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

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: CFTC File: RIN 3038-AD06 and SEC File: No. S7-39-10
Implementation of Certain Provisions Related to the Definitions of Major Swap Participant and Major Security-Based Swap Participant of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Stawick and Ms. Murphy:

We appreciate the opportunity to provide comments on proposed rules under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") recently published by the Commodity Futures Trading Commission (the "CFTC") governing the definition of "Major Swap Participant" and "Major Security-Based Swap Participant."

Our firm, Riverside Risk Advisors LLC ("Riverside") is an advisory boutique specializing in derivatives and structured financial products. We bring expertise and advice to our clients without conflicts of interest, resulting in transparency, better understanding of risks and improved pricing and transaction terms. Our professionals have extensive experience as derivatives structurers, traders and marketers at some of the world's largest derivatives dealers. Our interest in providing commentary is in promoting the proper functioning of the derivatives markets by increasing access, transparency, innovation and sound decision-making, and not to serve the narrow interests of any particular constituency.

Background

Section 712(d)(1) of the Dodd-Frank Act directs the CFTC and the SEC, in consultation with the Board of Governors of the Federal Reserve System (collectively, the "Commissions"), to further

define certain key terms. Pursuant to this mandate the CFTC issued proposed definitions and a request for public comment on December 21, 2010 (the "Proposed Definitions").

Our Proposal

Our comments relate to (1) the "potential future exposure" portion of the definition of Major Swap Participant and Major Security-Based Swap Participant (collectively "Major Participants") and (2) the consequences of designation as a Major Participant. In short, we ask that the Commissions:

1) Allow for a model-based option to measuring "potential future exposure," and
2) Consider what consequences should be applicable to an entity as it "crosses the threshold" to become a Major Participant.

Potential Future Exposure

Under the Proposed Definitions any entity that maintains a "substantial position" in Swaps for any of the major Swap categories (excluding positions held for hedging commercial risk and hedging positions held by any employee benefit plan) would be classified as a Major Participant.

The proposed test for a "substantial position" has two parts – one based on "current exposure" and one based on the sum of "current exposure" and "potential future exposure." Current exposure is measured based on the difference between the mark-to-market value (using industry standard practices) of an entity's swap positions which have negative value to that entity, less the value of the collateral the entity has posted in connection with those positions.

The calculation of "potential future exposure" is based on the notional amount of an entity's swap positions, with each notional amount multiplied by a prescribed risk factor based on the type and maturity of the Swap at issue. There is also a simple adjustment to apply some benefit for netting under counterparty documentation. As alluded to in the Proposed Definitions, this approach to calculating potential future exposure is substantially similar to the "current exposure method" under the Basel II minimum capital standards for banks.

The table below, reproduced from the Proposed Definitions, shows the prescribed risk factors.

TABLE TO § 1.3 (SSS)—CONVERSION FACTOR MATRIX FOR SWAPS

Residual maturity	Interest rate	Foreign exchange rate and gold	Precious metals (except gold)	Other commodities
One year or less	0.00	0.01	0.07	0.10
Over one to five years	0.005	0.05	0.07	0.12
Over five years	0.015	0.075	0.08	0.15

Residual maturity	Credit	Equity
One year or less	0.10	0.06
Over one to five years	0.10	0.08
Over five years	0.10	0.10

These simplistic measures are flawed, and the Proposed Definitions acknowledge as much. That said, to illustrate the shortcoming with a few specifics, a quick inspection of the table above reveals the following:

- The factors have large economically-unjustifiable discontinuities. Perhaps the most egregious of these is that an interest rate swap with a maturity of five years has a factor of 0.5% while one with a maturity of five years and one day has a factor of 1.5% - three times as large.

- The same factor is applied to potential exposures to interest-rate-swap counterparties who pay floating and fixed. In the current rate environment, potential exposures under the former tend to be much larger than potential exposures to the latter, often by a factor of 3 or more for an at-the-money swap.

- The factors do not take into account how far a Swap is in- or out-of-the-money. All else equal, however, the potential exposure under a derivative contract (as measured probabilistically) is less the further the contract is out-of-the-money for the entity measuring its exposure.

- All credit swaps have a single factor of 10%, regardless of maturity, the reference entity's market spread (now the market's principal summary measure of credit quality) or any measure of anticipated price volatility. A 6-month CDS on the US Government is given the same factor as a 10-year CDS on a reference entity whose bonds trade at deep discounts to par.

- For maturities up to 5 years, the factors for credit swaps are larger than the factors for equity swaps. While the most highly-publicized losses in the recent financial crisis relate to credit default swaps, it is still true that for a given reference entity the equity tends to exhibit higher price volatility than the CDS.

- The factors for equity swaps and commodity swaps make no distinction between high-volatility and low-volatility stocks and commodities.

The list above is not exhaustive. It is in fact a well-understood criticism of simple notional-based factors that they potentially encourage the taking of large risks that have small factors and discourage the taking of small risks that have large factors. In addition, the add-on methodology employed by the notional-based approach does not address (1) the portfolio effects of diversification and correlation within a book of exposures and (2) "wrong-way" risk (i.e., an adverse correlation between counterparty default risk and the value of its derivative contracts).

