth test ignores returning bids and offers in the hedging interval of 30 minutes, and because the CFTC 5x multiple is close to the Market Depth 4.8 multiple, we properly conclude the 5x is a fair multiple where the market can easily absorb the block trade within the given interval with no significant loss of liquidity in the market place. It is here at 5x Average Trade Size, or 1x Market Depth Threshold, where the CFTC should begin to set its required Block Thresholds for interest rate swaps.

In fact we conclude that the CFTC could set required Block Thresholds for interest rate swaps at, or equal to, the suggested Market Breadth Thresholds and their multiples (11.8 on average) of average trade size, if available liquidity of adjacent swap instruments are to be considered in the process.

Considering Other Market Proposals: ISDA, SIFMA Study

In an attempt to guide rule makers, other market organizations considered various techniques. In January 2011, ISDA and SIFMA published a study entitled "Block trade reporting for the over the counter derivatives markets." In such a study, the author considered various markets and cautioned rule makers not to set block size thresholds too high because too high a threshold would result in a loss of liquidity.

The author considered 'good' and 'bad' examples of where market liquidity was impacted as a function of large trade size. ISDA cited the TRACE credit reporting system as a 'good' example where liquidity was not negatively impacted by block trade sizes. He also cited negative examples—that of the London Stock Exchange's "Big Bang" in 1986 and certain select interest rate futures markets.

Although thoughtful in certain respects, we found the ISDA study to be somewhat limited in many others with regard to method and conclusion.

ISDA TRACE Example

The TRACE trade reporting systems is not a good basis for comparison. TRACE is not a trade execution venue, but is a post trade reporting system, more similar to an SDR than to a SEF of DCM.

TRACE is not a block trade reporting system. TRACE does not consider available pre trade liquidity—*market depth* or *market breadth*--for corporate debt instruments, not does it set block trade sizes for any particular instrument. Nor was it ever designed as such. According to FINRA, it is a post trade reporting system designed 1) to bring basic post trade transparency to the US corporate bond market and 2) to capture post trade data so that regulators can "take a proactive role in supervising the corporate debt market."[5]

ISDA does correctly note that TRACE has different reporting requirements for trades of $5 million notional or more. However, trade size of five million is not a 'block' corporate bond trade in the institutional markets.

[5] See http://www.finra.org/Industry/Compliance/MarketTransparency/TRACE/FAQ/

It is well established in the corporate bond market that $5 million notional is actually a 'round lot' or standard minimum size increment in which institutional market practitioners trade with each other. Any increment less than $5 million is considered by the market to be a small trade or 'odd lot' typically not traded by institutional customers and usually traded by the 'odd lot' desk at a bond dealer.

To assert that $5 million is a block trade not only ignores accepted market convention, but also misjudges the definition of a block trade. As discussed early, the CFTC considers block trades which are those trades that cause 'significant price impact' or whose size is so large that it cannot immediately be absorbed by all the current bids or offers in the marketplace during a given time period. Simply put, for investment grade corporates, trades of $5 million in size do not meet this definition because they are readily absorbed by current liquidity in the marketplace.

ISDA Futures Markets Examples

ISDA also considers block trading rules and liquidity in certain futures markets to help guide rule makers in their block trade threshold determinations for the swap markets. To determine appropriate block trade thresholds, ISDA recommends that you consider the market's ability to absorb or 'offset' a block trade based on current market trade volumes. Simply put, by looking at trade volume data relative to the mandated block threshold--how quickly can the market absorb (or offset) the block trade?

To determine how quickly the market can absorb a block trade, ISDA's considers how many block trades could trade during the mandated trade delay or given interval. To arrive at this, the ISDA approach is in two steps. First, determine the *volume per block trade interval* by taking total daily volume divided by the number of actual intervals during the trading day. Second, determine the *absorption rate*--how many block trades will the market absorb during the given time delay or interval.

Step 1: Volume Per Interval (VPI) = Total Volume $_{daily}$ /# of Reporting Intervals

Step 2: Absorption Rate = Volume Per Interval /Block Threshold

According to ISDA, the result will show that too low an absorption rate and the block threshold is set too high, liquidity is harmed (thus the block trade threshold needs to be set lower). Too high an absorption rate and the market can readily absorb the block size, market liquidity is not hampered, and thus the block trade threshold is appropriate.

To illustrate this approach, ISDA considers certain interest rate and commodities futures markets. We focus on their interest rate futures analysis.

