

ENERGY VOICE BROKER COALITION

January 28, 2013

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

Re: Use of Voice Brokers in Trading Futures and Swaps; CFTC Notice of Proposed Rulemaking on Core Principles and Other Requirements for Swap Execution Facilities (RIN 3038-AD18); Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade (RIN 3038-AD18)

Dear Mr. Stawick:

On behalf of a group of energy voice brokers (the Energy Voice Broker Coalition or EVBs)¹ we write this letter to address concerns related to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”) and, in particular, related to several regulations proposed by the Commodity Futures Trading Commission (the “CFTC”). EVBs serve a critical role in the energy markets by bringing together buyers and sellers of various energy products. Many EVBs have been in business for decades providing brokering services in physical commodities and more recently providing brokering services for financially settled derivatives (swaps, futures, and options). EVBs are typically small businesses that focus on brokering in a limited number of contracts that allow commercial end-users to customize their hedging activities to their risk profiles. We understand that there are over 100 voice brokers in the energy markets. We do not anticipate that many

¹ Members of the Coalition are listed at the end of this letter.

members of the Coalition, for economic reasons and other reasons, will register as a swap execution facility (“SEF”). Instead, EVBs continue to provide brokering services and to give their customers access to a wide range of energy products that help them efficiently and effectively hedge their price risk associated with energy commodities. To that end, EVBs urge the CFTC to ensure that market participants can continue to have access to voice brokers on both designated contract markets (“DCMs”) and SEFs, especially for contracts that cannot be effectively executed using a central order book (“COB”).

I. Description of Current Activity

EVBs provide brokering services so that their customers can purchase and sell customized hedging and risk management products. Services are provided to a variety of customers in the energy industry, including oil companies, independent refiners and producers, power generators, financial institutions, etc. As “voice brokers,” we interact with our customers via a variety of means, including instant messaging, email and phone. Depending on the needs of a particular customer, activities include brokering of swaps, forwards and physical products as well as brokering of block futures contracts. Many of the transactions are in illiquid products, such as No. 6 Fuel Oil, structured products involving liquids, such as calendar swaps on European gasoline swaps versus RBOB swaps, or exchange-traded options, such as longer-dated options on crude oil or natural gas. When customers decide to execute customized trades, EVBs source the potential counterparties and help match market participants with reciprocal interests using market knowledge. The services of EVBs allow customers to preserve anonymity and limit the market impact of their trades, while providing them with cost-effective hedging and risk management services.

Prior to the enactment of Dodd-Frank, many customers had voluntarily decided to take advantage of the risk mitigation afforded by clearing. They utilized the cleared swaps

facility offered by the IntercontinentalExchange (“ICE”) or the exchange of futures for swaps (EFS) offered by NYMEX Clearport (“CME”), both of which were privately negotiated and executed off-exchange. To the extent a transaction involves a more liquid product that is actively traded on a DCM, some EVBs serve as introducing brokers (IB). The presence of a large number of market participants and the availability of pricing reference data and standardized terms allows customers to trade liquid products quickly and with minimal price disturbance.

However, even if a product is offered on a screen, such as a natural gas option, there may be no depth of market. For example, if a trader has an order for 100 lots of a non-standardized product but only 10 lots are available on the screen, most likely any liquidity will dry up as soon as the trader tries to fill the order. In such situations, a trader will use an EVB to put together an order for 100 lots on behalf of the trader, because in a market with very few participants, the disclosure of the intention of the trader to buy (or sell) could disrupt the market and lead to poor pricing. Therefore, the only viable execution method for customers seeking to trade in those products is off-exchange private negotiations bilaterally or via voice brokers.

Recent market developments in response to the implementation of Dodd-Frank, specifically the transformation of hundreds of over-the-counter (“OTC”) swap products into futures (*i.e.*, “faturization”) by CME and ICE, have shifted a significant portion of the EVB business from swaps to futures.² As a result of futurization, customers are utilizing block futures trades to enter into transactions for these formerly OTC products, which are negotiated off-

² In October 2012, NYMEX/Clearport transformed 620 of their OTC swap products into futures products and ICE added a similar number of new futures.

exchange and then submitted to the exchange for posting and clearing.³ These developments, where the block futures size is sufficiently small, have enabled EVBs to continue providing efficient risk management services to clients. As the CFTC moves forward with the implementation of Dodd-Frank, EVBs are pleased to continue assisting customers in executing trades on an exchange, as long as there is sufficient liquidity and depth in the market. The greater concern, and the primary focus of EVB business, however, is in less liquid products or structured products, including options, for which there is little or no market. As discussed below, it is in the best interest of the energy industry and energy markets for the CFTC to ensure that EVBs can continue to broker transactions in futures and swaps, with particular focus on less liquid products and products that benefit from special assistance from EVBs, such as options. Given that the recent migration to futures is in response to customer demand and may therefore be irreversible, our letter addresses our concerns in the futures market first.

