MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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

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

**Re: Notice of Proposed Rulemaking on Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants**

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its proposed rules on "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants" (the "Proposed Rules")[2] related to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] MFA strongly supports measures to reduce complexity in the swap markets, including standardization of trade documentation. In that vein, we are providing comments on the Proposed Rules that we believe will assist the Commission in adopting final rules that promote a robust and efficient marketplace for swaps.

## I. Effects on Documentation Negotiation

Section 731 of the Dodd-Frank Act[4] mandates that the Commission promulgate documentation standards that apply to swap dealers ("SDs") and major swap participants ("MSPs") and that promote "timely and accurate confirmation, processing, netting, documentation and valuation of all swaps."[5] MFA agrees that, consistent with Congressional

[1] 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.

[2] Notice of Proposed Rulemaking on "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants", 76 Fed. Reg. 6715 (Feb. 8, 2011) (the "Proposing Release").

[3] Pub. L. 111-203, 124 Stat. 1376 (2010).

[4] Section 731 of the Dodd-Frank Act adds Section 4s(i)(2) of the Commodity Exchange Act ("CEA").

[5] *Id.*

intent, swap documentation standards should address the confirmation, processing, netting, documentation and valuation of all swaps. However, we are concerned that the Proposed Rules, coupled with other proposed regulations concerning swap documentation,[6] will disadvantage customers in negotiating swap documentation with SDs and MSPs.

For example, the Proposed Rules, the Proposed Confirmation Rules and the Proposed Liquidation Rules (collectively, the "Proposed Documentation Rules") all contain detailed documentation requirements and short compliance deadlines.[7] In addition, the Proposed Rules require SDs and MSPs to adopt formal policies and procedures for compliance with documentation requirements, which senior SD or MSP management must approve in writing.[8] In practice, complying with these combined requirements (*e.g.*, finalizing the documentation and obtaining senior management approval) may only be possible if documentation templates prepared by SDs or MSPs remain unnegotiated, leading to the institutionalization of the terms favored by SDs and MSPs.[9] As a result, we are concerned that the Proposed Documentation Rules would enable SDs and MSPs to compel their customers to accept unfavorable terms or forego time-sensitive market opportunities, as we discuss in greater detail in Section III below. Accordingly, we recommend that the final rules not require senior management approval of the documentation. Rather, each party should be free to assess requisite approval levels for various kinds of swap activity based on its unique organizational structure.

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[6] *See* Notice of Proposed Rulemaking on "Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants", 75 Fed. Reg. 81519 (Dec. 28, 2010) ("Proposed Confirmation Rules"); Notice of Proposed Rulemaking on "Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants", 76 Fed. Reg. 6708 (Feb. 8, 2011) ("Proposed Liquidation Rules").

[7] For example, Proposed §23.504(a) and (b) require that the documentation include credit support arrangements, initial and variation margin requirements, types of assets that parties may use as margin, custodial arrangements for margin assets and objective and alternative criteria for valuing swaps.

Proposed §23.501(a)(1) of the Proposed Confirmation Rules provide that swap dealers and major swap participants, when entering into a swap with another SD or MSP, "shall execute a confirmation … according to the following schedule: (i) For any swap transaction that has been executed and processed electronically, within 15 minutes of execution; (ii) For any swap transaction that is not executed electronically, but that will be processed electronically, within 30 minutes of execution; or (iii) For any swap transaction that cannot be processed electronically by the swap dealer or major swap participant, within the same calendar day as execution."

In addition, proposed §23.501(a)(2) of the Proposed Confirmation Rules provide that SDs and MSPs, when entering into a swap with an entity that is not an SD or MSP, "shall send an acknowledgement … according to the following schedule: (i) For any swap transaction that has been executed and processed electronically, within 15 minutes of execution; (ii) For any swap transaction that is not executed electronically, but that will be processed electronically, within 30 minutes of execution; or (iii) For any swap transaction that cannot be processed electronically by the swap dealer or major swap participant, within the same calendar day as execution."

[8] Proposed §23.504(a).

[9] Those provisions that senior management of the SDs and MSPs have approved in previous negotiations will become standard and not subject to negotiation.