Futures Contract	***Block Threshold (BT)***	***YTD 2010 * Avg Daily Vol***	***Reporting Intervals***	***Vol Per Interval (VPI)***	***Absorption Rate (VPI/BT)***
Fed Funds	2,000	52,009	78	667	0.33
Eurodollars	*4,000*	*1,941,931*	*78*	*24,897*	*6.22*
Treasury 5 yr	5,000	509,712	78	6,535	1.31
Treasury 10 yr	*5,000*	*1,159,612*	*78*	*14,867*	*2.97*
Treasury 30 yr	3,000	326,481	78	4,186	1.40

Trading data for November 21, 2010 CME Group.

Figure 4. Absorption Rates for Interest Rate Products

In Figure 4, we consider some of the ISDA results for fed fund futures, five year treasury futures, and thirty year treasury bond futures. For these interest rate futures, ISDA claims an absorption rate of zero (actually .33) for Fed Funds, and an absorption rate of 1 (actually 1.31) for Five Year Treasury Futures and an absorption rate of 1 (actually 1.40) for Thirty Year Treasury Bond Futures.

That these markets can barely absorb one block trade per five minute trade delay interval, if at all, ISDA asserts "Block trades in interest rates products cannot typically be offset during the reporting delay despite significant activity in these contracts." [6] Thus, according to the ISDA method, block trade rules are far too high for these futures markets. Indeed, such a conclusion ties back to the broader theme of the overall study—that rule makers should be cautioned not to set block thresholds too high or a loss of liquidity in the market will result.

But to declare that the five year treasury and thirty year treasury bond futures markets suffer from low liquidity is to ignore a well-known fact—these two futures markets are two of the most liquid markets in the world. There is ample liquidity in these markets and has been for some time. Indeed with the introduction of electronic execution, volumes have only increased.

In fact, these markets are as liquid as two other interest rate futures markets the ISDA study fails to consider: Eurodollars and the 10 year treasury futures. It is well established that the Eurodollar future is the most economically equivalent to the interest rate swap. Market practitioners routinely trade between the two and hedge one with the other.

To consider block trade rules for interest rate swaps, one should certainly look to the Eurodollar futures market. In Figure 4 above, we do just that. We notice that using the ISDA absorption method, Eurodollars can absorb a healthy *6.22 Block Trades of 4,000 contracts each five minute interval*. Clearly, this result shows a vibrant and liquid market when considered by ISDA standards.

The same is true for the 10 year treasury future, which the ISDA study also neglects to include. We notice that using the ISDA absorption method, 10 year treasury future can absorb a healthy *2.97 Block Trades of 5,000 contracts each five minute interval.*

With such high rates of absorption observed for Eurodollar and 10 year note futures, why did the ISDA study chose to ignore these markets?

Aside from neglecting to consider other key interest rate futures markets—more akin to the interest rate swap market--the ISDA absorption method is itself somewhat limited. The ISDA absorption test wrongly assumes that trade volumes per time interval are a constant. This is quite an assumption. Trade volumes are not constant but vary significantly through the course of a normal trading day.

US 5 YR note (CBT) Mar12
Volume at 5 minute Intervals for 2/1/2012

Mean	Median	Mode	Minimum	Maximum
3,134	2,282	3,253	20	12,819

[6] Page 10. "Block trade reporting for over-the-counter derivatives markets" (ISDA-SIFMA, January 18, 2011).

The above table shows that interval analysis for the five year note future for 2/1/12. It clearly shows that volumes varied as widely as 20 contracts (minimum) and 12,819 contracts (maximum) for all five minute intervals during the trading day with a mean of 2,282 contracts.

More importantly, the ISDA absorption method neglects to consider liquidity and market absorption expressed by Market Depth *directly* and the Market Breadth more *broadly*. The ability to absorb a block trade should be measured *not* by rates of trading alone, but should also consider the availability of orders in the market place-- bids and offers--at the *current price* or near current price.

The question is not---what just traded, but are there enough bids to absorb the block trader's large *sell* order and, likewise, are there enough offers to absorb the block trader's large *buy* order. The Market Depth test directly addresses and quantifies this with a specific block threshold. Market Breadth then considers market depth—bid and offer-- availability in swaps adjacent to and most likely to be used as a hedge by the swap trader or market practitioner.

