Prepared Remarks

of

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Panel Three: Block Rules for Swaps and Futures

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My name is James Cawley. I am Chief Executive Officer of Javelin Capital Markets, an "all to all" trade execution venue for interest rate and credit default swaps that expects to register as either a Swap Execution Facility or DCM once the rules are finalized.

Thank you for inviting me here today to participate.

Why a Block Trade Rule?

To consider what should be appropriate block trade rules for DCMs & SEFs, we must first remind ourselves of such a rule's purpose.   We must remind ourselves that a block trade rule (where a market maker is given an extended time period before a block trade is reported), is designed to protect and encourage liquidity, not to hamper or lessen it.   Block trade reporting delays encourage market makers to provide liquidity in large size without fear that other market players might abuse them as they hedge or trade out of such large a position entirely.

What Should the Block Trade Threshold Be?

The block trade threshold test should be objective and straightforward. For a given time delay, the question is: what is the liquidity available to the trader before he must report the block trade to the market –and be exposed?

Too little liquidity within such a time interval, and the trader does not have enough time to get out of her trade or set her hedge. She is exposed and could lose money. Because of this risk, this trader is loath to quote such a large market next time. Overall market liquidity is decreased as a result.

The opposite, is also true.

Too much liquidity within a given interval, and the trader has too much time to set a hedge and he can now use the price moving information of block trade against the market and, as a consequence, liquidity is also lessened and market integrity suffers.

Thus, the block trade threshold should be exactly equal to the amount of liquidity available to the trader within the time interval, or before she must report the trade.   The threshold should be not too high, not too low, but just right.

"Available Liquidity," moreover does not just include trades, but also considers all firm orders available at the current price. In fact, the concept of "available liquidity" goes further. It considers the liquidity of other related markets. For example, if I hedge interest rate swaps with euro dollar strips, shouldn't I include the liquidity of that market in consideration of liquidity and block trade thresholds for swaps?

To be sure, the CFTC block trade rule for SEFs does set the interval at 15 minutes and it does consider trade data in setting the block trade notional threshold. But it does not yet consider price order data, nor does it consider liquidity from economically equivalent markets. It should, and it will be a better measurement if it does.

One Rule for All Equivalent Markets

But in order for this work, the same block trade rule must extend to all trade venues (SEF and DCM alike) for instruments within a given class of economic equivalence. For example, interest rate swap futures and their underlying swap instrument are economically equivalent—that is, they are equivalent in risk and trade relative to each other. As such, there should be one block rule that governs both. And such a rule should consider the available liquidity in both markets.

Neither SEF, nor DCM, but the CFTC should set such a rule. Only then can the market be assured that such a rule is objective, measured and a realistic measure of available liquidity. One trade venue must not be permitted to set it's own rule, while the other has it set for them. Such a scenario clearly raises the spectre of a 'race to the bottom" as market forces may game such a rule 'mismatch' in attempt to force more trades off market in a delayed reporting scenario or not report them at all.

Conclusion

In conclusion, we need to remember that block trade rules exist to encourage greater liquidity and transparency. There should be no such thing as block trade thresholds that are "too high" or "too low." There should only be objective thresholds, based upon observable available liquidity in a given market that considers also the liquidity in other markets economically equivalent to it.

Moreover, such a rule should be set by the regulator and applied in a uniform manner to avoid any gaming or 'regulatory arbitrage' that may manifest itself between such markets. The CFTC such calibrate and pass such a rule quickly. They should do so simultaneously along with all outstanding SEF rules. In the interim, the CFTC should place on freeze on all futures certifications on products that may be economically equivalent to those expected to be traded by SEFs. They should do so as not to create an unfair competitive advantage. Such gaming and lack of fair competition can only lessen market integrity and drive up execution costs on the end user.