



May 27, 2014

Ms. Melissa D. Jurgens  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21st Street, N.W.  
Washington DC 20581

Re: Review of Swap Data Recordkeeping and Reporting Requirements (RIN 3038-AE12)

Dear Ms. Jurgens:

Better Markets Inc.<sup>1</sup> appreciates the opportunity to comment on the above-captioned request for comment on the Swap Data Recordkeeping and Reporting Requirements (“Proposed Rules”), issued by the Commodity Futures Trading Commission (“CFTC” or “Commission”).

## **INTRODUCTION**

The financial markets are founded on information: who owes what to whom, when, how much, and under what circumstances. However, during the financial crisis, the terrible truth became apparent to all: market information largely consisted of a hopelessly tangled web of incomplete data recorded in dozens of places and languages. The lack of transparency and understanding of the vast network of swap exposures both led to and exacerbated the global financial crisis.

In an attempt to remedy this untenable situation, the Dodd-Frank Act mandated the creation of an important new element of the infrastructure of derivatives markets: the Swap Data Repository (“SDR”). By collectively warehousing data encompassing the entire universe of cleared and uncleared swaps, SDRs perform an essential role in creating and maintaining the transparent and fair marketplace envisioned by financial reform.

In its rulemakings to date, the CFTC has done an admirable job of requiring that swap transactions be appropriately documented. In particular, clarity regarding issues such as rehypothecation and segregation of margin assets, swap valuation methodologies, and documentation of swap qualifications for the end-user clearing exception provide much needed certainty in the swaps markets. The sheer size and complexity of these markets, however, continue to present new and unforeseen reporting issues that will

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<sup>1</sup> 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.

require ongoing regulatory efforts to ensure the new universe of swaps data is clean, accurate, and usable.

The Proposed Rules are a comprehensive set of guidelines and standards for SDRs. Below, we have provided detailed comments on certain provisions.

## **SUMMARY OF COMMENTS**

While the Proposed Rules dictate many of the swap data recordkeeping requirements, additional areas of focus have come to light, and indeed will likely continue to do so, as the regulatory reporting regime is implemented across markets. Generally, the most urgent outstanding concerns fall into several broad categories.

### *Bespoke Trades*

Many esoteric derivatives and derivatives based on infrequently traded components are entered into because of the precision with which they can match the risk profile of the counterparty. This serves the interest of the dealer because the counterparty can be charged a premium for a customized instrument and there are few, if any, comparable prices available to the customer. Additionally, when those contracts are unwound with a dealer in the future, the dealer knows precisely the counterparty positioning. This often means higher costs for counterparty customers, and in times of market stress (when such unwinding often takes place) these costs can quickly balloon.

Aside from concerns about the appropriateness of such derivatives recommendations, the practice of configuring several standard derivative products into a non-standard structured swap frustrates efforts to streamline, oversee, or aggregate derivative risks in any meaningful way. In order for the data reported to SDRs to be truly useful, it must be simplified and organized according to standard equivalents to the greatest extent possible.

**The market data reported to SDRs must be at least as useful and decipherable as the data available to dealers as they measure and monitor their own positions, as they do every day for economic, compliance, business, and legal reasons.**

### *Valuation Information*

Valuation information for each transaction should be reported to SDRs for all transactions, but in particular for uncleared transactions that lack the robust matching services otherwise provided by the clearing intermediary. Swap valuations are determined by a variety of complex variables, where small divergences in underlying curve shapes or other pricing conventions can lead to large discrepancies in valuations.

A centralized entity containing valuation information from both counterparties is able to provide the unique and necessary function of tracking such discrepancies and alerting market participants of potential errors, requiring timely reconciliation, and discouraging mismarking over time.

*Collateral, Margining, and Guarantee Information*

Every bi-lateral derivative is, in reality, two separate transactions. First, it is a derivative based on the price of the underlying product or security. Second, because it is a bilateral executory contract requiring financial performance, it is a credit transaction based on counterparty credit exposures to price moves. To the extent that the credit exposure is margined using reliable procedures and secure collateral, such exposure should be minimal. To the extent it is not so margined, the credit exposure could be material.<sup>2</sup> Information recorded and reported for each trade must be sufficient to value the collateral held by counterparties, and ensure that collateral and margin obligations are being satisfied over time.

