BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

February 22, 2011

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

Re: Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties (CFTC RIN 3038-AD25)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), the purpose of which are to establish business conduct standards for swap dealers ("SDs") and major swaps participants ("MSPs") in their dealings with their counterparties, all as required by or pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Introduction

A top Wall Street derivatives expert was recently asked – confidentially – how many complex derivatives would be sold if the compensation was the same regardless of complexity and, without any hesitation, he said "very few."

If there ever were a market that cried out for appropriate business conduct standards and robust disclosure rules, it is the derivatives market. With grossly distorted compensation incentives, dealers create ever more complex products ostensibly customized to meet client needs, but are, in fact, designed **not** to be understandable by anyone other than a derivatives expert.

1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

As a result, the history of the derivatives markets is littered with disasters and scandals arising from transactions sold by dealers to customers who never knew or understood the ramifications of the complex financial instruments they were sold. From industrial companies like Proctor and Gamble and Metallgeselschaft to financial entities like AIG, Long-Term Capital Management and Barings, enormous sums have evaporated from the balance sheets of major businesses through these instruments. And the losses to governmental entities like Orange County, California, Jefferson County, Alabama, the State of Wisconsin Investment Board, the State of West Virginia and the Denver school district have directly cost taxpayers tens of billions of dollars.

These are just a few debacles that achieved headline status; many equally egregious, but less prominent derivatives explosions have gone unreported. Is it any wonder that Warren Buffet referred to derivatives as "financial weapons of mass destruction?"

The Dodd-Frank Act established business conduct standards for SDs and MSPs[2] in large part to protect the public from this mayhem. This provision and the Proposed Rules will greatly reduce the potential that customers will enter into arrangements without the full appreciation of the extraordinary risks associated with derivatives.

It is entirely proper to focus on SDs and MSPs. Derivatives risk is difficult to understand or even discern for those who are not experts in such products, including even sophisticated financial professionals who are fully capable of handling conventional financings. Anyone who has witnessed a sales pitch by a derivatives expert understands the salesperson's great advantage over the customer, and even greater potential reward. This advantage is inherent in the complexity of the product. Like the proverbial car salesman who understands that the real profit is in the "add-ons and extras" which are less understood by the customer, SDs and MSPs are incentivized to make the transactions as complicated as possible, deriving much greater profit and compensation from each layer of derivative complexity and risk.

Transparency is the solution: full, clear and understandable disclosure, in addition to availability of information. And the Proposed Rules properly focus on these requirements, *particularly as they relate to "Special Entities."* Many SDs and MSPs will complain and suggest that full disclosure will cause them to forego this business; however the continued out-sized profitability of derivatives makes clear that these complaints and prophesies are simply inaccurate.

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2 Dodd-Frank Act, Section 731.

Summary of Comments

We will comment on a number of provisions of the Proposed Rules, but a few themes are predominant:

- ***Seemingly complex transactions should be disaggregated and documented as straightforwardly as possible.*** Many bi-lateral derivatives transactions are actually composites of much easier to understand derivatives risk. For instance, an interest rate swap and an oil swaption might be packaged to suit the specific needs of a customer. Each of these is independently easier to assess in terms of risk and easier to monitor in terms of results. The Proposed Rules must require that transactions be documented and priced separately, in their simplest forms.

- ***Listed hedge equivalents must be provided to customers.*** Often, dealer customers are sold esoteric derivatives when conventional, listed contracts could address their risks almost as precisely as the complex (and always very expensive) derivative transacted. The more esoteric a derivative is, of course, the more difficult it is to understand both the derivative itself and the pricing of the derivative. Not coincidentally, the more complex it is, the more profitable it also is for the SD or MSP. SDs and MSPs must be required to provide customers the hedge equivalent alternatives and the appropriate information on price correlations.[3]

- ***Where credit arrangements are built into swaps through forbearance of collateral posting, the embedded credit and its price must be disclosed separately from the swap price.*** Often counterparties to SDs and MSPs do not understand that a sophisticated financial institution would never take on credit exposure without pricing it and allocating it properly against total capacity for exposure to the counterparty. If an SD or MSP allows a customer not to post, it is not for free. Like other aspects of the transaction, the price and the impact on credit availability must be disclosed.[4]

- ***The risk disclosure and scenario analysis required to be provided by SDs and MSPs to counterparties must include information on liquidity and volatility with respect to the proposed swap.*** These factors, along with counterparty risk, are at the heart of the complexity and unique risks of derivatives. Disclosures of risks and projected scenarios are completely inadequate without consideration of these factors.

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3 This is directly related to the need for reported swap data to include hedge equivalent pricing for post trade analysis by regulators and the public.

4 The separate pricing for post trade disclosure, addressed in other proposed rules, is an obvious boon for price transparency, and the same principles apply here. Furthermore, clarity of pricing will promote competitiveness which will ultimately benefit the customers and the public.

- ***In judging the independence of advisors for Special Entities, indirect forms of influence and compensation, historically used by dealers, must be specifically addressed.*** Entities that are active in the financial markets, like SDs and MSPs, have many ways and means to influence representatives of Special Entities to achieve a maximally profitable outcome. The permitted relationships between independent representatives of Special Entities must be narrowed and specific examples of these tactics must be included in the Proposed Rules.

