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Morgan Stanley

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

Re: Package Trade Rules

Dear Mr. Stawick,

Morgan Stanley appreciates the opportunity to comment to the Commodity Futures Trading Commission (the "***Commission***" or "***CFTC***") regarding the package transaction rule amendments being self-certified by ICE Swap Trade, LLC ("***IST***"). Package transactions are an important tool for our clients in reducing their execution expenses and risks, and so it is critical to a smooth and efficient swap market that the Commission act swiftly and judiciously to address issues around package transaction execution in advance of the expiration of existing no-action relief on May 15, 2014.

Our views may be summarized as follows:

1. Package transactions deliver benefits to market participants that cannot be obtained by trading the components of the package separately. These benefits almost always derive from there being exactly two parties to the trade. Therefore, it is vital that the CFTC allow market participants to continue to execute package transaction components as a single economic unit;

2. There are multiple ways to accomplish this;

3. Swap Execution Facilities ("***SEFs***") should be encouraged to innovate and offer different ways, subject to CFTC approval, to process package transactions;

4. The Commission, and not individual SEFs, should determine which types of package transactions must be transacted on-SEF; and

5. Not all package transactions lend themselves to being transacted on-SEF. Continued relief is therefore necessary for certain package transactions.

Definition of Package Transaction

Specificity is critical in defining what is and is not a package transaction, especially since the CFTC and IST are using slightly different definitions. In providing no-action relief for package transactions, the CFTC states:

> "For purposes of the relief granted in this letter, a 'package transaction' is a transaction involving two or more instruments:
>
> (1) that is executed between two counterparties;
>
> (2) that is priced or quoted as one economic transaction with simultaneous execution of all components;
>
> (3) that has at least one component that is a swap that is made available to trade [("***MAT***")] and therefore is subject to the CEA section 2(h)(8) trade execution requirement; and
>
> (4) where the execution of each component is contingent upon the execution of all other components."[1]

In its rule amendment, IST provides:[2]

> "As used herein, a 'Packaged Transaction' is a Transaction that satisfies the following criteria:
>
> (i) the Transaction consists of two or more components that are priced as a package;
>
> (ii) the execution of each component is contingent upon the execution of each other component;
>
> (iii) one or more components are Required Transactions; and
>
> (iv) the size of offsetting components are approximately equivalent (measured by the amount of risk of fluctuation of a specified asset)."

We note the following issues with the above definitions:

(A) Only the IST definition recognizes the need for package components to have offsetting market risks. However, we think it is important that the definition specify that the net market risk should be small in relation to the risks of the components.

(B) The CFTC definition admits packages that the IST definition does not (or might not). One example is a compression, where individual components need not offset

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[1] CFTC Letter No. 14-12, February 10, 2014

[2] Submission 14-02, February 11, 2014, regarding ICE Swap Trade, LLC- Rule Amendment - Amended Rulebook, Rule 701(k)

at all. Another possible example is a butterfly spread involving MAT swaps, because no two legs of a butterfly spread have approximately equivalent offsetting risks.

Morgan Stanley respectfully proposes the following definition, which for purposes of the remainder of this letter we refer to as "**Package Transactions**":

A Package Transaction is a transaction that satisfies all of the following criteria:

(a) It is priced or quoted as one economic transaction (the "**package**");

(b) At least one package component is a swap that is MAT;

(c) Execution of the components is simultaneous or near simultaneous;

(d) The execution of each component is contingent upon the execution of each other component; and

(e) The net market risk of the package is small in relation to the gross risk of the components measured individually.

Benefits of Package Transactions

Package Transactions can be divided into two broad categories: "Client Compressions," and "All Other." The benefits of Client Compressions have been well documented, and include reduced credit exposures, reduced operational complexity, and lower clearinghouse fees. Without further relief, compressions that include MAT swaps would require clients to execute a specific set of trades on-SEF in order for those trades to ultimately be offset at the clearinghouse against the client's existing positions. We believe that on-SEF trading is unnecessary for Client Compressions, since the client's market risk is not materially affected.

Apart from compressions, All Other packages generally share a defining risk characteristic: the expected market risk of the package is less than that of any of the components. This gives rise to an economic benefit when (and only when) a package is traded as a single economic transaction, with a single buyer and seller.

By way of background, securities and derivatives transactions generally involve a liquidity provider (the market maker) and a liquidity taker (the customer[3]). The liquidity provider makes bids and offers for different assets. The spread between the bid and the offer reflects a multitude of factors, including the transaction size, riskiness of the asset, and current market conditions such as liquidity and volatility.

When a package is traded between exactly two counterparties, the liquidity provider and the liquidity taker face equal and opposite market risks. We shall refer to this as "**risk symmetry**" between the buyer and seller. When a package has a lower market risk than any of its components, the risk to each counterparty is minimized by trading the entire package in a single

[3] The customer in this instance may be a swap dealer or any other SEF participant.

transaction. If, on the other hand, package components were traded separately, each component would have a higher market risk. Market makers would reflect this in wider bid-offer spreads to the customer. Customers might also face additional costs in the form of multiple commissions or other fees.

Market participants favor markets that minimize the risk of individual transactions and the associated fees. Also, systemic risk should be lower when one small market risk changes hands, as opposed to when two or more larger risks are traded. Therefore, it is essential that Package Transaction rules preserve risk symmetry, which means providing for a single buyer and a single seller of the package.

In the absence of any special allowance for Package Transactions, the MAT swap component(s) would generally have to be transacted separately, and there would be no way to assure risk symmetry. It is therefore vital to the future of Package Transactions that the Commission issue relief or new guidance in advance of May 16, 2014.