Further, recent reporting has highlighted the importance of accurate and up-to-date information regarding a counterparty's parent-guarantee status. As banks and dealers move to restructure their operations in an attempt to reduce their regulatory obligations, features such as transaction- and entity-guarantees are suddenly linchpin issues in the global regulatory climate. Information indicating whether a particular transaction and/or its counterparty-entities are guaranteed by a parent-entity should be recorded and reported to SDRs for each transaction.

**DISCUSSION**

*Comprehensive risk information for bespoke trades, including hedge equivalents, must be reported to SDRs*

One of the most important potential services of centralized reporting of financial data is the transparency it can provide to customers of global derivatives dealers in assessing the risks, costs, and appropriateness of their portfolios. Any derivative transaction or trading strategy involving derivatives recommended to a counterparty should be based on reasonable due diligence to determine whether the recommendation does indeed meet the applicable standard. This should not be a controversial proposition. Confirmation that the standard is being appropriately applied and met, however, can be illusive to both customers and authorities.

Dealers often recommend complex derivatives with multiple embedded risks, marketing them as "customized" or "built-to suit" the needs of counterparties. However, the same result can generally be achieved by simply disaggregating the risks into separate swaps, many of which might be available in listed markets. In a disaggregated form, they are more easily understood, valued, and tracked by risk monitoring systems used by counterparties.

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<sup>2</sup> Professor John Parsons of MIT and Professor Antonio Mello of the University of Wisconsin have written extensively on the forborne derivatives collateral and the embedded loan. Some of these materials can be found at:  
<http://bettingthebusiness.com/2010/10/25/otc-5-the-collateral-boogeyman-%E2%80%93-packaging-credit-implicitly-and-explicitly/>  
<http://bettingthebusiness.com/2010/10/07/otc-3-the-collateral-boogeyman-%E2%80%93-the-delusion-of-%E2%80%9Cfree%E2%80%9D-credit-from-your-friendly-neighborhood-derivatives-dealer/>.

With grossly distorted compensation incentives, it is not surprising that derivatives dealers structure increasingly complex derivative products ostensibly customized to meet client needs, many of which are designed **not** to be understandable by anyone other than a derivatives expert. As a result, the history of the derivatives markets is littered with disasters and scandals arising from complex products sold by dealers to customers who never knew or understood the ramifications of the instruments they were sold. In the United States alone, the losses to governmental entities like Orange County, California; Jefferson County, Alabama; the State of Wisconsin Investment Board; the State of West Virginia; and the Denver school district have directly cost municipal U.S. taxpayers tens of billions of dollars. International regulatory transparency initiatives have emerged in large part to protect the public from such predatory and preventable behaviors.

It must be emphasized that there is a distinction between transactions and risks. A transaction may consist of a single product/risk component, or it may consist of an almost infinite number of product/risk combinations. From the perspective of portfolio risk analysis, there is no difference between derivatives entered into separately and compound derivatives. This, of course, makes sense: traders could not deal in derivatives risks if the individual risks in a given transaction could not be independently described and measured with a significant degree of understandability, accuracy, and confidence.

The following example may be illustrative:

Power Plant Owner A enters into a swap with Dealer B to guarantee the difference between the price 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 transaction example 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.

It is obvious and critical that the standard swap components must be included in the data reported to the SDR upon execution. Failing to clearly disaggregate the complex swap into component risks presents many challenges:

- The risks and exposures cannot be aggregated appropriately.
- The ability to easily value or analyze the swap is unnecessarily obscured.
- Dealers are incentivized to over-structure simple trades in order to reduce regulatory requirements and to facilitate their ability to charge opaque and excessive fees.

Indeed, only a tiny percentage of all transactions are required to be recorded beyond the capacity of typical trade data capture systems. This means that virtually all transactions that are characterized as bespoke are simply composites of understandable derivatives risks. This makes sense: traders deal in derivatives risks and it is inconceivable that they would undertake individual risks in a given transaction without being able to describe and measure those risks with a very high degree of confidence. Combining risks in a single instrument must not be allowed to obstruct reporting of meaningful information. Indeed, it should be noted that such hedge equivalent pricing directly parallels the systems implicitly used by DCOs to allow netting credits for initial margin in differing, but price-related contracts. This requirement is straightforward and indispensable to comprehensive reporting.

The reporting entity must assign and report a market-based price to the components of a composite swap, whether it is mixed (partially within the domain of the CFTC's swaps regulation) 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.

