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Sent: Monday, February 14, 2011 3:24 PM
To: rule-comments@sec.gov; RealTimeReporting <RealTimeReporting@CFTC.gov>
Cc: erosen@cgsh.com
Subject: Proposed Real-Time Reporting Rules; CFTC RIN 3038?AD08; SEC File No. S7?34?10
Attach: Letter re Real Time Reporting.pdf

On behalf of the Firms listed below, please find attached a comment letter regarding the proposed swap and security-based swap real-time public reporting rules.

Please contact Edward J. Rosen at 212-225-2820 with any questions.

Thank you.

The Firms

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February 14, 2011

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Re: Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information File No. S7-34-10;[1]

Real-Time Public Reporting of Swap Transaction Data, RIN 3038-AD08.[2]

Dear Secretary Murphy and Secretary Stawick:

This letter is submitted, on behalf of the undersigned firms (the "Firms"), in response to the captioned rule proposals (the "Proposed Rules") published by the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC" and, together with the SEC, the "Commissions") pursuant to sections 727, 763 and 766 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The Firms appreciate the opportunity to provide comments to the Commissions with respect to the Proposed Rules.

[1] 75 Fed. Reg. 75208 (Dec. 2, 2010) (the "SEC Proposal").

[2] 75 Fed. Reg. 76140 (Dec. 7, 2010) (the "CFTC Proposal" and, together with the SEC Proposal, the "Proposed Rules").

SUMMARY

The Firms support the establishment of an appropriate real-time reporting framework for swaps and security-based swaps ("SBS"), as contemplated under Dodd-Frank.[3] As part of Dodd-Frank's real-time public reporting framework, the Commissions are instructed to develop exceptions to the Act's real-time reporting requirements in the case of "block" size transactions. In establishing appropriate reporting intervals for block transactions the Commissions are further instructed to "take into account" whether public disclosure under the framework would "materially reduce market liquidity."[4]

I. Overview of Proposed Rules

Very generally, the Proposed Rules would, with some exceptions, require real-time public reporting of all swap and SBS transaction data. Under the CFTC Proposal, a standardized swap with a notional size greater than the greater of (a) the 95th percentile of transaction sizes in the relevant swap category or (b) five times the largest of the mean, median or mode transaction size in that swap category would be subject to a 15-minute reporting delay, at which time notional size would be reported using a rounding convention. Under the SEC Proposal, an SBS with a notional size greater than an as-yet-unspecified threshold would have its price and other transaction data reported publicly in real time, except that the SBS's notional size would be subject to delayed reporting 8 to 26 hours after execution. The SEC Proposal would additionally exclude block transactions in equity total return swaps ("TRS") from the proposed reporting protocol for block transactions in other SBS.

The Proposed Rules would implement an arbitrary and inflexible reporting framework that will in many cases result in precisely the adverse liquidity impacts that Congress directed the Commissions to avoid. Specifically, the Proposed Rules include no indication that the Commissions have yet studied or quantified the liquidity impact of the Proposed Rules on specific categories of swaps, or evaluated whether the likely liquidity impact would be material. The Proposed Rules do not, as intended by Dodd-Frank, include a principled framework for evaluating and resolving conflicting impacts on transparency and liquidity.

Instead, the CFTC Proposal defines block transactions by reference to a two-part test with a questionable premise and a methodology not grounded in the requirements of the statute: in one case using metrics derived from the futures market, a market whose liquidity characteristics are substantially different from the liquidity characteristics of the various swap markets trading in different asset classes; and in the second case using a transaction size multiplier that is based on a mathematical formula lacking any understandable connection to the objectives of Dodd-Frank. The CFTC also does not purport to correlate its proposed 15-minute

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[3] For convenience, we refer in this letter to swaps and security-based swaps collectively as swaps, except as otherwise indicated.

[4] Commodity Exchange Act ("CEA") Section 2(a)(13)(E)(iv) and Securities Exchange Act of 1934 ("SEA") Section 13(m)(E)(iv).

reporting interval to an analysis of relevant swap market liquidity and predicted liquidity impacts.[5]

Although the SEC, in contrast, intends to rely on empirical analysis of the swap markets in setting block size thresholds,[6] the SEC's proposal to report block prices, in real time, without displaying size, seems likely either to result in inferences of transaction size (and direction) based on the illiquidity premium observed in the displayed price or to invite conjecture and confusion as to whether the displayed price signals a price trend, an illiquidity premium, or a combination of the two. As a result, this aspect of the SEC Proposal is not likely to achieve its intended purpose or will engender confusion and speculation rather than transparency.

The SEC's proposal to exclude equity TRS from the block transaction exception is difficult to understand. Public reporting of block transactions in equity TRS presents the same liquidity concerns as public reporting of block transactions in other swaps. On the other hand, equity TRS are a far less important source of price transparency. The transparency of the cash equities market makes it particularly unlikely that market observers will look to equity TRS prices, rather than cash equity prices, for equity price discovery. There is no evidence that market participants have or would use SBS to avoid other real-time reporting obligations. Indeed, the evidence is to the contrary. It seems difficult to justify the proposed exclusion of equity TRS from block transaction treatment in the face of these considerations.

If adopted in their current form, or based on the methodologies described in the Proposed Rules, the resulting reporting frameworks have the potential to impair market liquidity significantly and impose significant pricing inefficiencies on major users of the various swap markets—a particularly troubling result in the context of a transparency framework, the ostensible purpose of which is to improve the pricing available to market participants.

Furthermore, inconsistencies between the CFTC and SEC Proposals (applicable to block transaction provisions and many technical details of the Proposed Rules, such as required data elements) would, if adopted, significantly complicate implementation. These inconsistencies are not merited by differences between swaps and SBS. Because the jurisdictional distinctions between swaps and SBS do not correspond to distinctions between trading lines or business units (e.g., single-name and index credit default swaps ("CDS") are transacted by the same business unit), it is all the more important for the Commissions to harmonize their frameworks better.

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[5] In contrast, as described in Part V of the letter's Discussion section, the European Union ("EU") generally tailors reporting delays to the size of the transaction relative to the particular instrument's trading volume.

