



April 11, 2011

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

Re: Swap Trading Relationship Documentation Requirements for Swap Dealers and
Major Swap Participants
(CFTC RIN 3038-AC96)

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 (“Commission” or “CFTC”), the purpose of which are to establish requirements for swap trading relationship documents for swap dealers (“SDs”) and major swap participants (“MSPs”) as required by or pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

Introduction

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 were often recklessly indifferent to the consequences of their actions, it is clear in retrospect that many financial institutions and commercial businesses entered into trillions of dollars of transactions which they did not fully understand. Worse, some of these trades were so complex that they could not be understood. Required documentation forces parties to understand the nature and consequences of transactions.

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 poorly documented transactions

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.

evidenced by 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.

Clear and thorough standards for documentation are essential if this is not to be repeated. In the Proposed Rules, the CFTC has done an admirable job of requiring that over-the-counter swap transactions are appropriately documented. In particular, required clarity regarding issues such as rehypothecation and segregation of margin assets,² swap valuation methodologies³ and documentation of qualification of a swap for the end-user exception⁴ will provide needed certainty in the OTC marketplace. Coupled with the reporting requirements of the Dodd-Frank Act, and, in particular, reporting based on hedge equivalent contracts, available information on the marketplace will be complete, useful and, because of the documentation requirements, reliable.

However, the Proposed Rules fail to address a major issue. The Proposed Rules detail required credit support arrangements, such as initial and variation margin requirements, types and valuation of assets used and, as described above, rehypothecation and segregation requirements.⁵ However, in many (if not most) instances, counterparties forbear from collecting collateral up to a cap. Such forbearance arrangements impose the most significant obligations that end-users and other OTC counterparties must meet because they almost invariably include “credit triggers,” which are generally based on credit ratings. **If a credit trigger is tripped, the counterparty 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 a counterparty, they must be a primary focus of the Proposed Rules. History provides many examples (not the least of which was AIG) that the terms and conditions of credit triggers define the most important obligations associated with entering into an uncleared swap.

The use of forbearance under a credit support annex (“CSA”) between an SD or MSP and an end-user or other counterparty can be usefully understood as a revolving loan of funds from the dealer to the counterparty to provide required collateral, where the “loan” can be called for repayment upon the occurrence of a credit trigger event.⁶ In fact, the practice by dealers is to estimate the average daily outstanding (but uncollected) collateral

² Proposed Rules, Section 23.504(b)(3).

³ Proposed Rules, Section 23.504(b)(4).

⁴ Proposed Rules, Section 23.505(a).

⁵ Proposed Rules, Section 23.504(b)(3).

⁶ 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/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/>

(i.e., principal) over the expected life of the swap (i.e., loan term) and calculate an appropriate charge for extending the credit (i.e., interest). That charge is then added to and embedded unseen into the cost of the swap to the end-user.

Confirming this view, the Comptroller of the Currency requires that bank dealers aggregate amounts of forborne collateral with commercial loans extended by the bank dealer to the same entities.⁷

And, of course, bank dealers typically decrease lending capacity by such amounts.

The documents must include the basic terms of the credit agreement:

- **The maximum amount of the credit to be extended;**
- **The method of determining how much credit has been extended;**
- **The term of the facility and early call rights (the credit trigger); and**
- **The price of the credit (or implied cost) and the method of payment.⁸**

A related issue arises from the Proposed Rule requirement that SD and MSP documentation of the qualification of a swap for the end-user exception which includes “[t]hat the counterparty generally meets its obligations associated with non-cleared swaps.”⁹ This allows the SD or MSP to facilitate compliance with the requirement of the Dodd-Frank Act that, for a swap to qualify for the end-user exception, one counterparty:

...notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into noncleared swaps.¹⁰

Obviously the factor of “how” obligations are met, as required by the Dodd-Frank Act, is omitted from the requirement of the Proposed Rule. If this is the source of disclosure as directly suggested in the Notice of Proposed Rulemaking,¹¹ *disclosure on this important point will be inadequate* and will not ensure compliance with the statutory requirements of the Dodd-Frank Act.