## II. Valuation

### A. Valuation Methodology

The Proposed Rules require the documentation for a swap to include an agreement by the parties as to "the methods, procedures, rules, and inputs for determining the value of each swap" that is based on objective criteria to the maximum extent possible.[10] Further, the Proposed Rules require the parties to set forth those valuation methods, procedures, rules and inputs with enough specificity for the parties, the Commission or any applicable prudential regulator to determine the value of the swap,[11] which we interpret as essentially requiring the inclusion of a valuation formula in the documentation.

Section 731 of the Dodd-Frank Act did not specifically require that the Commission mandate the inclusion of valuation methodology in swap documentation. Accordingly, MFA respectfully recommends that the Commission not mandate that parties agree upon objective and alternative valuation methodologies in their documentation. We think that these requirements will not work in practice and we do not see an obvious regulatory or market benefit to imposing these requirements. Rather, we believe that the valuation of swap transactions needs to be flexible to adapt to new market information. While we recognize that the Commission does have a legitimate regulatory interest in monitoring valuation disputes, we believe the Commission can adequately address that interest without mandating specific valuation methodologies.

Although we understand the Commission's desire to standardize swap documentation to the extent possible, under current market practice, the absence of agreed valuation methodologies or formulas does not create inefficiencies because both dealers and non-dealers are able to use proprietary models to value swaps and manage their risk accordingly.[12] It is only when a valuation dispute arises that parties might need to use methods, such as conducting a dealer poll, to establish price. Therefore, if the final rules require swap documents to include a valuation method or formula, parties will need to spend additional time negotiating issues not currently negotiated and trying to agree on matters that do not require advance agreement. This extended negotiation will impose substantial additional transaction costs and provide little or no obvious benefit.

In bilateral swap markets, where parties trade directly with each other, parties typically negotiate enabling agreements (*e.g.*, master agreements and credit support annexes published by the International Swaps and Derivatives Association Inc. and other similar "master agreements")

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[10] Proposed §23.504(b)(4) provides that "the swap trading relationship documentation shall include written documentation in which the parties agree on the methods, procedures, rules, and inputs for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap. To the maximum extent practicable, the valuation of each swap shall be based on objective criteria, such as recently-executed transactions or valuations provided by independent third parties such as derivatives clearing organizations."

[11] *Id.*

[12] SDs and MSPs generally do not want to share their proprietary models. Requiring them to utilize objective valuation methodologies will likely only increase their pricing requirements because of their need to rely increasingly on third parties.

that will then serve as the basis for all future swap transactions between the parties. Each future swap transaction is then evidenced by a separate confirmation. In order for parties to include a valuation formula in their enabling agreements, they would either need to develop a single formula that would work for any swap covered by that agreement or include multiple valuations formulas for each possible type of swap entered into under that agreement. In the alternative, the Commission could require the parties to include the valuation formula in the relevant swap confirmation. However, the confirmation for a trade is typically quite short, setting out the specific economic and legal terms of the transaction. The confirmation does not typically address, nor does trade timing typically permit, it to address formulaic and back-up valuation methodologies. Therefore, requiring parties to comply with a requirement to include valuation methodologies in swap documentation would, in practice, be an extremely time consuming and almost impossible task.

We are also concerned about the proposed valuation requirements for customized swaps, for which the parties often cannot easily identify a formula to arrive at valuations. Specifically, writing valuation formulas for customized swaps creates two problems. *First*, the formula might require subjective inputs or, even if objective inputs are available, they may not be the same inputs that a party uses for its own internal risk modeling or valuation purposes. Unless all of the inputs are objective and match those used by the trading parties, the utility of a valuation formula is uncertain. *Second*, the market, which ultimately defines value, might assign a value to a swap based on factors not taken into account in the formula.[13] Thus, the valuation formula might lock parties into a value that does not reflect true market value. If the valuation discrepancy were considerable, it would be a significant concern to the trading parties[14] and might be a concern to regulators, because the value forms part of the determination of how much systemic risk a party's swap portfolio creates.[15] Therefore, MFA respectfully requests that for all trades (whether standard or customized) the Commission not adopt the prescriptive approach of requiring inclusion of valuation methodology in swap documentation.

