ISDA® Safe, Efficient Markets

October 25, 2012

Mr. Richard Shilts
Director
Division of Market Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Dear Mr. Shilts:

The International Swaps and Derivatives Association, Inc. ("**ISDA**"), on behalf of its members with reporting obligations under Part 43 and Part 45 of the Regulations ("**Reporting Rules**")[1] of the Commodity Futures Trading Commission (the "**Commission**") and other similarly situated persons, is writing to identify difficulties related to certain interpretations of the Reporting Rules that would be harmful to clients of swap dealers ("**SDs**").

ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

ISDA recognizes the importance of the various Reporting Rules and strongly supports initiatives to increase regulatory transparency. We also appreciate the efforts of Commission staff over the past several months to provide direction and clarification where possible as our members begin preparations for complying with the new Reporting Rules.

We are concerned that the interpretation of the rules to require the reporting of post-priced swaps before the related market activity or observation period is completed will have a negative impact on market participants which trade these products. We discuss these concerns in detail below and provide recommendations for Commission action where appropriate.

Post-priced swaps

A post-priced swap is a transaction in which the price and/or its size is determined by reference to market activity or an observation period that occurs after the client places its order. As the

[1] See, 17 CFR Part 45 Swap Data Recordkeeping and Reporting Requirements, and 17 CFR Part 43 Real-Time Public Reporting of Swap Transaction Data.

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Commission staff is undoubtedly aware, for swap transaction categories that are not post-priced, the SD and its client have agreed on all terms of the transaction, including price and size, at the point of execution. In these situations, the SD is committing capital and is therefore at risk on the position. While the SD may or may not hedge that transaction, all Rule 43 and 45 terms are known at the point of execution and thus can be fully and meaningfully reported to the market with no additional risk to the client.

Post-priced swaps, which occur across asset classes but most commonly in the delta-one equity space, work differently. In these situations, the client makes a transaction request (either by phone or electronically) for a swap with the SD. The nature of the client's order will depend on their objectives and the market environment. Examples of client requests might be: (1) a "guaranteed" price (e.g., a market observable volume weighted average price or "VWAP" published on Bloomberg) with or without a set notional size, (2) an average price based on the SD's hedge executions with or without a benchmark ("target VWAP"), (3) executions subject to a price limit (e.g., Limit VWAP), or (4) a combination of some or all of the above, as clients often modify their order throughout the day in reaction to price movements and/or market developments. Regardless of the combination of variables, in all of these scenarios, the ultimate size and/or price is not known at the time the client makes the transaction request,[2] and market activity **subsequent** to the client's transaction request will impact the price received by the client and the actual size of the swap. Accordingly, exposing that client request before the subsequent market activity is complete will be harmful to the client.

Size - While it may be that the size specified by the client in the initial transaction request will be the ultimate size of the transaction, the SD does not guarantee execution of the size requested and may reduce the size of the transaction to reflect the SD's ability to execute its hedge at the specified pricing methodology. For example, if an early closure, trading halt or other market disruption event occurs that affects positions that would be established to hedge a transaction, or if the pricing methodology specified in the transaction request includes pricing conditions (e.g., Limit VWAP) that could not be met because market prices in underliers that would have been used to establish a hedge transaction were not within the relevant parameters, the size of the transaction will be reduced to reflect the portion of the transaction the SD was able to hedge. If the SD could not establish any hedge, the transaction request will not result in a swap transaction.

Price - More importantly, the price of a post-priced swap is not known until after the SD has completed its hedge or the observation period has occurred. For "best efforts" pricing methodologies, such as target VWAP, whether or not a target benchmark is specified in the transaction request, the price of the transaction will be a volume-weighted average price of the SD's hedges. Even for "guaranteed" benchmark transactions, the price will not be determined until that benchmark is known. Accordingly, in both cases – best efforts pricing and "guarantee" pricing – transactions in the swap underlier, components of the swap underlier or related securities/futures by other market participants during the hedging period will impact the price of the client's transaction. If the client's transaction request is known to the market at the time it is made, other market participants, knowing that there will likely be demand or supply, as the case

[2] We note that this discussion does not purport to portray the complete spectrum of client activity in this market segment.

may be, in positions that would be established to hedge the transaction, will push the price against the interest of the client.

For these reasons, we are concerned that: (1) certain interpretations of the requirements of Part 43 and Part 45 do not take into account the difference between post-priced swaps and other swap transaction categories; and (2) if these interpretations hold, they will fundamentally change the nature of the market for post-priced swaps to the detriment of clients. Requiring reporting for client transaction requests to enter into a post-priced swap with putative size and an indication of the nature of pricing methodology is tantamount to exposing to the marketplace the client's desire to trade rather than limiting that information to just the SD. If all market participants are aware of client transaction requests, it will become materially more expensive for SDs to source appropriate hedges. This additional expense would be borne by the client.

Many institutional customers use index swaps to perform global asset allocation strategies. If their orders are exposed to the market before the related market activity or observation period, other market participants will use that information to their disadvantage. While the liquidity for swaps on the S&P 500 is deep, global and regional indexes may be composed of shares from relatively less liquid markets where the exposure of their orders will directly impact price levels (indeed, even large S&P 500 transaction requests also could be impacted by exposure to the market prior to the price being determined). Accordingly, we believe that the policy question regarding the time of execution for these transactions essentially is a question of customer protection.

Time of execution for post-priced swaps

Under Part 43, "execution" is defined both as (a) agreement by the parties to the terms of a swap that legally binds the parties under applicable law and (b) occurring simultaneously with or immediately following "affirmation" of the transaction. The rule defines "affirmation" to mean the process by which the parties verify that they agree on all the Primary Economic Terms ("**PETs**") of the swap. [3] Although Part 45 does not provide an express definition of "execution," the preamble states that execution only occurs after all of a swap's PETs have been agreed.[4]

In the case of post-priced swaps, while some PETs for a particular trade are agreed and may be enforceable at the time of the transaction request for a swap, the actual price and size of the transaction, if any, will be determined at some point later in the day as a result of the specified pricing methodology and availability of the SD's hedge.[5]

For example, a swap priced using a volume-weighted average price, time-weighted average price, market on close, or other pricing formula based on subsequent cash market transactions will not have a price until the relevant pricing period for that pricing methodology is complete. Further, if the SD is unable to execute a hedge for the full size specified in the client's transaction request, then the size of the swap transaction between the SD and its client will be

[3] 17 C.F.R. §43.2
[4] 77 Fed. Reg. 2148 (January 13, 2012).
[5] Such trades may include volume-weighted-average-price trades, time-weighted-average-price trades, and market-on-close trades. Examples of trade executions are provided in the attached annex.

reduced to that amount which the SD actually was able to hedge using the pricing methodology specified in the transaction request.

In the above post-priced swaps examples, although the Parts 43 and 45 definitions of "execution" have not been met due to the lack of a final price and size, the parties may, and often do, have legally binding and enforceable rights under applicable law. To address this inconsistency in a way that is operationally efficient by allowing SDs to use their current systems that capture trade information only when price and size are known, achieves the overall goal of regulatory and public transparency but not at the expense of reporting open unfilled "orders", **we recommend that, for purposes of Parts 43 and 45, post-priced swap transactions should be deemed "executed" (and hence reportable) only when the price and size are finally determined.**

This treatment is consistent with the approach that currently applies to analogous cash market trades that are priced by reference to a formula, i.e., the way that VWAP trades are reporting in the U.S. equities market. In addition, such treatment will not adversely affect overall market transparency, as the underlying cash market that is the basis for the pricing is completely transparent, so reporting of the swap prior to finalization of the pricing terms will not perform a price discovery function. Furthermore, reporting of these swaps before the final price is established would be equivalent of disclosing an "order" prior to its full and at times even partial execution. If such premature disclosure were required, certain market participants may trade ahead (front run) and negatively impact the price to the client. The effect of this would be to add a material transaction cost to trading a swap as compared to cash, listed options or future markets. This higher cost would be imposed on long term investor types and benefit high-frequency trading strategies and other "predatory" or non-economic traders.

