June 3, 2011

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

Re: Reopening and Extension of Comment Periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on matters identified in the above-captioned reopening and extension of comment periods relating to certain proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), promulgated pursuant to or in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Introduction

The CFTC was wise to reopen and extend the comment periods relating to the Proposed Rules for several reasons. As stated by the CFTC, it allows the public to comment on the Proposed Rules as a "substantially complete mosaic."

Reopening also draws attention to the many relationships among the Proposed Rules. Better Markets reviewed and commented on individual Proposed Rules as they were promulgated. But, it was only when the process was completed and we viewed the Proposed Rules as a whole that we appreciated the true quality of the work completed by the Commissioners and staff. The challenge of responding to the many requirements of the Dodd-Frank Act was daunting. To have created an intricately balanced and inter-related *system* of regulation, which the Proposed Rules represent, is a tremendous service to the American people, for which we all should be grateful.

[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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This letter will address the following topics:

- Analysis of the costs and benefits of the Proposed Rules.
- General principles which intersect the Proposed Rules.
- Implementation sequence for the Proposed Rules.

The Costs and Benefits of Avoiding Another Financial Crisis Must Be Considered

In the notice of the reopening and extension of comment periods, the CFTC sought comments on the costs and benefits related to the Proposed Rules.[2] The Commodities Exchange Act ("CEA") requires the CFTC to consider costs and benefits in the promulgation of its rules and sets forth the following considerations:

> The costs and benefits of the proposed Commission action shall be evaluated in light of—
>
> (A) considerations of protection of market participants and the public;
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> (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;
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> (C) considerations of price discovery;
>
> (D) considerations of sound risk management practices; and
>
> (E) other public interest considerations.[3]

The only reasonable way to consider costs and benefits of the Proposed Rules is to view them as a whole. Title VII of the Dodd-Frank Act was debated and enacted as a coherent and inter-related structure *to achieve the very goals that are listed above* as considerations. Title VIII authorizes regulations which are, by definition, consistent with the cost/benefit considerations set out in the CEA.

The Proposed Rules reflect the structural integrity of the Dodd-Frank Act. Rather than comparing the Proposed Rules to a mosaic as the CFTC staff and Commissioners have done, it may be better to describe them as components of a finely-crafted timepiece. Their true value derives from how well they work together in concert, like the springs and wheels of a fine watch. Any effort to assess the costs and benefits of any single Proposed Rule, or worse, an element of such Proposed Rule, is woefully inadequate if it does not reference the integrated regulatory system.

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[2] 76 FR 25724 at page 25725.
[3] CEA, Section 19(a).

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In terms of benefits, it is a classic case of the whole far exceeding the sum of the parts. This is such an extreme case that the only sensible way to think about benefit is to think of each Proposed Rule as representing an undivided share of the benefit of the entire Dodd-Frank Act regulatory system.

And what is the size of this benefit? Quantification starts with the purpose of the Dodd-Frank Act, as stated succinctly by Congress:

> *To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.*[4]

In historic context, the purpose of financial reform is to avoid a repeat of the collapse suffered by the worldwide financial markets in 2008. The benefit is therefore measured by the cost of such a collapse.

The best measure of that benefit is the cost of the 2008 financial crisis, which is, to this day, still accumulating. While the numbers are so large that they defy comprehension, they have been estimated by a number of respected, independent experts. For example, a little over one year ago, Andrew G. Haldane, Executive Director, Financial Stability of the Bank of England estimated that the worldwide cost of the crisis in terms of lost output was between $60 trillion and $200 trillion, depending primarily on the long term persistence of the effects.[5] While one could debate the probability of another crisis and when and how it might precisely occur, the benefit of avoiding such an event is indisputably enormous.

Therefore, when properly viewing benefits vs. costs of the Proposed Rules as a whole, the benefit **must include the avoided risk of a new financial crisis which would likely have costs of tens of trillions of dollars to our broader economy.**[6]

But even this analysis understates the potential benefit. In the long run, the financial sector will ultimately profit from greater transparency and strengthened credit quality of its participants. It is not surprising that financial market participants are unwilling to countenance this benefit. Like the energy and industrial sector of the early 1970s when faced with environmental regulation, financial companies are bound to focus only on costs which affect only their profit potential and often only in the current accounting cycle. But there is little question that the illustrative energy and industrial companies soon achieved higher profits from the efficiencies and modernization required by environmental regulation.[7]

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[4] Dodd-Frank Act, Preamble.

[5] See: http://www.bankofengland.co.uk/publications/speeches/2010/speech433.pdf.

[6] See also, www.bettermarkets.com for a discussion of the costs of the crisis.

[7] Michael Porter and Class van der Linde, "Green and Competitive: Ending the Stalemate," Harvard Business Review (1995).

Similarly, the financial sector will in the not-to-distant future benefit from the "financial stability" and improved "accountability and transparency in the financial system" which is the purpose of the Dodd-Frank Act and the Proposed Rules. In our system, obtaining the long term benefit of a prudent financial system is in the responsibility of lawmakers and regulators, not corporate and finance executives who have responsibility for individual companies and their profitability.

