



February 28, 2011

**Via Electronic Submission:** <https://comments.cftc.gov>

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

**Re: Notice of Proposed Rulemaking on Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants; RIN 3038-AC96**

Dear Mr. Stawick:

Managed Funds Association (“MFA”)<sup>1</sup> appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the “Commission”) on its proposed rule on “Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants” (the “Proposed Rule”).<sup>2</sup> MFA strongly supports the goals of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)<sup>3</sup> to enhance transparency and reduce systemic risk. In addition, we generally support measures to reduce complexity in swap markets. We appreciate the opportunity to offer our views on various aspects of the Proposed Rule that we believe will enhance it and assist the Commission in adopting a final rule that is in the best interests of counterparties and the overall functioning of the marketplace.

## **I. General**

Section 731 of the Dodd-Frank Act<sup>4</sup> mandates that the Commission promulgate documentation standards that apply to swap dealers (“SDs”) and major swap participants

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<sup>1</sup> 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 \$1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

<sup>2</sup> 75 Fed. Reg. 81519 (Dec. 28, 2010) (the “Proposed Rule Release”).

<sup>3</sup> Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>4</sup> Section 731 of the Dodd-Frank Act adds Section 4s(i)(2) of the Commodity Exchange Act (“CEA”).

(“MSPs”)<sup>5</sup> and that promote “timely and accurate confirmation, processing, netting documentation and valuation of all swaps.”<sup>6</sup> MFA agrees that, consistent with Congressional intent, documentation standards should address the acknowledgment,<sup>7</sup> confirmation<sup>8</sup> and valuation of trades. However, before the Commission publishes final rules related to the confirmation of swaps, portfolio reconciliation<sup>9</sup> and portfolio compression,<sup>10</sup> we respectfully request that the Commission evaluate the operational abilities of market participants to meet the requirements. We believe that market participants have notable differences in their resources and experiences with respect to post-trade exercises. Thus, we believe that it would best serve the Commission’s goals and prevent disruptions of the swap markets, if the Commission provided market participants additional time to design, test and implement measures to meet the new requirements.

MFA notes that the Proposed Rule has certain provisions that require performance by two or more persons. For example, Proposed Rule 23.501(a)(1) requires SDs and MSPs to execute confirmations within certain mandated timeframes. While one party may be responsible for sending the acknowledgment, the other party must sign the acknowledgment to create a confirmation, and each party has little control as to whether its counterparty complies with their requirements. Certainty of trade execution is vital for all market participants. Thus, non-compliance with any of these requirements by any participant to a transaction should not result in termination or cancellation of such transactions. In addition, the Commission should only require SDs or MSPs to deliver acknowledgments, but not mandate the timeframe for confirmation of swaps. The final rules also should not obligate a SD or MSP to place all terms of a swap in the acknowledgment, rather the acknowledgment should only include the primary economic terms that enable each participant to the transaction to verify the core economic aspects of the trade. These requirements will balance the goals of Section 731 of the Dodd-Frank Act to ensure timely and accurate documentation with the principle of legal certainty of trade execution, and at the same time, will be flexible enough to adapt to swap market structure.

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<sup>5</sup> The Commission has not yet promulgated final rules defining MSP and SD, but for the remainder of this letter, when reference is made to either MSP or SD, it shall mean an entity likely to be included in such category based on the Securities and Exchange Commission’s and the Commission’s current joint proposed definitions.

<sup>6</sup> Section 731 of the Dodd-Frank Act.

<sup>7</sup> Proposed Rule § 23.500(a) defines “acknowledgment” as “written or electronic record of all of the terms of a swap signed and sent by one counterparty to the other.”

<sup>8</sup> Proposed Rule § 23.500(c) defines “confirmation” as “the consummation . . . of legally binding documentation . . . that memorialized the agreement of the counterparties to all of the terms of a swap transaction. . . . a confirmation is created when an acknowledgment is manually, electronically, or by some other legally equivalent means, signed by the receiving counterparty.”