[6] See SEC Proposal at 75228 (noting that the SEC intends to propose specific thresholds after first collecting and analyzing additional data on the SBS market); see also SEC Division of Risk, Strategy, and Financial Innovation, Memorandum regarding Security-Based Swap Block Trade Definition Analysis, dated January 13, 2011.

We discuss these and related concerns in this letter's Discussion section.[7]

II. General Principles and Recommendations

Block size parameters and reporting intervals cannot be informed by abstract mathematical formulae, preconceived percentages or multipliers, or other metrics computed by reference to markets with different liquidity characteristics. They must be based on relevant market data and informed by the purposes to be served by adopting a block transaction rule. Otherwise, the rules will not achieve their purpose and will disrupt otherwise efficient markets.

As a corollary, block transaction rules must be based on the liquidity characteristics of the relevant product market. Given the significantly different liquidity characteristics of futures and securities, they are generally not appropriate models for swaps. A recent joint study sponsored by ISDA and SIFMA highlights some significant differences between swap markets and the futures and securities markets:[8]

- First, swap transactions are more infrequent than transactions in futures and securities. There are only 4 million outstanding interest rate swap ("IRS") transactions. The same number of trades is conducted on the CBOT and CME in 15 days. For the 1,000 liquid single-name CDS, average daily trading volume is about 3 trades per day per reference entity, and 80% of those CDS trade fewer than 5 contracts per day. Large trades may have a particularly significant impact on markets in which trades occur infrequently.

- Second, in addition to being relatively low, swap trading volume can also be quite volatile. For example, the trading volume of certain IRS can range from 300 to 1,000 trades per day over a one-month period. This volatility will make it more difficult for regulators to establish block transaction rules that are suitable at all points in time. As a result, the Commissions should take care to examine these markets over a sufficient period of time to obtain a comprehensive view of liquidity and its characteristics over time.

- Third, swap transactions tend to be much larger and more customized than transactions in futures and securities. The average size of a 10-year USD

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[7] We have not sought in this letter to address the detailed technical and operational issues raised by the Proposed Rules, except to note general considerations relevant to implementation of a public transparency framework. Those issues have been analyzed and addressed by other commenters. In particular, we generally support the views expressed by SIFMA and ISDA on those issues. See Letters from Robert Pickel, Executive Vice Chairman, International Swaps and Derivatives Association, Inc., and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA to Elizabeth Murphy, Secretary, SEC (Jan. 18, 2011) (the "ISDA/SIFMA SEC Letter") and to David Stawick, Secretary, CFTC (Feb. 7, 2011) (the "ISDA/SIFMA CFTC Letter," and, together with the ISDA/SIFMA SEC Letter, the "ISDA/SIFMA Letters").

[8] See ISDA and SIFMA, *Block transaction reporting for over-the-counter derivative markets* (Jan. 18, 2011) (the "ISDA/SIFMA Study"), attached as Annex 2 to the ISDA/SIFMA Letters.

interest rate swap was $75 million, as compared to $2 million for U.S. Treasury Note futures. As a result, block transaction thresholds and reporting delays that seem appropriate in other markets could be extremely limiting in the swap context.[9]

- Fourth, swap markets include many fewer participants than futures and securities markets, with as few as 250 participants in certain credit derivatives markets. These participants also tend to be much more sophisticated than participants in other markets. This structure suggests that the benefits of transparency may be more limited (sophisticated traders rely less on public data) and the costs of reduced liquidity may be greater than in other markets (since public reports will be more likely to signal a specific trader's identity and intentions).

In addition, any analysis of existing block transaction thresholds in the futures or securities markets must correct for the impact of the availability of swaps not then subject to reporting requirements. Swap markets have functioned as a "safety valve" by allowing market participants to enter into hedging transactions without reporting obligations that could derail their risk management goals. For instance, futures trading has moved to commodity swap markets, and corporate bond trading has an outlet for large transactions in the CDS markets. The Commissions need to carefully consider why the swap and SBS markets have developed with their current liquidity characteristics. They are fulfilling a demonstrable, important and legitimate need—the ability of major corporations and institutional investors to execute large-size and in some cases customized transactions—where other markets have failed to do so due, in part, to restrictive block trading and reporting rules. Imposing block size parameters and reporting intervals derived from futures or securities markets could artificially engineer a swap market structure characterized by smaller transactions executed at a higher frequency, and undermine the very pricing efficiencies afforded large end-users by the current market structure.

Furthermore, establishing classes or categories of swaps that are subject to uniform block transaction parameters is useful only if swaps within the defined class or category share the same liquidity characteristics. Real-time reporting may have very different impacts on swaps within the same broadly defined asset classes. The ISDA/SIFMA Study reveals significant liquidity variation within swap asset classes. For example, average daily trading volume per reference entity for single-name corporate CDS is 3 trades per day, while average daily trading volume per reference entity is 20 trades per day for CDS written on high yield indices. Likewise, trading volume varies significantly across interest rate products; swaps in U.S. dollars are traded much more frequently than swaps denominated in other currencies. The Commissions should therefore determine swap instrument groupings with sufficient granularity to tailor reporting rules appropriately to the characteristics of instruments with comparable liquidity characteristics.

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[9] See SEC Proposal at 75226, question 97.

The Commissions should also ensure that their public reporting frameworks are designed to enhance price discovery and do not result in dissemination of misleading or incomplete information that will lead to poorly informed conjecture about the meaning of the displayed information. As a related matter, the obligation to report should not be triggered until price, size, and other transaction terms required to be reported are available. Additionally, customized transactions should not be subject to the same real-time reporting requirements as standardized transactions, because they have little price discovery value and immediate disclosure could interfere with subsequent hedging transactions. Similarly, inter-affiliate transactions serve no price discovery function, and should not be subjected to the burden and expense of public reporting.

The Commissions should also seek to coordinate their reporting obligations with similar obligations imposed by non-U.S. regulators and should avoid a duplicative or inconsistent reporting regime that would result in the same transaction being reported in multiple jurisdictions (perhaps in different formats and at different times).

