THE FINANCIAL SERVICES ROUNDTABLE

Financing America's Economy

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

Regarding: (i) Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants; (ii) Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants

RIN Number 3038–AC96

Dear Mr. Stawick:

The Financial Services Roundtable[1] respectfully submits these comments in response to the request for comments by the Commodity Futures Trading Commission (the "Commission") with respect to its proposed rulemaking, RIN Number 3038-AC96, Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants[2] and Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants[3] (together, the "Proposing Release"), implementing certain requirements of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[4] The Proposing Release is part of a massive rulemaking endeavor by the Commission to implement the provisions of Title VII of the Dodd-Frank Act ("Title VII") and subject swap transactions to comprehensive regulation and regulatory oversight. The Proposing

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.
[2] 76 Fed. Reg. 6715 (February 8, 2011).
[3] 76 Fed. Reg. 6708 (February 8, 2011).
[4] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1897 (July 21, 2010).

Release in particular relates to Section 731 of the Dodd-Frank Act and related provisions which added a new section 4s(i) to the Commodity Exchange Act (the "CEA") requiring swap dealers ("SDs") and major swap participants ("MSPs") to conform to swap trading relationship documentation standards prescribed by the Commission. The Proposing Release includes proposed swap trading relationship documentation requirements and invites public comment on certain aspects of those standards.

The Roundtable's views on these proposed requirements follow:

1. The Commission's proposal with respect to documenting valuation procedures is not workable in its current form and should be deferred pending further study.

The Commission has proposed that the documentation for a swap would be required to 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."[5] The proposal would also require that, to the maximum extent practicable, the valuation of each swap be based on "objective criteria" and the swap documentation include alternative methods for determining the value of the swap if any input required to value the swap becomes unavailable.[6] Moreover, the proposed regulations would require that "[s]uch methods, procedures, rules, and inputs shall be agreed for each swap prior to or contemporaneously with execution and shall be stated with the specificity necessary to allow the swap dealer, major swap participant, counterparty, the Commission, and any applicable prudential regulator to determine the value of the swap independently in a substantially comparable manner."[7] We understand why the Commission considers this degree of certainty desirable. However, we believe that this proposed requirement is inconsistent with current market practice and will significantly disrupt the bilateral swap markets at a time when such markets are undergoing dramatic other changes in response to Title VII and the Commission's rules.

Title VII gives the Commission the authority to provide rules on documentation relating to valuation, but does not mandate that it do so. Given the lack of a Congressional mandate, we do not believe the Commission should use this authority to cause a fundamental shift in one of the core economic aspects of current swaps, especially while the Commission and market participants are under the pressure of crafting and responding to the final Title VII rules. The types of valuation models the Commission proposes are not part of most swap transactions as they currently exist. For example, the ISDA Master Agreements provide that the party determining the close-out value of a swap must act in good faith and in a commercially reasonable manner, and provide guidance as to the types of inputs that should be considered—but they do not include specific sources of those inputs, and they afford a significant degree of discretion to the party making the calculation, especially in circumstance under which such inputs are unavailable or unreliable. The type of specificity the Commission proposes to require

[5] *Proposed Rule* §23.504(b)(4)
[6] *Id.*
[7] *Id.*

would represent a sea change in the way that swap valuation is handled. It would add a significant, highly complex element to the negotiation of swap terms; diminish standardization as parties negotiate bespoke approaches to valuation; undermine legal certainty if the valuation methodology is determined not to be adaptable to all circumstances; and potentially require disclosure of proprietary models.[8] In addition, the loss of the ability to exercise good faith judgment in valuation procedures may well lead to less accurate valuations in times of economic stress. Those tracking valuations in the context of residential mortgage-backed securities during 2007 and 2008, for instance, watched market prices deviate significantly from "intrinsic values" determined by reference to anticipated cash flows and default rate. A rigid valuation methodology might well lead to inappropriate results in such a circumstance, potentially accelerating systemic instability.

The Commission itself, in its more recent proposal regarding margin requirements, recognizes how time-consuming it is to review valuation methodologies. In particular, the Commission proposes that the parties rely on other entities' models to calculate initial margin, acknowledging that it does not have the resources to review proprietary models.[9] The Commission also proposes to tie the calculation of variation margin to the valuation methods it would require under the new documentation standards. By contrast, the joint prudential regulators, in a concurrent proposal, anticipate that variation margin would be determined by marking the positions to market, thus invoking an established body of accounting guidance. Although we will comment on the Commission's margin proposals in a separate letter, we note that we do not believe the Commission's current proposal for calculating variation margin presents a viable solution, in that it relies on a valuation standard that we do not believe can be achieved.