Likewise, focusing only on the cost of individual Proposed Rules is misleading, wrong and inconsistent with the statutory mandate. As made clear in the Dodd-Frank Act, it is undeniable that the Proposed Rules are intended and designed to work as a system. Costing-out individual components of the Proposed Rules inevitably double counts costs which are applicable to multiple individual rules. It also prevents the consideration of the full range of benefits that arise from the system as a whole that provides for greater stability, reduces systemic risk and protects taxpayers and the public treasury from future bailouts.

Such a constricted and misguided approach also fails to consider offsetting operational efficiencies deriving from a common system. For example, several elements of the system envisioned by the Proposed Rules require transaction data to be recorded using uniform codes and procedures, which will then allow for meaningful data sets (e.g., use of futures equivalent price groups). In implementing the entire system, these costs must be incurred only once. But when individual rules are evaluated in isolation, the cost appears to be incurred in connection with each rule.

The practical truth is clear from the statements of industry representatives -the actual cost of implementation is imminently manageable. The infrastructure that is required is neither unprecedented nor difficult to construct. In many cases it has already been constructed by industry participants for their own internal accounting and compliance. The reality is that industry participants are far more concerned about achieving near term clarity from finalization of the Proposed Rules so they can avoid wasteful duplication and start-and-stop implementation programs, than about the basic costs themselves.[8]

For example, the following remarks from the implementation roundtable are instructive:

> It's not about the money, because I think all of us here would spend as much money as necessary to get things done. It's a question of clarity of regulation and well thought out regulation. The last thing anybody would want would be to have to change something, for it to work very, very badly, and have to change it again. So it's well thought out -- obviously,

[8] Joint CFTC-SEC Roundtable on Implementation Phasing for Final Rules for Swaps and Security-Based Swaps under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, May 2, 2011, Transcript ("Implementation Roundtable Transcript"), Day One, page 110, line 2 through page 116, line 2.

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> very well thought out regulation and clarity is what we're all after right now.[9]

Viewed in this light, the broad economic benefits of the Proposed Rules (i.e., avoiding the trillions in costs of another financial collapse) will, without question, dwarf the near-term costs of industry implementation – as distinguished from the near-hysterical claims made by self-interested industry participants.

While this analysis leads to the inevitable conclusion that benefits of the Proposed Rules far exceed costs, it does not mean that the CFTC should promulgate rules which require processes and procedures which unjustifiably burden financial market participants when there are superior alternatives available. These issues can and have been fully explored and debated in voluminous comment letters and countless hours of roundtables and meetings between industry participants, experts and interest groups and CFTC staff and Commissioners.

Industry has spared no expense or effort in making sure that their views are heard at every step along the way of the regulatory process. From the highest to the lowest levels at every agency and department, industry has pressed their case over and over again.

There is simply no basis for any claim that all these efforts weren't heard and taken into account throughout the process, including in connection with the cost-benefit analysis. The result simply means that the Proposed Rules are indisputably justified by the cost/benefit analysis required by the CEA. In truth, the cost/benefit discussion is a distraction from the real work of determining how to achieve the best implementation of the Dodd Frank Act as possible. It is in the interest of the industry and the public to move on from distractions which divert scarce resources from the important tasks assigned to the CFTC.

General Principles which Intersect Proposed Rules

There are several general principles which apply to multiple, intersecting Proposed Rules. In the comment letters submitted by Better Markets, we endeavored to assert these principles consistently. This section identifies certain important principles and describes their applicability to individual Proposed Rules in light of comments received from the public in comment letters and at roundtables.

[9] Implementation Roundtable Transcript, Day One, page 112, Remarks of Ronald Levi, GFI Group

Conflicts of Interest

In the Better Markets comment letter relating to the Proposed Rules on conflicts of interest in derivatives clearing organizations ("DCOs"), designated contract markets ("DCMs") and swap execution facilities ("SEFS"), we chronicled the history and current condition of derivatives markets in relationship to the extraordinary influence of a few dealer banks on market infrastructure providers.[10] These infrastructure providers depend on volume for revenues. **With derivatives trading concentrated among a very small number of dealer banks, infrastructure providers are highly susceptible to influence and control exercised by large dealers**. These observations were reiterated in the Better Markets comment letter related to swap data repositories ("SDRs").[11] (The systems provided by DCOs, DCMs, SEFs and SDRs are sometimes referred to herein as "market infrastructure.")

This pervasive direct and indirect structural influence entrenched an anti-competitive oligopoly prior to enactment of the Dodd-Frank Act. However, in the post-crisis environment, which combines even greater concentration of market power and legally mandated clearing, execution and data reporting, such structural advantages and conflicts of interest simply cannot be tolerated.