An inappropriately designed block transaction framework can have significant and immediate adverse consequences for liquidity. We therefore recommend that the Commissions act both cautiously and incrementally. It would be less costly to begin with a block transaction framework that errs on the side of being possibly too accommodating, with the relevant levels tightened over time, based on evidence obtained directly from relevant markets (as occurred in the case of TRACE), than to impose an overly restrictive regime based on inferences drawn from other markets, as occurred with significant adverse consequences in the case of the London Stock Exchange's implementation of real-time reporting.

In this regard, it seems clear that a real-time reporting and block transaction framework will necessarily take considerable time to define, build and implement. We believe the Commissions should therefore adopt a phased implementation process by prioritizing swap categories with characteristics and market infrastructure that are perceived to lend themselves most readily to earliest implementation under the new framework. As noted above, because the jurisdictional distinctions between swaps and SBS do not correspond to distinctions between business units, it is critical that the Commissions adopt harmonized frameworks.

DISCUSSION

I. Requirements of Dodd-Frank

As articulated in Dodd-Frank, the goal of real-time reporting is to "enhance price discovery."[10] Congress also recognized, however, that, in the context of large transactions, a tension exists between price transparency and liquidity. In recognition of this tension, Congress explicitly required the Commissions to take into account the potential adverse impact of public reporting on liquidity. Recognizing that fairly granular differences in swap terms and tenors

[10] CEA Section 2(a)(13)(B) and SEA Section 13(m)(1)(B).

result in differences in liquidity characteristics, Congress further specifically instructed the agencies to make these evaluations in the context of individual swaps, based on each swap's particular liquidity characteristics.[11]

In order to accomplish Dodd-Frank's goal of ensuring that the Commissions' initiatives for increased transparency through real-time reporting do not impair liquidity, there are a number of determinations that must be made. The results of these determinations must then be evaluated in the light of the purpose of a block transaction rule and Dodd-Frank's related directives and objectives.

II. Application to Block Transactions in Swaps

As the Commissions are aware, the purposes of a block transaction exception are, first, to identify transactions of a size that, if executed transparently and at once in an open market, would move the market and result in inefficient execution costs, and, second, to enable such transactions to be executed privately under circumstances in which the risk intermediary will have an opportunity to liquidate or hedge its block position risk before disclosure to the market occurs. Disclosure prior to that time will enable other market participants to trade preemptively on the signal of impending hedging transactions, increasing the risk intermediary's execution costs. In turn, the risk intermediary would have to price the increased hedging/liquidation costs into the block transaction, resulting in inefficient pricing and defeating the purpose of the exception.

As the foregoing suggests, in order to define a "block" size transaction, the Commissions must determine the threshold level above which the public disclosure of a swap transaction would be expected to move the market. This, in turn, requires an analysis of the distribution of transaction sizes in the relevant swap market. Implicitly, this also requires a determination as to the level of specificity with which the Commissions are to group swaps for this purpose. Based on Dodd-Frank, the answer to this must be: whatever level of specificity drives material differences in liquidity.

Next, the Commissions must determine, for each such transaction size (and sizes above that level), the time that would likely be required by a risk intermediary to liquidate, hedge or offset the position (or its risk) through non-block transactions. This determination must be made on the basis of an analysis of transaction volume in the relevant swap. In order to avoid an unnecessarily complex framework, it is reasonable for the Commissions to seek to establish a limited number of volume tiers for this purpose.

It is arguable that this is precisely what Dodd-Frank requires, and conversely all that Dodd-Frank permits, the Commissions to do in establishing a block transaction reporting

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[11] See CEA Section 2(a)(13)(E) and SEA Section 13(m)(1)(E) (mandating that the Commissions address liquidity impact and specify particularized block transaction criteria).

framework. Any framework that is more restrictive than the foregoing would, by definition, impair liquidity at some level.

Alternatively, given Dodd-Frank's clear transparency objectives, and the fact that the specific directive in Dodd-Frank is that the Commissions "take account" of material liquidity impacts, we believe it is reasonable for the Commissions to look at the results of the approach outlined in general terms above and to evaluate the relative transparency and liquidity impacts of the resulting reporting framework with a view toward achieving an appropriate balance between the two. Where the transaction size implied by the outlined approach would result in the real-time reporting of too few transactions to support transparency (taking into account the real-time reporting of a risk intermediary's non-block size hedging transactions), upward adjustment of the block threshold would be appropriate.

The Proposed Rules, however, would not achieve either result.

III. CFTC Proposal

In contrast to the conceptual approach described above, the CFTC Proposal appears to be based on inapposite data sets and uses questionable methodologies that do not meet the requirements of the statute. It also proposes a one-size-fits-all reporting interval that, on its face, is not informed by observed transaction volumes in particular swap markets or the different types of swaps that trade in a particular market. Together, the CFTC's "percentile/distribution" and "multiple/social size" tests set thresholds that are too high, given the relatively low daily transaction volume in the swap markets (which is described in more detail above).

A. Minimum Block Size

The CFTC Proposal would require swap data repositories ("SDRs") to apply a two-pronged test in order to determine an appropriate minimum block size. The SDR would need to first apply the "percentile/distribution test" to find the notional or principal size that is greater than 95% of the trades in that category of swap instrument.[12] The SDR would then need to apply the "multiple/social size test," which calculates the transaction size that is five times the highest of the mean, median or mode transaction size (the "social size") in the relevant swap instrument.[13] The SDR would be required to set its block size threshold at the larger of these two results.[14]

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[12] See CFTC Proposed Rule ("PR") 43.5(g)(1)(i).

[13] See CFTC PR 43.5(g)(1)(ii).

[14] In contrast, the SEC has not yet established how it will determine minimum block transaction thresholds but notes that these thresholds must be set in a way that "takes into account whether public disclosure of such transactions would materially reduce market liquidity." SEC Proposal at 75228.

1. *Percentile/Distribution Test*

According to the CFTC, its proposed 95% metric is drawn from observations of the futures markets and related block transactions in futures (with an unexplainable rounding upward to the nearest 5% increment).[15] This approach is inappropriate for a number of significant reasons.

First, the liquidity characteristics of the futures and swaps markets could not be more different. Using the highly liquid futures market as a proxy for illiquid swaps markets has not been, nor do we believe would be, justified. It also disregards the specific requirement in Dodd-Frank that the Commission make these evaluations in the context of individual swaps, based on each swap's particular liquidity characteristics,[16] and not based on futures markets data.