II. Futures and Options Contracts

Block Trade Thresholds

As noted above, many of the OTC swaps that EVBs used to broker on behalf of customers have recently been transformed into futures contracts. Notwithstanding this transformation, EVB customers continue to engage in bilaterally negotiated block futures and options in these products, given there is little, if any, trading on the exchange screen. EVBs are gravely concerned that the CFTC may require DCMs to raise the minimum block sizes for the

³ Although the focus of this letter is on energy products, we ask that the CFTC consider the potential benefits of voice brokers to other markets, such as agriculture. Currently, certain agricultural options, such as grains, are not permitted to be executed as block trades. This limits the ability of voice brokers to assist customers in large or structured transactions for which there is not sufficient liquidity and depth in the market to transact on a screen. Therefore, we urge the CFTC to encourage and facilitate the execution of block trades in all physical commodity options.

new futures contracts (as well as existing options contracts). There will be negative consequences for both customers' use of these particular futures contracts and for the markets in these contracts, more generally.

Arbitrarily setting higher block thresholds on futures and options will prevent many EVB customers from entering into transactions in these contracts, if the block thresholds exceed their hedging needs, credit risk and/or financial capacity to enter into such transactions. If the block minimums are raised, customers will be forced to either to take a larger price risk than they reasonably need or they will have to forego such transactions entirely or hedge only the benchmark commodity risk and leave unmanaged their basis risk. This will be destabilizing for these market users and cannot be a goal of Dodd-Frank.

Trading of Contracts in Illiquid Markets

Executing a transaction on the COB in a thinly traded contract will expose or telegraph the trades/trading strategies of the end-user to other traders in the market. Given the customized nature of these transactions, it would be difficult to enter into cross transactions, as an EVB may lose one leg of the transaction if any portion of the transaction was exposed to the market for five to fifteen seconds, such as structured products created for a client with multiple legs (*e.g.*, a calendar swap on European gasoline versus RBOB gasoline). In some instances, there may not be any active bids or offers in a particular contract, leaving the end-user with no trading options. In such circumstances, for futures or options contracts with high block minimum thresholds and little or no active trading on a COB, many customers may resort to using more standardized contracts, for which there is active trading on the COB, even though these contracts do not address their specific risk management needs.

The experience of EVBs with these products has demonstrated that it will be difficult, if not impossible, to put certain contracts onto a COB. Many of these products have

been illiquid for years or do not trade actively on a COB; restricting them to a COB will not make them more liquid or increase trading on the COB. EVBs are very concerned that forcing them onto a COB will reduce or destroy any liquidity in these products, as this will drive clients away from these products, to more liquid, but less customized, products that trade more actively on the COB, if such products are available. As a result, end-users will simply stop using the products that do not actively trade on the COB, ultimately destroying these markets.

To address this concern, DCMs have offered futures contracts with block minimums at levels which are intended to permit these futures contracts to be executed bilaterally or through voice brokers. We recommend that the CFTC monitor trading volumes on these converted OTC swaps (as well as related options contracts) to better judge the appropriateness of the assigned minimum block sizes. Analysis of this data over at least one year, given the major changes that have occurred in the markets, or until such time as the CFTC can evaluate how competitive markets (DCMs and SEFs) develop, would allow the Commission to establish rules relating to this newly created class of futures contracts. EVBs believe that it is important to ensure that market participants can continue to utilize voice brokers to access the markets in futures and options contracts. To the extent that trading activity grows (and the CFTC can monitor the growth with data provided), a particular contract (futures, options or swaps) could be made “available to trade,” and thereby be subject to COB requirements. This proposal is by far the best way to facilitate the trading of these contracts and to allow them, where market forces provide, to achieve trade levels that can support active trading on a COB for that contract.