The danger of such conflicting interests is underscored by the new reliance on market infrastructure providers for the security and stability of the marketplace. As a result, certain principles must be applied consistently to assure the statutorily mandated transparent, competitive and fair marketplace for derivatives:

- Ownership by dealers and major market participants must be limited even more than it is under the Proposed Rules.

- Requirements for independent membership on boards of directors and key committees (risk management, for DCOs, and membership, for DCMs and SEFs) must be greater.

- Access to information and trade execution must be even-handed. Preferential access parallels disproportionate influence, as participants which control volume bargain for access and receive influence in return.

- Fee rebates, discounts and revenue and profit shares, which are substantively the same as preferential access, must be prohibited. These practices simply

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[10] Better Markets Comment Letter, Conflicts of Interest Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities (CFTC RIN 3038-AD01), November 17, 2010; see also Better Markets Comment Letter, Core Principles and Other Requirements for Swap Execution Facilities (CFTC RIN 3038-AD18), March 8, 2011. All of the comment letters filed by Better Markets referenced in this footnote and in any other place in this comment letter are, individually and collectively, fully incorporated by reference as if fully set forth herein.

[11] Better Markets Comment Letter, Swap Data Repositories (CFTC RIN 3038-AD20), February 22, 2011.

transfer costs to less influential participants who must follow the lead of the large liquidity providers.

- The process for review of swaps for mandatory clearing by DCOs must be open to input from and scrutiny by regulators, customers and the public.[12]

- Incentives of futures commission merchants, introducing brokers, SEFS, swap dealers ("SDs") and major swap participants ("MSPs") received in exchange for use of various market infrastructures must be fully disclosed.[13]

These practices might pose less of a concern regarding conflicts of interest in other contexts; but in the relatively small, highly concentrated and often illiquid derivatives markets they cannot be permitted if transparency, stability and fairness are to be achieved. Indeed, such long-standing practices have killed competition for years in the existing markets and will do so again in the new markets unless they are expressly prohibited, limited and aggressively policed.

High Frequency and Algorithmic Trading

Similarly, derivatives markets are a high risk environment for high-frequency and algorithmic trading ("HFT") practices. The Dodd-Frank Act rulemaking process provides a useful opportunity for the CFTC to get ahead of the continuing "innovation" by traders, which has already overwhelmed regulators in the equity markets.

The primary purposes of the derivatives markets are to accommodate hedging of risk by businesses and to provide price discovery. Hedgers undoubtedly need market liquidity to achieve these goals. It has been shown that HFT generates volume, which benefits market infrastructure providers through higher fees; but HFT does not reliably generate liquidity for market participants.[14] In addition, many widely used tactics of HFTs are specifically designed to influence pricing decisions by providing false signals of market price levels and depth.[15] As a result, the CFTC must take an expressly restrictive approach to HFT:

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[12] Better Markets Comment Letter, Process for Review of Swaps for Mandatory Clearing, (CFTC RIN 3038-AD00), January 3I, 2011.

[13] Better Markets Comment Letter, Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers (CFTC RIN 3038-AC96), January 18, 2011; Better Markets Comment Letter, Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants (CFTC RIN 3038-AC96), January 24, 2011.

[14] Kirilenko, Andrei A., Kyle, Albert S., Samadi, Mehrdad and Tuzun, Tugkan, The Flash Crash: The Impact of High Frequency Trading on an Electronic Market (May 26, 2011). Available at SSRN: http://ssrn.com/abstract=1686004 – which describes how, in conditions of market stress, HFT exacerbates volatility.

[15] Better Markets Comment Letter, Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (CFTC RIN 3038-AD26), January 3, 2011; Better Markets Comment Letter, Proposed Interpretive Order – Antidisruptive Practices (76 FR 1493), May 17, 2011.

- Certain practices, in particular placement of large numbers of orders which are mostly to be canceled, must be prohibited or restricted as inherently disruptive by imposing minimum time limits before cancellation of orders or trading out of positions.

- Such HFT practices must be included within the scope of "abusive practices" which are prohibited by DCMs and SEFs, or alternatively included within the meaning of "fraudulent trading" which is required to be so prohibited.[16]

- Requirements on DCMs and SEFs with respect to the capability of market monitoring and risk systems must be geared to the demands of the technologically-enabled trading which they support.[17]

Congruence

Several of the Proposed Rules focus on the relationship between swaps and risks of a given counterparty which are offset by such swaps, i.e., hedges. The statutory end-user exception requires that swaps subject to the exception must "hedge or mitigate commercial risk."[18] The definition of "major swap participant" uses substantially the same concept.[19]

The Dodd-Frank Act and the Proposed Rules confer specific, but narrow, benefits on swaps which are qualifying hedges. Failure to qualify does not mean that the swap cannot be entered into; it merely means that the counterparty does not receive the special benefit. As a result, the Proposed Rules must establish proper standards which are narrow and clearly within the meaning of the statutory provisions.

These Proposed Rules address the issue of swaps which hedge a defined commercial risk. If the product, term, quantity and price referenced in the swap and the commercial risk are precisely the same, it is clear that the swap is a hedge for the commercial risk. However, it is common to offset a defined commercial risk with a swap that is not precisely the same. The Proposed Rules use a standard of "economically appropriate" to describe a swap which hedges a risk.