Discussion of the Proposed Rules

Disclosure of Disaggregated Risks. The Proposed Rules impose obligations on SDs and MSPs regarding disclosure of material information to a prospective counterparty.

> At a reasonably sufficient time prior to entering into a swap, a swap dealer or major swap participant shall disclose to any counterparty to the swap (other than a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant) material information concerning the swap....[5]

In addition, the Proposed Rules impose standards relating to the suitability of swaps for counterparties.

> A swap dealer or major swap participant shall have a reasonable basis to believe that any swap or trading strategy involving swaps recommended to a counterparty is suitable for the counterparty based on information obtained through reasonable due diligence concerning the counterparty's financial situation and needs, objectives, tax status, ability to evaluate the recommendation, liquidity needs, risk tolerance, ability to absorb potential losses related to the recommended swap or trading strategy, and any other information known by the swap dealer or major swap participant.[6]

These provisions of the Proposed Rules are important features of the system of standards imposed pursuant to the mandate of the Dodd-Frank Act. They are, however, incomplete.

SDs and MSPs often recommend complex swaps with multiple risks embedded, marketing them as customized or "built-to suit" the needs of the counterparty. The same

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5 Proposed Rules, Section 22.431.
6 Proposed Rules, Section 22.434.

result can be achieved by disaggregating the risks into separate swaps, some of which might be available in more transparent markets. In a disaggregated form, they are at least more easily understood and tracked by risk monitoring systems used by the counterparty.

The Proposed Rules must require that an SD or MSP offer swaps with separable derivatives risks documented and priced separately so that the customer can see and readily compare alternative sources and comprehend the risks. Otherwise, disclosure is incomplete.

Indeed, without such disclosure, it is difficult to see how anyone could determine if such a swap is suitable. Put another way, **unless swaps are disclosed in understandable, disaggregated forms, they cannot be suitable.**[7]

Disclosure of Hedge Equivalents. Many esoteric swaps and swaps based on infrequently traded price points are entered into because of the precision with the risk profile of the counterparty. This serves the interest of the SD or MSP in several ways. The counterparty can be charged more because it is a rarer instrument and there are few if any comparable prices.

Unfortunately, the value of this precision is often not worth its costs. The illiquidity of the swap involves risks which are difficult to measure. The above-quoted requirement of disclosure **cannot** be satisfied unless the counterparty is provided information to make an informed decision on this matter.

This can easily be accomplished. The SD or MSP must disclose listed hedge equivalents and their costs to the counterparty. Information on historic price correlations between the alternatives must also be disclosed. [8]

Further, an evaluation of the relative liquidity of the proposed, esoteric swap and the listed hedge equivalent must also be provided.

Finally, if the SD or MSP is not required to post margin to the counterparty under the esoteric swap, the difference in potential credit exposure to the counterparty must be described as well.

With this information, a counterparty can effectively evaluate whether the esoteric swap, which is typically much more profitable for the SD or MSP but perhaps riskier than the conventional alternative, is suitable for the customer.

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7 Similarly, disaggregation will greatly aid the transparency and usefulness of post trade data which is to be disseminated to the regulators and the public.

8 This is a direct analog to the need for the post trade reporting of hedge equivalent pricing so that regulators and the public can evaluate the market and positions.

Disclosure of Embedded Credit; Suitability. SDs and MSPs routinely enter into swaps under the condition that they will not require the counterparty to post margin or collateral, up to a cap. Some market participants may believe that there is no cost or consequence to forgone margin or collateral. ***If this were true, it would mean that the SD or MSP exposes itself to credit risk without charging for it and without decreasing the capacity of the SD or MSP to add additional exposure to the counterparty's risk. This defies logic.[9]***

Free lunches and something for nothing are not commonly found on Wall Street.

Inescapably, in this common practice of transacting derivatives bi-laterally, there is not one transaction, but two: a swap and an extension of credit. If the dealer's counterparty does not understand this in detail, the transaction cannot be understood.

The disclosure provision of the Proposed Rules must address this issue. It must specifically require disclosure of the following information:

1. The effect of the transaction on the capacity of the SD or MSP to extend incremental credit to the counterparty.

2. The method used by the SD or MSP to calculate the amount of credit extended, from time to time.

3. The amount charged for the extension of credit.

The Proposed Rules also address the issue of suitability of a proposed swap for the counterparty in the provision quoted above.[10] Embedded credit arrangements, and especially the provisions which require immediate cash funding of margin on an event such as a credit rating downgrade, are an integral part of the transaction. It is impossible to determine if a swap is suitable unless such embedded transactions are included in the analysis.

The suitability requirement must require the SD or MSP to consider embedded credit transactions relating to margin or collateral, including "credit rating triggers," in assessing suitability.

