



December 31, 2010

Via Electronic Submission: <http://comments.cftc.gov>

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: A Study Mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 719(b)

Dear Mr. Stawick:

Managed Funds Association (“MFA”)¹ appreciates the opportunity to provide comments to the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”, and together with the SEC, the “Commissions”) on the Commissions’ December 9, 2010 Notice of Acceptance of Public Submission on, *A Study Mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 719(b)* (the “Notice”).² MFA strongly supports the goals of the over-the counter (“OTC”) derivatives regulation set forth in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) to enhance transparency and reduce systemic risk, and we generally support the measures aimed at increasing the standardization of process and protocols in derivatives markets. As customers, we want to ensure that, as the Commissions are developing rulemakings related to OTC derivatives, those rules are in the best interests of customers and the overall functioning of the marketplace.

I. General Comments on the Use of Standardized Computer Readable Descriptions and Algorithms in Derivatives Markets

MFA appreciates the opportunity to comment on the Notice. Given the short time-frame for providing such comments, MFA can provide only general written responses to the questions and topics raised by the Notice. The complex nature of the Notice’s subject matter might be

¹ MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

² 75 Fed. Reg. 76,706 (Dec. 9, 2010).

better addressed through an in-person meeting where MFA members might provide more informative answers to the Commissions through an interactive dialogue. If staff of the Commissions would find it helpful, MFA members would be pleased to make representatives available as a resource.

The Notice uses the terms “standardized computer readable algorithmic descriptions,” “algorithmic descriptions,” “standardized computer readable descriptions” and “ontologies” somewhat interchangeably throughout the Notice. The use of multiple terms gives rise to some doubt as to exactly what computer-based solution the Commissions have in mind. The discussion of many different processes, *e.g.*, confirmation, messaging, valuation, etc., creates additional uncertainty. The Commissions may be asking questions regarding the use of standard descriptions for swap terms, like duration, an upfront amount, and the indexed rate. The Commissions might also contemplate the use of a mathematical formula that provides certain results (*e.g.*, an algorithm). Possibly, the Commissions envision a derivatives modeling protocol with both standard descriptors and mathematical formulas. MFA recommends that the Commissions further clarify the subject matter of the study and possibly re-solicit answers to more tailored questions.

Derivatives markets participants, including MFA members, continually work to standardize industry practices and terms, where appropriate. Standardization improves efficiency and minimizes disputes. Such standardization allows for the use of algorithms and standardized computer readable descriptions for trading, settlement and maintenance of derivatives trades. However, the use of such electronic-based tools is only possible where the terms of the derivatives are sufficiently uniform. Complex derivatives and customized derivatives do not currently lend themselves to the use of algorithms or standardized computer readable descriptions.

II. Calculation of "Net Exposures to Complex Derivatives" and Other "Computerized Analysis"

Generally, firms value and analyze derivatives by using internal valuation models and external market information. Algorithms and standardized computer readable descriptions play some limited role in this process. More standard contracts such as vanilla interest rate swaps can be easily valued utilizing a relatively simple algorithmic model by referencing external inputs such as market interest rate curves. In contrast, market participants often use more sophisticated proprietary algorithmic valuation models to value complex derivatives that have multiple factors driving their value. In general, the more complex a derivative might be, the more difficult it is to arrive at a market standard algorithmic valuation model that can be used by counterparties to reach a common valuation.

Where standardized computer readable descriptions might be useful across derivatives markets is for the exchange of information regarding exposure and collateral requirements after counterparties have performed their own valuations. A standardization of such processes would increase transactional efficiency and reduce discrepancies regarding the exchange of information on exposures and collateral requirements.

III. Current Practices Concerning Standardized Computer Descriptions of Derivatives

MFA members and other derivatives markets participants have taken affirmative steps to move towards a higher degree of standardization, where appropriate, within individual derivatives markets to make trade execution, confirmation and processing more efficient. One tool that enables the improvement of market practices is the use of standardized computer readable descriptions. In certain markets, participants have collaborated to standardize the legal terms of widely traded derivatives to the degree that, using standardized computer readable descriptions, such contracts are now able to be matched and confirmed on electronic platforms and reported to trade repositories.³ For example, DTCC's Trade Information Warehouse is a fully operational trade repository for credit derivatives. The warehouse utilizes standardized computer readable descriptions of derivatives to manage life cycle events for a substantial portion of the OTC credit derivatives market. In addition, MarkitSERV relies on standardized computer readable descriptions of derivatives to match and confirm a wide range of standardized derivatives products on an electronic platform.⁴

However, the successful move towards the use of standardized computer readable descriptions of derivatives in certain markets and for certain instruments should not lead the Commissions to conclude that mandating similar practices across all derivatives markets is advisable or even possible. The individual markets and products that do not utilize standardized computer readable descriptions of derivatives do not do so for a reason. Many instruments that have multiple factors determining their value are too complex or customized. They require manual confirmations and active management of life cycle events. Thus, even sophisticated users of derivatives do not operate exclusively through fully-automated, electronic systems.