### B. Valuation Disputes

The Proposed Rules require each SD and MSP to notify the Commission or another regulatory authority of any swap valuation dispute with respect to security-based swap agreements[16] not resolved within one business day (if with another SD or MSP) or five business

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[13] A formulaic or quantitative valuation of a swap may not reflect market value, which is subject to supply and demand for the specific product, and is not objective because it relies on inputs that are not objective.

[14] Valuation discrepancies might create corporate and disclosure issues because trading parties may need to explain why actual recoveries do not match the valuations suggested under the formulas in its swap documentation.

[15] Valuation is an integral component for determining whether a company has a swap portfolio that constitutes substantial positions or a swap portfolio that presents substantial counterparty exposure. *See* "Further Definition of 'Swap Dealer', 'Security-Based Swap Dealer', 'Major Swap Participant', 'Major Security-Based Swap Participant', and 'Eligible Contract Participant', 75 Fed. Reg. 80174 at 80180-1 (Dec. 7, 2010).

[16] Although the Proposing Release at 6719 refers to security-based swap agreements, proposed §23.504(e) is not so limited. At a minimum, MFA suggests that the Commission make clear that proposed §23.504(e) only applies to security-based swap agreements.

days (if with a party not an SD or MSP).[17] Although, as discussed above, MFA does not believe that the Commission should require the use of specific valuation methodologies, we strongly agree that the Commission should adopt rules related to valuation disputes and their timely resolution.

However, as a general matter, MFA questions whether regulators need notice of every unresolved dispute because many are immaterial from a systemic risk or regulatory perspective. In cases where notice is deemed necessary, we believe the proposed dispute resolution period of one business day for SDs and MSPs is too short. Generally, valuation disputes may require discussion and negotiation by and among several levels of management and many different operational teams at an SD or MSP.[18] Therefore, we recommend that in the final rules the Commission adjust the notice periods and incorporate a materiality threshold for disputes. Specifically, we propose that the final rules give parties five business days to resolve a valuation dispute in an account before they must give regulators notice and only require notice to regulators where the amount in dispute exceeds either (a) $100 million, or (b) both 10%[19] of the higher of the parties' valuation and $50 million. In addition, we strongly believe that any notices of disputes should be treated confidentially by regulators, and not be subject to public access.

### C. Application to Traded Swaps

The Proposed Rules are not clear that the valuation methodology or documentation standards do not apply to swaps traded on a designated contract market ("DCM") or swaps traded on templates promulgated by a derivative clearing organization (a "DCO")[20] and subsequently submitted for central clearing. In both of these circumstances, parties will use standardized documentation and will determine valuation by reference to the trading market. Thus, we recommend that the Commission clarify that the Proposed Rules do not apply to those swaps.

## III. Timing of Confirmations

Proposed §23.504(a) provides that each SD and MSP must "ensure that, prior to or contemporaneously with entering into a swap transaction…the [SD or MSP] executes written swap trading relationship documentation". However, proposed §23.504(b)(2) provides that "[t]he swap trading relationship documentation shall include all confirmations of swap

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[17] Proposed §23.504(e).

[18] For example, a valuation dispute might require consultation and/or approval from representatives of the trading desk, credit, risk, compliance, legal and accounting departments as well as senior management.

[19] This proposed threshold of 10% is consistent with proposed Rule §23.502(b)(4) (*i.e.*, the suggested threshold for valuation disputes requiring reconciliation under the Proposed Confirmation Rules).

[20] Although not suggested in the Proposed Rules, MFA strongly believes that documentation rules, such as the Proposed Rules, should neither infringe on a party's ability to negotiate terms with its clearing firm, nor require the disclosure of the terms of any such clearing arrangement to an SD, MSP or other counterparty (*e.g.*, as in a trilateral give-up agreement). *See* MFA comment letter to the Commission dated April 11, 2011 on the Commission's Notice of Proposed Rulemaking on "Requirements for Processing, Clearing, and Transfer of Customer Positions", 76 Fed. Reg. 13101 (Mar. 10, 2011) for further discussion of this issue.

