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Via Electronic Submission: http://comments.cftc.gov
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Commodity Futures Trading Commission
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Washington, D.C. 20581

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

Re: Definition of "Major Swap Participant" and "Major Security-Based Swap Participant;" Joint Proposed Rulemaking of the Commodity Futures Trading Commission and the Securities and Exchange Commission (collectively, the "Commissions") (File Number S7-39-10)

Ladies and Gentlemen:

We are pleased to provide the following comments regarding the joint rules recently proposed by the Commissions for "Further Definition of Swap Dealer, Security-Based Swap Dealer, Major Swap Participant, Major Security-Based Swap Participant and Eligible Contract Participant" (the "Proposed Rules").

Our comments below are technical in nature and focus on the proposed quantitative measurements for determining "Major Swap Participant" and "Major Security-Based Swap Participant" status. The comments seek to promote consistency among important overlapping regulatory schemes for measurement of financial risk, as well as internal consistency.

We appreciate the Commissions' efforts to draft definitions of the terms that are straight-forward and generally easy to apply. As drafted, however, the rules could in a number of contexts materially overstate the particular risks posed by a market participant. We suggest the following simple changes as a way of preserving the desirable simplicity of approach, while more accurately reflecting the underlying risks:

- **Potential Future Exposure – Potential Future Exposure in respect of Fixed Obligations Should not Exceed the Present Value of such Obligations. (Proposed Rule § 1.3(sss)(3)(ii) under the Commodities Exchange Act (the "CEA") and Proposed Rule 3a67-3(c)(2) under the Securities Exchange Act of 1934 (the "1934 Act"))**
    - The notional-based formula set forth in the Proposed Rules can overstate the potential outward exposure of a position for which the only obligation of the holder is to make one or more fixed payments. For example, if the market participant is the purchaser of an option the premium for which is to be paid at expiry or over the term of the option, the maximum potential future exposure attributable to such position should not exceed the present value of the remaining premium payment(s) due under the option. The Proposed Rule recognizes the appropriateness of this adjustment, but applies it only in the context of credit default swaps (Proposed Rule §1.3(sss)(3)(ii)(A)(4) under the CEA and Proposed Rule 3a67-3(c)(2)(i)(D) under the 1934 Act).
    - Accordingly, as is the case for credit default swaps, the potential future exposure for <u>any</u> position with a fixed downside risk should not exceed the present value of the maximum amount of remaining fixed payments that could be due under the position.

- **Potential Future Exposure – Notional Amounts Should be Adjusted to Reflect Delta Weighting. (Proposed Rule §1.3(sss)(3)(ii) under the CEA and Proposed Rule 3a67-3(c)(2) under the 1934 Act)**
    - There is no question that delta-weighting of notional amounts would provide a more accurate assessment of risk than equal weighting of all notional amounts regardless of delta. A deep-out-of-the-money option provides less exposure than an option written closer to the exercise price and than a linear position (such as a swap or forward contract) with the same notional amount. The question is whether, as a practical matter, delta-weighting should be taken into account in the required calculation under the proposed rules cited above. We believe that closely related regulatory developments clearly indicate that it should be.
    - Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the business of regulating such persons as Major Swap Participants and Major Security-Based Swap Participants is closely tied to the identification and regulation of systemic risks by the newly created Financial Stability Oversight Council (the "FSOC"). The Commissions have

recently proposed Form PF "to assist the [FSOC] in its assessment of systemic risk in the U.S. financial system" and to allow it to "identify potential threats to the financial stability of the United States." It is contemplated that hundreds of advisers will file this form quarterly and that hundreds more will file the form on an annual basis (completing only Section 1). The importance of delta-weighting to an accurate assessment of the risks is clearly reflected in this recently proposed form.

- Proposed Form PF requires that the notional amounts of options positions be delta-weighted. (See Proposed Form *PF*: Section 1b, Question 11; Section 2a, Questions 23 and 25; Section 2b, Questions 27 and 38; Section 3, Question 47; and Section 4, Question 68. See also Proposed Form CPO-PQR, Schedule B, Question 5.) We respectfully request that for purposes of calculating aggregate potential outward exposure under the Proposed Rules, market participants be permitted to use the same methodology for delta-weighting their non-linear positions that they use in completing Form PF and/or Form CPO-PQR.

- **Potential Future Exposure – The Discount Factor for Centrally Cleared Swaps and Security-Based Swaps Should be at or about 100%. (Proposed Rule §1.3(sss)(3)(iii)(A) under the CEA and Proposed Rule 3a67-3(c)(3)(i) under the 1934 Act)**

  - The Commissions propose that the potential future exposure of those positions that are centrally cleared be discounted by 80%. This discount factor reflects to a significant extent the risk mitigating effects of daily marking to market and corresponding exchanges of variation margin. The percentage does not, however, seem to reflect the risk-mutualization benefits of clearing. In effect, cleared swaps and security-based swaps are more akin to future contracts and exchange-traded options than to OTC derivatives. Accordingly, as for futures and exchange-traded options, the discount should be much closer to 100%. (See, e.g., Basel Committee on Banking Supervision: International Convergence of Capital Measurement and Capital Standards – a Revised Framework, Comprehensive Version (June 2006), Annex 4 (Treatment of Counterparty Credit Risk and Cross-Product Netting), Section II(6) ("An exposure value of zero for counterparty credit risk can be attributed to derivative contracts or SFTs that are outstanding with a central counterparty (e.g., a clearinghouse)."))

- **Potential Future Exposure – Potential Future Exposure Should be Offset on a Counterparty-by-Counterparty Basis by Excess Collateral Posted. (Proposed Rule §1.3(sss)(3) under the CEA and Proposed Rule 3a67-3(c) under the 1934 Act)**

  - If:

    - the value of collateral posted by a market participant to a counterparty is <u>greater</u> <u>than</u> the mark-to-market value of its positions with such counterparty having negative value (after applying permissible netting), or

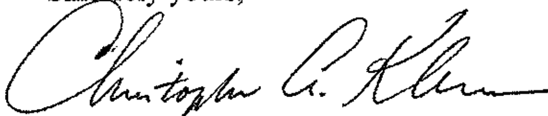
- the value of collateral posted by a market participant's counterparty is less than the mark-to-market value of the participant's positions with such counterparty having positive value (after applying permissible netting),

(each, effectively, resulting in "excess collateral" posted by the market participant), this excess collateral should be permitted to be used to reduce the participant's potential future exposure, as calculated under the Proposed Rules, in respect of the positions with that counterparty (but not below zero).

- As a practical matter, for market participants that mark their derivatives positions to market daily and exchange variation margin to offset the current exposure presented by one party to the other, any excess collateral "posted" by such a participant will generally correspond to initial margin or "independent amount" posted by the participant to its counterparty (including a clearinghouse). Initial margin and independent amount are specifically designed (and calibrated) to offset a counterparty's potential future exposure – that is, the risk of loss to the participant's counterparty arising from the possibility of future market movements in the counterparty's favor that the participant fails to collateralize and that occur prior to the time at which the counterparty is able to terminate the underlying positions. As such, to the extent that a participant is posting excess collateral to a counterparty – whether directly, to a tri-party collateral account, or to a clearinghouse, it should be permitted to reduce its measure of outward potential future exposure in respect of that counterparty by the amount of such excess collateral.

We appreciate the Commissions' attention to these comments.

Sincerely yours,



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