Reporting of Block Trades

We urge the CFTC to clarify and confirm that an EVB may report the execution of a block trade to a customer immediately following execution on an exchange but *prior* to

being cleared. Currently, brokers in certain markets, while they can inform the counterparties to the trade that their trade has been executed, are prohibited from reporting to their other customer that a block trade has been executed until it has been accepted for clearing. Although the time between executing and clearing a block trade may be relatively short, this restriction results in a delay of several minutes, especially when reporting a more complicated transaction, such as a trade involving multiple legs. We believe that this restriction significantly inhibits post-trade transparency and creates confusion in the markets, as this delay misleads customers about what might be available in the market, which we believe is contrary to the objectives of Dodd-Frank. While it is reasonable for a DCM to ensure that trading is conducted fairly for those trading on the screen that are not parties to the block trade, we do not believe there are any provisions with the Commodity Exchange Act or CFTC regulations that require such a delay and we urge the CFTC to clarify that such a delay is unwarranted.

III. Swap Execution Facilities

Voice Brokers for Permitted Transactions

Dodd-Frank provides that swap transactions subject to a clearing requirement can be required to be executed on a DCM or a SEF (the “trade execution requirement”). However, the trade execution requirement is not applicable to a swap if no DCM or SEF “makes the swap available to trade” or the related transaction is subject to the end-user exception from the clearing requirement.⁴ Under the CFTC’s proposed rules addressing the core principles and other

⁴ A swap transaction will be excepted under the “end-user exception” from the clearing requirements if a counterparty to the swap is not a financial entity, that non-financial counterparty is using the swap to hedge or mitigate commercial risk, and the non-financial entity elects to use the end-user exception. If the non-financial end-user is an SEC filer, then approval to rely on the exception must be obtained from an authorized committee of its board or governing body.

requirements applicable to SEFs, once an SEF or a DCM determines that a swap is “available to trade,” absent an exception (*e.g.*, end-user), it must be traded on an approved SEF or DCM.⁵

Under proposed § 37.9(c), a swap may be executed on an SEF through a voice broker if the swap is not made “available for trading” by an SEF or a DCM (*e.g.*, a “permitted transaction”). According to the proposing release,

For block trades, swaps not subject to clearing, and bespoke or illiquid swaps, the Commission interprets the statute’s language “by any means of interstate commerce” to allow execution methods that may include voice. This method of execution is consistent with the use of voice in the futures markets for executing block trades, where in light of the size of the trades, pre-trade transparency is not required.⁶

EVBs are very supportive of this proposed rule, as it is essential for the CFTC to permit the use of voice brokers for permitted transactions on SEFs that are not subject to the trade execution requirement. In doing so, the CFTC will facilitate and promote the development of swap markets, as commercial end-users, through the use of voice brokers, will utilize more customized swap products that could not otherwise be actively traded on a SEF. Such an outcome will help the CFTC achieve one of the fundamental objectives of Dodd-Frank, the development of SEFs as a new regulated marketplace for swap transactions. Therefore, the CFTC should codify this proposed rule in its final rules addressing SEFs.

⁵ Core Principles and Other Requirements for Swap Execution Facilities, 76 Fed. Reg. 1214 (January 7, 2011).

⁶ 76 Fed. Reg. 1221. According to the proposing release, “[i]t is also possible that a SEF might choose to offer to facilitate bilateral trading for those transactions not bound by the CEA’s execution requirements and, therefore, the use of voice may be acceptable. The Commission notes that with respect to these types of transactions, market participants may have an interest in choosing their counterparty in light of the credit risk involved. Voice transactions must be entered into some form of electronic affirmation system immediately upon execution.” *Id.*

Available to Trade Determination

The CFTC has proposed the following criteria to determine whether a swap is sufficiently “available to trade,” under its proposed rules to address the process by which a DCM or an SEF makes a swap “available to trade”:⁷

- Whether there are ready and willing buyers and sellers;
- The frequency or size of transactions on SEFs or DCMs, or of bilateral transactions;
- The trading volume on SEFs or DCMs, or of bilateral transactions;
- The number and types of market participants;
- The bid/ask spread;
- The usual number of resting firm or indicative bids and offers; and
- Whether an SEF’s trading system or platform or a DCM’s trading facility will support trading in the swap.⁸

Instead of using these subjective criteria to determine if a contract is “available to trade,” EVBs believe that the CFTC should use an objective analysis to determine if a swap is “available to trade.” First, for a swap to be available to trade, there should be resting bids and offers for that instrument on that platform for at least half of the relevant trading hours for a 90-day period prior to any availability to trade determination. Second, each swap must have been traded an average minimum number of times per day (e.g., at least five or more) during the same

⁷ Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade, 76 Fed. 77728 (December 14, 2011).