Better Markets advocates a different standard: "congruence."[20] This market-based principle is what industry participants do as a routine matter: subdivide (or some say

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[16] Better Markets Comment Letter, Core Principles and Other Requirements for Designated Contract Markets (CFTC RIN 3038-AD09), February 22, 2011; Better Markets Comment Letter, Core Principles and Other Requirements for Swap Execution Facilities (CFTC RIN 3038-AD18), March 8, 2011.

[17] Better Markets Comment Letter, Core Principles and other Requirements for Designated Contract Markets, (CFTC RIN 3038-AD09), February 22, 2011; Better Markets Comment Letter, Core Principles and Other Requirements for Swap Execution Facilities, (CFTC RIN 3038-AD18), March 8, 2011.

[18] Notice of Proposed Rulemaking, End-user Exception to Mandatory Clearing of Swaps, 75 FR 80747.

[19] Notice of Proposed Rulemaking, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 FR 80174.

[20] Better Markets Comment Letter, End-user Exception to Mandatory Clearing of Swaps, (CFTC RIN 3038-AD10), February 22, 2011; Better Markets Comment Letter, Further Definition of "Swap Dealer," "Security-

disaggregate) their commercial risks as to time and scope and then hedge the subdivided parts. Swaps that are, in fact, hedges must be congruent (an exact match) with a subdivision of the commercial risk to be an actual hedge that qualifies under the law and the Proposed Rules. If a swap is not congruent, it exposes the claimant to speculative risks which are beyond the offsetting commercial risk. This is expressly impermissible under the law.

For example, an end-user may be exposed to the price of natural gas delivered at the Houston Ship Channel over the next six weeks. In the market, that price is always equal to the Henry Hub natural gas price plus a basis amount reflecting incremental transmission. If the end-user enters into a swap on Henry Hub prices for months 4-6, it is congruent with a subdivision of the commercial risk. If, instead, the swap is for natural gas delivered in north Texas for months 5-7, it is not a congruent hedge. The north Texas prices are generally correlated to Houston Ship Channel, but not the same because they reflect further transmission; and month 5-7 gas prices are correlated as well, but different because month 7 is not in the risk set represented by the commercial risk. The end-user would be exposed to the basis risk between Houston Ship Channel and north Texas and the temporal basis risk of the seventh month vs. the fourth month, in effect speculating on those risks.

That is why a congruence standard rather than an economically appropriate standard better fits the statutory requirement.

End-User Exception Reporting Requirements

The end-user exception to the clearing mandate applies on a "swap-by-swap" basis. A swap must have certain characteristics, and the claimant must take certain steps with respect to such swap, if the swap is to be exempted from the clearing mandate. Specifically, a swap is subject to the exception if the counterparty claiming the exception:

(i) is not a financial entity;

(ii) is using swaps to hedge or mitigate commercial risk; and

(iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into noncleared swaps.[21]

Actual potential end-users have expressed a legitimate concern about the need to report and keep track of significant information with respect to each individual swap they enter into under the exception. Their stated preference is a "check the box" system in which individual swaps can relate to a single filing through a reference code included in the

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Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (CFTC RIN 3038-AD06), February 22, 2011.

[21] Dodd-Frank Act, Section 723.

individual swap data transmission to the SDR of which reaffirms matters in the referenced filing.[22]

At the same time, 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 exemption is claimed, including how the claimant meets the requirements for the exception.[23]

These two Proposed Rules, if they are implemented in concert, provide an excellent way for end-users to document their claim to the exception using a "check-the-box" process which allows both easy and reliable compliance.

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

Tracking the claim to the exemption 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. The SDR will maintain a series of spreadsheets for each end-user, each representing individual commercial risks and bearing a unique code.

Every swap entered into for which exemption is claimed, including quantity in the corresponding units, and swap identifier code, must be recorded in cells of the spreadsheet identified to that risk. The check-the-box system will be implemented by a data field provided by the SDR which simply references the claimant's hedging program to which the swap relates, thereby tying the submitted swap data to the correct spreadsheet.

This is not difficult or burdensome and is currently routine business practice. Indeed, as discussed in a recent roundtable, this system is consistent with the ordinary course of business for most actual commercial hedgers today; they customarily establish individual hedging strategies and track execution of the hedges for each risk to be hedged.[24] This, of course, makes sense. How else would a business know if it was actually hedged or hedging the risks it intended to hedge or track the hedges it entered into?

[22] Implementation Roundtable Transcript, Day Two, Pages 220 -221.
[23] Proposed Rules, Swap Data Repositories, Section 49.14, 75 FR at 80930.
[24] Implementation Roundtable Transcript, Day Two, page 219, line 11 through page 232, line 17.