⁷ Office of the Comptroller of the Currency, Risk Management of Financial Derivatives, Comptroller’s Handbook at page 50 (January 1997); available at <http://www.occ.gov/static/publications/handbook/deriv.pdf>

⁸ It must be noted that the practice by dealers of embedding the cost of credit in the price of the related swaps seriously impairs the transparency of the market. As a result, neither the end-user nor the public nor regulators know the true price of the swap or the credit. Only the dealer knows these values. Data disseminated to the public in real-time must include accurately priced swaps. If the price of the swap and the price of the credit are separately disseminated, the public will receive needed information about market prices for the swaps and market participants will be able to evaluate the quality of offers they must consider for the extension of credit in lieu of posted collateral.

⁹ Proposed Rules, Section 23.505(a)(5).

¹⁰ Dodd-Frank Act, Section 723.

¹¹ CFTC, Notice of Proposed Rulemaking, Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants (CFTC RIN 3038-AC96), 76 FR 6719.

The Proposed Rules must approach the issues associated with how the end-user is to meet its obligations with a focus on market realities. Specifically, the common use of CSAs in which SDs and MSPs extend credit to counterparties by forbearance from requiring posted collateral, creates enormous and poorly disclosed risks to end-users and those who are exposed to end-users. Careful analysis of these arrangements reveals that the obligations under the CSAs which can be triggered at any time **are the most important obligations under a non-cleared swap**. *Therefore, there must be greater disclosure regarding these arrangements to the regulatory agencies and the public.*

It is therefore necessary for the Commission to determine whether a party relying on the end-user exception is taking adequate steps to mitigate the credit risks associated with non-cleared swaps. To make this determination, the Commission must have access to sufficient information about how the party expects to meet its financial obligations under the swaps. That information must include not only the generic types of arrangements that the end-user intends to use, but the terms of those arrangements as well.

The Proposed Rules fail to require the disclosure of essential information, and, therefore, the Commission will be unable to discharge its duty of risk assessment with respect to non-cleared swaps.

Additionally, the Proposed Rules do not require disclosure of **any** information regarding the substantive terms of those arrangements. *In the context of actual market practices, the designation of these methods, without any accompanying detail, is meaningless.*

Determining how an end-user is to meet its “obligations associated with entering into uncleared swaps,” as mandated by the Dodd-Frank Act, is meaningful only if the recipient of the information is in a position to understand what the obligations under the swaps are. As described above, the terms and conditions of credit triggers define the most important obligations associated with entering into an uncleared swap. The end-user must be required to describe its ability to fund margin fully if all credit triggers are tripped, specifying its access to liquidity. Any other mechanism for disclosing how an end-user will meet its obligations is of minimal importance compared with this requirement.

Comments

Section 23.504(3) of the Proposed Rules must be amended by the addition of the following clause:

Terms under which credit may be extended in the form of forbearance from funding of margin, including caps on such credit, methods of determining the amount of credit consumed against such cap, the method of calculating and paying the cost of such credit extension and any conditions under which such forbearance may be withdrawn.

Clause Section 23.505(a)(5) of the Proposed Rules must be amended to read as follows:

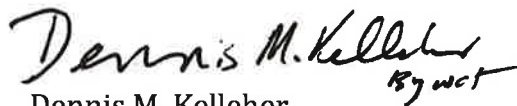
A statement describing how the counterparty generally meets its obligations associated with swaps entered into with the SD or MSP and not cleared, including any obligation to immediately fund margin under the swap documentation which has previously not been deposited with the SD or MSP.

Conclusion

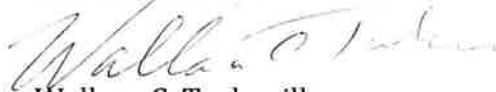
The Dodd-Frank Act clearly establishes a policy under which the clearing of derivatives is preferred. While conditions are recognized allowing bi-lateral, OTC swap transactions, the CFTC must diligently regulate the practice so that the exceptions are narrow and the transaction entered into under the exceptions prudently documented. The suggested amendments to the Proposed Rules are essential if this is to be accomplished.

We hope that our comments will assist the Commission as it finalizes its regulations.

Sincerely,

Handwritten signature of Dennis M. Kelleher in black ink. The signature is cursive and includes the initials "By wct" written below it.

Dennis M. Kelleher
President & CEO

Handwritten signature of Wallace C. Turbeville in black ink.

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