February 22, 2011

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

Re: Swap Data Repositories
(CFTC RIN 3038-AD20)

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 purposes of which are to establish registration requirements, statutory duties, core principles and certain compliance obligations for registered swap data repositories ("SDRs"), all as required by or pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Introduction

The Dodd-Frank Act creates a new element of the infrastructure of the derivatives market, the SDR. Its role is essential to the transparent and fair marketplace envisioned by financial reform.

It is painfully obvious that the financial crisis, which brought us to the brink of international economic collapse, was in large part the result of a shadow financial market. While some financial market participants knew well what they were doing and/or were recklessly indifferent to the consequences of their actions, financial institutions and commercial businesses entered into trillions of dollars of transactions which they did not fully understand. Worse, some were so complex that they could not be understood.

[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.

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The financial markets are founded on information: who owes what to whom, when, how much and under what circumstances. When AIG and Lehman failed, the terrible truth became apparent to all: a hopelessly tangled web of data recorded in dozens of places and languages was uncovered and the effort to sort it all out emerged as a separate, potentially lethal threat to the system.

The requirement of central repositories for all swap data using uniform language and measurement standards is essential to prevent that from ever happening again.

Regulators will never be able to prevent financial "wizards" from wreaking havoc on the marketplace occasionally, but at least it will be done in the open and more easily remedied.

The Proposed Rules are a comprehensive set of guidelines and standards for SDRs. We have commented in detail below on certain of the provisions. Yet, the Proposed Rules do not fully address a fundamental, threshold question: what is the best organizational approach for SDRs? The answer seems obvious, though it is clear that powerful interests would prefer a sub-optimal resolution of this question.

SDRs serve a public purpose, mandated by law and integrated into the regulatory structure. They exist only because they are needed to protect the public's interest in a functioning market. SDRs will never be conventional businesses. The system will work best if they are structured as public utilities or highly regulated common carriers of information.

An alternative approach has superficial appeal: SDRs could be financial market membership entities. Unfortunately, because of today's market structure, this alternative is fraught with danger. It suffers from excessive concentration and therefore ***greatly expands systemic risk.***

As the Comptroller of the Currency recently reported, merely "[f]ive large commercial banks represent 97 percent of the total banking industry notional amounts" of derivatives trading.[2] This report and other factors led the Securities Exchange Commission to also conclude correctly that "[t]rading in the OTC derivatives market is currently dominated by a small number of firms."[3]

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2 OCC's Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2009" available at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq409.pdf)

3 17 FR at page 65887.

The Proposed Rules do not sufficiently address the pervasive influence over "infrastructure" for the massive, diverse and complex derivatives markets by a narrow oligopoly of financial institutions. This oligopoly has been referred to by antitrust expert Robert Litan as the "Derivatives Dealers' Club."[4] We have attached an earlier comment letter which we filed with the CFTC detailing the variety of direct and indirect influences which financial institutions exert over the derivatives markets infrastructure.

These institutions have repeatedly used their influence over the providers of essential market infrastructure to gain advantage over, and sometimes deter or defeat, competition. By controlling volume, and as a consequence the revenues of market infrastructure providers, their influence is inherently enormous. Because the sector includes so many inherent means for exerting informal influence, and because history has shown the willingness of financial firms to exert that influence, governance and ownership rules must be strict and detailed. Thus, rules relating to ***both*** formal ***and*** informal mechanisms of control are essential to achieve a fair and competitive marketplace.

Rules establishing standards for the governance and operations of SDRs must, at a minimum, parallel those relating to other market infrastructure providers such as derivatives clearing organizations, swap execution facilities and designated contracts markets. We urge the CFTC to adopt this approach in the final rules related to SDRs.

Summary of Comments

Our comments are organized according to several subject matter areas as set forth below.

- Information received and stored by SDRs
    - Information needed to verify and track swaps for which the end-user exception is claimed must be required and properly stored and reported to the CFTC.
    - Critical information related to counterparty exposures on uncleared swaps must be compiled and tracked.
    - SDR coverage of classes of swaps must be comprehensive to avoid cherry-picked data categories, which risks orphaned swaps and can lead to misleading information data sets.

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4 Robert E. Litan, "The Derivatives Dealers' Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interest Parties," The Initiative on Business and Public Policy at Brookings (2010) (available at http://www.brookings.edu/~/media/Files/rc/papers/2010/0407_derivatives_litan/0407_derivatives_litan.pdf).

- Information provided to the CFTC
    - Steaming of data to the CFTC is essential. The information will be far less useful if it is not available in real-time, especially considering the speed of trading activity in markets dominated by automation.
    - The data must be accessible through systems that allow analysis for ongoing monitoring (for example, for position calculations and the pricing of less liquid instruments using listed hedge equivalents) and ad hoc purposes. The best solution is for the CFTC to build and maintain these systems because they must be uniform and inter-connected.
- Governance and conflicts of interest
    - Governance must be structured to avoid Boards of Directors and key committees dominated by self-interested members. The Proposed Rules must be tightened significantly.
    - The role of chief compliance officer must be far more protected from influence or they risk being largely ineffective.
    - Fee concessions for volume must be prohibited. There is no other way to achieve the fair access required by the Dodd-Frank Act. In the limited circumstances in which data can be used by the SDR for commercial purposes, access must be provided fairly and equally in terms of price, priority and speed of transmission.
    - Notification of a transfer of equity interests should be made in time to allow input by the CFTC before it becomes a *fait accompli.*

Information Received and Stored by SDRs

Information to verify and track claims to end-user exception

The Proposed Rules impose a general requirement on SDRs to provide systems to identify, aggregate, sort and filter information regarding swaps for which the end-user exception is claimed.[5] However, the requirement is not nearly specific enough to ensure compliance with the Dodd Frank statute.

Abuse of the end-user exception is likely to be a significant problem. While the words "hedge or mitigate a commercial risk" may appear simple, they are actually an invitation to enterprising traders to speculate as much as they can by gaming the concepts.

[5] Proposed Rules, Section 49.14.

In the wake of the Enron catastrophe, many energy firms disavowed speculative trading, telling their investors and the rating agencies that their trading desks would be limited to hedging activities. However, it was well-known that the potential for huge profits motivated many to employ inventive ways to skirt the stated policies.

The data issues related to the end-user exception fall into two categories: entitlement to the exception and the means by which end-users will meet their obligations.

Tracking the claim to the exception can be relatively simple. Each claimant must be required to record in a spreadsheet format each commercial risk intended to be hedged by month and quantify the risk in an appropriate way. Every swap entered into for which exception is claimed, including quantity in the corresponding units and swap identifier code, must be recorded in cells identified to that risk.

This is not difficult or burdensome. Indeed, this is ordinary course of business for most actual commercial hedgers today who establish hedging strategies and track execution of the hedges for each risk to be hedged. The following is a 4-month example of a utility partially hedging natural gas price exposure at a power plant in Maryland:

Month	June	July	August	September
Price Risk Hedged	320,000 MMBTU Gas Tetco Zone 3	330,000 MMBTU Gas Tetco Zone 3	340,000 MMBTU Gas Tetco Zone 3	315,000 MMBTU Gas Tetco Zone 3
Hedges	150,000 MMBTU HH Swap [ID #] 140,000 MMBTU HH Swap [ID #] 50,000 MMBTU Tetco Zone 3 Basis Swap [ID #] 100,000 MMBTU Tetco Zone 3 Basis Swap [ID #]	150,000 MMBTU HH Swap [ID #] 140,000 MMBTU HH Swap [ID #] 50,000 MMBTU Tetco Zone 3 Basis Swap [ID #] 100,000 MMBTU Tetco Zone 3 Basis Swap [ID #]	150,000 MMBTU HH Swap [ID #] 140,000 MMBTU HH Swap [ID #] 50,000 MMBTU Tetco Zone 3 Basis Swap [ID #] 100,000 MMBTU Tetco Zone 3 Basis Swap [ID #]	150,000 MMBTU HH Swap [ID #] 50,000 MMBTU Tetco Zone 3 Basis Swap [ID #]

The discipline of recording a hedging strategy and the hedges by category will, by itself, result in greater compliance.

It would also be very feasible to require the SDR to create a system in which an exception message would be triggered if risk was exceeded by the hedge swap quantities, The system would measure and compare quantities of the risk to be hedged and the hedges. It would take into account basis swaps as shown above and nearest listed hedge equivalent prices (i.e., Henry Hub to Tetco Zone 3 in the table). Hedge equivalents, which provide partial hedges, would be adjusted by appropriate delta factors for basis risk between the hedged risk and the nearest listed equivalents.

Information Relating to Counterparty Exposures

The defining characteristic of swaps that are not cleared is counterparty exposure. SDRs will enable regulators and the public to better understand the size and nature of market price risks. But, counterparty exposures must also be identified and tracked to quantify the risk to the system.

In practice, there are two categories of contractual arrangements for bi-lateral swap obligations: those which are governed by ISDA Credit Support Annexes to Master Swap Agreement ("CSAs") and those in which margining arrangements are established in less formal short-form confirmations. The most significant are those governed by CSAs.

The CSAs typically establish the procedures for collateralizing credit exposures. CSAs apply to all swaps between the parties rather than individual swaps. Exposures are measured on a net portfolio basis by mark-to-market calculations, plus (in some, but by no means all, cases) an "additional amount" that serves as a rough analog to initial margin.

In many instances, counterparties forbear from collecting collateral up to a cap. Such forbearance arrangements are the most significant obligations that end-users must meet because they almost invariably include "credit triggers," which are generally based on credit ratings. **If a credit trigger is tripped, the end-user is required to fully fund collateral that has been previously forborne, at the very time it is most difficult to do so.** Because these forbearance arrangements can have such a dramatic and debilitating impact on an end-user, they must be a primary focus of the Proposed Rules.

SDRs can provide the means to track these counterparty exposures.

- All Master Swap Agreements and CSAs must be provided to SDRs and filed in an electronic library

- The amount of forbearance (i.e., cap on uncollateralized exposure) permitted to each counterparty and the credit triggers must be reported separately, as well as any unusual forms of collateral permitted.

- Data on individual swaps must cross reference the credit files to connect them to the relevant CSA.
- Counterparties must periodically report the level of credit consumed.
- The occurrence of any triggering event must be reported.

This information will allow exposure to be monitored and provide early warning of potential market disruption from credit trigger events.

Comprehensive Coverage of Swap Categories

In the Notice of Proposed Rulemaking[6] (the "NPR"), the CFTC asks whether an SDR should be required to accept all data within a category of swaps if it accepts some.[7] ***The answer must be an emphatic "yes."***

If not, there is the very real possibility that some swaps may be orphaned and reported to the CFTC separately, which would impair oversight and market understanding. First, it would be a very inefficient system.

Second, and much more importantly, if the analytical tools available to the CFTC are provided by the SDR (as discussed below), the exclusion of related swaps from the set of data could render the analysis using those tools meaningless or -- much worse -- misleading.

If this were permitted, key data would be omitted from the analyses. To the greatest extent possible, related trade data must be analyzed together allowing the development of useful valuations based on the listed hedge equivalents as required.

Information Provided to the CFTC

Streaming of data to the CFTC

The CFTC poses the question whether streaming of data should be required rather than periodic transmission of data by SDRs.[8] ***Again, the answer must be an emphatic "yes."***

[6] CFTC Notice of Proposed Rulemaking, Swap Data Repositories (RIN 308-AD20), 75 FR 80898.
[7] NPR at 80905.
[8] NPR at 80906.