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The following is a 4-month example spreadsheet for 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 #]

Moreover, the discipline of recording a hedging strategy and the hedges by category will, by itself, result in greater compliance. **To the extent that an end-user claimant is not tracking commercial risks against hedges, this will require self-monitoring of 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 then 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, to adjust for basis risk between the hedged risk and the nearest listed equivalents. This framework would likely be of great help in terms of providing regulatory transparency in a consistent manner.

Contrary to baseless assertions by some, including those **not** actual end-users, these procedures would not be burdensome at all and would, at most, require slight administrative changes in labeling or classification.

End-User Exception – Un-margined Credit Exposure

Every bi-lateral swap is, in reality, two separate transactions: it is a derivative on the price of the underlying product or security and it is a credit transaction based on counterparty credit exposures to price moves. If the credit exposure is margined using reliable procedures and secure collateral, then the exposure is minimal. To the extent it is not so margined, the credit exposure is material, and therefore compensation must be paid to the party incurring the exposure if the transaction reflects true value.

If there were ever any doubt about this, the discussion of this issue in the recent implementation roundtable should put it to rest.[25] **Disclosure relating to the credit half of the swap transaction is essential.**[26] This disclosure intersects several Proposed Rules:

- The information provided to SDRs by claimants of the end-user exception relating to meeting financial obligations, as discussed above, must address the claimant's ability to fund calls for immediate margin funding if credit triggers are tripped.

- Documentation of swaps with end-users must clearly specify the terms and the costs associated with the credit extended under the swap.[27]

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[25] Implementation Roundtable Transcript, First Day, pages 190, line 4 through page 193, line 11.

[26] Better Markets Comment Letter, End-user Exception to Mandatory Clearing of Swaps, (CFTC RIN 3038-AD10), February 22, 2011.

[27] Better Markets Comment Letter, Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, (CFTC RIN 3038-AD96), April 11, 2011.

- Business conduct standards for SDs and MSPs dealing with customers must properly address disclosure relating to the credit side of the transaction as well as the derivatives side.[28]

Disaggregation: Real Time Data Reporting, End-user Exception, Definition of Agricultural Product and Definition of Major Swap Participant

In the CFTC roundtable on unique identifiers and other topics, one of the industry's representatives described how composite derivatives are broken down into more conventional units or legs for purposes of internal recording and monitoring a market participant's portfolio.[29] His analysis of the need for disaggregation is correct. Often dealers structure derivatives which are composites of straightforward swaps. They may bridge asset classes or be composed of different products within asset classes. Execution in a single transaction is irrelevant, only the component risks matter.

Sometimes composite swaps are characterized as "bespoke" or customized transactions, suggesting impenetrable complexity. **However, the claimed complexity is almost always artificial.** In fact, this so-called "complexity" is purposefully structured and the claim is almost always misleading, too often intentionally so.

Eliminating this seeming complexity requires nothing more than to follow the lead of the industry as discussed by several participants in the roundtable: disaggregation by the reporting entities of composite transactions into legs based on risk, rather than limiting the data by the documented or structured form of the transaction.

The following example may be instructive. Power Plant Owner A enters into a swap with Dealer B to guarantee the difference between the prices of natural gas and power at given delivery points for gas and power serving the plant. It is used by Power Plant Owner A to fix the difference between the cost of fuel expected to be consumed at its plant in eastern Maryland and the electricity output expected to be sold into the grid. Power Plant Owner A expects to consume 329,333 mmbtu of gas and generate 34,667 mwh of electricity for sale. The difference in cost and price guaranteed by the swap is $486,573, which is the fixed amount paid by Dealer B. Plant Owner A will pay the actual difference in prices on the notional quantities.

In reality, the above transaction is nothing more than a combination of the following two swaps:

- A natural gas swap at the delivery point (Tetco M3) for the period with a quantity equal to the quantity of assumed consumption fixing the price at $4.36/mmbtu; and
- A power swap at the delivery point (Pepco) with a quantity equal to the quantity of assumed power sold fixing the price at $55.47/mwh.

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[28] Better Markets Comment Letter, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, (CFTC RIN 3038-AD25), February 22, 2011.

[29] CFTC Roundtable, January 28, 2011. Swap Data Recordkeeping and Reporting, Comments of Adam Litke commencing on Transcript page 187.

The industry participants in the January 28 roundtable hosted by the CFTC indicated that only a tiny percentage of all transactions require recordation beyond the capacity of their trade data capture systems. **This means that a large percentage of the transactions which are claimed to be "complex" or "bespoke" are simply composites of easily understandable derivatives risks handled by disaggregation as described by those industry representatives.**

This, of course, makes sense and is how it must happen: traders deal in derivatives risks and it would be concerning (to say the least) if the individual risks in a given transaction could not be described and measured with some degree of understandability, accuracy and confidence. **Traders combining risks in a single instrument for whatever reasons must not be allowed to obstruct reporting of readily available meaningful information.**

This type of transaction might meet the specific needs of a customer. But why not simply enter into multiple swaps which are each more transparent than the composite transaction? Convenience is one answer, but it is not very persuasive since documentation is almost exclusively electronic.