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Thank you for your consideration of these concerns. Please contact me or ISDA staff if you have any questions or concerns.

Sincerely,

Robert Pickel
Chief Executive Officer

Cc: Mr. Gary Barnett, Director, Division of Swap Dealer and Intermediary Oversight

Annex: Timing of execution for pricing – Equity examples

Scenario 1: GVWAP over entire day, for a broad based equity swap on DJTA

9:09 am	Client X indicates they will trade on Swap long 10,000 Units of a specific Index Sector (DJTA – Dow Jones Transports). The order is specifically for Guaranteed Volume Weighted Average Price over the day (Guaranteed VWAP).
9:30 am	Equity Market opens. DJTA index opens at 4,912.41.
9:30 am – 4:00pm	Dealer begins engaging in hedging activities for this swap. As part of overall hedging activities, dealer will go to the market to execute physical trades, generally on a net basis (taking into account other hedging activity that is also occurring throughout the day). Knowing that the client receives the objective VWAP price on the swap, the dealer attempts to match VWAP on its hedging activities as best as possible.
4:00 pm	Final closing price prints for the DJTA at 5,028.61. Thus the final Volume Weighted Average Price is known for the day: 5,014.01. This is the price that the client receives on the swap. Dealers advocate REPORTING PETs known at this time (Price and Size).

Scenario 2: TWAP for 4 hours, for a broad based equity swap on S&P 500 Energy Sector Index

9:09 am	Client X indicates they will trade on Swap long 100,000 Units of a specific Index Sector (S&P 500 Energy Sector – S5ENRS). The order is specifically for Time Weighted Average Price (TWAP) over the course of 4 hours.
9:30 am	Equity Market opens. S5ENRS index opens at 500.00
9:30 am – 1:30pm	Dealer begins hedging activities for this swap. As part of overall hedging

activities, dealer will go to the market to execute physical hedges, generally on a net basis (taking into account other hedging activity that is also occurring throughout the day)

1:30 pm — After 4 hours of trading, the price over the specified time is known, and the TWAP price is calculated as 498.76 This is the price that the client receives on the swap. Dealers advocate REPORTING PETs known at this time (Price and Size).

<u>Scenario 3: Best efforts VWAP for 4 hours, with a limit of 503.00 for a broad based equity swap on S&P 500 Energy Sector Index</u>

12:00 pm — Client X indicates they will trade on Swap 100,000 Units of a specific Index Sector (S&P 500 Energy Sector – S5ENRS). The order is specifically for best efforts Volume Weighted Average Price (VWAP) over the course of 4 hours, with a limit of 503.00 - "A best efforts VWAP with Limit Order" means that the Swap will be priced and sized based on the Dealer's ability to affect hedges in a manner and quantity that seeks to achieve VWAP with an upper price capped at the limit level (i.e., if the price hits or exceeds the limit, no further hedges until the price declines below the limit).

12:00 pm — Spot price of S5ENRS is 501.22

12:00 pm – 3:32pm — Dealer begins hedging activities for this swap. As part of overall hedging activities, dealer will go to the market to execute physical hedges, generally on a net basis (taking into account other similar orders throughout the day)

3:32pm — Spot price of S5ENRS reaches 503.00.

4:00 pm — After 4 hours of trading, the dealer is only able to execute 89,000 shares of the index, below the limit of 503.00. At that point, the swap trade is considered complete, and the price of the swap is 502.36 (based on the average executions of the 89,000 shares that were filled over the course of that time). Dealers advocate REPORTING PETs known at this time (Price and Size).

Scenario 4: Market on close for an MCSCI WORLD index

9:09 am	Client X indicates they will trade on Swap 100,000 Units of a specific Index (MSCI World). The order is specifically for Market Close.
6:30 pm	Final closing price for the MSCI world is known (at approximately 6:30pm, the following business day. This is due to the fact that it's a global index, with many currencies, and the calculation agent requires that much time to get the prices published). Dealers advocate REPORTING PETs known at this time (Price and Size).