transactions". Although such timing may be appropriate for enabling documentation, it is unclear to how the timing would apply in practice with respect to confirmations and such timing is inconsistent with the Commission's Proposed Confirmation Rules, which contemplate the delivery of a confirmation *after* parties execute a swap transaction.[21]

Proposed §23.504(a) requires parties to negotiate all trade confirmation terms prior to execution of the trade. In practice, this requirement would elevate trade certainty over trade timing, which may have broad implications for the market. For example, if an SD's or MSP's counterparties must choose between quick execution and the negotiation of all terms, the Proposed Rule's timing requirements might substantially limit end users' ability to engage in proper risk management using tailored swaps. In addition, by increasing the amount of time needed to enter into a confirmation, it might decrease the number of transactions in the markets, thereby decreasing liquidity and increasing volatility.

Further, SDs will encounter additional risks as market conditions may change between when the SD provides pricing for a swap and, after satisfying the Proposed Rules' 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, which will have the effect of reducing market liquidity and efficiency. Accordingly, we respectfully request that the Commission eliminate any reference to "confirmation" in the Proposed Rules.

## IV. Document Submission

The Proposed Rules stipulate that swap trading relationship documentation include, among other things, the name of the clearing member for the dealer and, if known, the counterparty.[22] MFA believes that one of the benefits of central clearing is anonymity. Once parties submit a swap for central clearing, it need not retain or know any information about the counterparty. Given the benefits of anonymity offered in central clearing, MFA is unclear why a requirement to record each party's clearing firm should be included in the final rules. Thus, we recommend that the final rules on swap documentation do not require any identifying information about the parties and their firms (and related terms) through which each party submits swaps for central clearing.

## V. Non-Compliant Documentation

The Proposed Rules require that upon acceptance of a swap by a DCO, the swap trading documentation must include a representation that the terms of the cleared swap conform to templates established under the DCO's rules.[23] In addition, the rules provide that all terms of the swap, as carried on the books of the clearing members, must conform to the terms of the cleared

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21 *See* proposed §23.501(a) of the Proposed Confirmation Rules.

22 Proposed §23.504(b)(6)(iii).

23 Proposed §23.504(b)(6)(v)(C)

swap established under the DCO's rules.[24] MFA generally supports mandating that the documents and terms of cleared derivatives contain the terms required by the applicable DCO. However, these requirements, together with those regarding valuation, custodial arrangements, etc.,[25] raise the question of what happens if there is a document defect, whether minor or major. We strongly believe that market participants need to and do value legal certainty in their trading contracts and that the existence of defects in documentation required by existing regulation must not permit one party or the other to void a contract. Therefore, we believe that it is imperative that the Commission affirmatively clarify that defects in required regulatory documentation do not render a contract void or voidable by one of the parties.

## VI. Application of Requirements to Existing Documents

The Commission has requested comment on the implementation of the Proposed Rules, particularly with respect to existing agreements.[26] MFA strongly objects to the Commission applying any of these requirements to existing contracts because it is fundamentally inconsistent with the Dodd-Frank Act. Section 739(5) of the Dodd-Frank Act specifically provides that the Dodd-Frank Act shall not constitute a "regulatory change, or similar event … that would permit a party to terminate, renegotiate, modify, amend, or supplement 1 or more transactions under the swap."[27] Imposing these requirements on existing agreements would clearly require that existing agreements be "negotiated".

In addition, several legal and pragmatic issues would arise should the Commission require parties to modify documentation for existing swap transactions. For example, if the parties cannot agree on an objective valuation model, does that mean their previous agreement becomes void or voidable? How will parties negotiate documents if such negotiation requires the consent of a third party, such as a rating agency or creditor, and the parties cannot obtain such consent? Given the myriad of existing agreements, these issues could result in significant, unintended consequences and would require a substantial allocation of resources. Therefore, we strongly urge the Commission not to apply the final rules retroactively, but rather limit the application of the final rules to trades entered into following implementation of final rules.

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[24] Proposed §23.504(b)(6)(v)(D).

[25] *See* Proposed §23.504(b)(3) and (4), and the previous discussion in this letter.

[26] Proposing Release at 6720.

[27] Section 739 of the Dodd-Frank Act adds Section 22(a)(5) of the CEA.

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 have 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