<sup>9</sup> Proposed Rule § 23.500(i) defines “portfolio reconciliation”, which captures: (a) reviewing terms of swaps, (b) exchanging valuation data, and (c) resolving any material differences in terms or valuations.

<sup>10</sup> Proposed Rule § 23.500(b) defines “bilateral portfolio compression exercise” as “an exercise in which two swap counterparties wholly or partially terminate some or all of the swaps outstanding between those counterparties and replace those swaps with a smaller number of swaps whose combined notional value is less than the combined notional value of the original swaps included in the exercise.” The definition of “multilateral portfolio compression exercises” is substantially similar, but refers to exercises with more than two participants.

## **II. Comments on the Proposed Confirmation Rule**

### **A. Timing Requirements**

#### **1. Ability to Negotiate**

MFA generally supports the Commission's efforts in the Proposed Rule to standardize the timing requirements for trade acknowledgment<sup>11</sup> because it may reduce operational risk in the swap markets. However, we respectfully request that the Commission further consider the implications of its proposed timing requirements.

Specifically, the Proposed Rule, with its pre-trade draft acknowledgment requirement, seems to prioritize documentation certainty over trade timing. For complex, customized or heavily negotiated swaps, in practice, the Proposed Rule would force parties to:

- (1) accept that, at times, they will be unable to execute time-sensitive swaps (*e.g.*, swaps attempting to capitalize on a brief opportunity in the market) because market participants will be unable to negotiate all terms prior to execution; or
- (2) concede on certain terms that they otherwise would rigorously negotiate in order to execute their swaps in a timely manner.

Accordingly, the Proposed Rule may disadvantage entities that are not SDs or MSPs, particularly those with less negotiating power or that need to execute swaps promptly to avail themselves of market opportunities, and thus, may impede entities that are not SDs or MSPs from effectively hedging risk.

Moreover, if parties are unable to execute swaps in a timely manner, there will be implications for the swap markets beyond limiting parties' ability to take advantage of current market conditions. For instance, increasing the amount of time needed to enter into a swap might decrease the number of transactions in the markets, thereby decreasing liquidity and increasing volatility. In addition, SDs will encounter additional risks as market conditions may change between when the SD provides pricing for a swap and, after satisfying the Proposed Rule's requirements, when it can execute a transaction. SDs can take several measures to address this risk, including widening their bid/offer spreads or choosing not to make markets for customized transactions altogether. Given the potential negative effects on the markets, we recommend that the final rule not contain provisions requiring SDs and MSPs produce a draft confirmation containing all of the terms to a transaction prior to execution.

MFA is also concerned that the Proposed Rule's suggested timing for confirmation does not reflect current practice in the over-the-counter derivatives markets, particularly where parties to the swap do not execute or process the trade electronically. Under current market practice, to exploit favorable economic conditions, parties will execute a swap with the expectation that they will have time to negotiate non-economic terms after execution, which is more often the case for

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<sup>11</sup> See *e.g.*, Proposed Rule Release at 81531.

complex or customized swaps or swaps where the counterparties must negotiate allocation of the legal risks and rights. If the Commission adopts our recommendation that the timing requirement only apply to the delivery of a trade acknowledgment (which would only include the primary economic terms of the transaction), then current market practice would not be wholly disrupted as parties could negotiate non-economic terms after they executed the trade.

## **B. Consistent Timing for Certain Financial Entities**

MFA applauds the Commission for providing longer confirmation periods for certain swaps entered into between a SD or MSP and an entity that is not an SD or MSP.<sup>12</sup> The Proposed Rule, however, would require SDs and MSPs to treat swaps that they enter into with certain financial entities<sup>13</sup> almost identically to swaps that they enter into with other SDs and MSPs.<sup>14</sup> We recommend that the Commission require SDs and MSPs to afford the same treatment to all entities that are not SDs or MSPs, including financial entities.

