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Sent: Friday, September 24, 2010 8:50 AM
To: dfdefinitions <dfdefinitions@CFTC.gov>; OTCDefinitions@CFTC.com; rule-comments@sec.gov
Subject: File Number S7-16-10: Comments with respect to the definition of Major Swap Participant
Attach: Dodd-Frank Act - Definition of MSP.pdf

Ladies and Gentlemen:

Thank you very much for the opportunity to comment regarding key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Please find attached above our comments with respect to the definition of "Major Swap Participant" in the context of the interest rate swap markets.

Thank you again for the opportunity to comment.

Respectfully submitted,

CONVEXITY CAPITAL MANAGEMENT LP

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September 24, 2010

Via Electronic Mail: dfadefinitions@cftc.gov rule-comments@sec.gov
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Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington DC 20581

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number S7-16-10: Definition of “Major Swap Participant”

Ladies and Gentlemen:

Thank you very much for the opportunity to comment regarding key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. With respect to the definition of “Major Swap Participant” in the context of the interest rate swap markets, we respectfully submit the following comments:

- **Substantial Position in Swaps – Notional amounts should be taken into account only on a risk-adjusted basis.**
 - In determining whether a person “maintains a substantial position in swaps” for any interest rate derivative (including swaps, forwards, options), if notional amount is to be used as one gauge of the substantiality of a position, it should be included on a duration/risk adjusted basis, such as a 10-year bond equivalent basis, if it is to be of any usefulness. By way of example:
 - In the ordinary course of business, one may enter into a single transaction or multiple transactions (“pieces”) with the same counterparty where the sum of the pieces in comparison to the single transaction has identical risk but a multiple of the notional. For example, one can purchase a 4-year interest rate cap with respect to a

particular interest rate or 16 individual 3-month caps with respect to the same rate. In aggregate, when compared to the 4-year cap, the 16 individual caps cover the same 4-year period to expiration, have identical risk, and represent sixteen times the notional amount. The 10-year bond equivalent notional exposure of the 4-year cap and that of the sum of the 16 cap 'pieces' would be identical.

- Left unadjusted, a transaction's notional amount is not instructive, as it can intentionally be manipulated without altering the risk or economics of the transaction by altering other terms of the transaction. For example, consider a swap where the notional is 100. One party will pay a fixed rate of 4% and the other party will pay a floating rate "X". Alternatively, the swap could be drafted as having a notional of 10, a fixed rate of 40% and a floating rate of X*10.
- Further, in the context of interest rate options, for options that are purchased (*i.e.*, long option positions), the amount taken into account should be the *lesser* of the risk adjusted notional amount (*e.g.*, the delta-weighted ten-year bond equivalent notional amount) of such option *and* the market value of such option. (This is because the risk posed by a long option holder is, at most, that it won't be able to return the variation margin it has received and, by definition, this amount cannot exceed the market value of the option.) This highlights the broader point that in many swaps (particularly options), the risk is asymmetric and thus the risk presented by a short position should be regarded differently than the risk represented by a long position.
- The notional amounts of positions that are offsetting should be permitted to be netted provided that they are (x) cleared with the same clearing house and through the same FCM or (y) for positions that are not yet cleared, entered into with the same over-the-counter counterparty.
- The amount of risk represented by a dollar of notional amount (even when reported on a bond-equivalent and/or delta-weighted basis) of course varies depending on the risk characteristics of the particular type of swaps. Accordingly, it would be helpful to consider applying risk metrics such as Value at Risk, volatility and a small group of broad-market stress tests in finally assessing which portfolios are those of Major Swap Participants.
- Finally, as provided in the legislation, risk mitigants such as clearing and high-quality collateral should also be taken into account.
- **Substantial Counterparty Exposure – Positions should be disregarded to the extent adequately collateralized.**
 - In determining whether outstanding swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the

United States banking system or financial markets”, swaps should be taken into account only to the extent that they are not “adequately collateralized” with U.S. dollars, U.S. Treasury securities or other high-quality collateral consistent with that which is currently acceptable for listed futures and options.

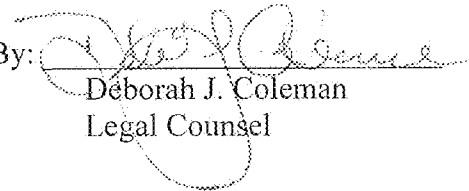
- “Adequate collateralization” might be defined as high-quality collateral with a value (as discounted by the clearing organization through which the swap is cleared or, for swaps that are not yet cleared, by the swaps dealer that is the counterparty to such swap) equal to $(100 + x)\%$ of the value of the swap (the “Adequate Collateralization Amount”). “100%” would represent full variation margin and “x%” would be the appropriate level of initial margin (*e.g.*, Independent Amount) for swaps in the general category in which the swap falls, as set by the Commission. The Commission might maintain and adjust from time to time a schedule of adequate initial margin levels, based on information provided by the clearing organizations and major dealers, consistent with current methodology and risk analytics used in the markets, such as the SPAN margining system.
- Accordingly, swaps would be counted toward “substantial counterparty exposure” only to the extent of the *excess* of (x) the Adequate Collateralization Amount *over* (y) the aggregate value of the high-quality collateral actually posted (as discounted by the clearing organization through which the swap is cleared or, for swaps not yet cleared, by the dealer that is the counterparty to such swap).

Thank you again for the opportunity to submit comments in respect of the CFTC’s and SEC’s Advance Joint Notice on Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. If you have any questions or would like to discuss our comments, please contact Mike Pradko (Chief Financial Officer) or Deborah Coleman (Legal Counsel) at 617-585-8500.

Respectfully submitted

Convexity Capital Management LP

By:


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Legal Counsel