ISDA Analysis of the CFTC Block Trade Test

Finally, ISDA considers the CFTC Block Threshold test by applying it to the 5-10 interest rate swap market with data from Tri-optima. It determines that the *Multiples of Average Trade* test would give a suggested block size of $375 million and the *95% Percentile Distribution* test would give a suggested block size $250 million for 5-10 year interest rate swaps.

That this would require 98% of the market to report trades, as ISDA asserts, remains to be seen. We were unable obtain such data to run the same analysis.

That said, although percentile requirements in the nineties may seem high for the interest rate swap market, they are not inconsistent with other liquid markets.

Observed Market	***Percent of Block Trades***
Interest Rate Futures (CME)	1%
Crude Oil Futures (NYMEX)	<4%
U.S. Equity Index (CME)	<1%
Cash Equity (NYSE)	13%

Trading data for 1/27/2012-2/2/2012, CME Group.

Nasdaqtrader, MonthlyMarketSummary December 2011

Figure 5 Percentage of Trades that are Block

In Figure 5, we consider the percentage of block trades in other transparent marketplaces. We observe that for interest rate futures they are equal to 1% of daily trade volumes, while they are less than 4% for crude oil futures and less than 1% for equity index futures. We notice that for less generic and more

diverse cash equities market place at the NYSE, the percentage of trades the execute as block increases to 13%.

Therefore, the range in these marketplaces lies between the 99th and 87th percentiles for trades which are block, with generic and focused products like interest rate futures and equity indices tending to the higher of the block percentile range or 99th percentile and the less generic, less homogenous products tending to the lower 87th percentiles.

Blackrock, in its comment letter, stated that the 95th per centile may be too high for interest rate swaps and instead suggested the 75th percentile. Unfortunately, they gave no justification for it.

We would argue something different. Given that most markets observed fall between the between the 87th and the 99th percentile range for block trades, regulators should be mindful to set the final OTC Derivative Block Threshold not only firmly within 87-99 range, but rule makers should place it firmly in the nineties, if such a setting is to properly account for interest rate swap liquidity relevant to other traded products.

Conclusion

Rule makers should be mindful not to set block trading sizes too high such that liquidity or transparency is negatively impacted. But trade size must be seen *relative to its own market place*. The interest rate swap market is one of the largest markets in the world—it is estimated to be at least $300 Trillion today or a staggering twenty dollars of swap for every dollar of US GDP. Average trade sizes can range in the *tens* or *hundreds* of millions of dollars. Consequently, it should not be considered unusual to set block trade thresholds in the *hundreds of millions* or even *billions*.

The SDMA study proposes a threefold test that includes 1) Market Depth 2) Market Breadth and 3) the *multiples of average test* for optimal block threshold determinations.

First, unlike the ISDA method, the SDMA Market Depth test considers orders—*bids* and *offers*—or available liquidity in the market for a given swap at a given time. It avoids considering trades and trade size alone. In an effort to be conservative, we consider *available liquidity* only from a limited number of dealers and ignore recurring bids and offers they may occur within the given interval once the current depth is swept by the block trade.

Second, with the Market Breadth test, we consider available liquidity in hedging swaps adjacent to the 'focus' swap that traders routinely use as hedging vehicles. Again to be conservative, we ignore swaps non adjacent to the focus swap. Again to be conservative, we also ignore available liquidity from other hedging tools such as Eurodollar or Treasury futures.

Further, we argue that block thresholds should be seen on a *risk equivalent basis* consistent with market practice. In our Market Depth test, we observe from sampling available liquidity of six dealers that this risk should be $300,000 per basis point. It is interesting to note that Blackrock suggested that the optimal block trading size should be $300,000 per basis point in its comments letter.[7]

Finally we examine trade count and trade size by comparing Market Depth and Breadth relative to a *multiples of average* trade test. By doing this we found that a 5x multiple is consistent with Market

[7] Page 8. Real-Time Reporting of Swap Transaction Data; RIN 3038-ADOB. (Blackrock, 2/7/2011)

Depth at the low end of our test. Indeed, we observe that an 11x multiple is possible as an acceptable multiple of average trades test when Market and Market Breadth was considered together.

The SDMA believes that setting the right block thresholds is critical to encouraging that the 'vast' majority of swaps trade on regulated SEFs consistent with Congressional intent and the goals of transparency and greater liquidity are met under the *Dodd Frank Act*.

Respectfully Submitted,

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