Similarly, the CFTC offers no insights as to how its upward rounding to 95% is methodologically correlated to observed differences in the liquidity characteristics of the two markets. Even were it to do so, however, the more fundamental problem is the CFTC's failure to take account of the relationship between futures markets and swap markets and how the separate markets function. Specifically, the CFTC's analysis ignores the fact that swaps themselves have for many years performed as surrogates for block trading interest. The CFTC's analysis fails to account in any way for the impact and relevance of such transaction data.

The top percentile/distribution test also does not account for the distribution—dispersal and clustering—of swap transaction sizes. For example, in a market characterized by many small trades and a few very large trades, a trade at the 80th size percentile could very easily be large enough to move the market, but would nevertheless be required to be reported in real time. Even if a 95% metric of the type proposed by the CFTC happened coincidentally to be appropriate for a particular swap, there is no basis on which to expect that same metric to be appropriate for all swaps as a result.

The CFTC's proposed percentile/distribution test also relies entirely on relative transaction size. As noted in the SEC Proposal, relative transaction size alone is not an effective metric for identifying trades likely to generate subsequent transactions that are distinguishable from the rest of the market.[17]

2. *Multiple/Social Size Test*

The CFTC's proposed social size test is appropriately focused on identifying a "social size" that is based on transaction size observations from the relevant market. However, the CFTC's proposal to take the highest of median, mode and mean transaction size, and then to calibrate the minimum threshold at 5 times the resulting size, seems designed simply to produce

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[15] See CFTC Proposal at 76162.

[16] See supra note 11.

[17] See SEC Proposal at 75229.

a higher threshold so as to preclude transactions that would otherwise qualify as block trades under the percentile/distribution test from qualifying as such. In light of the large mean transaction size in many swap markets, the CFTC's proposed framework would effectively categorize only extremely large transactions as block-sized. It is very likely that trades far smaller than 5 times social size affect market prices. In contrast to the CFTC's approach, the ability to move market prices should, in the first instance, be the overriding consideration in establishing appropriate block size thresholds.

Accordingly, at bottom, the CFTC's proposed framework seems intentionally skewed to produce a preconceived high block threshold for the sake of it and not to achieve the objectives (practical and statutory) of establishing a block transaction exception in the first place. We respectfully request that the Commission instead adopt a threshold rooted in the empirical analysis required under Dodd-Frank.

B. Block Transaction Reporting Delays

The CFTC Proposal would require all block transactions to be reported within 15 minutes of execution, with minimal exception.[18] The reporting party would be required to report all required data at this time, including notional size, although the CFTC has proposed a rounding convention (e.g., if the notional or principal amount is greater than 250 million, round to ''250+'') such that only a size range would be publicly disseminated.[19]

As we note above, block transaction reporting delays should reflect the amount of time it is expected to take a risk intermediary to hedge its block exposure without undue market impact. The CFTC's universal 15-minute reporting delay is not based on any metric that correlates the delay to the liquidity characteristics of the relevant product and, in many cases, will not afford the risk intermediary sufficient time to hedge or liquidate its position.

The CFTC appears to have based this approach on the delay permitted by TRACE. As in the case of the CFTC's percentage/distribution test, this approach is based upon unproven premises and assumptions. First, the liquidity characteristics of the swap markets differ substantially from that of the corporate bond market (as highlighted above). Second, the use of TRACE and data from the corporate bond market ignores the reality that CDS have for many years been used as a proxy for block-sized corporate bond transactions precisely because of illiquidity in the market for block-sized corporate bond transactions. None of the studies cited by the Commissions analyzes the extent to which TRACE reporting requirements increased the use of CDS to manage large credit exposures. Without such an analysis, it would be inappropriate to use TRACE as a model for block transaction reporting delays in the context of the swaps market.

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[18] We note that the CFTC contemplates different reporting delays for customized transactions not subject to mandatory clearing. See CFTC Proposal at 76167.

[19] See CFTC PR 43.4(i).

In underestimating the liquidity costs of real-time reporting of swap transactions, each Commission has failed to demonstrate that TRACE has been a good model for balancing liquidity and transparency effects in the market for large corporate bond transactions. As noted in the SEC Proposal, research has shown that the implementation of TRACE had little impact on reducing spreads in low-volume bond markets.[20] This data on the effect of reporting on thinly-traded segments of the bond market is a better indication of the likely effects of reporting on the even more illiquid swap markets than the impact of TRACE on bond markets generally. Moreover, most studies of TRACE have focused only on its effect on spreads (particularly in smaller transaction sizes) and have not examined its effect on either market depth or resiliency, particularly in the case of large-sized transactions.[21]

Finally, there is no justification for assuming that the same reporting interval will have undifferentiated liquidity impacts regardless of transaction size, swap type and individual market. In contrast to the approaches the Commissions appear to have adopted, Dodd-Frank requires that the Commissions employ a more discriminating impact analysis, especially in view of the diversity of contract types, asset classes and markets in swaps and SBS.

C. Aggregate Block Transaction Limits

The CFTC has requested comment on a proposal to limit the aggregate notional or principal amount of block transactions to a percentage of the aggregate overall notional or principal volume traded over the prior year.[22] In the designated contract market ("DCM") context, the CFTC has separately proposed to limit block and other off-exchange transactions to 15% of total transaction volume.[23]

If block size thresholds are appropriately set at levels that minimize adverse liquidity impacts, the proposed aggregate restriction would have one of two effects. Either it will not create a binding constraint or, if it does, it will result in presumptively adverse liquidity impacts. As in other elements of the CFTC Proposal, the imposition of an aggregate 15% limit will achieve an arbitrarily higher block transaction threshold, but the CFTC identifies no principle or metric that ties the additional limit to Dodd-Frank's objectives.

Under Dodd-Frank, any increase in block transaction thresholds above the social size level should be based solely on the conclusion that the level of resulting market transparency is inadequate, a determination that is no way informed by the 15% metric on which the Commission has requested comment. The suggestion that transparency requires 85% (by

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[20] See SEC Proposal at 75225, citing Amy K. Edwards, Lawrence Harris, & Michael S. Piwowar, Corporate Bond Market Transparency and Transaction Costs, J. of Fin., Vol. 62, at 1421–51 (2007).