There are other possibilities. A composite swap obscures the market price of each of the component swap units. It may even allow the dealer and the customer to record the separate composite risks at different prices. It may also simply have the marketing appeal of an apparently clever solution to a seemingly complicated problem.

Regardless of the actual reason(s), **the market data available to the CFTC must be at least as useful and decipherable as the data available to dealers as they measure and monitor their own positions, as they must and do every day for economic, compliance, business and legal reasons.** The reporting entity must assign a market-based price to the components of a composite swap, whether it is mixed (partially within the domain of the SEC's regulation of security-based swaps) or multi-asset (composed of multiple assets classes). Likewise, swaps within asset classes but involving different products or temporal terms must be assigned component prices.

Self-serving claims of complexity or misleading labels for products purposefully aggregated for whatever reason must be disregarded.

To require less ignores reality and incentivizes complex documentation of straightforward and understandable derivatives transactions. This not only frustrates transparency, it encourages obscurity, behind which will be all manner of unseen risks.

The data issues associated with composite swaps intersect many areas covered by the Proposed Rules:

- Disaggregation for purposes of real time reporting means that the data set which SDRs will disseminate will provide far more useful information in terms of both price transparency and market analysis and monitoring.[30]
- Importantly, end-users can claim exemption on the hedges that they enter into because they are not corrupted by other risks embedded in the swaps.[31]
- The volume of swap risk excluded from the calculations underlying the definition of MSP will more accurately reflect the exclusion for commercial hedges.[32]
- Disaggregation will be important for composite agricultural price indexed swaps. In a disaggregated form, individual swaps can be identified as within the definition of "agricultural commodity" in the Proposed Rules.[33]

The importance of this issue goes beyond the meaningfulness of the data set generated pursuant to the Dodd-Frank Act. Bringing transparency to the reported data will eliminate a major incentive for non-standard documentation of standard derivatives transactions. It will eliminate the motive of obscuring the substance of transactions in order to hide risks and costs or mislead customers. **Ultimately, all market participants, *including the swap dealers,* will benefit from eliminating the transient allure of obscuring individual transaction terms.**

Hedge Equivalent Pricing

The mirror image of disaggregation is hedge equivalent pricing. Disaggregation will assure that individual derivatives risks on the books of market participants will be reflected in the data accumulated by SDRs. The practical utility of this data requires that it be grouped in subsets defined by hedge equivalent prices.

Such subsets consist of positions whose prices move in relation to the price of a liquid, listed contract. When this condition exists, the liquid contract is based on a reference price and the market is expressing the view that the other prices in the subset are related so that the reference-priced contract can be used as an imperfect, but more liquid, hedge of the other prices within the set. "Hedge equivalency" is the mathematical relationship, based on market views of correlation, which can be used to adjust the terms

[30] Better Markets Comment Letter, Real Time Reporting of Swap Transaction Data, (CFTC RIN 3038-AD08), February 7, 2011; Better Markets Comment Letter, Swap Data Recordkeeping and Reporting Requirements (CFTC RIN 3038-AD19), February 7, 2011.

[31] Better Markets Comment Letter, End-user Exception to Mandatory Clearing of Swaps, (CFTC RIN 3038-AD10), February 22, 2011.

[32] Better Markets Comment Letter, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (CFTC RIN 3038-AD06), February 22, 2011.

[33] Better Markets Comment Letter, Agricultural Commodity Definition, (CFTC RIN 3038-AD23), November 26, 2010.

(primarily notional quantity) of the reference priced contract to better reflect the economic results of the less liquid position for purposes of hedging.

Use of hedge equivalency is important to understanding the market implication of trade data. Volume and price movement in a reference-priced contract or a less liquid contract in the subset each has implications for the specific contract; but each also has implications for prices in the entire subset.

Hedge equivalency intersects a number of Proposed Rules and other CFTC regulations.

- **One important application is in the companion proposed rules relating to large dealer physical swap data reporting and position limits.** While these rules are not included in the Proposed Rules, the concept intersects with Proposed Rules as described below. In such proposed rules, positions are to be calculated based on "paired swaps," which focus on futures equivalents. As Better Markets points out in its related comment letters, the direction adopted by the CFTC is commendable, but the application of the principle must be more in line with market realities without over-reliance on characteristics of physical delivery.[34]
- SDRs are responsible for collection and dissemination of trade data. **This requirement will only be meaningful if the data disseminated to the public and to regulators is in a form that can be useful.** Systems which employ the concept of hedge equivalency are essential and incorporation of this by SDRs must be required by CFTC rules.[35]
- Hedge equivalency directly parallels the systems implicitly used by DCOs to allow netting credits for initial margin in differing, but price-related contracts. While this practice has traditionally been obscure and, at times, apparently arbitrary, the Proposed Rules bring some transparency, but more is required. **Since these price relationships are commonly understood in the marketplace, similar transparency is the least that should be required of DCOs.[36]**
- The concepts directly parallel "linked contracts" relating to regulation of foreign boards of trade, and should be applied consistently. **It is fundamental that the positions in a hedge equivalent subset interact with each other,** and a contract within such a price-related subset which is offered by a foreign board of

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34 Better Markets Comment Letter, Position Reports for Physical Commodity Swaps, (CFTC RIN 3038-AD17), December 2, 2010; Better Markets Comment Letter, Position Limits for Derivatives (CFTC RIN 3038-AD15 and 3038 AD-16), March 28, 2011.

