Bloomberg

Bloomberg L.P. 731 Lexington Avenue New York, NY 10022 Tel +1 212 318 2000 bloomberg.com

January 30, 2013

U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

ATTN:
Chairman Gary Gensler
Commissioner Jill E. Sommers
Commissioner Bart Chilton
Commissioner Scott D. O'Malia
Commissioner Mark P. Weitjen

RE: Derivatives Clearing Organization ("DCO") General Provisions and Core Principles, Rule 39.13(g)(ii)

Commissioners:

We are writing to you today to draw your attention to a serious concern that we have with the Derivatives Clearing Organization ("DCO") General Provisions and Core Principles, and more specifically, with regulation 39.13(g)(ii) which sets out the minimum liquidation time for financial futures and financial swaps.[1] In particular, financial swaps have a five (5) day minimum liquidation time and financial futures have a one (1) day minimum liquidation time (the "margin requirements").

While we believe that some futurization of swaps is a natural market evolution, we also recognize that certain markets are being forced to futurize as rational actors seek to take advantage of regulatory arbitrage between two economically equivalent financial products that can be executed on a swap execution facility ("SEF") or on a designated contract market ("DCM") and must be cleared. The exchanges were specifically asked by market participants to create an economically equivalent financial futures product with the same risk characteristics as a swap in order to avoid, among other things,[2] the Commission's margin requirements.

In two separate dissenting opinions opposing the rule, neither Commissioner O'Malia nor Commissioner Sommers could point to a reason to justify why financial swaps and financial

---

[1] 76 FR 69438 Rule 39.13(g)(ii), November 8, 2011 (*Derivatives Clearing Organization General Provisions and Core Principles*).

[2] A number of our buy-side market clients are concerned about reaching the $8 billion de minimus swap dealer safe harbor notional amount and being classified as a swap dealer simply because they are required to include the notional value of cleared financial swaps in the de minimus calculation. Our view is that cleared financial swaps should not count towards the de minimus amount.

futures were treated differently for margin purposes.[3] To that point, even Chairman Gensler struggled to point to any reason to justify the difference in margin treatment other than to note that the five (5) day margin is "consistent with current market practice."[4] Of course, the margin should only be "consistent with current market practice" if Title VII, the new SEF regime and the other implementing regulations add no increment of additional safety to these markets. We believe that the disparity in the margin rule on its face will be the strongest driver of the forced "futurization" of economically equivalent financial swaps, such as Markit's credit default swap indices. Therefore, the decision to impose widely differing margin requirements on economically equivalent financial products with the same risk profile which must also be traded on a SEF or a DCM and cleared seems, in our view, to be arbitrary and capricious.

It is worth stressing that the process of marking swaps to market has changed dramatically under Dodd-Frank. Pre-Dodd-Frank exchange-traded futures market were marked-to-market and collateralized on a daily basis through variation margin, while the "Pre-Dodd-Frank" bi-lateral OTC swaps market generally marked swaps positions on a much less frequent timeframe and did not collect variation margin on a daily basis. Consequently, with no collection of daily variation margin to account for daily price movements, it was completely logical for market participants and clearinghouses to apply a significantly more conservative risk calculation to the initial margin they required for swaps in the event of default. While this practice was reasonable in a "Pre-Dodd-Frank" world, it is not reasonable in a post-Dodd-Frank world where financial swaps are subject to a clearing mandate and required to be collateralized on a daily basis through collection of variation margin by a clearinghouse. The clearing mandate and the daily variation margin that Title VII and the CFTC regulations require for cleared financial swaps renders the "Pre-Dodd-Frank" differences in the initial margin requirements for cleared swaps irrelevant.

While we believe and agree that liquidity should be an important consideration in the risk management and clearing process, we do not agree that the debate about margin requirements should turn on liquidity alone. But if it did, then we would note that an important measure of liquidity is the bid-ask spread, which provides markets participants with an indication of the cost of executing a transaction. Generally, more liquid markets have tighter spreads and less liquid markets typically have wider spreads. According to a study conducted by the International Swaps and Derivatives Association and Nera Economic Consulting in November 2011,[5] which compared bid-offer spreads on select interest rate futures on a registered exchange with interest rate swaps found on three OTC swap trading platforms, it appears that the bid-ask spread on similar interest rate futures and U.S. dollar interest rate swaps are quite comparable. Given the conclusion of this study, we do not understand how all financial futures are considered to be more liquid than all financial swaps as it relates to the margin treatment set forth in Rule 39.13(g)(ii). Furthermore, we fear that the real world consequence of the application of higher

---

[3] 76 FR 69474, 69478. ("Commissioner Sommers notes that "In the face of our admitted inability to determine appropriate liquidation times for particular swaps, we are picking a one-day time for some, based on the underlying commodity, and a five-day time for all others, even though this ''could result in less-than-optimal margin calculations.'' This defies common sense."). (While Commissioner O'Malia notes that "the Commission has not demonstrated that the minimum liquidation times that it has decided to mandate are "prudent").

[4] Id at 69473.

[5] http://www2.isda.org/functional-areas/research/discussion-papers/ ("Costs and Benefits of Mandatory Electronic Execution Requirements for Interest Rate Products" dated November 10, 2011).

margin to financial swaps will result in higher economic costs for that product and directly undermine one of the goals of Title VII, which was "to promote the trading of swaps on swap execution facilities".[6]

Cleared futures contracts and economically and risk equivalent cleared swaps subject to the trading requirement should not be subject to different margin regimes. Any mandate to treat economically equivalent instruments with the same risk profile in a radically different fashion opens up two possibilities. Either the swap executed on a SEF or a futures exchange is being "over-margined" by a factor of five, or the futures contract executed on a futures exchange is being "under-margined" by a factor of five. If the futures contracts are under-margined, then clearinghouses backed by taxpayer funds will also be under-margined because of an incorrect regulatory mandate. This outcome could lead to clearinghouses absorbing more risk than they otherwise would have if they were permitted to margin cleared financial products that are economically equivalent using an appropriate risk-based metric regardless of the formal label given to the product.

The exclusive contract that Markit and the Intercontinental Exchange have concluded to create swap futures based on CDS indices, coupled with the disparate margin requirements, will force trading to the futures market as market participants seek to legally avoid the Dodd-Frank regime. Fortunately, the Commission recognized that these markets are novel and complex, and consequently, reserved the right, by order, to "establish shorter or longer liquidation times for particular products or portfolios." These recent developments are exactly the type of situation the Commission had in mind when it approved this language. Therefore, as an entity that plans to register with the Commission as a SEF once the final SEF rules are approved, we formally request that the Commission adopt an order that requires DCOs to impose the same margin requirements for financial swaps as they impose on financial futures that are economically equivalent and have a comparable risk profile.

I am happy to discuss these issues with each of you further.

Sincerely,

George Harrington
Global Head of Fixed Income Trading

---

[6] 17 CFR Part 37 (observing that Section 733 of the Dodd-Frank Act, New CEA § 5h(e) states that a goal of the Dodd-Frank Act is to "promote the trading of swaps on swap execution facilities and to promote the pre-trade price transparency in the swaps market.").