[21] See Hendrik Bessembinder & William Maxwell, Transparency in the Corporate Bond Market, 22 J. Econ. Persp. 217, 225 (2008).

[22] See CFTC Proposal at 76165.

[23] See CFTC PR 38.502, 75 Fed. Reg. 80572, 80616 (Dec. 22, 2010).

notional) of all transaction volume to be reported in real time is not correct for a wholesale marketplace.[24]

IV. SEC Proposal

The SEC has not yet proposed how it will determine minimum block transaction thresholds but notes that, consistent with the Firms' recommendation, these thresholds must be set in a way that "takes into account whether public disclosure of such transactions would materially reduce market liquidity."[25] The SEC has, however, proposed a reporting delay for block transactions. The SEC Proposal would require real-time reporting of all transaction data, except notional size, which would be reported with a delay of 8 to 26 hours.[26] Unlike the CFTC, the SEC does not propose replacing actual notional size with a range or proxy amount. The SEC also explicitly provides that equity TRS must be reported in real-time regardless of the size of the trade.[27]

A. Real-Time Reporting of Block Transactions

The Firms agree with the SEC that, if swap counterparties are required to report the notional size of a block transaction, this report should be delayed. However, the real-time disclosure of all transaction data other than size would not accomplish the purpose sought to be achieved by limited disclosure (and the related delay in reporting actual size). Market participants may well be able in many cases to infer the direction of the trade and the liquidity premium reflected in the reported price and to estimate the notional size.[28] Nor is it necessary for price observers to guess the notional size with accuracy in order for the price disclosure to have the effect that the reporting interval is intended to avoid. As a result, even without any direct information about the notional size of the trade, other parties will frequently be in a position to predict subsequent hedging transactions and act in a manner that will increase the cost of the hedging activity.

The SEC's proposed solution—to require the reporting of a normalized price or reporting of a "dummy" trade size—would introduce potentially misleading information into the market.[29] Although these techniques could potentially protect the ability of the risk intermediary to liquidate or hedge its block position risk, this protection would come at the expense of transparency for other market participants, who could be prompted to trade on misleading information. The Firms believe that it would be preferable to delay reporting of all information

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[24] In its DCM proposal, the CFTC notes that 410 (mostly energy, forex and weather) of the 570 contracts it examined in establishing the 85% threshold were traded off-exchange. See id. at 80589.

[25] SEC Proposal at 75228.

[26] See SEC PR 902(b)(1) & (2).

[27] See SEC Proposal at 75232–33.

[28] See id. at 75234, question 126.

[29] See id. at 75234, question 128.

for a period the duration of which would afford the risk intermediary sufficient opportunity to hedge its risk while providing other market participants accurate information as soon as possible thereafter.

The Firms would also like to address the SEC's requirement that the parties to a block transaction report notional size after an appropriate delay. The SEC acknowledges that TRACE never requires the parties to report exact notional size but does not fully explain why it has chosen not to adopt this approach in the SBS context.[30] The SEC notes that it "preliminarily believes that disseminating the full size of a block transaction, albeit with a delay, would further promote price transparency while having only minimal costs."[31] However, the Firms believe that, as discussed in Parts V and VII below, regulators should act incrementally and on the basis of empirical data. Therefore, we would recommend that the SEC gather further data on the costs and benefits of disclosing notional size before requiring such disclosure for all transactions. The Firms would urge the SEC alternatively to consider, at least initially, requiring swap parties to report size in a manner consistent with TRACE's "disseminated volume caps" and the rounding approach articulated in the CFTC Proposal.

B. Treatment of Equity TRS

Equity TRS raise the same liquidity concerns for major investors as other swaps. The SEC's proposed prohibition on block transaction reporting delays[32] for large equity TRS transactions would increase the cost and risk to risk intermediaries of entering into such transactions, impairing liquidity in such transactions and/or increasing associated execution costs to large investors.[33] This cost increase would not be limited to the equity TRS market; participants in the underlying cash markets could also face serious reductions in liquidity as a direct result.

The SEC has indicated that it proposed this prohibition to discourage SBS market participants from evading post-trade transparency in the equity securities markets by using synthetic substitutes in the SBS market. The Firms believe that such evasion of securities regulation is not a practical concern. In the years since the development of equity TRS, there is no evidence that this practice is or has ever been widespread, even though it can be accomplished under current reporting frameworks.[34] Moreover, the vast majority of equity TRS are hedged using instruments that are themselves subject to real-time reporting requirements.

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[30] See id. at 75232–33.

[31] Id. at 75233.

[32] See SEC PR 907(b)(2)(i).

[33] See SEC Proposal at 75234, question 122.

[34] Market participants enter into equity TRS for a variety of other, *bona fide* reasons, such as customizability and operational efficiencies.

The pricing of equity TRS, the extent to which they are hedged in the cash market and the native transparency in the cash equity markets also significantly mitigate the incremental price discovery benefit derived from public reporting of equity TRS.

V. Related Precedents and Proposed Framework

In considering appropriate reporting intervals, we urge the Commissions to consider a model based, in its architecture (not its specific quantitative levels), on the approach to equities reporting implemented under the EU's Markets in Financial Instruments Directive ("MiFID"). The MiFID framework tailors reporting delays to the size of the transaction relative to the particular instrument's trading volume. For example, MiFID requires regulators to consider the transaction size and average daily turnover ("ADT") in the instrument in order to determine the appropriate deferred reporting threshold and delay.[35] This is done first by classifying products into four separate liquidity "buckets" based on ADT and then by increasing the reporting delay for transactions that are large in size relative to the product's ADT. Given that trading volume varies more substantially across swaps, the Commissions should consider the possibility that more granular "bucketing" will be required to adequately preserve liquidity in specific categories of swaps.