⁸ 76 Fed. Reg. 77732.

time period. The CFTC should independently evaluate every swap's compliance with these criteria and design other criteria to take into account the uniqueness of each swap market.⁹

The CFTC should regularly review its determinations and, where a swap no longer meets the requirements, remove that swap from the list of instruments "available to trade." This will ensure that the market for a particular swap and/or any economically equivalent contracts will be sufficiently deep and liquid to ensure there is the minimum level of trading activity that is needed to support exchange trading of the particular swap. The CFTC should confirm these objective criteria in its final rules.

In addition, the CFTC's involvement in this process must not be limited to reviewing the determinations made by SEFs and DCMs for consistency with the Commodity Exchange Act and CFTC regulations. Instead, EVBs, along with many other market participants, strongly believe that the CFTC should make this determination.¹⁰ While the CFTC is correct in noting that SEFs and DCMs may be most familiar with the trading of swaps, it should be noted that the incentives of SEFs and DCMs are not necessarily aligned with those of the market participants, including commercial end-users. EVBs are concerned that a single SEF or DCM would have the power to bind the entire marketplace and the history of central execution markets suggests a significant and possibly insurmountable first-mover advantage for the trading facility that first brings a given product to market. Therefore, an SEF or a DCM has a financial incentive to make a swap "available to trade," even if it is premature, because that particular swap is not

⁹ We believe that the CFTC should also make an evaluation similar to "available to trade" for futures and options, so that futures and options that are not sufficiently liquid and/or are not actively traded on a COB, should not be subject to constraints imposed on more actively traded contracts. While Dodd-Frank does not require mandatory trading of futures and options, we believe there should be comparable criteria to determine if a contract must be traded on a COB.

¹⁰ See 76 Fed. Reg. 77730, text at footnote 17.

sufficiently liquid to be traded on an exchange. Unlike commercial market participants that rely on non-standardized and therefore relatively illiquid swaps for customized hedge protection, SEFs and DCMs would not bear the costs of the poor pricing or diminished trading of illiquid swaps that cannot be traded bilaterally.

The mission of the CFTC should be to develop robust and active swap markets and to promote efficiency and competition in the swap markets as a whole. Accordingly, it would be more appropriate for the CFTC to determine if there is enough demand for a swap to be made “available to trade.” The CFTC should modify its final SEF rules to ensure that the CFTC makes the determination that a swap is available to trade. In addition, EVBs request that the CFTC rules assure that EVBs are permitted to participate on any regulated SEF at a reasonable cost and that SEFs are not permitted to exclude an EVB or EVBs generally from accessing the SEF. The CFTC should confirm that a voice broker is permitted to execute transactions on a SEF (and a DCM) for contracts that do not meet “available to trade” criteria, regardless of the size of the transaction.

IV. Conclusion

The futurization of over 1,000 ICE and NYMEX swap contracts is unprecedented. As a result, the CFTC must ensure that market participants will continue to have access through voice brokers for execution as either futures or swaps. Therefore, to the extent the CFTC addresses the concerns raised in this letter regarding voice broker access to SEFs and the available to trade determination, the CFTC must provide similar relief for futures and related options contracts, as market participants will likely continue to favor futures contracts over swaps.

While we appreciate that these issues must be addressed by the CFTC in a timely manner, the CFTC should allow SEFs and DCMs some additional time to develop new markets

for these products. We urge the CFTC to refrain from raising block levels on futures or options contracts prior to developing a system through which market participants can actively trade in these contracts. In addition, we believe that the CFTC should not make any additional changes to the current futures model for futurized swaps and EFSs, until other competitive markets (*i.e.*, SEFs) are up and running. This will give the CFTC the opportunity to evaluate the impact of these changes, once these markets have fully developed.

Finally, we believe it is crucial that trading in futures and options contracts should be subject to the same rules applicable to swaps. The CFTC should create a level playing field for all contracts that are traded on a SEF or a DCM as this will benefit the energy markets and all energy market participants.

* * * *

We appreciate the opportunity to provide comments to the CFTC on the role of EVBs in the futures and swaps markets and to share concerns regarding the ability of customers to continue to use voice brokers to maintain access to futures and swaps. EVBs welcome the opportunity to discuss any questions the CFTC may have with respect to these comments.

Sincerely,

A.E. Bruggemann & Co.
Atlas Commodity Markets, LLC
Evolution Markets Inc.
Forward Insight Commodities LLC
Heat Energy Group LLC
LCM Commodities LLC
Link Crude Resources, LLC
MOAB Oil, Inc.
OTC Global Holdings, LP
Pinnacle Derivatives Group LLC
PVM Oil Associates