We understand that more transparency and consistency in valuing swap positions may be desirable. But we believe that the Commission should not force swap counterparties to make fundamental changes to the way they value those positions without engaging in deliberative study and completing a comprehensive cost-benefit analysis. *We therefore request that the Commission withdraw this aspect of its documentation proposal at least until it has the time to conduct such study and analysis with the thoroughness they deserve.*

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[8] The proposals state that a swap dealer or major swap participant "is not required to disclose to the counterparty confidential, proprietary information," but only if the independent valuation requirements of the proposed rules are satisfied. *Proposed Rule* § 23.504(b)(4)(iii). The Commission further asks whether internal valuation modeling mechanics should be required to be disclosed in "sufficient detail for [counterparties] to undertake comparative analysis of such information and verify the valuation calculation." Internal modeling, for many swap dealers and major swap participants, is some of their most sensitive and closely-held business information and should not be required to be disclosed. 76 FR 6720.

[9] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, RIN 3038 – AC97, 76 FR 23732 (April 28, 2011).

2. <u>Swap counterparties should not be required to modify their documentation with retroactive effect</u>.

The Commission's discussion of proposed Section 23.504 indicates that the Commission is considering retroactive application of its documentation standards to existing swaps.[10] While the Commission says that existing swap documentation is "likely"[11] compliant with these standards, we do not see how this can be the case given the significant changes proposed by the Commission with regard to agreed valuation methods,[12] credit support documentation[13] and orderly liquidation standards,[14] among others. Revising existing trade documentation creates significant hardships, including for commercial end-users. Such revisions would require consensual agreement to new terms, especially with regard to changes to valuation and credit support, and as counterparties cannot be forced to agree, it should be expected that they will not agree to terms they consider adverse. Renegotiation would be time-intensive, require significant involvement by both business and legal personnel, involve *every* outstanding contract to which an affected party was a counterpart, and occur in the midst of significant other changes that are already challenging the resource availability of many market participants. Additionally, in the experience of our members, reopening even "narrow" issues under existing swaps typically, at least, leads to other aspects of the agreement being reopened by the other party and is viewed by such party as an invitation to renegotiate all the terms of agreement with the result that most of the terms in the entire agreement are reconsidered. In this regard, we do not believe it is realistic to assume that "narrow" issues can be dealt with discretely. Amendments to existing agreements may also change the accounting treatment of those agreements, including in some instances having the very adverse effect of depriving counterparties of hedge accounting treatment—a burden that would be borne most heavily by end-users. We also note that renegotiation of existing agreements to provide for specified valuation methods may in fact change the *value* of those transactions as determined by contract participants under their internal models. If implemented across an entire portfolio, this could have significant adverse effects on swap counterparties.

The Commission has requested guidance on how long it would take to bring existing documentation into compliance with the proposed standards and asks whether three months is sufficient time to revise trades with registrants and if six months is sufficient time to revise trades with non-registrants.[15] As noted above, we believe that requiring such revision is inappropriate. If the Commission were nonetheless to require retroactive application of these provisions, the time involved to complete renegotiations would be much, much greater, and the Commission would also have to determine how to address circumstances in which no new agreement could be reached. The need to agree

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[10] *See* 76 FR 6720.
[11] *Id.*
[12] *See* Section 1 *infra*.
[13] *See* Section 3 *infra.* We realize that the Commission is not proposing to apply margining requirements retroactively, and so arguably the credit support provisions would not need to be included. However, we do not believe the documentation rule proposal is clear on this point.
[14] *See* Section 6 *infra.*
[15] *See* 76 FR 6720.

on valuation procedures could alone make such renegotiation impossible, and certainly not feasible in a three to six-month time frame. We believe it is not a good use of limited resources for market participant to have to combine the significant compliance work that is involved with necessary changes mandated by Dodd-Frank with this proposed reworking of valid documentation for existing, fully negotiated trades, and we ask the Commission to adopt rules on a prospective basis only.

3. <u>The proposed rules regarding credit support arrangements underestimate the time, expense and complexity of such negotiations.</u>

The Commission's proposed rules would require that trade documentation include specified "credit support arrangements" that must be negotiated before and entered into contemporaneously with any trade.[16] Such credit support arrangements would include initial and variation margin requirements, acceptable types of assets to be used as margin, asset valuation haircuts, terms restricting the investment and rehypothecation of assets used as margin for uncleared swaps, and custodial arrangement for margin assets, including, if applicable, the segregation of those assets with an independent third party.[17] We agree that, to the extent such requirements are to be part of a trade, they should be agreed concurrently with the execution of the swap. We are concerned, however, that the Commission has significantly underestimated the time and intensity of effort that will be necessary to accommodate these types of changes and to establish appropriate custodial arrangements on terms acceptable to all parties.

