RIVERSIDE | Risk Advisors

April 11, 2011

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

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

Dear Mr. Stawick:

We appreciate the opportunity to provide comments on proposed rules under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") recently published by the Commodity Futures Trading Commission (the "CFTC") governing swaps documentation standards. For the record, this is the fourth comment letter we have sent regarding the proposed rules, an indication of our commitment to contributing to a successful outcome of this process.

Our firm, Riverside Risk Advisors LLC ("Riverside") is an advisory boutique specializing in derivatives and structured financial products. We bring expertise and advice to our clients without conflicts of interest, resulting in transparency, better understanding of risks and improved pricing and transaction terms. Our professionals have extensive experience as derivatives structurers, traders and marketers at some of the world's largest derivatives dealers. Our interest in providing commentary is in promoting the proper functioning of the derivatives markets by increasing access, transparency, innovation and sound decision-making, and not to serve the narrow interests of any particular constituency.

Background

The CFTC has proposed a rule which would require Swap agreements to contain "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 the swap. The agreed methods, procedures, rules and inputs would be required to constitute a complete and independently verifiable methodology for valuing each swap entered into between the parties."

Clarifications Requested

We would like to ask the CFTC to provide clarification in the following areas:

- Based on our reading of the proposed rule and explanatory text, it appears that the "value" of a Swap for purposes of the proposed rule is the market value used for margining purposes (or the "Exposure" under the ISDA Credit Support Annex). Is the scope of the proposed rule limited to margining?
- If not, is it the CFTC's intent to impose a requirement that the parties to a Swap transaction be obligated to terminate Swaps at prices determined by the agreed-upon methodology? The intended effect of the use of the word "termination" in the proposed rule is unclear to us.
- If termination prices are to be determined according to the agreed-upon methodology:
    - Does the requirement apply only when a Swap terminates by its own terms (e.g., under a "mandatory cash settlement" provision or "market value" termination option). Likewise, does it apply to contemplated amendments, such as "market re-coupon" provisions?
    - Or does it apply also to negotiated terminations outside the "four corners" of the Swap documentation? If so, is the obligation mutual in all cases? Or does the obligation fall only on Swap Dealers and Major Swap Participants?
- Paragraph (b)(4)(iii) of the proposed rule seems to contemplate the potential for a difference between valuation according to the documentation and valuation for financial reporting purposes. Are we correct in reading the proposed rule as having no direct impact on valuation for financial reporting purposes?
- What other significance, if any, will attach to the valuation resulting from the prescribed methodology?
- Can the parties to a Swap agree to a provision under which the valuation method can change during the term of the transaction? If so, does any change have to by mutual agreement? Or may the parties agree to a provision in the initial documentation allowing one party (presumably the Swap Dealer) to unilaterally change the methodology, assuming a written explanation of the new methodology is provided?

The Evolution of Pricing Methodologies and Unintended Consequences

In considering the questions above, it is important to appreciate that valuation methodologies evolve over time. The pace and direction of this evolution can be difficult to predict. We have seen valuation methods for some products change under a range of circumstances, including, but not limited to, the following:

- The introduction or increase in liquidity of a related financial product leads to a change in hedging approach and with it, the generally-accepted valuation model.
- A single player or a small number of players have a unique insight that ultimately becomes accepted by the marketplace.
- Market practitioners learn from mistakes and make adjustments.

- A known component of value is not considered material under a given set of market conditions, and therefore accepted valuation practice involves a crude assumption to deal with it. Then market conditions change, changing the impact of the previously immaterial factor, with the result being a more rigorous treatment of it in the valuation model.

Even US dollar interest rate swaps, perhaps the most vanilla of OTC derivatives, have undergone a meaningful re-thinking of valuation methodology since 2007. Two factors in particular which have received much more focus are the funding valuation adjustment (in short, the difference in value which results when one moves from LIBOR-based discounting to discounting based on a more meaningful funding rate) and the credit valuation adjustment (in short, the fair valuation of a counterparty's non-performance risk on a derivative). This seems natural given that the financial crisis of 2008-09 brought both credit spreads and liquidity (or funding) spreads to levels not seen since interest rate swaps had become an established component of the capital markets.

The proposed rule does recognize the potential need for adjustment in unusual circumstances, calling for "complete alternative methods for determining the value of the swap in the event that one or more inputs to the methodology become unavailable or fail, such as during times of market stress or illiquidity." But this language falls short of addressing the issue raised above for two reasons. First, it shows no recognition that evolution of valuation methodologies occurs through all market conditions, not just stressed ones. Second, it is nearly impossible to predict with any precision how valuation methodologies will adjust during the next period of market stress.

For example, consider the case of a plain vanilla US Dollar interest rate swap between a Swap Dealer and an end-user of high credit quality under a standard Credit Support Annex with two-way daily margin. Had this proposed rule been in effect in 2007, the valuation methodology hard-wired into the deal documentation at that time would likely have proved too rigid and inconsistent with best practices today. Specifically, the documentation would likely have provided for discounting of the cash flows under the Swap based on the LIBOR curve. Today, many Swap Dealers take a "funding valuation adjustment" which, for swaps governed by standard two-way margin, in effect results in discounting cash flows at the overnight index swap ("OIS") curve. OIS rates are slightly lower than LIBOR swap rates. Therefore the effect of this change is to slightly increase duration and increase the magnitudes of valuations in either direction.

Had this hypothetical transaction been subject to a hard-wired valuation approach written in 2007, the "in the money" counterparty party today would in effect be taking under-collateralized credit exposure to the "out of the money" counterparty. Worse yet, if termination values were required to be set based on the written methodology the "in the money" party in effect would be forced to terminate at a loss relative to the true replacement value given the market's updated valuation conventions.

We do not believe either of these results represents the CFTC's intention. We also believe that given the broad language of the proposed rule, some form of clarification is warranted.

Conclusion

The proposed rule requiring a "complete and independently verifiable [valuation] methodology" in swap documentation can potentially be read to create some detrimental consequences, which could actually increase risk in the financial system. Such potential consequences include the under-collateralization and transaction mispricing that could result if parties are forced to value Swaps under outdated methodologies. We assume these results are not intended, and therefore believe clarification by the CFTC is warranted.

We would be pleased to discuss our thoughts in more detail, should the CFTC so desire. Thank you again for this opportunity to comment.

Respectfully submitted,

Frank Iacono
Partner
Riverside Risk Advisors LLC