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9 Professor John Parsons of MIT and Professor Antonio Mello of the University of Wisconsin have written extensively on the forborne derivatives collateral and the embedded loan. Some of these materials can be found at:
http://bettingthebusiness.com/2011/02/14/the-collateral-boogeyman-is-back/
http://bettingthebusiness.com/2010/10/25/otc-5-the-collateral-boogeyman-%E2%80%93-packaging-credit-implicitly-and-explicitly/
http://bettingthebusiness.com/2010/10/07/otc-3-the-collateral-boogeyman-%E2%80%93-the-delusion-of-%E2%80%9Cfree%E2%80%9D-credit-from-your-friendly-neighborhood-derivatives-dealer/
http://bettingthebusiness.com/2010/10/11/otc-4-the-collateral-boogeyman-%E2%80%93-lobbyists-trot-out-the-free-lunch/

10 Proposed Rules, Section 23.434.

We have discussed the issues relating to disclosure of embedded credit transactions in a comment letter filed today with respect to the End-User Exception to Mandatory Clearing, which is attached hereto.

Disclosure of Liquidity and Volatility Risks. A fundamental reason that derivatives are difficult for counterparties to understand and evaluate is that many are traded in highly illiquid markets subject to great price volatility. The swaps that will be affected by the Proposed Rules will be precisely the types of derivatives that are most difficult to understand.

The Proposed Rules require disclosure of material information concerning swaps and requires scenario analyses for unlisted swaps.[11] The CFTC has asked for comment on the requirement of value-at-risk ("VaR") analyses. In both the disclosure and the scenario analyses, information concerning the liquidity and the volatility of the market for the swaps under consideration must be provided. Historic liquidity and volatility must be included in the disclosed information. And these factors must be used in a VaR analysis as part of the scenario analyses.

Guidance for the scenario analyses must be provided in the regulations. Liquidity is generally represented by an assumed holding period for liquidation of a position on a default. DCOs often use holding periods of 3 days for listed, cleared swaps in calculating initial margin. In the scenario analysis required by the Proposed Rules, "worst case" scenarios of 5 and 10 days must be required.

Volatility is represented by the confidence interval. In its solicitation for comment, the CFTC mentions 95 percent. This is lower than the standard used by DCOs for most contracts. The scenario analyses, like the DCO initial margin calculations, are used to estimate levels of risk based on prudent assumptions. This is a higher standard than reasonably-expected trading profit or loss. **The confidence interval must be 99 percent at a minimum.**

Independence of Representatives of Special Entities. Under the Proposed Rules, a Special Entity must engage an independent representative in connection with a swap in which an SD or MSP acts as an advisor.[12] The independence of the advisor is measured in large part by reference to the term "material business relationship."

> The term "material business relationship" means any relationship with a swap dealer or major swap participant, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the representative, *provided however, that material business*

[11] Proposed Rules, Section 23.431.
[12] Proposed Rules, Section 23.440(c)(3).

> *relationship does not include payment of fees by the swap dealer or major swap participant to the representative at the written direction of the Special Entity for services provided by the representative in connection with the swap executed between the Special Entity and the swap dealer or major swap participant.* [Emphasis Added][13]

The emphasized language must be deleted. One motive which a Special Entity, SD or MSP and a representative might have for using this proviso is to avoid legal impediments that are imposed on the Special Entity by statute or organizational documents. It could also be to obscure the actual amount of compensation which is paid. In neither case is the indirect compensation of the independent representative appropriate.

In addition, the use of indirect means to influence the advice provided to Special Entities has been far too commonplace, especially in transactions involving state and local government entities. For example, dealers have been known to provide advantageous allocations of securities in public offerings to influence advisors, just one mechanism which is difficult to detect.

To address this, the independent representative disclosure requirement in the Proposed Rules must be expanded. In the Proposed Rules:

> Any swap dealer or major swap participant that offers to or enters into a swap with a Special Entity shall have a reasonable basis to believe that the Special Entity has a representative that... [m]akes appropriate and timely disclosures to the Special Entity....[14]

The requirement must be that ***all* business relationships**, including but not limited to the participation in public offerings, during the one-year look-back period in the Proposed Rules are disclosed and that the SD or MSP obtains and reviews a copy of that disclosure.

In addition, the one-year look-back should be supplemented. The Proposed Rules should cover business relationships entered into in the year following the swap transaction pursuant to formal and informal agreements occurring prior to the date of the swap transaction.

Conclusion

The conduct of business between SDs and MSPs and their counterparties was a substantial reason for the market conditions which prevailed before the enactment of the Dodd-Frank Act. This undisclosed and uncontrolled environment was a direct cause of the

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13 Proposed Rules, Section 23.450(a)(1).
14 Proposed Rules, Section 23.450(b).

accumulation of massive risk that was virtually unknown to regulators and members of the public, contributing significantly to the financial crisis. The prudent regulation of the conduct of SDs and MSPs is one of the most important features of the reform of these markets. The additional disclosures proposed here are necessary if the goals of Dodd-Frank in this area are to be achieved.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

Dennis M. Kelleher
President & CEO

Wallace C. Turbeville
Derivatives Specialist

Better Markets, Inc.
Suite 1080
1825 K Street, N.W.
Washington, D.C. 20005
(202) 618-6464
dkelleher@bettermarkets.com
wturbeville@bettermarkets.com

www.bettermarkets.com