In particular, tri-party custodial arrangements are not yet common in the swap markets. Although there is, as the Commission knows, significant interest among some parties in such a development, we believe it is going to take time for custodians to come up to speed, for market standard terms to develop and for market participants to agree on custody agreements with respect to collateral and the mechanics relating to the posting and return of collateral for such arrangements. Negotiation of credit support arrangements can be complex, time consuming and contentious. We encourage the Commission to consider these issues in setting an implementation deadline for this requirement, and as noted above, to avoid making it retroactive to existing agreements.

4. <u>The proposed auditing rules are overly prescriptive and a deviation from the Commission's long-time policy of establishing principles-based requirements.</u>

Proposed Section 23.504(c) would require that each swap dealer or major swap participant conduct an "independent internal or external audit" of no less than 5% of swap trading documentation to ensure compliance with the new requirements. The specificity of this requirement is not in any way tailored to the applicable entities or the number or type of swap agreements they enter into in any year, potentially leading to unnecessary costs. Moreover, the core principles that will apply to these entities, including the maintenance of a robust compliance program, should make this sort of prescriptive requirement unnecessary. We believe that any type of documentation audit

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[16] *See Proposed Rule* §23.504(b)(3).
[17] *Id.*

should be, at most, an aspect for consideration by the affected entity in establishing its compliance program and internal controls, and that the scope and substance of such review should be left to such entity's reasonable discretion.

5. Swap dealers and major swap participants should not have responsibility for confirming the availability of the end-user exception for their counterparties.

Proposed Section 23.505 would require swap dealers and major swap participants entering into transactions with parties who are relying on the end-user exception to "obtain documentation sufficient to provide a reasonable basis on which to believe" that the counterparty meets the end-user exception. We do not believe swap dealers and major swap participants should be placed in a position of policing the use of the end-user exemption by their customers, especially to the extent a critical aspect of the exemption is the *purpose* of the swap, which is going to be particularly within the knowledge of the entity claiming the exemption. Further, we do not believe a swap dealer or major swap participant should be subject to liability or regulatory consequences if an entity inappropriately claims the exemption. And we are not sure what documentation would be "sufficient" to provide such a reasonable basis.

At the same time, we understand that the Commission will not want swap dealers and major swap participants to facilitate the use of the end-user exemption by entities that are obviously not commercial end-users. An alternative would be to require a swap dealer or major swap participant to obtain a representation from its counterparty that the counterparty satisfies the conditions of the end-user exemption, with a further condition that the swap dealer or major swap participant have no actual knowledge that the representation was false at the time it was made. *We request that the Commission either consider such an alternative or remove the requirement entirely.*

6. The Commission should not require market participants to consent to the application of statutory provisions

Proposed Section 23.504(b)(5) would require any swap trading documentation executed with either a swap dealer or a major swap participant to include a provision agreeing on the rights and restrictions that would apply in the event a counterparty becomes subject to FDIC receivership under the orderly liquidation authority ("OLA") provisions of the Dodd-Frank Act or existing provisions of the Federal Deposit Insurance Act.[18] We do not believe this is appropriate. To the extent the statutory provisions apply, they will apply whether or not there are contractual consents to such provisions. And if the statutory provisions do not apply, including as a result of Congressional action, it is inappropriate to require contract parties to commit themselves contractually to such obligations or surrender rights that they would otherwise have had.

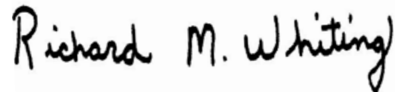
The Commission indicates that it is taking this approach in part to ensure that parties are aware of the possible effects of the OLA provisions on their contractual rights. Such awareness can be achieved by providing notice to the parties rather than by

[18] *See* 76 FR 6715.

requiring specific contractual provisions. The proposed rule would require that documentation include a consent provision which would allow the FDIC to transfer a qualified financial contract from the party subject to receivership to a third party pursuant to the terms of the OLA provisions in the Dodd-Frank Act. While these powers are generally delegated to the FDIC in the Dodd-Frank Act, the Act contains no requirement that swap parties contractually agree to specific terms and conditions for application of OLA. Such a contractual agreement would limit or foreclose a counterparty from challenging the FDIC's application of its OLA powers so long as the FDIC actions complied with the pre-authorized consent in the swap documentation. Absent a clear indication that Congress intended for parties to bind themselves to specific OLA provisions, the application of such provisions is best left to the FDIC at the time it is executing its authority.

We appreciate the opportunity to express our views on these extremely complex issues. We are confident that the Commission will adequately address the areas of specific concern that the Roundtable has addressed above. If you have any questions about this letter, or any of the issues raised by our comments, please do not hesitate to call me or Brad Ipema, the Roundtable's Senior Regulatory Counsel, at (202) 589-2424.

Sincerely,



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