SDRs will soon collectively hold a cache of price and volume data for the vast majority of executed derivative transactions around the world, for the first time in history. This information will provide the source-data for the most accurate and robust valuation and risk analytics ever to exist. If designed to properly make use of this invaluable trove of information, SDRs could single-handedly ameliorate the lack of price discoverability.

We have commented on this subject in prior comment letters.<sup>3</sup> 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

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<sup>3</sup> See Better Markets, Inc. Comment Letter to the CFTC regarding Proposed Rule on Agricultural Commodity Definition, November 26, 2010; Better Markets, Inc. Comment Letter to the CFTC regarding Swap Data Recordkeeping and Reporting Requirements, February 7, 2011; Better Markets, Inc. Comment Letter to the CFTC regarding Reporting, Recordkeeping, and Daily Trading Records Requirements for Major Swap Participants, February 7, 2011; Better Markets, Inc. Comment Letter to the CFTC regarding Swap Data Repositories, February 22, 2011; Better Markets, Inc. Comment Letter to the CFTC regarding Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, April 11, 2011; Better Markets, Inc. Comment Letter to CPSS/IOSCO regarding Report on OTC Derivatives Data Reporting and Aggregation Requirements, September 23, 2011; Better Markets, Inc. Comment Letter to the FSB regarding the Feasibility Study on Approaches to Aggregate OTC Derivatives Data, February 28, 2014.

non-standard documentation of standard derivatives transactions. Ultimately, all market participants will benefit from eliminating the transient allure of obscuring individual transaction terms.

*SDRs should perform regular reconciliation of trade valuations*

The variety of valuation components that determine even the most standard swap price provide ample opportunity for discrepancy in valuation amongst counterparties. This is particularly relevant for uncleared swaps, as each counterparty provides its own independent valuation of a trade as it marks it to market throughout its life.

In the days prior to centralized reporting databases, there was no obvious mechanism for regular reconciliation of valuations on a trade-by-trade basis. Following execution, two parties would confirm payment flows for individual trades and aggregated variation margin flows on a counterparty-wide basis, but agreement on a mid-life trade valuation was only an issue upon unwind. Unsurprisingly, significant discrepancies in unwind values – particularly in less-liquid products – were not uncommon, and this was particularly dramatic during the crisis when small trades could require enormous mark-to-market payouts in order to close. Indeed, in the scramble to assess derivative portfolio exposures around the time of Lehman’s failure, it was not uncommon to hear anecdotes of a trader discovering that a “buy” had been misbooked as a “sell” several years beforehand, requiring painful and often costly after-the-fact adjustments.

A more nefarious issue, of course, is the still-ample opportunity for a trader to mis-mark his or her trades for profit according to his or her own risk profile. While basic compliance controls are meant to combat this, they are frequently insufficient or impractical for illiquid or complex swaps with scant market data for confirmation. Requiring the two sides of a trade to agree on its value on a regular basis is a simple and commonsense additional control on such conflicts of interest.

These are just a few examples of the unnecessary operational risk that simple reconciliation of trade valuations on a regular basis could prevent. SDRs, which unlike clearinghouses will receive data from both cleared and uncleared trades, are an obvious mechanism to perform such reconciliations, and the CFTC should require them to do so.

*Reporting of current exposure, netting, and collateralization information on bilateral portfolios of OTC derivatives transactions is crucial*

The issues associated with credit are central to monitoring the functioning of the derivatives markets. It should be remembered that the proximate cause of the failure of AIG was not a direct balance sheet loss associated with derivatives. It was the required immediate funding of margin under agreements that allowed large unfunded credit exposures to be built up over time. This is typical of catastrophic events in the derivatives markets. Inadequate liquidity to fund margin calls is the most likely cause of default and must be monitored.

The terms governing the credit exposure portion of the transaction are typically governed by a Master Swap Agreement and Credit Support Annex (“CSA”) between the

counterparties. The defining characteristic of swaps that are not cleared is counterparty exposure. SDRs will enable regulators and the public to better understand the size and nature of market price risks. But, counterparty exposures must also be identified and tracked to quantify the risk to the system.

CSAs typically establish the procedures for collateralizing credit exposures. CSAs apply to all swaps between the parties rather than individual swaps. Exposures are measured on a net portfolio basis by mark-to-market calculations, plus (in some, but by no means all, cases) an “additional amount” that serves as a rough analog to initial margin.