Financial entities are a class of market participants that includes pension plans, private funds, insurance companies and banks. Designation of a market participant as a financial entity does not necessarily correlate with the entity having a large swap portfolio or being highly sophisticated with respect to swaps. Financial entities will often encounter the same challenges as other entities that are not SDs or MSPs in complying with the proposed timeframes for confirming swaps, and they may also suffer from the negotiation and economic disadvantages discussed in Section II.A.1 above. Therefore, we think it inappropriate to treat financial entities differently than other entities that are not SDs or MSPs for purposes of trade confirmation, and request that any final confirmation rules provide that SDs and MSPs must confirm swaps with all entities that are not SDs or MSPs, including financial entities, on the same timeframe.

## **C. Clarification of “Processed Electronically”**

In the Proposed Rule Release, the Commission requests comment as to whether it needs to further define the term “processed electronically”<sup>15</sup> and whether it should mandate electronic processing of all transactions.<sup>16</sup> As an initial matter, MFA would appreciate the Commission

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<sup>12</sup> See, e.g., Proposed Rule 23.501(2) and (3). The SD or MSP is required to send an acknowledgment within a certain timeframe, but the Proposed Rule is silent as to when the counterparty must confirm. However, as discussed herein, the SD or MSP must maintain policies to confirm with financial entities within one calendar day.

<sup>13</sup> Proposed Rule 23.500(e) uses the defined term “financial entity”, which means a financial entity, as defined in new section 2(h)(7)(C) of the CEA (which codifies the end user exemption from mandatory central clearing). The term “financial entity” does not include SDs or MSPs. The inconsistent use of terms between the Proposed Rule and the CEA is confusing. We recommend that the Commission either use a new defined term or use the same term, but add a parenthetical to remove SDs and MSPs, in the places where “financial entity” appears.

<sup>14</sup> Proposed Rule 23.501(2) would require SDs and MSPs to confirm swaps that they do not electronically execute and process on the same calendar day as execution. Proposed Rule 23.501(3) would also require SDs and MSPs to have processes in place to confirm trades with financial end users on the same calendar day on which they execute the swap.

<sup>15</sup> Proposed Rule Release at 81523.

<sup>16</sup> *Id.*

clarifying what it means for a trade to be “processed electronically”.<sup>17</sup> On the one hand, the term could mean the simple entry by an SD or MSP of trade information into its trade capture system. That system, upon receiving trade information, generates an acknowledgment which the SD or MSP then sends to its counterparty by facsimile, e-mails or other electronic methods. On the other hand, the term could refer to electronic matching platforms.<sup>18</sup>

If “processed electronically” refers to the electronic matching process, we firmly believe that the Commission should not mandate that parties process all transactions electronically because electronic processing is not suitable for all swaps. There exists a wide variety of swap transactions, which may differ in complexity as well as in the number of highly negotiated terms. As a result, it is unlikely that matching platforms can capture all of the trade terms required in a complex swap. If the Commission were to adopt a requirement that all swaps be “processed electronically”, it would effectively limit the types of swaps into which parties can enter. Therefore, we hope that in the final rule, the Commission clarifies that “processed electronically”, means electronic transmission of trade acknowledgments, because we believe that for customized trades, acknowledgments sent by e-mail, facsimile or other electronic methods are the only current viable options.

#### **D. Application to Life Cycle Events**

The Proposed Rule’s timing requirements (as discussed in Section II.A.1 above) apply not only to the execution of a new swap, but also to other lifecycle events. The Commission identifies two categories of events as constituting “life cycle events”: (1) events that affect the material terms of the swap (*e.g.*, novation, modification, partial termination, etc.); and (2) events that pertain to the exposure that the swap references (*e.g.*, dividend payment, merger, market disruption, etc.). In the Proposed Rule Release, the Commission asks whether they should carve certain lifecycle events out of the rule and whether they should allow an extended compliance period for confirmations of certain lifecycle events.<sup>19</sup>

MFA supports confirmation of lifecycle events; however, parties should have the ability to negotiate the timing by which they acknowledge and confirm such events. Once a lifecycle event occurs, parties to a swap may need to renegotiate certain trade terms. As discussed in Section II.A.1 above, the proposed timing requirements raise a number of issues and may disadvantage entities that are not SDs or MSPs during negotiations. Accordingly, MFA respectfully requests that the Commission not place specific timing requirements for the confirmation of lifecycle events.

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<sup>17</sup> The proposed definition of “processed electronically” in Proposed Rule 23.500(j) refers to an SD or MSP entering trade information into its computer processing systems to facilitate clearance and settlement.

<sup>18</sup> Electronic matching platforms allow parties to enter trade terms. The platform matches the terms and either notifies the parties that there are discrepancies or, if there are no discrepancies, generates a confirmation or otherwise notifies the parties that their trade is complete.

<sup>19</sup> Proposed Rule Release at 81523.

### **E. Exchange Execution and Clearing Satisfying Requirements**

The Commission requests comment as to whether executing a swap on a designated contract market (“DCM”) or swap execution facility (“SEF”) or clearing a swap through a derivatives clearing organization (“DCO”) should satisfy the proposed confirmation requirement.<sup>20</sup> MFA strongly supports permitting all of the foregoing to satisfy the acknowledgment and confirmation requirements. As the Commission states in the Proposed Rule Release, “[t]imely and accurate confirmation of transactions is critical for all downstream operational and risk management processes.”<sup>21</sup> Execution of swaps through a DCM or SEF should result in nearly instantaneous accurate confirmations. Thus, such execution meets the Commission’s policy objectives.

### **III. Proposed Portfolio Reconciliation Rule**

In the experience of MFA’s members, market participants have natural incentives to perform portfolio reconciliation in connection with their risk and collateral management processes. MFA offers the following observations on current portfolio reconciliation practices, which the Commission should consider in formulating the final rule.<sup>22</sup>

#### **A. Current Market Practice on Portfolio Reconciliation**

It is our members’ experience that, under current market practice, market participants reconcile their swap portfolios on a periodic basis to ensure proper payment processing and collateral management and to accurately evaluate and manage counterparty and market risk. Market participants become aware of the need to reconcile swap portfolios at a position level if there are position level discrepancies that result in margin disputes. However, absent any such margin disputes, we believe it is unnecessary to require a formalized reconciliation process, freeing market participants to allocate resources to other operational functions. Thus, MFA respectfully recommends that, for market participants who regularly exchange collateral on their derivatives exposure with a counterparty, the Commission should require position level portfolio reconciliation only upon the occurrence of a material dispute regarding margin. Otherwise, the regulations arguably impose costs to market participants without achieving material benefits.

Market participants have different policies and procedures with respect to their reconciliation practices, which are a function of, among other things, their different business models, structures and the type of swaps they trade. Accordingly, it is difficult to establish a universal set of “best practices” for portfolio reconciliation that will be compatible with these different entities and not result in unintended consequences. As a result, we think that, rather than adopt prescriptive portfolio reconciliation rules, the Commission should provide general

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<sup>20</sup> *Id.* at 81523. See Proposed Rule 23.501 and Section II.A.1 above regarding the proposed confirmation requirements

<sup>21</sup> *Id.* at 81521.

<sup>22</sup> MFA has no comments on the proposed definitions of “bilateral portfolio reconciliation exercise” or “multilateral portfolio reconciliation exercise” in Proposed Rule § 23.500(i).

principles and guidelines as to what constitutes “best practices” in respect of portfolio reconciliation in order to complement and enhance current market practice.

## **B. Valuation Disputes**

The Proposed Rule provides timing requirements for the resolution of valuation disputes.<sup>23</sup> We recommend that the Commission clarify that a party must establish a valuation discrepancy of 10% or more on a portfolio basis, provided that the discrepancy exceeds at least some nominal value (*e.g.*, a dollar threshold) before the timing requirements of the Proposed Rule apply. Moreover, for market participants that regularly exchange collateral on their swaps, a dispute should exist only when one party is unwilling to satisfy a collateral call from its counterparty. With these additional clarifications, the final rule would not require market participants to spend time and resources resolving insignificant discrepancies, and instead would strike an appropriate balance between allowing counterparties to transact in an efficient manner and, at the same time, implementing requirements to protect the broader markets.

On a related note, in order to create a uniform process by which swap market participants resolve valuation disputes, members of the Collateral Steering Committee of the International Swaps and Derivatives Association, Inc. (“ISDA”) have been diligently collaborating to establish a protocol that ISDA hopes will become the market standard approach. The Commission should support industry participants crafting a market-driven solution. The Commission should provide for a flexible timeframe to resolve valuation disputes, as many disputes involve customized transactions that will take time to research and resolve. Not doing so risks the impositions of requirements that do not reflect the practical realities and many granular considerations of valuation disputes.

## **IV. Proposed Portfolio Compression Rule**

In the Proposed Rule Release, the Commission states that portfolio compression exercises “reduce the risk, cost, and inefficiencies of maintaining unnecessary transactions on the counterparties’ books” and that “reduced transaction count decreases operational risk”.<sup>24</sup> The Commission also notes that compression may provide “a more accurate expression of overall market size and composition, and provide market participants with a more precise picture of their exposures.”<sup>25</sup> MFA generally supports the risk mitigation benefits of portfolio compression. However, we respectfully ask that the final rules provide parties that are not SDs or MSPs with the option, but not the obligation, to participate in compression exercises.

The Proposed Rule requires SDs and MSPs to put in place policies and procedures regarding portfolio compression with parties that are not SDs or MSPs.<sup>26</sup> We believe, however, that multilateral compression exercises are appropriate only for those entities with swap

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<sup>23</sup> Proposed Rule 23.502(a)(5) and (b)(4).

<sup>24</sup> Proposed Rule Release at 81525.

<sup>25</sup> *Id.*

<sup>26</sup> Proposed Rule 23.503(d)(2).

portfolios large enough for a compression exercise to yield meaningful benefits and efficiencies. Unlike SDs and MSPs, parties that are not SDs or MSPs likely do not have swaps portfolios of a substantial size.<sup>27</sup> Additionally, these entities already have incentives to reduce the number of outstanding uncleared swaps to minimize counterparty risk and maximize liquidity. Accordingly, we support participation of parties that are not SDs or MSPs in such exercises on an elective basis, but not a mandatory one.

In particular, with respect to cleared swaps, MFA respectfully requests that the Commission reconsider whether there are additive benefits of having parties that are not SDs or MSPs participate in multilateral compression exercises. Mandatory central clearing provides the same benefits that the Commission is seeking to achieve by requiring portfolio compression, namely the reduction of risks, costs and operational inefficiencies associated with large swap portfolios. In addition, mandatory central clearing will provide greater transparency regarding the size and composition of the swap markets to all market participants. Thus, we believe that requiring participation by parties that are not SDs or MSPs in portfolio compression exercises for cleared swaps is of questionable added benefit.<sup>28</sup>

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MFA appreciates the opportunity to comment on the Proposed Rule and respectfully submits these comments for the Commission's consideration. If the Commission or its staff has any questions, please do not hesitate to call Carlotta King 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. Gary Gensler, Chairman  
The Hon. Michael Dunn, Commissioner  
The Hon. Bart Chilton, Commissioner  
The Hon. Jill E. Sommers, Commissioner  
The Hon. Scott D. O'Malia, Commissioner

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<sup>27</sup> Sections 721 and 761 of the Dodd-Frank Act, respectively, define "major swap participant" and "major security-based swap participant" to include, among other things, entities that have substantial positions in swaps. If an entity had a swap portfolio of sufficient size to necessitate the imposition of mandatory portfolio compression requirements, by definition, it would likely be an MSP.

<sup>28</sup> Except for swaps not cleared by operation of the end-user clearing exception, most uncleared swaps will be too customized or illiquid for a DCO to clear. By their very nature, they will lack the requisite standardization for multilateral compression exercises. Accordingly, to include uncleared swaps in multilateral portfolio compression exercises would be an immense technical challenge and the associated costs may outweigh any benefits.