Streaming of data is critical to real-time analysis by the CFTC. SDRs will be a key cog in the system for real-time availability of trade data to the public, which is mandated by the Dodd-Frank Act.

Streaming to the CFTC is a necessary component of that system.

Systems for Monitoring and Analysis

The CFTC must have access to systems that enable both routinized and *ad hoc* analyses of the data. If these systems are not robust, the usefulness of the data will be limited to after-the-fact forensic analysis of catastrophic events. It is clearly better for the CFTC to have continuous understanding of the forces affecting the marketplace.

The Proposed Rules require that these systems must be provided by the SDRs,[9] but they must also be required to be uniform and compatible.

Data may be collected by multiple SDRs based on different categories of swaps. The practical implications are clear: the CFTC staff will have to use a number of different systems, which is simply inefficient and may well be ineffective.

But, there is a much deeper problem with such an approach. Marketplaces do not exist in isolation. They are inter-related. The CFTC must have the ability to understand and analyze the relationships between markets as disparate as agriculture and interest rates.

The CFTC requests comment concerning the need to specify standards for calculating positions.[10] If the analytical systems are provided by SDRs, these standards must be uniform and must be established by the CFTC. Methodologies for valuing positions, potentially based on data from multiple SDRs, based on listed hedge equivalents must be established. In theory, this can all be accomplished by demanding that systems provided by SDRs function inter-connectedly. However, in-house systems to calculate positions must also be implemented to best assure that seamless efficiency is achieved.

The best solution is for the CFTC to develop a single, in-house system for monitoring and analysis. The alternative to outsourcing these systems to SDRs, chosen in the Proposed Rules, will entail a level of uniformity and connection that may burden its reliability and usefulness. Requiring the SDRs to provide analytical and monitoring systems that are uniform and connectable is clearly inferior to a common system developed and implemented by the CFTC. ***The Proposed Rules inadequately address the need for inter-connected systems; but, more importantly the approach of relying on the SDRs, taken***

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9 Proposed Rules, Section 49.17(c)(2).
10 NOPR at 80906.

in the Proposed Rules, is fundamentally flawed. The CFTC should reverse this approach.

Governance and Conflicts of Interest

Corporate Governance

The approach to corporate governance of SDRs taken in the Proposed Rules is radically different from the approach employed with respect to other organizations that are to provide essential "market infrastructure" under the Dodd-Frank Act: derivatives clearing organizations, designated contract markets and swap execution facilities. Ownership percentages and requirements for independent representation on boards of directors and key committees are not specified.[11]

Instead, the Proposed Rules rely heavily on the duty that these governance instrumentalities maintain an "independent perspective."

The term *"independent perspective"* means a viewpoint that is impartial regarding competitive, commercial, or industry concerns and contemplates the effect of a decision on all constituencies involved.[12]

One factor that distinguishes SDRs, and may be a motivation for the different approach, is that SDRs provide a more routinized and defined service than other market infrastructure providers.

While this rationale is seductive, it ignores an important countervailing factor: it will be much easier for SDRs to gravitate toward membership organizations dominated by oligopolies of large financial institutions ***because*** their function is so routinized. The amorphous concept of "independent perspective" is simply not strong enough to counterbalance this force, which has been so corrosive of independence in this marketplace.

The Depository Trust Clearing Corporation ("DTCC") is a telling example. It has developed an excellent organization to manage data flows in securities markets. However, DTCC is dominated by influences of major banks. Its organizational structure and board composition demonstrate this. When financial institutions were compelled to act to bring some semblance of order to the credit default swap market, DTCC was put forward as the organization to manage the data warehouse function.

DTCC appears to have done a fine job in this role. It has provided useful input in several roundtables and, presumably, numerous meetings with the CFTC. Its capability is

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[11] Proposed Rules, Section 49.20.
[12] Proposed Rules, Section 49.2(a)(15).

not a concern. However, DTCC is not a regulator and does not answer only – or even primarily -- to the public's interests. The real question is whether any similar organization subject to so much direct and indirect influence by a club of major banks could possibly comply with SDR Core Principles 2 and 3 under the Dodd-Frank Act:

> **(2) GOVERNANCE ARRANGEMENTS.—Each swap data repository shall establish governance arrangements that are transparent—**
>
> > **(A) to fulfill public interest requirements; and'**
> >
> > **(B) to support the objectives of the Federal Government, owners, and participants.**
>
> **(3) CONFLICTS OF INTEREST.—Each swap data repository shall—**
>
> > **(A) establish and enforce rules to minimize conflicts of interest in the decision-making process of the swap data repository; and**
> >
> > **(B) establish a process for resolving conflicts of interest described in subparagraph (A).[13]**

Any structure with such direct and indirect influences would conflict with these express provisions of the Dodd Frank law.

Therefore, the Proposed Rules must include governance rules for SDRs which parallel the rules governing the other providers of swap market infrastructure: derivatives clearing organizations, designated contract markets and swap execution facilities.

Chief Compliance Officers ("CCOs"). We propose that the role of boards of directors relating to CCOs as set forth in the Proposed Rules be expanded, clarified and made more specific.

The Dodd-Frank Act changes the fundamental regulatory approach to derivatives market participants. For many years, market participants operated in an environment in which regulation was viewed as an obstacle to doing business. Changing this corporate culture requires attention from the highest levels of the corporate entity, and that means the Board of Directors generally and the independent members of the Board in particular.

Affiliates. The Proposed Rules must address the issue of affiliates and controlled groups. Compliance should be addressed based on the entire group. An affiliated organization should not provide a vehicle for avoidance of compliance with rules. A single senior CCO should have overall responsibility of each affiliated and controlled entity, even

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[13] Dodd-Frank Act, Section 728.

if individual entities within the group have CCOs. The annual report on compliance should likewise address both group and individual entity compliance.

The Role of Boards of Directors and Conflicts of Interest. The business realities of SDRs are unique. Inherently, they involve complex decisions concerning data which define the derivatives markets and the analysis available to the CFTC and the public. Simultaneously, ***they will be subject to the influences of their major customers, the large financial institutions generating the data that they collect, manage and distribute.***

The duties of a CCO will often come into conflict with the perceived interests of powerful customers. One duty specified in the Proposed Rules is resolution of conflicts of interest, which will be particularly contentious.[14] In these businesses, the express and implicit barriers to independent judgment related to compliance (which often is a perceived obstacle to profitable trading by customers) are unusually large.

The independent members of the boards of directors are, by design, independent from senior management. Compliance is less likely to be viewed by them as an obstacle and more likely to be viewed as an independently significant goal.

We propose the following provisions be added to the Proposed Rules to address the need for independence of a CCO from traders and managers:

1. The decisions to designate or terminate a CCO (or to materially change the CCO's position or responsibilities) should be ***the sole responsibility*** of the independent members of the board of directors acting by majority vote.

2. The CCO ***must not*** be an attorney representing the board of directors or executive management in legal matters. The potential for conflict of interest is inherent in this relationship.

3. While day-to-day reporting responsibility of a CCO will inevitably be to an executive officer, the CCO ***must also have a direct reporting line to the independent directors or Audit Committee*** and the CCO should meet with and report to that Audit Committee no less than once a quarter.

4. Compensation of a CCO should be the ***sole*** responsibility of the independent members of the board of directors, and not the responsibility of a senior officer.

The Proposed Rules must require that the CCO meet with the board of directors *and* senior officer to discuss the effectiveness of compliance policies at least once each year. As suggested above, a meeting once a year will be clearly insufficient for the independent members of the board of directors to become adequately and reasonably familiar with the compliance issues faced by the CCO. Thus, the CCO should meet ***at least quarterly*** with the Audit Committee. This will provide the foundation for the independent members of the board of directors to become truly effective protectors of the CCO and it will make it much

[14] Proposed Rules, Section 49.22(d)(2)(i).

less likely that the CCO will succumb to the pressure to permit risky and inappropriate practices that serve the interests of powerful customers.

The Proposed Rules specify several activities relating to conflicts of interest that are to be undertaken in consultation with the board of directors "or" the senior officer.[15] In each of these cases, the consultation should be with **both** the independent members of the board of directors **and** the senior officer.

Finally, the duty of the CCO to prepare an annual report regarding compliance, certify the report and furnish the report to the CFTC is central to the efficacy of the Proposed Rules. Under the Proposed Rules, the report must be furnished to the board of directors.[16]

We propose that the CCO present his or her finalized report to the board of directors and executive management prior to its submission to the CFTC. In addition, we propose that the independent directors and/or the Audit Committee, as well as the entire Board, be required to review and approve the report in its entirety or to detail where and why it disagrees with any provision. The CCO should be required to then file the report with the CFTC, either as approved or with statements of disagreement.

Volume-Based Fee Discounts and Commercial Use of Data

The Proposed Rules specifically permit SDRs to grant volumetric fee discounts so long as the discounts are available to all participants.[17] ***This is completely inconsistent with the mandate of the Proposed Rules that access be provided on a fair, open and equal basis.***[18]

The volume of data provided by an individual participant is largely unrelated to the cost structure of an SDR. Any fee discount simply means that other participants must pay more.

Reporting of swap data will most often be the duty of swap dealers. They will control flows to the SDRs. If large swap dealers can also receive discounts, the cost of the service will overwhelmingly be placed on other market participants.

In the context of SDRs, volumetric fee discounts are inherently unfair and unequal and, therefore, must be prohibited as inconsistent with the statute.

The Proposed Rules generally prohibit the commercial use of data by SDRs, subject only to limited circumstances in which they receive consent by the suppliers of the data.[19]

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[15] Proposed Rules, Section 49.22(d)(2).
[16] Proposed Rules, Section 49.22(e).
[17] Proposed Rules, Section 49.27(b)
[18] Proposed Rules, Section 49.27(a).
[19] Proposed Rules, Section 49.17.

If the data is ever used for commercial purposes, the SDR must be required to provide data to the public on equal terms as to price, priority and speed of transmittal.

Notification of Transfers of Equity Interests

The Proposed Rules require notification of the CFTC by an SDR in connection with the transfer 10 percent or more of its equity interests on the business day following the day the SDR enters into a firm obligation to make the transfer.[20]

The Proposed Rules properly recognize the important implications of such a transfer. These transactions will be infrequent and will clearly demand the attention of SDR management.

However, the threshold must be lowered to 5 percent. The CFTC should look to the rules of the Securities Exchange Commission addressing reporting thresholds for acquisition of interests in reporting companies. Acquisition of beneficial ownership of ***5 percent*** of a class of shares triggers reporting obligations.[21] Because of the unique position of SDRs in the derivatives marketplace, the reporting threshold must be no higher than 5 percent.

In addition, the requirement of disclosure after the obligation is entered into is inadequate. To allow the CFTC to make comment on the transaction, notice should be given on the day that the SDR becomes aware that a transfer is reasonably likely, but no later than the day the obligation is entered into.

Conclusion

Dramatically changing the way business is conducted in the so-called shadow markets is a central focus of the Dodd-Frank Act. This uncontrolled environment was a direct cause of the accumulation of massive risk that was virtually unknown to regulators and members of the public, resulting in the financial crisis. The essential service provided by SDRs is one of the most important features of the reform of these markets and it must be done right.

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20 Proposed Rules, Section 49.5(a).
21 Securities Exchange Commission, Rule 13d-1.

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

Sincerely,

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