These documents address the entire portfolio of derivatives entered into by the counterparties. In most cases, they measure the net credit exposure by providing for bilateral netting of offsetting positions. They also often establish requirements related to margin, including thresholds for posting, qualifying investments, and compensation for the extension of credit.

Current information relating to credit exposures is critical to fulfilling the purposes of SDRs relating to resolution of defaults. As a threshold matter, information necessary to evaluate net bi-lateral portfolios must be captured by SDRs. We recommend that the following reporting to SDRs be required:

- Every significant market participant must file copies of all Master Swap Agreements, CSAs, and Master Netting Agreements with an SDR to which it reports swap data. A separate sub-file with a reference number will be maintained for each counterparty to the market participant.
- A summary of the terms of such documents, specifying (at a minimum):
  - Margin calculation terms, including marking to market and initial margin;
  - Depository arrangements for margin collateral; and
  - Applicable margin thresholds and terms governing compensation for the extension of credit.
- Every derivatives transaction that is not cleared and is reported to the SDR must record the proper sub-file reference number in a field designated for that purpose.
- Periodically (daily or weekly), the market participant must report to the SDR for recordation in the appropriate sub-file –
  - The amount of any margin threshold which has been consumed and the amount of such threshold remaining;
  - The amount of collateral and the depository institution that holds the collateral (see discussion of valuation, above); and

- Whether the terms permitting revocation of any thresholds have been triggered.
- The amount of forbearance (i.e., cap on uncollateralized exposure) permitted to each counterparty and the credit triggers must be reported separately, as well as, any unusual forms of collateral permitted.
- Data on individual swaps must cross-reference the credit files to connect them to the relevant CSA.

It must be pointed out that these reporting requirements are by no means onerous. Filing the basic documentation and summaries should be done electronically and once for each counterparty. The systems used to report uncleared transactions must include a field that is set up on a one-time basis to record the sub-file reference number applicable to each counterparty. Finally, the periodic reporting tracks information that any prudent market participant should monitor. The reporting function can be easily automated.

Crucially, the systems of each SDR must allow regulatory authorities to access reports for each market participant listing by counterparty, including:

- Net value of portfolio positions;
- Margin Threshold consumed and available; and
- Margin held.

In many instances, counterparties forbear from collecting collateral up to a cap. Such forbearance arrangements are the most significant obligations that end-users must meet because they almost invariably include “credit triggers,” which are generally based on credit ratings. **If a credit trigger is tripped, the end-user is required to fully fund collateral that has been previously forborne, at the very time it is most difficult to do so.** Because these forbearance arrangements can have such a dramatic and debilitating impact on an end-user, they must be a primary focus of the Proposed Rules.

This information will allow exposure to be monitored and provide early warning of potential market disruption from credit trigger events.

*The guarantee status of both the trade and the counterparties should be reported to SDRs*

The CFTC’s Cross-Border Guidance (“Guidance”), which outlines which types of international swaps trades will be subject to U.S. regulation, and to what extent they will be subject, places a new heightened significance on whether or not a trade is considered to be guaranteed by a U.S. entity. In essence, a trade between foreign counterparties that benefits in some way from the guarantee of a U.S. entity is required to comply with heightened regulation, as compared to those trades without such a guarantee.



It has been reported that, since the release of the Guidance in July, 2013, foreign swap counterparties have begun taking steps to restructure agreements with counterparties such that new swap trades will not be so guaranteed, and therefore not subject to CFTC regulation. While such "de-guaranteeing" raises a host of compliance issues that deserve the serious attention of regulators, they are largely outside the scope of this request for comment. However, the need for comprehensive collection of trade data related to the guarantee status of swaps trades is now indisputable.

With respect to the determination of whether a trade is subject to a U.S. guarantee, the Guidance is appropriately nuanced and relies on a variety of facts and circumstances about each trade, as opposed to simply the corporate structure of the booking entity. For this reason, the SDR must capture information about both the guarantee-status of the booking entity, as well as the guarantee status of the individual trade. If a trade is booked into an entity that benefits from the credit support of a U.S. registered entity, it must be reported to the SDR. If the individual trade or counterparty benefits from any form of third-party credit support from a U.S. entity, it must be reported to the SDR. Given that this factor now determines the regulatory and compliance regimes to which a given trade will be subject, it is an indispensable piece of trade data and must be recorded as such.

## **CONCLUSION**

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

Sincerely,

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President & CEO



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