Possible Solutions

The solution proposed by IST is to treat Package Transactions as akin to block transactions. This approach is one way to provide risk symmetry, because a block can be privately negotiated between two counterparties. However, this solution is overreaching in respects, in that all Package Transactions get treated like blocks, regardless of their size. Other solutions exist, and we offer one such solution below. However, we think that innovation by SEFs should be encouraged. We applaud IST for proposing a way forward, and while we would like to see other SEFs do the same, we believe that package definitions and treatment should be decided by the Commission. This will avoid discrepancies among SEFs with regard to Package Transactions.

Some packages will in fact be blocks, and should be treated as such. We suggest that a package be treated as a block if any of its component swaps exceeds the relevant block thresholds. In this case, risk symmetry can be preserved as per the IST proposal.

Morgan Stanley proposes the following approach for non-block Package Transactions. It relies on the fact that many of the most common packages can already be traded on multiple SEFs as a single economic transaction at a single price between two counterparties. By way of terminology, we will refer to a package mandated to trade on-SEF as a "Mandated Package" ("***MP***").

1. Packages whose components are all MAT swaps should be designated as MP effective May 16, 2014;

2. Packages to facilitate Client Compressions should be exempted from SEF trading requirements entirely to allow clients to continue prudent risk management practices. As the CFTC has previously noted, portfolio compression is an important mechanism that "can be an effective and efficient tool for the timely and accurate processing and netting of swaps by

market participants."[4] Such compressions should be encouraged, not rendered impossible, which would be the consequence of designating them MP:

The next four proposals concern only those packages which are neither compressions nor blocks, do not comprise MAT swaps exclusively, but do contain at least one component that is not a MAT swap.

3. The Commission should decide, based on the capabilities generally offered by SEFs[5], which packages to designate as MP. The idea is that unlike under the general MAT determination process, individual SEFs would not make MP determinations. This approach would be more likely to ensure that market participants have a sufficiently broad range of SEFs available to them before on-SEF trading is required.

   If the Commission were to leave the MP determination process up to individual SEFs, we fear that some SEFs would use it as an opportunity to create a monopoly for themselves. For example, a SEF might decide to make amortizing swaps MAT (which is in itself a problem), then to make packages of amortizing swaps and mortgage securities MP. Customers wishing to trade such packages would be forced onto a single SEF.

4. For RFQs, the Commission can subject MP transactions to the same degree of competition as MAT swaps. In other words, the Commission can require that RFQs on MPs be sent to the same minimum number of recipients as MAT swaps. This would promote competition while preserving risk symmetry, because the winner of the RFQ will trade the entire package.

5. Trading of packages in anonymous central limit order books (CLOBs) is problematic if any of the package components is a bond or similar security, because such components would be principal transactions between the dealer and the matching counterparty in the CLOB. As a result, the dealer will have securities law and KYC/AML responsibilities that require it to know the identity of, and pre-approve trading with, any counterparty to such trades. It is therefore not acceptable for dealers to face unknown parties accessing the CLOB. Unless an acceptable solution is found, a dealer's only recourse is not to trade such packages in CLOBs. Among the possible solutions are:

   A. SEFs could engineer an approach to disclose the identities of clients using sponsored access in their CLOBs. This could be done without compromising the anonymity of any single trade. For example, the SEF could notify participants that a particular group of counterparties had been enabled to trade, or were currently active in the CLOB, via sponsored access. This says nothing about which participants were involved in which orders in the CLOB;

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4 CFTC Confirmation, Portfolio Reconciliation, Portfolio Compression and Swap Dealer Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55932 (September 11, 2012).

5 Such capabilities would include multiple SEFs being able to price, trade and post-trade process all components of the Package Transaction.

B. SEFs could find a way to act as riskless principal, or find a third party willing to act as riskless principal, in order to intermediate the non-swap legs of the package;

C. SEFs could require FCMs that sponsor access by clients to have their broker-dealer intermediate the non-swap components of packages; or

D. SEFs could build a matrix of entitlements that would enable participants to choose which counterparties were acceptable to them on various package transactions, and then engineer the CLOB so as to allow participants to trade only with acceptable counterparties.

None of these solutions is broadly available today, and all would require considerable time and effort to put in place. All require some kind of compromise, either in the form of loss of anonymity via the give-up process, loss of open access to the SEF, or introduction of intermediaries who would need to be compensated for taking on credit risk.

6. For all other Package Transactions (i.e., those that are not Client Compressions, blocks and not MPs), we propose that the CFTC a) allow the transaction to be treated as per the IST proposal for package types that can currently be processed through a SEF; b) allow other treatments proposed by SEFs that the Commission deems acceptable; or c) extend the current no-action relief until such time as an acceptable solution is found and put in place.

Although many common packages can quickly become MPs, there are many other less common packages that will require treatment as per item #6 above, probably in the form of no-action relief initially. Examples include asset swaps involving securities not traded on multiple SEFs, packages with many components and for which SEFs have not developed package pricing capabilities, futures invoice spreads, swaps with corporate bond issuers, and exercises of swaptions.

We appreciate the opportunity to comment to the Commission on Package Transactions generally and on IST's proposal specifically. Any questions about this letter may be directed to Dexter Senft (212-761-2466).

Respectfully submitted,

Dexter Senft
Managing Director

cc. The Hon. Mark P. Wetjen, CFTC Acting Chairman
The Hon. Scott O'Malia, CFTC Commissioner