35 Better Markets Comment Letter, Swap Data Repositories, (CFTC RIN 3038-AD20), February 22, 2011.

36 Better Markets Comment Letter, Risk Management Requirements for Derivatives Clearing Organizations, (CFTC RIN 3038-AC98), March 21, 2011.

trade can have wide ranging implications.[37] The Proposed Rules must recognize these relationships.

SEF Definition and Real-Time Reporting of Swap Transaction Data

A substantial portion of the Proposed Rules which implement the real-time data dissemination requirement of the Dodd-Frank Act addresses block trades.[38] The Proposed Rules allow for delayed dissemination because block trades are used to introduce large positions into the market. Immediate market knowledge could affect prices because of their size. The Proposed Rules adopt a methodology to establish standards defining block trades, taking into consideration the characteristics of the market in question.

This block trade rule intersects with the definition of swap execution facility, although the definition does not reflect that fact. The definition of SEF permits the use of systems which employ requests for quotes ("RFQs").[39] This means that execution of a swap via an RFQ system will meet the standards established in the Dodd-Frank Act for mandated, transparent trade execution for all swaps subject to the mandatory clearing requirement.

In the SEF Proposed Rules, it is clear that the justification for allowing RFQs qualifying execution methods is twofold:

- They aid in the execution of block trades.
- They are useful for matching swap counterparties for illiquid products.

The usefulness of RFQs for block trades is apparent. This use is consistent with the Dodd-Frank Act which explicitly requires separate analysis of the requirement for real-time reporting of block trade data and the transparency that would result.

The SEF definition derives from the types of matching systems that may be used to fulfill the Dodd-Frank Act execution requirement for mandatorily cleared swaps. SEFs are defined as entities which provide qualifying matching systems.

With this in mind, the illiquid product justification for RFQs makes little sense. Swaps which will be subject to mandatory clearing are, by definition, reasonably liquid; otherwise the DCO could not measure risk to set initial margin. By permitting RFQ-based matching beyond block trades, the Proposed Rules are simply enabling a process which is best described as an electronic negotiation device for mandatorily cleared swaps. There is simply no way that this could be understood as satisfying the transparent execution standard required by the Dodd-Frank Act.

The real time reporting and SEF definition Proposed Rules must be linked. RFQs must only be permitted as a qualifying execution method for transactions which qualify for

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[37] Better Markets Comment Letter, Registration of Foreign Boards of Trade, (CFTC RIN 3038-AD19), January 18, 2011.
[38] Proposed Rules, Real Time Reporting of Swap Transaction Data, 75 FR 76140.
[39] Proposed Rules, Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214.

delayed dissemination of trade data. This logical intersection must be reflected in the final rules.

Definition of Major Swap Participant

The definition of "major swap participant" intersects with a large number of the Proposed Rules. The definition of MSP must be adequate to the statutory purpose for the concept itself. This means that the definition must be informed by the ways the concept of MSP is applied in the Dodd-Frank Act and in the Proposed Rules.

The Proposed Rules definition interprets the statutory standard of "substantial positions" in terms of credit exposure.[40] Thresholds are established for inward exposure (credit exposure of the potential MSP to other market participants) and outward exposure (credit exposure of market participants to the MSP). If credit exposures are sufficiently large as calculated in accordance with the Proposed Rules, a market participant holds "substantial positions" and constitutes an MSP.

This approach would be adequate if the concept of MSP were relevant under the Dodd-Frank Act and the Proposed Rules only to matters in which credit risks posed by (outward exposure) and to (inward exposure) an MSP were at issue. However, this is simply not accurate. MSP are subject to restrictions with respect to which credit exposure is irrelevant, such as business conduct standards. The level of credit exposure associated with a market participant has nothing to do with the question whether they should be subject to business conduct standards.

As a result, the Proposed Rules must include a threshold of aggregate market presence in term of the size of positions maintained, *without regard to the uncollateralized risk associated with those positions.* This must function as a separate and parallel standard to the risk-based standards in the Proposed Rules.[41]

Sequencing of Effective Dates of Rules

In recent weeks, much has been made of determining ways to phase in and sequence implementation of the Proposed Rules. This was the subject of a two-day series of roundtables jointly sponsored by the CFTC and the SEC. Representatives of DCOs and probable SDs, MSPs, SEFs and SDRs joined other interested parties on the various panels. Several general points were made:

- Each category of financial market utility, DCOs, SEFs and SDRs, seemed to believe that they should be first in sequence.