In establishing "social size," we also recommend that the Commissions, for swap categories traded predominantly over-the-counter (which will naturally include all categories initially), take into account the average size of inter-dealer trades in the relevant market. In many cases, the "market moving" size will correlate with a level somewhat above the level at which inter-dealer transactions are executed in the relevant swap or SBS. That level can serve as a proxy for the size of transactions at or below which there is thought to be no market-moving impact (i.e., the initial block size level should be set at a level just above the inter-dealer market "social size"). As suggested above, if the block size level implied by this approach would result in an inadequate level of reported transactions to provide meaningful transparency, the block size level should be increased, but only to the level necessary to achieve an effective balance of the interests of end-users and market observers (e.g., where the volume of reported transactions would provide meaningful transparency). A limited number of additional block size levels with longer reporting delays should then be established above this initial block size level in a manner consistent with the MiFID-like approach outlined above.

In approaching either element of a block transaction reporting framework, the Commissions should carefully consider the unique structure of swap and SBS markets in terms of (1) overall liquidity relative to other markets that have implemented real-time public reporting[36] and (2) the considerable variation in liquidity across and within asset classes. As noted above, it would be methodologically unsound to rely on the experience of other markets,

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[35] See Commission Regulation (EC) No. 1287/2006 (Aug. 10, 2006), Annex I, Table 4 (reproduced in the attached Appendix). Although the EU is currently in the process of revising MiFID, we understand that this general framework will remain (albeit likely with some changes to its calibrations).

[36] See SEC Proposal at 75226, question 100 (noting the relative illiquidity of SBS markets).

such as TRACE in the corporate bond context, that do not have similar liquidity characteristics and whose participants have had access to OTC swaps as alternatives for the private execution of large transactions.[37]

Additionally, as noted above, attempting to vary block size thresholds and reporting delays by asset class is not a sufficiently granular approach through which to satisfy Dodd-Frank's mandate; the Commissions must evaluate and group individual swaps, even those within the same asset category, to the extent they exhibit unique liquidity characteristics. This may entail categorization that takes into account swap term variations as well as variations in tenor.[38] A block transaction reporting framework that considers only an instrument's asset class will necessarily be too blunt an instrument for accomplishing Dodd-Frank's objectives.

VI. Special Pricing, Customized, Inter-Affiliate, and Cross-Border Transactions

A. Special Pricing Transactions

The Firms understand that the Commissions would, absent an applicable block transaction delay, require the parties to report a transaction "as soon as technologically practicable"[39] after "execution," which is defined as the moment when the parties to the transaction become bound under applicable law.[40] We further understand that the Commissions would require the public transaction reporting to include, among other data, the price and size of the transaction.[41] However, for some transaction types, including block and non-block trades, the price or size of the transaction cannot be determined at the time the swap is negotiated. For example, the parties may base the price of the swap on an as-yet-unknown price reference, such as a subsequent market closing price or third party quotations, an average of such prices over time, or a volume-weighted average price. Regardless of whether the parties are deemed to have "executed" the trade, which will depend on the facts and circumstances of the transaction and applicable state or other law that the parties have chosen to govern the contract,[42] it clearly would not be practicable for the transaction to be reported until all the data that the Commissions require to be reported is available.

This approach would be consistent with the treatment of analogous transactions in other markets. For example, specially priced trades in the equity securities market are not

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[37] The SEC Proposal acknowledges potential differences. See id. at 75280.

[38] See id. at 75233, question 114.

[39] CFTC PR 43.2(t); SEC Proposal at 75216.

[40] See CFTC PR 43.2(k); SEC Proposal at 75216, n. 55.

[41] See CFTC Proposal at Appendix A; SEC PR 901(c).

[42] See CFTC Proposal at 76144. We agree with ISDA and SIFMA that the Commissions should look to existing industry standards in developing a coordinated approach to the timing of "affirmation," "execution," and "confirmation." See ISDA/SIFMA SEC Letter at 6–7 and ISDA/SIFMA CFTC Letter at 7–8.

reported until the special price is established.[43] When a broker-dealer is filling a large customer order, the price of the entire transaction may not be determined until the broker-dealer has entered into several smaller transactions in order to accumulate sufficient shares to fill the order. The price at which the broker-dealer sells to the customer may reflect the volume-weighted average cost of the interim trades. Each of these trades must be reported, but the final trade between broker-dealer and customer is not reported until the price is known and, even then, it is reported with a weighted average price modifier.[44]

Accordingly, we request that, consistent with the treatment of similar transactions in other contexts, the Commissions clarify that swap transactions need not be reported until all information that must be included in the public transaction report is available.

B. Customized Transactions

Practically speaking, customized transactions cannot be reported publicly in a manner that enhances price discovery and preserves confidentiality. As the Commissions expressly recognize in proposing that customized transactions be reported with a special indicator, non-disclosed terms in customized transactions materially affect the price of those transactions.[45] In other words, public reporting for customized transactions would not aid price discovery. On the other hand, real-time reporting of size and other transaction details would prevent parties to a bespoke transaction from effectively hedging their risk in more standardized markets.

The Firms believe that it would be more effective and less costly for the Commissions to require public reporting of a few key terms of a customized swap: asset category, a proxy for size (e.g., an identifier if the transaction is block size), and some indication that the transaction is customized. Full transactions reports would still be provided for regulatory (i.e., non-public) purposes, and so there should be no concerns that limited public dissemination would impede regulatory oversight.

C. Inter-Affiliate Transactions

The Firms believe that reports of inter-affiliate transactions should not be captured by public reporting requirements.[46] As the SEC notes in its Proposal, public reporting of these trades would do little to improve price discovery.[47] Despite the limited value of

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[43] See FINRA, Trade Reporting Frequently Asked Questions, http://www.finra.org/Industry/Regulation/Guidance/p038942#404

[44] This approach is consistent with defining "affirmation," "execution" and "confirmation" in accordance with industry standards for the particular product. See supra note 42.

[45] See CFTC Proposal at 76153; SEC Proposal at 75215.

[46] See id. at 75238, question 151.

[47] See id. at 75275.

transparency and potential that reporting these transactions could introduce misinformation into the market, the SEC would require a full report of all material terms of the transaction with an additional, rather than alternative, indicator that the transaction was not conducted at arm's length on the open market.[48]

On the other side of the cost-benefit equation, public reporting of inter-affiliate transactions could seriously interfere with the internal risk management practices of a corporate group. For example, one entity in a group may be better positioned to take on a certain type of risk, even though another entity must, for unrelated reasons, actually enter into the transaction with an external counterparty. Public disclosure of a transaction between affiliates could prompt other market participants to act in a way that would prevent the corporate group from following through with its risk management strategy by, for instance, causing adverse price movements in the market that the risk-carrying affiliate would use to hedge. Because public reporting could confuse market participants with irrelevant information and raise the costs to corporate groups of managing risk internally, we suggest that the Commissions collect data on these transactions but not require dissemination to the public at large.

D. Cross-Border Transactions

In light of the global integration of swap markets, the Firms believe that the Commissions should give careful consideration to the potential duplication of real-time reporting obligations overseas. The SEC Proposal would require an SBS between two non-U.S. counterparties to be reported in real-time if it is either (1) executed in the U.S. through any means of interstate commerce or (2) cleared through a clearing agency with its principal place of business in the U.S.[49] In both cases, the parties will likely be required to report the transaction in one or both of their home jurisdictions,[50] and the transparency objectives of the Proposed Rules will be served without additional reporting obligations in the U.S., so long as that jurisdiction imposes comparable real-time reporting responsibilities. At the same time, the Commissions could avoid the confusion that could arise from multiple transaction reports in different jurisdictions at different times by deferring to a foreign reporting regime where both parties are not domiciled in the U.S.[51] In doing so, the Commissions could also avoid potential conflicts

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[48] See SEC PR 901.

[49] See SEC PR 908. The CFTC has not proposed specific provisions relating to the cross-border applicability of its proposed real-time reporting rule. However, it does request comment as to whether its rule should apply to transactions between two non-U.S. persons and how it should treat transactions between non-U.S. swap dealers/major swap participants and U.S. end-users. See CFTC Proposal at 76146.

[50] See CFTC Staff, "Derivatives Reform: Comparison of Title VII of the Dodd-Frank Act to International Legislation" at 5 (Oct. 5, 2010), available at http://www.cftc.gov/ucm/ groups/public/@newsroom/documents /speechandtestimony/gmac_100510-cftc2.pdf (describing, among other things, reporting obligations in the EU and Japan).

[51] Such deference would also be appropriate in a transaction between two non-U.S. persons where one or both of the parties is or are registered in the U.S.

between U.S. reporting obligations and foreign (particularly, EU) privacy laws applicable to non-U.S. parties.

The same considerations apply to the SEC's proposal to require the U.S. counterparty to a swap between a U.S. person and a foreign person to report the transaction, even if the non-U.S. counterparty is an SBS dealer or major SBS participant and the U.S. counterparty is not.[52] While the foreign SBS dealer or major SBS participant will likely be required to report the transaction in its home jurisdiction and have the capacity to do so, the unregistered U.S. counterparty probably will not have the systems in place to report all swap data to an SDR. As a result, unregistered counterparties, including end-users, may refuse to enter into transactions with foreign SBS dealers or major SBS participants in order to avoid the costs of developing the necessary reporting systems. This could reduce price competition and defeat an important goal of Dodd-Frank. The Firms believe that the most efficient solution would be for the foreign SBS dealer or major SBS participant to report the transaction in such cases in accordance with the rules of its home jurisdiction.

The Commissions can also ensure that they retain access to data reported to foreign SDRs by establishing a regime for cross-registration of SDRs in multiple jurisdictions.

VII. The Implementation Process

By adopting an incremental approach, the Commissions can avoid imposing significant costs on market participants (including end-users who rely on swap markets to hedge commercial risk) or permanently altering the structure of swap markets. While there may be some cost (e.g., less than optimal transparency for a temporary period) to starting with broad real-time reporting exceptions, this cost is minimal when compared to losses arising from foregone hedging opportunities that an overly narrow exception could cause. The Commissions can always impose more stringent requirements as warranted by additional data regarding the impact of real-time reporting. It would be substantially more difficult to reverse the damage that would be caused by initially imposing overly restrictive requirements.

The London Stock Exchange provides a good example of what can happen when real-time reporting rules are imposed without fully considering potential liquidity impacts or providing an adequate implementation period. The London Stock Exchange initiated real-time reporting for all trades in 1987, but had to revert to a 24-hour block transaction reporting delay within 2 years due to a material reduction in liquidity.[53]

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[52] See SEC PR 901(a)(1).

[53] See ISDA/SIFMA Study at 8–9.

TRACE provides a better implementation model. TRACE phased in block transaction reporting delays from 75 minutes to 15 minutes over the course of 4 years.[54] While the specifics of TRACE reporting (e.g., 15-minute reporting delays, $5 million block transaction size) would not be appropriate for the swap markets, its phased approach to implementation, which allowed regulators to simultaneously monitor market changes, should be emulated.

Because the Commissions' rules governing execution of block transactions on swap and SBS execution facilities ("SEFs") are directly based on real-time reporting block transaction rules (SEFs would be required to set thresholds that are *greater than* SDR block transaction thresholds[55]), the costs of setting overly restrictive thresholds will be amplified. The Commissions should not only keep this interaction in mind as they develop appropriate real-time reporting exceptions, but they should also reconsider how minimum block transaction sizes for the purposes of reporting interact with minimum block transaction sizes for the purposes of execution on a SEF. There is no obvious reason that block transaction thresholds for execution should be higher than for reporting. Both exceptions serve the same purpose of addressing the liquidity concerns associated with large size transactions. Indeed, imposing *pre-trade* transparency on block transactions would only exacerbate the problems created by an inappropriately small block transaction threshold. As a result, if anything, block transaction levels on SEFs should be no higher than those established under the Commissions' reporting frameworks.

In addition, the Commissions should carefully consider the technical systems, market infrastructure and operational pre-requisites to a fully functioning real-time public reporting regime in establishing an appropriate implementation timeline. Any timeline must recognize the practical challenges that SDRs and market participants will face in defining and implementing industry-wide collection and dissemination mechanisms and internal data collection systems, respectively.

We believe that imposing deadlines that do not provide ample time for these processes to occur will create potentially costly non-compliance due to a lack of necessary infrastructure. The Firms have identified three key steps that regulators, SDRs, and market participants will have to take in order to establish a functional market-wide system of real-time reporting:

- ***Taxonomy and Symbology.*** Both Commissions would require SDRs to report publicly (and parties to report to SDRs) a number of specific data elements. For each element, the Commissions would need to establish, and parties would need to implement, a method of identifying particular types of swap

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[54] See NASD, News Release, NASD Announces Nes [sic] Trace Implementation Date (Nov. 28, 2001); NASD, News Release, NASD's Fully Implemented "TRACE" Brings Unprecedented Transparency to Corporate Bond Market (Feb. 7, 2005).

[55] See CFTC PR 37.201, 76 Fed. Reg. 1214, 1242 (Jan. 7, 2011); SEC PR 800, SEC Release No. 34-63825 (Feb. 2, 2011).

transactions and identifiers for market participants.[56] Indeed, the CFTC and SEC are currently engaged in a study mandated by Dodd-Frank regarding the feasibility of standardized computer-readable algorithmic descriptions for derivatives; it would be premature to adopt reporting rules until completion of that study and consideration of its results.[57]

- ***External Infrastructure.*** SDRs and other registered entities would need to develop the infrastructure to accept data from market participants and disseminate it to the public under agreed protocols. Given that multiple independent entities will necessarily be involved in this process, it will take some time to build an interconnected system with compatible protocols.

- ***Internal Infrastructure.*** Swap and SBS dealers, major swap and SBS participants, SEFs, exchanges, clearing organizations, SDRs and other market participants will be required to build internal systems to capture trade information in real time, to format it in conformity with applicable protocols and to receive and communicate such data from and to SDRs.

The experience of other markets in implementing real-time public reporting can be instructive in terms of addressing these considerations. As noted above, full TRACE implementation occurred over a period of four years (from mandate to full implementation).[58] The Commissions should expect that a similar period, at a minimum, will be needed for public swap reporting, given that the swap markets are significantly more complex and varied and less developed infrastructurally than the corporate bond markets.[59] The Commission should consider a staged implementation process, perhaps by prioritizing swap categories the characteristics and market infrastructure of which are perceived to lend themselves most readily to implementation under the new framework. Consistent with TRACE, the Commissions should also consider step-by-step reductions in block transaction reporting delays.[60] This would allow them to assess the impact of shorter reporting delays on an on-going basis.

As part of the implementation process, given the complexity and novelty of the contemplated reporting framework, it will be critical for the Commissions to begin with a pilot program that would allow them to evaluate the operational integrity of the infrastructure implementing the new framework and to gather data on the impact of real-time public reporting on swap markets. This approach could be particularly valuable, precisely because swap markets

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[56] It will also likely be necessary to identify whether a price is associated with a bilateral trade or a cleared trade and, if the latter, the applicable clearing organization, as these distinctions may well have price impacts.

[57] See 75 Fed. Reg. 76706 (Dec. 9, 2010).

[58] See supra note 54.

[59] See SEC Proposal at 75244, questions 179–82.

[60] See FINRA, TRACE Announcement Archive (Sept. 30, 2003 and July 14, 2004), http://www.finra.org/Industry/Compliance/Market Transparency/TRACE/Announcements/P117685.

differ significantly from markets already subject to real-time reporting in number and types of participants, volume of trading, dispersal of information and other characteristics. Because of these differences, data regarding the impact of public reporting on these other markets is unlikely to provide a good indication of its potential impact on swaps.

Finally, the Firms urge the Commissions to coordinate in overseeing an incremental, phased implementation process. We note that the jurisdictional divide between swaps and SBS does not correspond precisely to the business realities of trading and dealing in these products. A single business unit engaged in SBS trading will almost invariably also engage in swap trading. The Commissions can reduce the costs of implementation and reporting errors by establishing consistent reporting obligations (e.g., the same data fields) and ensuring that these obligations become effective at the same time and in the same order.[61]

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[61] Such a consistent approach would also address mixed swaps.

The Firms appreciate the opportunity to comment on the real-time reporting provisions of Dodd-Frank and the associated Proposed Rules. We would be pleased to provide further information or assistance at the request of the Commissions or their staffs. Please do not hesitate to contact Edward J. Rosen (212 225 2820) of Cleary Gottlieb Steen & Hamilton LLP, outside counsel to the Firms, if you should have any questions with regard to the foregoing.

Respectfully submitted,

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[62] UBS Securities LLC has filed separate comment letters on the issues presented here. See Letters from Andrew Downes and James B. Fuqua to the Commodity Futures Trading Commission and to the Securities and Exchange Commission, each dated February 7, 2011. While the recommendations set forth in those letters differ somewhat from those in this letter, UBS Securities LLC supports the analysis made in this letter and believes that's the recommendations herein present a workable approach to address the concerns raised by the Proposed Rules.

APPENDIX

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Table 4

Deferred publication thresholds and delays

The table below shows, for each permitted delay for publication and each class of shares in terms of average daily turnover (ADT), the minimum qualifying size of transaction that will qualify for that delay in respect of a share of that type.

		Class of shares in terms of average daily turnover (ADT)			
		ADT < EUR 100 000	EUR 100 000 ≤ ADT < EUR 1 000 000	EUR 1 000 000 ≤ ADT < EUR 50 000 000	ADT ≥ EUR 50 000 000
		Minimum qualifying size of transaction for permitted delay			
Permitted delay for publication	60 minutes	EUR 10 000	Greater of 5 % of ADT and EUR 25 000	Lower of 10 % of ADT and EUR 3 500 000	Lower of 10 % of ADT and EUR 7 500 000
	180 minutes	EUR 25 000	Greater of 15 % of ADT and EUR 75 000	Lower of 15 % of ADT and EUR 5 000 000	Lower of 20 % of ADT and EUR 15 000 000
	Until end of trading day (or roll-over to noon of next trading day if trade undertaken in final two hours of trading day)	EUR 45 000	Greater of 25 % of ADT and EUR 100 000	Lower of 25 % of ADT and EUR 10 000 000	Lower of 30 % of ADT and EUR 30 000 000
	Until end of trading day next after trade	EUR 60 000	Greater of 50 % of ADT and EUR 100 000	Greater of 50 % of ADT and EUR 1 000 000	100 % of ADT
	Until end of second trading day next after trade	EUR 80 000	100 % of ADT	100 % of ADT	250 % of ADT
	Until end of third trading day next after trade		250 % of ADT	250 % of ADT	