In order to address the shortcomings of the "current exposure method," as well as to better align regulatory capital requirements with best practices for banks' internal risk measurement and capital management, Basel II allows banks to utilize an "internal model method" ("IMM") for determining the sum of current and potential exposure to OTC derivative counterparties. Under Basel II, in order to be eligible to utilize the IMM, a bank must obtain approval from its regulator. Annex 4 to the Basel II framework specifies several of the quantitative characteristics of an eligible internal model.[1] In addition, based on lessons from the recent financial crisis, the

[1] Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version, June 2006.

Basel III framework has called for additional modeling stress to cushion against higher correlation of systemically-important counterparties and higher volatility of the market risk factors that drive counterparty exposure.[2]

We propose that the Commissions consider allowing end-user counterparties the option to use a model-based approach, similar to the IMM used by banks in the context of capital assessment, to demonstrate that the sums of current and potential exposures for the various Swap categories are below the thresholds specified in the final definitions. We are not necessarily proposing that the Commissions adopt the provisions of Basel III verbatim for purposes of a model-based option, though it does seem a reasonable starting point for consideration given its recent adoption by international banking regulators.

We are aware of the Commissions' stated preference for a notional-based approach as creating easily-replicable calculations and reducing burdens on the vast majority of smaller counterparties. Our proposal would still allow counterparties to rely on the simple notional-based calculations, as they appear in the final rules. But we believe that those few counterparties for whom the notional-based calculations materially differ from the true economic risk their activities pose on the system should be given the opportunity to demonstrate a more economically-rational measure, while still reporting the simple measure. This would allow such entities to avoid unnecessary categorization as Major Participants, thereby reducing burdens on both the counterparties and the Commissions, removing the incentive to structure transactions to minimize their impact on the calculation (at the expense of transparency and economic efficiency) and mitigating an impediment to innovation. We believe a model-based-option, done properly, can accomplish these things with little to no increment to systemic risk.

The Consequences of "Crossing the Threshold"

It would seem logical that the rules prohibit an entity which is not in compliance with the requirements applicable to Major Participants from executing a transaction or transactions which would make it "cross the threshold" and become a Major Participant. However, given the mark-to-market based nature of the current exposure calculation, it is possible that an entity that was previously not a Major Participant crosses the threshold "passively" by becoming a Major Participant as a result of an adverse market move.

In this circumstance, the consequences of crossing the threshold may threaten the survival of the entity in question, and potentially the stability of the markets generally. While we have not yet seen proposed capital and margin requirements applicable to Major Participants, we expect those requirements to be significant. Having those requirements suddenly "spring up" as the result of an adverse market move would be highly likely to result in the failure of the entity in question.

In fact, one would expect events similar to those surrounding the failure of AIG Financial Products, the proximate cause of which was a credit downgrade triggering margin requirements under its CDS contracts. And though it's not as widely publicized as the events relating to AIG, the failure of the Canadian ABCP conduits a year before was also quite disruptive to the credit markets. These entities were obligated to post additional margin on their CDS transactions just as their short-term funding dried up. By comparison, the largest monoline insurance companies, such as MBIA and Ambac, did not have significant springing margin requirements in their

[2] Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, December 2010.

derivatives businesses. As a result, their gradual decline, while not a pleasant event for their counterparties, was less frenzied and less disruptive to the credit markets than the failures of AIG FP and the Canadian ABCP conduits.

In light of these experiences, we do not believe that the rules governing Major Participants should be written to mandate springing capital and margin requirements.[3] Rather, we propose consideration of an optional "maintain or improve" regime, which could be used at the election of a Major Participant in lieu of springing capital and margin requirements. Under such a regime any new transaction, including a termination or amendment, must (1) reduce the degree of the entity's non-compliance with at least one of the tests used to determine status as a Major Participant (e.g., current exposure, potential exposure, leverage), (2) not increase the degree of non-compliance with any of the other tests and (3) comply with other limitations as determined by the Commissions (e.g., no longer maturities, no new risk types). Such a rule would effectively put non-conforming Major Participants into a form of wind-down mode and serve as a limit on their ability to become more systemically important, while avoiding the market disruptions that could result from groups of small entities in effect being forced into liquidation as a consequence of the same market events.

We are aware that the Proposed Definitions do not specifically solicit comments on the consequences of Major Participant designation. We are also aware that a rule yet to be written may address the concerns we raise here.

Conclusion

Allowing for a model-based option to measuring "potential future exposure" would address the shortcomings of the simple notional-based add-on approach, potentially avoiding unnecessary burdens on market participants and the Commissions. We also believe that implementing a "maintain or improve" option, in lieu of capital and margin, for those entities which "cross the threshold" to become Major Participants would better promote the Act's objective of reducing systemic risk.

We would be pleased to discuss our recommendations in more detail, or to suggest specific operative language, should the Commissions so desire. Thank you again for this opportunity to comment.

Respectfully submitted,

Frank Iacono
Partner
Riverside Risk Advisors LLC

[3] We do believe, however, that parties should be free to privately negotiate "springing" margin requirements if they believe it is to their mutual advantage to do so. Our objection here would be to a one-size-fits-all set of rules which serves as a substitute for the judgment of the parties.