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[40] Proposed Rules, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 FR 80174.

[41] Better Markets Comment Letter, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (CFTC RIN 3038-AD06), February 22, 2011. To repeat, all of the comment letters filed by Better Markets referenced in this footnote and in any other place in this comment letter are, individually and collectively, fully incorporated by reference as if fully set forth herein.

- Potential SDs and MSPs and their customers were primarily concerned about customer documentation requirements and connectivity.

- There is substantial precedent in terms of software and hardware for each element of market infrastructure required under the Proposed Rules.[42] Connectivity among these elements is conceptually straightforward. A series of APIs will be established so that one infrastructure provider (for example a SEF) can "write" to another (in this case an SDR or a DCO) so that data can be translated into a format usable by the market infrastructure provider which is an aggregator of trade data.[43]

It is notable that industry participants, who have often advocated against proscriptive rules, seem to seek intervention by regulators on the issue of phasing and sequencing. This strongly suggests that regulators and the public should be skeptical of the claimed concern about phasing. While it might appear to be rational on the surface, it more likely seems to be based on a simple desire for delaying implementation to buy time for industry to secure changes to the law and regulation through means of influence.

Support for the "skeptical" interpretation emerged from the roundtable. Much was made of complex plans for phasing without a balanced discussion of the need to phase in the first place.[44] Panel members raised concerns which simply ignored (or were ignorant of) the substantive requirements of the Proposed Rules which build in phased implementation.[45]

Several important conclusions can be drawn from market participant's comments at the roundtable.

- **The most important thing regulators can do is to provide a clear date for implementation.** Market participants will work toward that date and can generally achieve it.[46] If issues arise which impair their ability to comply, these can be dealt with on a case-by-case basis.

- A key factor for DCOs is clarity on the issue of segregation of margin accounts.[47] This will have a structural effect on DCOs and clearing, so clarity is essential.

- The business model for SEFs depends on the rapid confirmation that a swap has been accepted for clearing to provide reliable execution. This is in the context of the open access requirements of the Proposed Rules requiring DCOs to

[42] See, for example, Implementation Roundtable Transcript, First Day, page 52, lines 3 through 13.
[43] See, for example, Implementation Roundtable Transcript, First Day, pages 132, line 9 through page 133, line 14.
[44] See, for example, Implementation Roundtable Transcript, First Day, pages 167, line 9 through page 168, line 9.
[45] See, for example, Implementation Roundtable Transcript, First Day, pages 52, line 14 through page 54, line 20.
[46] See, for example, Implementation Roundtable Transcript, First Day, pages 50, line 10 through page 51, line 18.
[47] See, for example, Implementation Roundtable Transcript, First Day, pages 79, line 3 through page 81, line 10.

accommodate multiple SEFs. This is not a technological issue. It is a question of which side – SEF or DCO – is going to bear the risk of failed clearing of a swap that has been executed.[48] Clarity on this point is critical.

Aside from the need for clarity just stated in two isolated cases, implementation under the Proposed Rules as written should proceed smoothly. In fact, "phasing" is already built into the system:

- It should be remembered that the clearing mandate requires that a DCO initiate a process for determination that a contract will be mandatorily cleared. DCOs will use this to phase in at a pace they consider prudent.

- The clearing mandate requires that the swap be "available for trading." This similarly allows SEFs to phase in the clearing mandate at their desired pace.

The critical issue, apart from the clarification points discussed above, relates to the form of the data to be collected and disseminated by the SDRs. This process can range from simple trade data to more meaningful, but complex formats for dissemination, monitoring and analysis. Simpler formats can be put in place to facilitate implementation of the Proposed Rules once protocols for unique identifiers of counterparties, products and transaction type are developed. It is clear that this would be a sensible first phase.

However, because of limited resources, the CFTC may well be heavily reliant on the SDRs for meaningful dissemination of trade data and the analytical process for monitoring and evaluating the markets. *It is absolutely critical that the CFTC makes clear the subsequent requirements for SDR performance of duties to manage the accumulated data.*

Finally, the need for SDs and MSPs to document relationships with customers is a real concern because of the sheer number of customers. However, the roundtable discussion makes it clear that the vast majority of trading volume derives from a very small percentage of customers.[49] If this is confirmed as a legitimate constraining factor, some phasing in of large customers should be considered by the CFTC. If implementation of the Proposed Rules for 98 percent of the market can be achieved, the remaining 2 percent should not impede timely implementation.

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[48] See, for example, Implementation Roundtable Transcript, First Day, pages 37, line 22 through page 39, line 20.

[49] See, for example, Implementation Roundtable Transcript, First Day, pages 195, line 14 through page 197, line 21.

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Conclusion

Timely implementation of the Proposed Rules is a critical matter. The cost of doing otherwise is simply too great for the world to bear and the benefit is too great for any delay to be justified. The Proposed Rules, with the inclusion of the change proposed above, greatly add to the protection of the public from the extraordinary risks posed by derivatives markets.

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

Sincerely,

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