IV. Current Use of Standardized Computer Readable Descriptions for Messaging of Derivatives Transactions

For OTC derivatives transactions (other than certain vanilla swaps which utilize trade matching platforms as noted in Section III above) that are executed bilaterally and not over an electronic execution platform, very little, if any, communication is done using standardized computer readable descriptions. Typically, for a bilateral OTC derivative transaction, traders exchange material terms by electronic message or over the telephone. Typically, there is no specific electronic format for such communications. The swap dealer will then produce a paper confirmation for execution and, prior to confirmation, the legal terms of the swap are discussed

³ See, for example, ISDA's *Credit Derivatives Determinations Committee and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions*. ISDA currently is working with various industry groups and participants, including MFA, to update the ISDA Equity Derivatives Definitions that market participants use to simplify the documentation process for equity derivatives transactions.

⁴ Specifically, MarkitSERV is able to match and confirm single reference entity credit default swaps (CDS), CDS indices, CDS index tranches, equity index and share options, equity swaps, variance swaps, and dividend swaps, interest rate swaps, inflation swaps and swaptions. <http://www.dtcc.com/products/derivserv/ms/match-confirm.php>.

and negotiated. After execution, the terms of the transaction are reported to a trade repository, if available.

Life cycle events for most bilaterally executed derivatives are also managed over electronic message or the telephone. Exposure and accompanying collateral requirements are determined on a counterparty-to-counterparty basis based upon a portfolio of derivatives transactions. Any discussion as to valuation or exposure discrepancies is generally conducted over the telephone or by electronic messaging. Computer readable descriptions of the transactions (or the valuations) generally are not used.

V. The Need for Standardized Computer Readable Descriptions of Derivatives

We believe that, in general, market participants, including many MFA members, have historically addressed the need for increased standardization of derivatives markets and products, including the use of standardized computer readable descriptions of derivatives, in an appropriate manner. Market participants largely drive standardization where market conditions have made it possible.

We respectfully suggest that the Commissions, when studying the possible use of computer readable descriptions and algorithms in derivatives markets, do so with a view towards facilitating market evolution. The Commissions should not impose mandatory requirements to use such computer-based tools. MFA recommends the Commissions study the feasibility of using standardized algorithms and methodology to identify and more efficiently resolve collateral or valuation disputes.

VI. Implementation

The appropriate method for the Commissions to implement standards for computer readable descriptions in derivatives markets would be to use a collaborative and principles-based approach. To encourage standardization in markets without hindering market efficiency, we believe the proper role of a regulator is that of a facilitator. Regulators such as the Commissions should engage market participants in an ongoing dialogue about how best to move the markets in the proper direction. However, given the dynamic nature of derivatives markets, the ultimate manner in which uniform computer readable description standards are adopted and the timing of such adoption should be left to the market.

VII. Computer Readable Descriptions Should not be Legally Binding

Legally binding computer readable descriptions may work to confirm certain trades. MFA, however, believes that a paper confirmation is necessary for many types of derivatives as the legally binding memorialization of a trade's terms. Standardized computer readable descriptions and algorithms should be tools, but generally should not serve as the actual and only means of communication or confirmation to form a legally binding trade. Certain standardized products can be electronically confirmed using computer descriptions. However, in order to do so, market participants must first execute paper agreements to enable the process to function. For example, when using MarkitSERV each data line item constitutes a binding legal

confirmation, but in order to execute a trade on MarkitSERV a party must first execute a Master Confirmation Agreement.

Electronic confirmation is only possible with standardized derivatives where there are no unique legal or structural terms. Complex trades require paper confirmations because electronic platforms and their common terms and algorithms cannot account for bespoke terms. Critical terms to a customized trade tailored additional termination events, embedded optionality, or allocation of legal rights in respect of a referenced security. These bespoke terms necessarily must be memorialized in a paper confirmation.

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MFA appreciates the opportunity to comment on the Notice. We would be pleased to meet with the Commissioners of the CFTC or SEC or either of their respective staffs to discuss our comments and use of algorithms with regards to derivatives in greater detail. If the Commissioners or staffs of the CFTC or SEC have questions, please do not hesitate to call Jennifer Han or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
General Counsel

CC: The Hon. Mary Schapiro, SEC Chairman
The Hon. Kathleen L. Casey, SEC Commissioner
The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner

The Hon. Gary Gensler, CFTC Chairman
The Hon. Michael Dunn, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner