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April 8, 2011

By Electronic Submission
David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: (1) RIN 3038–AC96 – Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants (the "Documentation Release"); and (2) RIN 3038-AC96 – Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants (the "OLA Provision Release" and, together with the Documentation Release, the "Releases")

Dear Mr. Stawick:

The International Swaps and Derivatives Association[1] ("**ISDA**") and the Securities Industry and Financial Markets Association[2] ("**SIFMA**") (hereinafter referred to as the "**Associations**") appreciate the opportunity to submit this letter to the Commodity Futures Trading Commission (the "**Commission**") in respect of the Releases and the rules proposed therein (the "**Proposed Rules**"), implementing provisions of the Dodd-Frank Wall Street Reform

[1] ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Its members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: www.isda.org.

[2] SIFMA brings together the shared interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, please visit: www.sifma.org.

and Consumer Protection Act (the "**Dodd-Frank Act**" or the "**Act**") regarding documentation and other requirements for swap dealers ("**SDs**") and major swap participants ("**MSPs**").

Our members strongly support the Dodd-Frank Act's goals of enhancing market integrity, improving market practices and mitigating systemic risk, and we appreciate the Commission's efforts to provide adequate notice and opportunities for consultation regarding rules to be promulgated under the Act notwithstanding extremely tight statutory deadlines. In a number of regards, we support the Proposed Rules; as to these areas, our comments suggest ways in which the Proposed Rules can be clarified or refined to avoid undue costs and unintended consequences. However, we are deeply concerned that the Commission's proposal relating to valuation models and methods reflects fundamental misunderstandings of the processes by which swaps are negotiated and transacted, the nature of swap valuations and the causes of valuation disputes.

If adopted in their current form, the Proposed Rules would require parties to lock in negotiated methods for valuation at the initiation of a swap. Even were this requirement to be adopted in a greatly simplified form, we would think it would be wholly impractical—it could not be accomplished in the ordinary course by willing counterparties. While valuation methodologies for the simplest of swaps would have a good measure of commonality, even such swaps require judgment-based modeling choices that would make agreement on valuation methodology challenging.[3] Agreeing on a model for even moderately complex swaps would require negotiations that could take sophisticated professionals months to complete, if they could do so at all (given that they would likely disagree on substance). And while a simple form of the valuation requirements would be impractical, in its current form, the proposed requirement--that the parties must agree on a valuation methodology that can survive the loss of any input to the valuation**--is wholly unworkable.**

Further, even could an agreement to lock in a valuation method be achieved (and we do not believe it can be), it would necessarily produce values that would become increasingly outdated over time. In so doing, the Proposed Rules would distort incentives for market participants and would impede the transmission of systemic and participant risk information to regulators. Accordingly, we respectfully urge the Commission to reconsider the Proposed Rules, particularly the proposal to mandate agreement as to swap valuation methodologies and to consider the recommendations further described below.

Summary

The Commission would require that swap documentation include terms relating to (i) payment obligations, (ii) netting of payments, (iii) events of default or other termination events, (iv) netting of obligations upon termination, (v) transfer of rights and obligations, (vi) governing law, (vii) valuations and (viii) dispute resolution procedures.[4]

[3] See Appendix A for an illustration of this point in the case of a simple interest rate swap.

[4] See proposed §23.504(b)(1).

The most immediate goal of these requirements we take to be that the parties to a trade have in fact agreed on its fundamental economic and legal terms prior to or contemporaneously with entering into a swap, and are communicating and maintaining appropriate records memorializing that agreement. We support this goal. In fact, each of the required elements of swap documentation is dealt with by existing industry-standard documents developed through ISDA as described below. We respectfully request that the Commission acknowledge these standard documents as complying with the requirements of new Section 4(s)(i) of the Commodity Exchange Act ("**CEA**").

However, as to the Commission's proposal to mandate that parties to a swap reach a detailed and inflexible agreement on valuation methodology, we disagree. We believe that these proposed requirements are neither feasible nor desirable.

The construction of valuation models and methodologies allows market participants to apply mathematical techniques and selected assumptions in order to synthesize large amounts of information about the marketplace in an efficient manner. Models allow their users to take into account information that would be too voluminous or complex to use in its raw form, greatly expanding the universe of usable information. Risk analysis and asset valuation require the development of models (whether by market participants or regulators). In a dynamic world, good modeling inherently demands flexibility. That is, as we must recognize that the world in general, and markets in particular, are constantly changing, it must inevitably follow that models that describe and anticipate markets and market values must change as well.

In light of the necessity that financial models be dynamic, even assuming that it were feasible to comply with the Commission's proposed requirement to negotiate agreed valuation methods for each swap (and we emphasize our belief that it is not feasible), there is no reason to believe that contractualizing the production of models could produce methods of valuation that would remain accurate and valid through the term of the swap (and much reason to believe they would not). Forcing parties to reach "agreed" valuation methods would neither reduce risk in the financial system nor eliminate true and fundamental disagreements about values. It is true that such an approach would potentially eliminate some margin disputes—but only because the parties would be obligated to accept mispriced marks. For the reasons discussed in this letter, the Proposed Rules would not lead to increased compression nor to contractual standardization. Far more critically, the Commission's proposed approach would impede the transmission of risk information to regulators. By mandating that parties bind themselves to negotiated valuation models that would grow outdated over time, the Proposed Rules would mask significant disagreements at market turning points when information about genuine disagreements could be critical to the Commission and other regulators charged with maintaining financial stability. Information about disputes in value ought to be a keystone to risk regulation; so we believe the valuation proposal, by artificially eliminating disputes and thus the flow to regulators of information about disputes, would materially diminish the regulators' ability to spot and ultimately to mitigate systemic risk. Moreover, we believe that the intended goals of the valuation proposal can be largely achieved by other feasible means, including a variety of the dispute notice and resolution initiatives that the Commission and other regulators are currently working with industry to develop.

As the Commission is aware, ISDA has for several years been an active participant in industry efforts directed by the OTC Derivatives Supervisors' Group (the "**ODSG**") to design and implement improvements to infrastructure, market design and risk management practices for OTC derivatives. Through the ODSG framework, the industry has committed to, and successfully implemented, a number of market improvements, including developing industry standards and operational practices for confirmations, portfolio reconciliation and trade compression. As part of that process, ISDA has developed a multi-layered strategy to address the root causes of margin disputes (and underlying valuation disputes), including through proactive portfolio reconciliation, market standards for investigation of disputed margin calls, and developing mechanisms for prompt resolution and reporting of significant disputes to supervisors.[5] We believe this ongoing approach developed by regulators and the industry, which focuses on early detection of material disputes and transmission of critical risk information to regulators and to senior risk managers in the relevant firms, provides the appropriate model for prudential risk regulation in connection with valuations. Combined with appropriate capital and margin levels, we believe this approach provides a superior and more practical means to managing disputes in light of the underlying uncertainty that causes them than would the imposition of a Commission-mandated agreement on a negotiated model.

In addition to the proposals relating to valuation, the Releases propose a number of documentation requirements relating to swap clearing, use of the end-user exception from mandatory clearing, and the FDIC's powers under the Title II of the Dodd-Frank Act, as well as requirements relating to the auditing of policies and procedures relating to documentation and regulatory reporting of valuation disputes. In the case of the end-user exception, we are concerned that the rules as proposed would put SDs and MSPs in the untenable position of having strict legal liability for matters that they can neither control nor effectively diligence. We therefore urge the Commission to clarify that SDs and MSPs may generally rely on representations provided by their counterparties to satisfy their obligations regarding use of the exception. In the case of the OLA Provision Release, we agree with the goals articulated by the Commission, but believe they can best be accomplished through a notice requirement rather than compulsory agreements. With regard to other aspects of the Proposed Rules, we suggest various clarifications and refinements.

Discussion

For convenience, we have organized our comments and recommendations in the order in which they are discussed in the Documentation Release and the OLA Provision Release.

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[5] Most recently, ISDA released to the ODSG certain work-in-progress drafts of the extensive documentation that is being developed in this endeavor, *i.e.*, the draft 2011 Convention on Portfolio Reconciliation and the Investigation of Margin Calls (the "**Convention**") and the draft 2011 Formal Market Polling Procedure (the "**MPP**" and together with the Convention, the "**DR Drafts**"). Pursuant to the commitment letter delivered to the Supervisors of the ODSG on March 31, ISDA released a revised draft of the Convention on April 7th and will release a revised draft of the MPP on April 26th on its website. The DR Drafts are expected to be widely adopted by OTC derivatives market participants that use the current ISDA Credit Support Annexes, and ISDA hopes to be able to have its offering conform with regulatory requirements.

I. What is Swap Trading Relationship Documentation?

As an initial matter, we believe it is useful to raise a definitional issue that goes to the clarity of the Commission's Proposed Rules. Proposed §23.504 would establish requirements for "swap trading relationship documentation," but does not define this term.

While the plain words of the term and the language of §23.504(b)[6] would seem to indicate that "swap trading relationship documentation" means those general contractual terms governing the overall relationship between swap counterparties, the requirements of the Proposed Rules in fact relate to a much broader range of documents and matters. Specifically, certain rules (§23.504(b)(2) and (b)(4)) relate to documentation for individual transactions; other rules (§23.504(b)(6)(i)-(v)(B)) establish recordkeeping and/or notice requirements; and still other rules (§23.504(b)(6)(v)(C) and (D)) are appropriate to documentation between a swap customer and its clearing intermediary rather than its swap counterparty.

One illustration of the confusion this definitional ambiguity causes is the uncertainty it creates as to the requirements applicable to confirmations. Proposed §23.504(a) would require execution of swap trading relationship documentation prior to or contemporaneously with entering into a swap transaction, while proposed §23.504(b)(2) specifies that swap trading relationship documentation includes confirmations. Together, these rules appear to require execution of a confirmation contemporaneously with or prior to entering into a swap. Such a result would be obviously impractical; moreover, it would directly contradict the Commission's proposed §23.501,[7] which establishes timing requirements for delivery of confirmations <u>after</u> execution.

We therefore request that the Commission clarify the Proposed Rules by distinguishing the requirements of proposed §23.504 by whether they relate (i) to relationship documentation or to individual transaction documentation; (ii) to the SD/MSP acting as a swap counterparty or to the SD/MSP acting as a clearing intermediary; and (iii) to contract or to notice and recordkeeping requirements. In particular we suggest the following:

i. "Swap trading relationship documentation" should be defined in accordance with its characterization in §23.504(b) as the relationship agreements between an SD or MSP and its swap counterparty with respect to uncleared swaps. Other terms should be used to describe documentation required in other contexts such as clearing documentation and documentation appropriate to agency executions.

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[6] In relevant part, proposed §23.504(b) provides that the trading relationship documentation shall be in writing and include "all terms governing the trading relationship between the swap dealer or major swap participant and its counterparty."

[7] *Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants,* 75 Fed. Reg. 81519 (proposed Dec. 28, 2010) (the "**Portfolio Reconciliation NPR**").

ii. Confirmations as to individual transactions should be excluded from the defined term "swap trading relationship documentation" and requirements for confirmations should be treated separately. Similarly, other requirements relating to individual transactions, such as those relating to valuation methods, procedures and inputs, should, to the extent that they are retained, be treated separately.

iii. Proposed §23.504(b)(6) should be removed from the rule for swap trading relationship documentation, and the substantive requirements should be relocated as appropriate depending on whether the proposal is intended to establish recordkeeping or notice requirements and whether those requirements are intended to apply to a swap counterparty or a clearing intermediary. To the extent the Commission intends to promulgate rules relating to clearing documentation, these should be set forth in a separate rule.

In addition, the Commission should provide a safe harbor from §23.504 for swaps entered into or subject to the rules of a designated contract market ("**DCM**") or swap execution facility ("**SEF**"). This safe harbor should, at a minimum, apply both where the SD/MSP will not know the identity of a counterparty to a transaction and where the SD/MSP will only learn the identity of the counterparty immediately before execution of the transaction, such as in the case of a transaction executed using a request for quote ("**RFQ**") system.[8] Clearly, under these circumstances, compliance with pre-execution documentation requirements is simply not possible other than through the use of standardized contractual terms established by the DCM or SEF.[9] Absent a safe harbor, the Proposed Rules would, contrary to Congressional intent, have a chilling effect on the use of RFQ systems and other non-anonymous matching systems used by DCMs and SEFs for swaps subject to the CEA's mandatory execution requirements.

II. Minimum Terms of Swap Documentation

As described below, we believe that ISDA's existing published documentation, which is widely used in the United States, will and should satisfy the Commission's requirements as to the required terms of swap documentation.

The following list sets forth CFTC-required documentation terms and describes how each is addressed by the forms of Master Agreement published by ISDA in 1992 (the "**1992 Agreement**") and in 2002 (the "**2002 Agreement**," and together with the 1992 Agreement, the "**Agreements**") or by the related ISDA Credit Support Annex (the "**CSA**"). We note that all of

[8] The Commission has separately proposed rules permitting SEFs to operate RFQ systems. See *Core Principles and Other Requirements for Swap Execution Facilities*, 76 Fed. Reg. 1214 (proposed Jan. 7, 2011).

[9] Consistent with this model of trading, regulations proposed by the Commission would provide that confirmations produced by the DCM or SEF will establish the definitive written record of the terms of transactions entered into through those facilities. See the Portfolio Reconciliation NPR at 75 Fed. Reg. 81520.

the terms described below may be amended by agreement of the parties, which agreement may be set out in the "Schedule" to the Agreement, in a transaction confirmation or another document. (We also note that the description below of which provisions of the ISDA documentation relate to particular proposed contractual requirements is somewhat simplified in that a number of provisions of the Agreement or CSA may be relevant; we have referred to the Agreement provision that is most on point.)

i. The obligation to make payments is established by Section 2(a) of the Agreements, although the required amount and timing of such payments will be set out in the transaction confirmation for any swap.

ii. Netting of payments is governed by Section 2(c) of the Agreements.

iii. Events of Default and other termination events are set out in Section 5 of the Agreements.

iv. Netting of payment obligations upon early termination is addressed in Section 6 of the Agreements.

v. Transfer of rights is governed by Section 7 of the Agreements.

vi. Governing law is required to be specified in a Schedule by Section 11(a) of the 1992 Agreement and by Section 13(a) of the 2002 Agreement.

vii. The requirements to establish the value of a swap in connection with the posting of margin is set out Paragraph 4 of the CSA.

viii. Dispute rights are set out in Paragraph 5 of the CSA.

As the Proposed Rules could create uncertainty as to the level of documentation required to meet the standard that "all terms" governing the swap trading relationship be included (and given the impossibility of perfect contracting), we respectfully suggest that a Commission statement acknowledging the general adequacy of ISDA documentation would enhance legal certainty and so market stability.

III. <u>The Proposed Requirement to Specify Agreed-Upon and Objective Methods to Determine Valuations</u>

A. Summary of the Commission's Valuation Proposal

The Commission's proposed §23.504 would impose a set of requirements on negotiated swap valuation methods, procedures, models and inputs that go well beyond any existing market practice, and which we believe cannot be implemented. The requirements of the Commission proposal as to swap valuation includes the following features:

i. there must be a written agreement on methods, procedures, rules and inputs for determining the value of any swap at any time from initiation to termination;

ii. such agreement must be memorialized not later than the time of entry into the swap;

iii. the method of valuation must be sufficiently transparent that any third party, including the Commission, could replicate it;

iv. the valuation methods must provide for use of agreed-upon fallbacks in the event of unavailability of any input; and

v. to the maximum extent practicable, the value of each swap is required to be based on objective criteria such as recently executed transactions or third party valuations provided by independent third parties such as derivatives clearing organizations ("**DCOs**").

The Commission implies that agreement on valuation methods and inputs would involve some amount of up-front effort and expense, which expense the Commission asserts would largely fall on swap dealers, rather than commercial users. However, once an initial investment had been made as to valuation methodology, it is implied that the agreement could be transported essentially with minimal cost from swap to swap. In the Commission's view, such agreements on valuation would have a number of benefits, including (i) minimizing disputes over valuation, (ii) reducing systemic risk, (iii) increasing the standardization of agreements, (iv) increasing compression of transactions, and (v) facilitating automation and central clearing of OTC derivatives.

As to each of these points, this letter will explain the basis for our disagreement. But we would emphasize again that all of these points of disagreement are secondary to our larger objection—what the Commission proposes to require is not something that market participants can reasonably achieve.

B. Overview of the Associations' Response to the Valuation Proposal

Currently, when parties to a swap enter into a trade, the transaction documentation will generally establish the party or parties to the trade who determine the value of the swap for purposes of collecting collateral, impose on that party a duty to act in good faith and in a commercially reasonable manner, and establish certain non-judicial dispute resolution mechanisms, though parties to a swap do not ordinarily lose their right to go to court unless they have agreed to binding arbitration, which is unusual.

ISDA documentation permits parties to a swap to value the transaction "dynamically," meaning that they may adjust their valuation models during the term of the transaction.[10]

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[10] We note in this regard that valuation of a swap frequently requires the valuation or specification of inputs (such as interest rate curves, correlation values and probabilities) that must themselves be partially constructed from existing data. That is, many "inputs" are themselves modeled values and the construction of such inputs requires the use of modeling assumptions. Therefore, unless otherwise specified, we use the term "model" in this letter generically to mean methods and procedures for valuing the expected future cash flows of a swap, including as applied to the construction and valuation of inputs.

Although the ability to change a valuation model does give rise to the possibility of valuation disputes, as the Commission rightly observes, it more significantly allows the parties to adjust their valuations in light of changes to market conditions and their understanding of the markets. Indeed, the Commission has separately proposed requiring each SD and MSP to maintain a risk management program that includes a daily measurement of market risk and credit risk, as well as periodic assessments of the effectiveness of its risk management program.[11] However, up-to-date information would have limited value unless the SD or MSP could take action based on it, for instance by updating a valuation method under which insufficient collateral is being posted to it under a swap.

By contrast, the Proposed Rules would effectively require the parties to agree on a fixed valuation model at the initiation of a swap and to maintain that model through the term of the swap. In section III.D of this letter, we explain why we believe that such a requirement is not feasible.

Assuming, for the sake of discussion, that such an agreement could be reached, the Commission is theoretically correct that the agreement could have the effect (we do not say the benefit) of "eliminating" disputes over valuation, at least for purposes of collateral requirements. In fact, if a model were to function in the way that the Commission describes, no collateral dispute should ever arise since the valuation of any swap would be simply a matter of plugging agreed inputs into a specified formula. Beyond the elimination of valuation disputes between parties by reason of an agreed-upon model, the Commission appears to believe that market participants generally could eliminate valuation disputes by evolving to a single consensus model.

We do not believe that divergent views over swap valuation either can or should be regulated out of existence. In fact, in our view, diverse approaches to valuation are healthy in a market economy, particularly to the extent that they reflect the competing analyses of independent market participants. In a free market, parties can and generally will disagree about the value of any asset, which inherently implies that they can and will likewise disagree as to the models (including disagreeing as to the value of inputs) that will in turn be used to value those assets. Ongoing disagreements as to value are normal and fundamental to the functioning of markets. A regulator-mandated "consensus" on value through the imposition of a market-universal model would mean that real differences in views as to prices or as to the means to determine appropriate prices, would be silenced.

Rather than imposing valuation agreement, we believe that the Commission and other regulators are moving in the right direction where they require that they be given notice of valuation disputes that are material.[12] By taking notice of valuation disputes, the Commission

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[11] See *Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants*, 75 Fed. Reg. 71397 (proposed Nov. 23, 2010) (the "**Risk Management System Proposal**").

[12] As the Commission is aware, many swap dealers are already providing information as to valuation disputes to the various regulators. The provision of this information has been discussed in some detail in prior ISDA letters. In particular, we refer to our letters dated February 28, 2011 in response to the Portfolio Reconciliation NPR. See also Section VII of this letter.

would potentially be made aware, for example, that an entity that it is responsible for regulating is at risk if its valuation models and assumptions turn out to be inadequate. Likewise, the Commission and other regulators would also benefit from being aware if there were particularly widespread disagreements in the market as to the value of a class of assets; notice of such widespread disagreement could alert the relevant regulators to a potential material shift in prices or a material increase in price volatility.[13]

In short, the fact that a valuation method is negotiated at the initiation of a transaction does not mean that the valuation is or will prove to be accurate over time. The more the valuation method diverges from the settlement value on termination (which divergence will become more likely over time), the greater will be the shock to the parties, the economic system and the regulators, when the actual owed amounts are calculated and paid.

C. Example of a Trade

As our views in regard to valuation procedures are at such variance with the Commission's proposals, it may be useful to work through an example, even if at the risk of being somewhat oversimplified. We think that this will help point out the reasons for our differences with the Commission with respect to the valuation proposals.

To start, the parties to a swap must determine the terms of the swap transaction. This can be complex and obviously highly negotiated (even before one gets to the problem of determining the value). In a particular swap, it is possible that there could be 100 economic terms (leaving aside noneconomic terms such as those relating to dispute resolution).[14] Notably, the economic terms of a swap may be significantly broader than is initially apparent. For example, terms relating to permitted types and uses of collateral, provisions for transaction adjustments and termination rights upon the occurrence of various contingencies (such as hedging disruptions) that may affect the swap or related hedge positions, all may have material effects on value.

Having agreed to the economic terms of a transaction, the parties must obviously agree to the price.[15] We note, however, that the problem of agreeing on a price is a different problem

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[13] For example, if the Commission became aware that a party was consistently engaged in material valuation disputes with counterparties, that could be an indicator that the party is in financial difficulty and should be more closely monitored. Similarly, if the Commission became aware that a particular asset class was frequently the subject of valuation disputes, that could be an indicator that there is in fact widespread disagreement over the value of the asset, indicating likely price volatility, which could indicate the desirability of imposing higher margin or capital requirements with respect to the asset.

[14] The number of economic terms is not unique to swaps. Any reasonably complicated contract may have numerous negotiated terms that have economic value to either party.

[15] We note that pricing conventions for swaps vary. For certain swaps, the price is frequently expressed as an interest rate spread paid over the life of the swap rather than an upfront payment. For others, a premium payment or another form of upfront payment is involved. In any case, where one side is acting as a dealer, the payment amount builds in the dealer's cost to provide the swap (including hedging cost) as well an expected profit. For purposes of this letter, the term "price" is used to express the value of these payments without regard to how they are made.

from agreeing on a valuation model. As a starting matter, parties may commonly agree on a price where they do not in fact agree on a net present value estimate of the swap based on expected cash flows so long as the seller's internal value (taking into account any factors that are specific to seller such as its benefit from using the swap as a hedge or the need to make a dealer profit) is lower on trade date than the buyer's internal value (also taking into account any buyer-specific values for the swap).[16]

Suppose then, for purposes of our example, that the theoretical "seller" values a swap's cash flows at 0 and the theoretical "buyer" values the same swap's cash flows at 20.[17] Economically speaking, the parties should both benefit by entering into a trade anywhere between these two prices. For our purposes, suppose that the parties agree to trade at a price of 10, splitting the difference between them.

Suppose further that the parties are required by regulation to agree on a valuation model. Assuming different internal values (as would generally be the case) such agreement would have to be inherently "forced" in the sense that the parties actually disagree. For purposes of the example, suppose that the seller and the buyer negotiate agreement on a valuation model that initially produces a valuation (ignoring any spread) of 9. Although neither party actually believes in the valuation, under the Proposed Rules, this mandated and artificial agreement would allow the parties to trade.

As we have stated, the fact that the parties have agreed to an initial valuation model does not mean that the model reflects the parties' actual views (in our example, it does not). We will, however, assume that the valuation model works in the way that the Commission anticipates, meaning that it produces a mathematical result that can be determined by any third party. Because the valuation model is clear, in a mathematical way, no valuation dispute can arise between the parties. Thus, at no point would we expect the Commission to receive notice of a valuation dispute since no dispute as to the model can or will arise.

The questions that follow are: (i) would it be possible to reach an agreement on valuation methodology that can survive the term of a swap or the loss of any input (see section III.D of this letter), (ii) what benefit or injury would result from the mandated agreement on the model (see Section III.E of this letter), and (iii) who would bear the expense of reaching such an agreement

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[16] For purposes of this letter, we will use the term "internal value" to mean the worth that a party puts on a particular asset or transaction, including a commodity or a swap. This "internal value" may be entirely a function of market prices or it may be derived in part from the party's own models. Presumably, the more liquid the particular derivative contract and its underlying inputs, the more likely it is that the party's internal value will be some function of publicly reported prices. On the other hand, in the case of an illiquid asset or transaction, a party will be more likely to rely on its valuation model. We assume that each party to a swap will have its own internal value as to that swap.

[17] The numbers 0 and 20 are just used for simplicity. They could reflect a wide difference in values (0 and 20 million) or they could reflect a narrow difference (0.00 cents vs. 0.20 cents). Fundamentally, though, the key point is that the parties do not agree on value; and given that they disagree on value, there is no reason to assume that they agree on the method by which value should be determined.

(see Section III.F of this letter). In Section III.G, we take up a number of additional issues relating to models.

D. The Valuation Process: Individuality and the Need for Flexibility

Valuing a swap is essentially a matter of estimating the net present value of expected (*i.e.*, probabilistic) future cash flows. The Commission's proposal would require that, as to any swap, a model or market benchmark for its value expectations be definitively established (or at least agreed) at the initiation of a transaction. It also implicitly assumes (i) that each model will have a limited and defined number of "inputs" as to which the parties can reach an agreement; (ii) that these inputs can be mechanically plugged in to produce a value; and (iii) that a model can be made sufficiently flexible to address future changes in the world merely by the specification of replacement inputs in case the initial inputs become "unavailable." All of these assumptions are incorrect.

The following discussion is intended to illustrate briefly the impossibility of two parties agreeing on a valuation model satisfying the criteria mandated by the Commission, and the reasons why a model agreed at initiation of a swap would likely not continue to be useful during the entire term of a swap. In addition, we discuss the Commission's proposed requirement that the parties agree on a method to assure that the unavailability of any input to a model will not prevent the parties from making calculations using the negotiated model.

1. Seller and Buyer Will Not Have the Same Models

In Appendix A and Appendix B, respectively, we have briefly described some of the necessary requirements for valuing a plain vanilla interest rate swap and a swap on a mortgage-backed security. Appendix A describes some of the considerations in modeling a very simple, single-currency, fixed vs. floating interest rate swap. It shows that, even for such a swap, expectations for future values (in the specific case, yield curves for the floating leg) must be constructed from limited data. The process for doing so involves the use of assumptions and proprietary techniques that will differ from party to party. Thus, even for such a swap, there is no universal model of valuation.

Appendix B describes in somewhat more detail the potential complexity of modeling the value of a swap on a mortgage-backed security, and demonstrates the significance of party-specific judgment and technique that go into the development and use of that model. As this example shows, judgment and technique can be significant at the input level, even before a full model is constructed. Obviously, the scope and magnitude of potential disagreements between parties about the elements of a valuation model will generally increase where the asset being valued is more complicated than an interest rate. As the example in Appendix B shows; even if both parties agree on all the underlying economic inputs that should be factors in modeling mortgage loss rates, there would likely be a wide divergence of views among market participants as to how much weight to attribute to each input. That is, it would seem unlikely to the point of incredibility that two parties would independently build a model that weights or uses these factors in the same manner.

2. Models Must Change Over Time

The Proposed Rules would require the parties to a swap lock in a valuation methodology that would be fixed at the initiation of a swap. However, valuation methodology raises difficult, information intensive and fundamentally **conditional and dynamic** judgments about future expectations. That is, swap valuations necessarily involve making ongoing judgments about the world and using inputs and assumptions that reflect the best knowledge and technology available at the time of each valuation. As the world changes, valuation models must be adjusted. To require parties to specify models at the initiation of a trade that can properly value the trade throughout its term is thus to task them to anticipate all potential future circumstances during the term of the trade. Such a task cannot be accomplished.

Appendix B provides examples of the reasons why models must be dynamic. For example, item number 3 in Appendix B relates to the correlation between mortgage defaults in different geographic areas. Prior to the market crisis, market participants generally had assumed, based on existing historical data, that geographic correlations in mortgage defaults were much lower than they turned out to be. When it became clear that historical correlations were too low, models had to be changed. Market participants that had continued to cling to outdated models would have very significantly misvalued their positions. However, even were the market participants to agree that a model should be changed, there is no assurance that they would agree on the same change (and in fact such agreement seems inherently unlikely).

3. The Requirement to Specify Alternative Methods for Determining Value in the Event of Failure of Any Input is Impractical

We have said above that we do not believe that the Commission's proposal is practicable, even stated in rather broad terms. However, the Commission's mandated valuation model has additional specific requirements that are not merely impractical; they are impossible. In particular, the Commission would require the parties to reach agreement on "alternative methods for determining the value of a swap in the event of the unavailability or other failure of any input required."

As a starting matter, we agree that having specified alternative inputs is useful in particular circumstances. In fact, swap documentation commonly includes provisions for the use of alternative information sources or inputs to calculate payments due on particular dates, primarily where the initial method of computation is based on a published market price (or other variable), and the relevant publisher ceases to operate. In that case, the swap documentation will often provide for calculation based on an alternative input; *e.g.*, a different publisher or a market. To take a simple example of this, where a particular pricing source for a currency exchange rate or an interest rate becomes unavailable, the parties would typically either specify a backup source or authorize one of the parties to select a reasonable alternative source, such as quotes from reference banks or dealers.

However, in other cases when a material input becomes unavailable, the parties will often retain flexibility to agree as to how to respond based on market conditions at that time. Such flexibility is important because an alternative input cannot be specified *a priori* in all cases, at least not in a way that is meaningful. To return to the example above, where a currency exchange rate is no longer published by Source A, the parties may reasonably look for the exchange rate published by Source B. However, there is quite a different problem of pricing if the relevant currencies cease to be directly convertible. In such a case, there is no directly observable market value. Any alternative input would at best need to be constructed by the parties at the time (for example through exchange rates for intermediate currencies), and at worst be arbitrary. Where an underlying asset or rate is not priced, forcing the parties to agree on an arbitrary input to satisfy a regulatory requirement is not good policy. Indeed, it is for the very reason that it is impossible to replace all potential inputs in a fair manner that swap agreements frequently allow for cancellation of a transaction where an input cannot be adequately determined.

In addition, it is unclear how a specified metric would qualify as an "alternative" under the Proposed Rules. For example, suppose that the value of a particular swap is related to the value of a particular type of oil at a particular delivery point at a particular time. What would it mean to require an alternative metric? Does that mean (i) a different grade of oil (how different), (ii) a different energy source, (iii) a different delivery point (how distant), or (iv) a different time period (how near or far)? The more closely any alternative is linked to the initial input intended to be used by the parties, the better it is likely to function as a proxy, but the more likely it is to be made unavailable as a result of the same circumstances that render the initial input unavailable. The more remote the alternative, the more likely it is to be available, but the less likely it is to be consistent with the original logic of the transaction.

We have also noted that any individual swap transaction could have up to 100 economic terms, and could thus require inputs from multiple sources; *e.g.*, currency exchange rates, interest rates, commodity prices, or volatilities. It is not clear whether market participants would be required to agree on a model that would assume the loss of only one input at any time or of any combination of inputs becoming unavailable. Certainly, it does not take very long before the alternative possibilities approach near-infinite complexity.

Moreover, the distinction between swap "models" and "inputs" is not a sharp line. In unstressed markets, some valuation inputs (*e.g.*, values of underlying assets) are directly observable from market prices published by third parties. However, it is frequently true that input values are not directly observable and, particularly in stressed markets, involve matters of judgment that may be the subject of disagreement. By way of example, the volatility of an option underlier is a common input into a model. However, this input must itself be the subject of a model, and when the market has been increasing, or decreasing, in volatility over the last month or week or day, parties may have very legitimate disagreements as to how to model that input, which will itself be an input to other models. In short, many model inputs are themselves modeled values that require significant data analysis and judgment to produce. As such they must be constructed at the time when they are needed and cannot always be specified in advance, at least not in a meaningful manner.

E. Cost/Benefits of Being Bound to the Agreed-Upon Valuation Model

For purposes of the following section of this letter, we have assumed that it would actually be possible for the parties to reach an agreement as to valuation methodology (although we do not believe this to be the case). We discuss why we believe any such negotiated model would not have the benefits anticipated by the Commission, but would in fact have a number of significant negative consequences.

1. Seller and Buyer Cannot Use the Agreed-Upon Model for Accounting and Other Purposes

The valuations produced by negotiated models required by the Commission for collateral purposes would necessarily be different from valuations that market participants produce for other purposes, including risk management and financial control, potentially leading to adverse results.

For example, suppose (i) that the "seller" as to a swap is a public investment fund, in which public investors may continuously purchase and sell shares; and (ii) that the "buyer" is a public corporation (or owned by a public corporation) whose shares are traded on a U.S. exchange. The boards of directors of each of the fund and of the public corporation have an independent duty to determine the value of the assets and transactions of the entity that they serve. Neither of the boards can satisfy their fiduciary duties to their investors by simply accepting the valuation that results from a model or methodology that was the result of a negotiated compromise, in part because, in the event of a default by the counterparty, the non-defaulting firm would not be able to enter into a replacement swap with a third party based on the compromise model or methodology. Accordingly, the accounting treatment of each of the entities should value the swap in a manner that is different from the value that has been "agreed" in the swap documentation. In short, the Commission may adopt a rule that forces "agreement" as to a valuation model for use in a contract, but that value determined for purposes of the contract cannot trump the value that may be given to the contract by the fiduciaries acting for each party.

Similarly, negotiated valuation models agreed at the initiation of a swap would not be useful in default situations. If there were a material divergence between the actual value of a swap on default, as then calculated, and the value resulting from a negotiated model, the model value could not be used to calculate close-out amounts. Otherwise, the party that was benefiting from the model would have an incentive to default, knowing that its losses would be calculated under a favorable model without regard to the amount legitimately owed to the non-defaulting party, let alone the obligation to make the non-defaulting party whole. Further, as noted above, the non-defaulting party would be unable to replace the swap at "model" value, causing it material harm and potentially leaving it unable to hedge its commercial risk.

By way of further example, we note that as a matter of prudent risk management, swap dealers currently make collateral calls using the same values they use to mark their positions for the purpose of calculating profit and loss. To the extent valuations by counterparties diverge, control groups at each swap dealer may review the levels at which the trading book is marked, and if the internal valuation is deemed incorrect, will require the trading book to be re-marked. This system imposes important checks and balances to ensure that positions are being appropriately marked. A consequence of the Commission's Proposed Rule would be that valuations for profit and loss purposes could widely diverge from valuations for collateral purposes, undermining risk-management controls that swap dealers currently have in place.

2. Seller and Buyer Do Not Have Shared Benefit in Updating the Model

Suppose that it became clear over time that the compromise model has become outdated (because, for example, assumptions used in such model or in valuing inputs have become outdated) and that the seller now wishes to amend the swap documentation to use a different "agreed" model. In effect, the seller now proposes a model that will require the buyer return the seller's collateral and instead post collateral to it. There is no reason for the buyer to accept this proposal; in fact, the buyer should reject the proposal since the negotiated agreement as to the "value" of the swap favors the buyer and changing that agreement (without receiving compensation for the amendment) would injure the buyer and its shareholders. Therefore, the buyer should reject the seller's request to amend the swap and should continue to collect excess collateral from the seller. In this case, the fact that the parties were required to agree to a model at the initiation of the transaction would seem to increase systemic risk as collateral is contractually misdirected.

The potential for a flawed result by requiring a lock-in to initial models can be demonstrated by another very simple example. Suppose that parties have entered into a swap and have contractually agreed to specific valuation methods and models. Suppose that during the course of a long-dated trade, one party (rightly, or at least reasonably) comes to believe that the agreed valuation methodology significantly underestimates volatility, potential costs arising from loss of liquidity, or the extent of the correlation between the market values of different assets (all of which obviously did happen following the market crash). Since that party would be prevented from seeking to adjust its collateral requirements or transaction valuations during the course of the trade, it would be exposed to credit risk from the mismatch between the marks produced by the agreed methodology and its own more reasonable marks. Further, there would be a mismatch as to the marks for collateral purposes and the value that the counterparty would be required to mark on its own books.

The danger of locking in a valuation model for the term of a trade can also be plainly illustrated if one imagines how such a static model would work in a cleared environment. Suppose that at Time 1, a DCO was using Model 1 to value the swaps it was clearing. Suppose that at Time 2, the DCO had come to realize that Model 1 had become significantly flawed and that it should instead adopt Model 2.[18] If the Commission's proposal were applied to the DCO, it would follow that the DCO could not change its valuation model as to pre-existing swaps, even though it had become clear to the DCO that the model it had been using is now outdated. This would obviously have the result that the amount of collateral that the DCO was moving would be materially understated or overstated in one direction or the other, which would mean that the DCO was creating credit risk as between its participants. In this instance, we think it follows that use of the flawed model would significantly increase systemic risk. It is presumably for this precise reason that the Commission has proposed to require DCOs to review the models and

[18] For a current example of such a scenario, see Christopher Whittall, "The Price is Wrong," *Risk Magazine*, March 5, 2010.

parameters used in setting initial margin requirements on a regular basis.[19] We think it obviously follows that the ability to review and update valuation models to avoid the risks stemming from an outdated model are equally important to market participants in the uncleared environment.

3. Commission Does not Learn of Valuation Dispute

Suppose, over time, the financial position of the buyer becomes weaker in part because of its use of internal valuation models that have become outdated or proven to be inadequate. In that case, the Commission and the other regulators would benefit from receiving information concerning any valuation dispute over a swap between the buyer and its various counterparties. Reports of such valuation disputes could very well serve as an impetus for the Commission and other regulators to provide particular attention to the financial strength of the buyer. However, the continued use by the buyer of a negotiated valuation model would in fact eliminate the potential for dispute between the parties to the trade, since the negotiated model would produce a numeric value (even if the wrong one). This agreement would thus squelch a potential dispute, which would in fact be better surfaced. In short, the forced use of the negotiated valuation model would deprive the Commission and other regulators of information about genuine material disagreements as to internal valuations that would provide useful information to regulators monitoring for the solvency of regulated entities and for systemic risk.

4. Negative Effect on Standardization and Compression

It is a premise of the Commission's proposal that its imposition of negotiated models for each swap transaction will result in (i) increased standardization of swaps and (ii) increased trade compression. We question these premises for the reasons set out below.

Reduced Standardization. On its face, it would appear that the more different types of contract terms that parties are required to negotiate, the less likely it is that the parties will negotiate contracts that are standardized or fungible. Suppose, for example, that Parties A/B and Parties C/D each reach agreement on a particular commodity option contract based on a particular type of commodity, delivery point, delivery quality, and delivery time. Assume that the contracts are identical and fungible. Under the Commission's proposal, each pair of parties would now be required to negotiate numerous additional items relating to valuation models, none of which is essential to the transaction, but each of which is potentially contentious. There is no reason to believe that the two pairs of parties would negotiate identical terms to all of these items, and in fact it would be highly unlikely that they would do so given the variety of potential points of election or negotiation. In short, it seems fairly self-evident that requiring parties to insert more negotiated provisions in their contracts would reduce standardization rather than increase it.

Reduced Compression. The Commission assumes that contractually agreed-upon static valuation models would increase the likelihood of trades being closed out or compressed. It seems to us that the opposite would more likely be the case where an agreed-upon model has

[19] *Risk Management Requirements for Derivatives Clearing Organizations*, 76 Fed. Reg. 3698 (proposed January 20, 2011) (see proposed § 13.39(g) at page 3720).

become outdated. Specifically, it could cause a party to resist closing out trades where that party was benefitting from an outdated valuation methodology. Where such a party wanted to exit the ultimate market risk of that trade, the party would be incentivized to enter into and maintain a new offsetting trade with a person different from its counterparty (and resist compression) on the first trade in order to arbitrage the collateral differences between the two trades based on the outdated valuation methodology of the first trade.

F. Out-of-Pocket Costs of Agreeing on a Fixed Valuation Model

It is implicit in the Commission's discussion of its valuation proposal that the parties' agreement on valuation as to any transaction could be achieved through some initial investment in negotiations for a particular transaction and that this initial agreement as to any particular transaction could be carried over to (i) other transactions of the same type with the same counterparty, (ii) other transactions of different types with the same counterparty and (iii) transactions with different counterparties. It is further implicit in the Commission's statement as to the models that the expense of developing and negotiating models will fall largely on the dealer, leaving any commercial user unharmed. We do not agree with any of these assumptions.

1. Negotiation of Agreed-Upon Models Would Initially Be Expensive

To start, the negotiation of the terms of a swap transaction can be quite complex (even before one gets to the problem of determining the value). As we have said, in a particular swap, it is possible that there could be 100 economic terms (leaving aside noneconomic terms such as those relating to dispute resolution).

As the very simple example in Appendix A to this letter describes, even a "plain vanilla" trade presents difficult modeling elements.[20] This very simple example makes obvious the practical difficulty of agreeing on a model even in "easy" cases. That level of difficulty would compound exponentially if parties were forced to "agree" on a model to value long dated swaps involving specific assets that are not the subject of liquid markets, as the terms of the swap, the asset classes involved and the time periods can all involve many more variables than would a simple interest rate swap.

It would be extremely difficult, for example, for parties to agree on a model for valuing energy prices for a long-term swap today, much less to design one that would apply under all future circumstances. It is hard to overstate the complexity of negotiating a model today to value a 10-year energy swap and having this model be sufficiently dynamic that it would work under all (anticipated) future circumstances of the world over the next 10 years. One would have to take account of factors such as (i) expected usage of energy in the United States and other energy markets, (ii) supply factors that might be influenced by discoveries of oil, or developments in transportation or regional developments, (iii) environmental considerations, (iv) changes in tax law, or (v) the occurrence of extreme events such as oil spills, political instability, large scale

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[20] As noted in Appendix A, even a "plain vanilla" swap involves the construction of curves using proprietary techniques that are likely to differ from trader to trader.

piracy or disruption of a reactor. This complexity would then be further compounded by the difficulties of getting both parties to agree to the use of this model over 10 years, particularly as the negotiated model will inherently be different from each party's internal model.

2. Negotiation of Agreed-Upon Models Would Continue to Be Expensive

The Commission asserts that costs of implementation of proposed §23.504—including costs of negotiating and documenting valuation models—will involve limited upfront expense that will disappear over a short time.[21] The Commission's cost statement indicates a belief that the negotiation cost for valuation models will quickly be reduced as (i) each swap dealer negotiates an agreed-upon valuation methodology with each of its counterparties and (ii) particular valuation methodologies become the market-accepted norms. We disagree. Even as between two counterparties, valuation methods will require constant renegotiation given (i) the differences in transactions, (ii) changes to the models that each party uses and (iii) changes in market circumstances. Further, there is no reason why any universal market norm of valuation should arise or why such a norm should be desirable. In fact, in a competitive market economy, numerous, diverse and ever-changing models of valuation are a healthy norm.

Begin with the simplest example: other transactions of generally the same type between the same counterparties. Assuming that the parties have been required to agree to a valuation methodology for a trade today, it would seem likely that they would agree the same valuation methodology for a similar trade on the next day. This of course raises the question of what will constitute a similar trade. Where the parties had in one transaction agreed on 100 terms, and in the next transaction ten of those terms are different, the model agreed as to the first transaction may not be sufficient or appropriate as to the second. For example, suppose that the first transaction assumed that all transfers of collateral and payments would be made in dollars and that the second transaction provided that transfers of collateral and payments would be made in Euros. Agreeing to a model as to the second transaction creates different and additional problems than does modeling the first transaction, and the parties cannot simply take their first model and copy it over to the second transaction.

Or assume that the second transaction has identical economic terms (other than price) to the first. However, as we have all learned, the world can be quite dynamic. Imagine parties who have negotiated valuation methodologies over the past several years for particular assets and rates: (i) energy, (ii) catastrophe insurance; (iii) coffee, (iv) housing defaults and (v) gold volatility. In every case, the models that parties use would likely be required to change materially over time to take account of new and unanticipated events (or events that may have been anticipated and either materialized or did not). In each asset class, any two parties who had agreed to valuation methodologies as to these assets over the last several years would likely now have to renegotiate their existing agreement as the models of both parties would likely have changed.

It is even more obvious that an agreement between Party A and Party B as to valuation methodologies will not necessarily dictate the terms of the agreement between Party A and Party

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[21] See the Documentation Release at 76 Fed. Reg. 6725.

C or that between Party B and Party D. Each of these arrangements must be individually negotiated between the parties.

In summary, there is no reason to expect any diminishing costs in negotiating valuation methodologies. It is more likely that these costs would stay constant (and high) over time.

3. Costs of Negotiation Would Fall on End Users

The Commission appears to expect that dealers will develop standard forms that will establish valuation methods with some finality. However, the documentation requirements imposed by the Commission are likely to be both extremely complicated and potentially contentious. It is unlikely that a significant end-user would enter into such a complicated long-term valuation agreement without heavy negotiation. The only way that the costs of agreeing to these terms do not affect end-users is if they do not negotiate, but simply accept the terms that are presented to them. Market experience does not indicate that this is (or should be) the case.

G. Additional Issues

1. Value of Internal Modeling

The Commission's proposal, and the related requests for comments, do not acknowledge the value of internal models, but treat them as inherently suspect. In place of internal models, the Commission would require objective pricing based, "to the maximum extent practicable," on "recently executed transactions" or "valuations provided by independent third parties such as derivatives clearing organizations."[22] The Commission's attempt to regulate the circumstances under which objective or public values are used is based on a number of premises that we think flawed, and which we think would create additional legal and economic uncertainty. Further, we think the Commission implies a negative comparison between public and private markets that is not correct; *e.g.*, the Commission seems to imply that participants in public markets do not make use of private models. Finally, we note that firms compete through the development of models, which are predictors of future values, and a requirement that firms disclose their models would discourage investment in such models as such investment would provide no competitive benefit.

a. Prices in Public Markets Also *Result* From Private Models

The Commission seems to suggest that public futures markets do away with the need for internal models with the implication that such markets have adopted agreed-upon models of valuation that work on a real-time basis. That is not the case. Public futures markets offer contracts in which only the termination payments are defined by contract; they do not define interim valuations by reference to any agreed-upon model. In fact, each participant in a futures market must essentially "bring" to that market its own internal model that allows it to participate in the bid/offer process. If all participants in the futures market had a single agreed-upon model that was fixed for the term of the futures contract, there would be no need for any bid/offer

[22] See the Documentation Release at 76 Fed. Reg. 6726.

process or indeed for a market. The "market" would simply be a calculation of a value based on a universal model.[23]

b. Development of Better Models is an Economically Useful Means of Business Competition

The Commission would seemingly require SDs and MSPs to disclose all of the contents of their models to other market participants other than "confidential, proprietary information about any model it may use internally to value a swap for its own purposes."[24] However, the Commission does not define the information that would be permitted to remain confidential; there is no explanation as to whether the confidential information would be the formulae used in the model or the inputs. Likewise, we are not clear what the phrase "for its own purposes" means. It is the clear implication of the Proposed Rules that confidentiality is deemed suspect and is to be limited to a minimum. We respectfully object to the notion that firms do not have a business interest in keeping their models confidential and we further believe that such confidentiality benefits the economy. That is, the Commission should acknowledge that the development of improved models and more accurate views of risk is very significant intellectual property. Investing in intellectual property is a way in which dealers (and in fact all market participants) compete. Firms that are able to value risk more accurately will be more likely to survive and prosper. In the Commission's effort to mandate consensus, there seems to be little incentive or opportunity for firms to develop models that diverge from the common wisdom.

2. Uncertainty of Requirements

The Commission's proposal would create substantial legal uncertainty around swap transactions. In particular, we refer to the Commission's requirement of objective pricing based, "to the maximum extent practicable," on "recently executed transactions" or "valuations provided by independent third parties such as derivatives clearing organizations."[25]

a. Legal Uncertainty

It is unclear what a requirement to use objective measures "to the maximum extent practicable" means or how it could be enforced. These are wholly ambiguous legal standards. Further, it is often the case that relatively small changes in contract terms, such as tenor, may

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[23] The Commission's observation with respect to the standardization of CDS is in the same vein. As the Commission itself observes, the procedure that has been developed for the efficient settlement of index and single name CDS (which the Commission cites as a success story) is not the regulatory mandate of a single valuation model for the industry. In fact, none of the procedural changes related to use of a standardized valuation method. Rather, the settlement procedures were based on a "standard auction" mechanism. As is the case with the futures market, each market participant brings its own internal model of value to the auction and can bid or offer on that basis. An auction price thus emerges from the interaction of divergent models; the price is not forced upon market participants through the imposition of a universal model to determine price.

[24] See the Documentation Release at 76 Fed. Reg. 6726.

[25] See the Documentation Release at 76 Fed. Reg. 6726.

create quite significant differences in valuation. The Commission should not have the power to overrule the parties to a contract and decide that these differences are to be ignored.

Similarly, the Proposed Rules would establish a regulatory preference for benchmarks against recently executed transactions, but there is no standard by which a party could determine how recent is recent enough. While we have questioned above whether it is in any way practicable to eliminate swap pricing uncertainty in times of asset value uncertainty, we emphasize that it is in time of market dislocations that the value of "recent" transactions may come most into question. That is, in a relatively static market, a previous transaction that is a month/week/day old may hold substantial evidence for value in the current market. But in a time of market dislocation, a day-old transaction may be entirely stale and even an hour-old transaction of little value.

It should also be borne into consideration that the "timing" of a transaction is not the only indicator of relative value. For example, the size of a transaction may have a very significant impact on pricing.

b. Economic Uncertainty

At the current time, there is no basis on which to assess the value or quality of prices that will be reported in the post-Dodd-Frank Act market. It is implicit in the Commission's proposal that liquid markets with well-reported prices will generally be available. While that is a hoped-for outcome, it is not a proven result. Thus, we think it is risky to require parties to contract on the basis of results from untested procedures in untested markets.[26]

We also note that when the Commission asserts that parties to an uncleared swap must look to the values that a DCO calculates in respect of a cleared swap, it does not give weight to the fact that—in a world of mandatory clearing—the uncleared swap will generally have economic terms that are different from the cleared swap in ways that are economically meaningful. Because the uncleared swap is likely meaningfully different from the cleared transaction, any price or value reported for the cleared transaction must be an imperfect proxy for the "value" of the uncleared transaction. The question then becomes how the parties to an uncleared swap translate that proxy into a value for the cleared swap—and the answer is that it can only be done through modeling.

3. The Commission's Proposal Goes Beyond the Congressional Mandate

We believe that the Commission overstates the Congressional grant of authority under Section 4(s) of the CEA. CEA Section 4(s)(i)(2), which instructs the Commission to adopt documentation standards, should be read in light of CEA Section 4(s)(i)(1) which requires SDs

[26] We note that the very fact that the Commission would have parties reference values on DCOs illustrates the reason that it is not desirable for parties to lock in to valuation methodologies. That is, a party would for most swaps not currently use a DCO price in its valuation methodology, as few such prices exist; however, in the future, if DCO prices become liquid, it is certainly possible that swap participants would rely on them, even for swaps that were entered into before the DCO prices became useful.

and MSPs to comply with standards relating to "timely and accurate" documentation, processing, netting and valuation of all swaps. Congress did not require SDs and MSPs to negotiate models with counterparties at the beginning of each transaction and indeed such a requirement is in tension with a requirement for accuracy given the rigidities it would produce. Moreover, Congress specifically spoke to the issue of required disclosures to counterparties, where it required disclosure of marks to market rather than valuation models and methodologies producing such marks.[27]

Further, the Dodd-Frank Act does not authorize the Commission to impose requirements that participants to a contract agree on dispute resolution procedures. We note that ISDA documentation provides numerous methods for parties to resolve disputes between them, ranging from relying on the commercially reasonable judgment of one party, to requiring mutual negotiation, to use of valuations or quotes from third-party swap dealers who do not have an economic interest in the disputed trade. However, the Commission's requirement that the parties to a swap must specify a non-judicial means of dispute resolution goes beyond the authority granted to the Commission under the statute: Congress gave no indication that it intended for the Commission to effectively prohibit parties from choosing judicial resolution of contract disputes. Denying the parties to a swap access to the judicial system is not a measure that should be taken lightly or without Congressional consideration.

IV. The Commission's Proposal Regarding Documentation Requirements for Cleared Swaps

As noted earlier in this letter, proposed §23.504(b)(6) includes documentation requirements for cleared swaps that variously appear to be recordkeeping, notice or agreement requirements. The nature of each requirement should be clarified and to the extent that any provision is intended to be a recordkeeping or notice requirement, the Commission should provide that it is not required to be included in the executed trading relationship documentation. In addition, we submit the following substantive comments:

i. To the extent that §23.504(b)(6) is intended merely to create record-keeping requirements, we do not object, but we observe that there is no obvious reason for requiring an SD or MSP to record the identity of its counterparty's clearing member to the extent such information is not needed to clear the swap.

ii. To the extent that §23.504(b)(6) is intended to require SDs and MSPs to provide specified notices to swap counterparties:

a) the Commission should distinguish the requirements based on the capacities in which an SD or MSP may act;

b) the Commission should make clear that the obligation to provide notice of the date and time when a swap is cleared and the identity

[27] See CEA Section 4(s)(h)(3)(B)(iii)(II), inserted by Dodd-Frank Act Section 731.

of the DCO is deemed satisfied when the counterparty receives a clearing report directly from the DCO;

c) an SD or MSP acting as the initial counterparty for a swap that the counterparty will clear away (an "**executing dealer**") should not be required to notify the counterparty of its own clearing member (since this information may be sensitive and is not material to the counterparty) or include the identity of the counterparty's clearing member in such a notice; and

d) the Commission should clarify that the requirements of §23.504(b)(6)(v)(B), (C) and (D) do not apply to an executing dealer. Subclause (B) is largely a factual statement about the contractual effect of clearing, but it is not directly relevant to the counterparty. It would be more meaningful to state that the counterparty's swap is now held by the clearing firm. Subclauses (C) and (D) assert facts about the counterparty's cleared swap that the executing dealer would not be in a position to know. Further, the Commission should clarify that a novation clause in an executing dealer's swap trading relationship documentation that provides that an OTC swap is extinguished when it is accepted for clearing should, in combination with a clearing notice, be sufficient for satisfying the requirement in subclause (A).

iii. To the extent that the Commission is concerned that rights and obligations of an FCM and its Customer as to a cleared swap could contradict the terms of a DCO's template, this issue could be addressed by a requirement that clearing agreements specify that the relevant templates are deemed part of any swap cleared under the agreement and that they control in case of conflict.[28] We do not recommend use of the language provided in §23.504(b)(6)(v)(C) and (D) which would create uncertainty as to the permissibility of negotiating swap-related terms other than those provided in a DCO's template such as termination rights.

V. The Commission's Proposed Audit and Senior Management Approval Requirements Are Redundant and Overly Prescriptive

We recommend deletion of the proposed requirement in §23.504 to provide for annual audits of at least 5% of new documentation as well as the requirement that documentation policies and procedures be approved in writing by senior management.

As registrants under the Dodd-Frank Act that are subject to Commission supervision, SDs and MSPs will be required to maintain comprehensive business, supervisory and

[28] We understand that this is currently standard practice in futures and swap clearing agreements that FCMs provide their customers.

compliance systems to ensure compliance with the Commission's rules. Procedures for auditing and approval of swap documentation are properly part of such systems and are already explicitly provided for in other Commission rule proposals relating to such systems. Proposed §23.600 regarding "risk management programs" would require each SD and MSP to monitor and manage "legal risk" by providing for (i) an assessment of whether transactions and netting arrangements have a sound legal basis, and (ii) documentation tracking procedures designed to ensure the completeness of relevant documentation and to resolve any documentation exception on a timely basis.[29] Periodic audits and proper approvals are a mandatory component of these risk management programs.[30] Proposed §3.3, relating to chief compliance officers ("**CCOs**"), would require each SD and MSP to designate a CCO personally responsible (to the Commission as well as senior management) for reviewing the adequacy of such policies and procedures. Taken together, these rulemakings and others include numerous safeguards to ensure the effectiveness of an SD's or MSP's risk management program, including rigorous internal controls, frequent review of compliance, and disclosure of policies and procedures to the Commission.

Moreover, audit and approval requirements, like other elements of a risk management system, should be designed to address the particular circumstances of each SD or MSP given its business and overall compliance practices. The Commission has recognized that regulation of risk management programs requires principles-based regulation that establishes the standards that must be met without dictating specific practices. As the Commission stated in proposing §23.600(b):

> The Commission recognizes that an individual firm must have the flexibility to implement specific policies and procedures unique to its circumstances. The Commission's rule has been designed such that the specific elements of a risk management program will vary depending on the size and complexity of a swap dealer's or major swap participant's business operations.[31]

In accordance with these principles, the Commission's risk management rules do not set rigid numerical audit requirements but rather require SDs and MSPs to design appropriate audit procedures and submit them to the Commission for review. We endorse this approach and believe it is equally appropriate for managing documentation. Thus, to the extent that the Commission deems it necessary to provide specific audit requirements for documentation, we recommend that it replace the 5% requirement with a principles-based requirement that SDs and MSPs conduct periodic audits sufficient to identify material weakness in their documentation policies and procedures.

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[29] See the Risk Management System Proposal (proposing §23.600(c)(4)(v) relating to documentation tracking procedures among other elements of risk management policies and procedures).

[30] See *id.*, particularly proposed §23.600(e) (quarterly audit) and proposed §23.600(b)(4) (submission of risk management program to the Commission).

[31] See *id.* at 75 Fed. Reg. 71399.

VI. The Commission's Proposal Regarding Reporting of Disputes

As indicated in an earlier section of this letter, we recognize the importance of reporting significant valuation disputes to prudential regulators. Such reporting transmits valuable information for use in assuring that capital and margin requirements are adequately calibrated to market risks for different types of transactions. In particular, the frequency and size of valuation disputes provide important indicators that valuations for an instrument or asset class may be volatile due to data or model limitations.[32] We therefore support the inclusion of a reporting requirement in the Proposed Rules as a component of prudential regulation of SDs and MSPs.

Proposed §23.504(e) would require SDs and MSPs to report valuation disputes that are not resolved (i) within 1 business day (if the counterparty is an SD/MSP) or (ii) within 5 business days (if the counterparty is not an SD or MSP). We urge the Commission to further consider the balance of costs and benefits, both for itself and for market participants, in establishing when a dispute must be reported. In particular, we suggest that the reporting requirement should be limited to material disputes above a certain dollar threshold and that only disputes that have had proper time to mature be subject to mandatory reporting. Few valuation disputes signal significant differences in views on how to value a swap or swap input, and only a subset of those would reflect elevated risk. Without creating properly calibrated thresholds, the reporting requirement would result in over-reporting of disputes that would create substantial informational "noise" for regulators. It would also be unduly burdensome for market participants.

In balancing costs and benefits for purposes of the reporting requirement, it is important to be cognizant of the manner in which valuation disputes arise. While parties to a swap have contractual rights to seek resolution of specific transaction-level valuation disagreements, disputes typically emerge from a portfolio-level process. As we have emphasized in this letter and as ISDA emphasized in its comments to the Commission regarding portfolio reconciliation, it is widely accepted and entirely proper that two counterparties to a particular transaction may produce legitimately different valuations at any given point in time. In fact, some level of discrepancy is not only common and expected, it should be viewed positively, as it indicates competitive parties developing independent views of current values. Valuation disputes therefore typically only arise when the discrepancies are sufficient to create a material collateral dispute at the portfolio level. Given these considerations, ISDA has advocated an approach to dispute resolution that would attach mandatory resolution requirements to material portfolio-level disputes. For the same reasons, we suggest that reporting requirements should also be based on portfolio-level margin disputes.

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[32] We note again in this regard that a requirement to agree to valuation models, methods and procedures at the initiation of a swap transaction would (assuming it could be implemented) significantly undermine the value of a dispute reporting requirement as a transmission belt for risk information. By requiring parties to lock into initially negotiated models for margin purposes, such a requirement would potentially mask the development of real disputes as the information, assumptions and valuation technologies of the parties to a swap evolve over time.

Similarly, while the Associations, and all swap market participants, seek the most rapid resolution of margin disputes possible, in practice, the resolution process necessarily takes time: portfolio and collateral data must be compared, portfolio reconciliation results must be analyzed to determine root causes of disputes, and various resolution methodologies must be deployed depending on the nature of the causes identified.[33] Frequently, these processes must be conducted across different time zones (*e.g.*, the U.S., Europe and Asia). Thus a meaningful amount of time is required to establish the nature and significance of a dispute.

ISDA has worked intensively with member firms and supervisors through the ODSG for the past two years to develop improved market practices for the investigation and resolution of disputed margin calls, including extensive use of portfolio reconciliation to avoid such disputes. Through the ODSG commitment process, materiality, timing and other practical issues have been intensively studied and debated by the industry. In light of these considerations, and recognizing that the ODSG framework also establishes reporting requirements tied to the portfolio reconciliation and dispute resolution process, we suggest that the Commission accept the approach established by the ODSG process, as updated from time to time, for reporting unresolved disputes.[34] While the ODSG materiality thresholds are tied to portfolio-level margin disputes rather than individual transaction valuation disputes (consistent with the way in which such disputes actually emerge), we submit that they reliably capture disputes that have as their source significant disagreements about swap values.

VII. The Commission's Proposal Regarding Documentation Supporting a Reasonable Belief of Proper Use of the End-User Clearing Exemption

The Dodd-Frank Act amends Section 2(h)(1) of the CEA to provide that it is unlawful for any person to transact in a swap that is subject to a mandatory clearing determination unless that person submits the swap to a DCO for clearing. However, the Act also provides an exception from mandatory clearing if one party to the swap is not a financial entity, is using the swap to hedge or mitigate commercial risk, and notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations in connection with entering into non-cleared swaps. Because only the swap counterparty to an SD or MSP may directly qualify to use this so-called "end-user exception," SDs and MSPs necessarily depend on their counterparties' proper use of the exception when agreeing not to clear a swap that is otherwise subject to mandatory clearing.

In order to police use of the end-user exception, the Commission proposes to require SDs and MSPs to obtain documentation from their counterparties sufficient to provide them with a reasonable basis to believe that any such counterparty meets the conditions for use of the end-user exception. The Commission further proposes that such documentation would be required to include five elements: (i) the identity of the counterparty, (ii) that it is electing to use the

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[33] A general discussion of these processes is provided in the portfolio reconciliation comment letter, the DR Drafts and other industry materials submitted as part of the ODSG process.

[34] Under the current ODSG framework, all participating firms will be required to send a monthly report to their primary supervisor listing all margin disputes in excess of $15 million that remained unresolved for at least 15 days.

exception, (ii) that it is a non-financial entity, (iv) that it is hedging or mitigating commercial risk, and (v) "that the counterparty generally meets its financial obligations associated with non-cleared swaps." These proposals raise two significant issues. First, the "reasonable basis to believe" standard creates uncertainty as to whether SDs and MSPs would be required to conduct affirmative diligence in order to confirm proper use of the end-user exception. Second, the proposed requirement to obtain documentation confirming "that"[35] a counterparty generally meets its financial obligations in connection with uncleared swaps is inconsistent with the requirements of the Dodd-Frank Act and would improperly burden end-users' access to the exception.

A. The "reasonable basis to believe standard"

The Commission should clarify that an SD/MSP can satisfy the requirements of proposed §23.505(a)(1)-(4) by relying on written representations of its counterparty, absent countervailing facts (or facts that reasonably should have put the SD/MSP on notice that the counterparty may be ineligible), which would trigger a consequent duty to inquire further. Indeed, the Commission should establish that satisfaction of the regulation in this manner will provide a safe harbor from violation of the mandatory clearing requirement. The SD/MSP should not be required to affirmatively investigate the counterparty's representations or obtain detailed representations as to the facts underlying the counterparty's qualifications.

Without such clarification, SDs and MSPs would face substantial pressures to interpret the "reasonable basis to believe" requirement conservatively and conduct extensive diligence, since the Dodd-Frank Act would make them primary violators where their counterparties improperly use the exception. Such a result would be untenable. The terms of the end-user exception are such that any required investigation would necessarily have to be extremely intrusive, putting the SD/MSP in the position of having to make expensive, unwelcome and time-consuming inquiries of its counterparty in order to obtain extensive and potentially private commercial or business-sensitive information. As the SD or MSP conducted its due diligence investigation, it follows that the end-user would remain exposed to the market risks that it wished to hedge.

We emphasize in particular the difficulty of conducting diligence regarding a party's status as a non-financial entity. Investigating financial entity status would, in many cases, require obtaining detailed information about a counterparty's business and swap activities. For example, determining that a counterparty is not predominantly engaged in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act, including interpretive rulings thereunder, could require close scrutiny of a counterparty's business lines together with analysis and interpretation by legal counsel to determine whether, and to what extent, the relevant activities could be conducted by a bank holding company. Even more troubling, determining that the counterparty is not an MSP would potentially require detailed historical knowledge of all of its swap activities. Moreover, as it appears that the Commission intends to require parties to qualify for the end-user exception on a trade-by-trade basis, the

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[35] In fact, Section 2(h)(7)(A)(iii) of the CEA, as added by Dodd-Frank, merely requires an end user to report "how" it generally meets its financial obligations associated with entering into swaps.

SD/MSP would be required to update its diligence prior to each trade to establish compliance with the Proposed Rules.

Failure to establish reasonable procedural requirements in this area would not simply create practical difficulties for SDs and MSPs. It would also substantially burden the ability of end-users to use swaps to hedge commercial risk. Indeed, faced with the prospect of intrusive, costly and time consuming investigations of their internal activities by SD/MSPs, end-users may employ less efficient means to hedge their commercial risks or simply choose to forego hedging entirely. Congress specifically intended to avoid such a result when it provided the clearing exception, and it instructed the Commission not to enact rules that would create barriers to commercial hedging.[36]

In addition, we submit that a requirement for end-users to provide their counterparts with proper representations in their swap trading documentation, in combination with the specter of regulatory penalties, would be sufficient to deter misuse of the end-user exception. Since a false representation would create a potential event of default for the counterparty under an ISDA master agreement and knowledge of such a misrepresentation would create legal liability for the SD/MSP under the Dodd-Frank Act, the end-user would have substantial incentives to ensure the accuracy of its representations.

B. Meeting Financial Obligations

While proposed §23.505(a)(5) is somewhat unclear on its face, it appears to require SDs and MSPs to obtain documentation necessary to establish a reasonable basis to believe that the counterparty generally meets its financial obligations associated with its uncleared swap transactions (both with the particular SD/MSP and with third parties). Such a requirement is not mandated by the Dodd-Frank Act, which merely requires a party making use of the end-user exception to notify the Commission as to how it generally meets financial obligations relating to swaps.[37] To the extent that it would require an SD or MSP to have affirmative knowledge as to whether its counterparty satisfies obligations relating to swaps with third parties, it would also be impractical and suffer from the same infirmities that would apply to the other affirmative investigation obligations as discussed above.

We do not believe special documentation requirements are necessary in connection with the Dodd-Frank Act requirement to report how an end-user satisfies its financial obligations. To the extent that an end-user provides its SD/MSP counterparty with collateral, third-party guarantees or other credit risk mitigants, the SD/MSP would obviously know this is the case and be able to verify the clearing exception reports submitted to swap data repositories. Therefore

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[36] See letter from Senators Dodd and Lincoln to Representatives Frank and Peterson, 156 Cong. Rec. S 6192 (daily edition, July 22, 2010) ("Regulators . . . must not make hedging so costly it becomes prohibitively expensive for end-users to manage their risk.").

[37] In other contexts, the Commission has interpreted this requirement to provide that end-users are to report the means by which the address their counterparty's credit risk, whether by providing collateral, third-party guarantees or otherwise. See *End-User Exception to Mandatory Clearing of Swaps*, 75 Fed. Reg. 80747 (proposed December 23, 2010).

we recommend that proposed §23.505(a)(5) be deleted. To the extent the Commission retains this documentation requirement, the Commission should clarify that it can be satisfied by a representation from the counterparty or by documenting that the counterparty generally meets its swap-related obligations to the particular SD or MSP.

VIII. Application of Proposed Rules to Existing Documentation

In the Proposed Rules, the Commission requests comment on an appropriate interval for implementation of the requirements for swap trading relationship documentation. In particular, the Proposed Rules ask for industry feedback as to how long it would take for SDs and MSPs to bring existing documentation into compliance with proposed §23.504. In addition, the Commission also specifically asks for feedback on whether there should be a safe harbor for "dormant" trading relationships where "no trades are presently in effect thereunder or there are trades that will run off in a short period of time."[38]

The Commission's discussion of implementation and requests for comments indicate that the Commission is considering retroactive application of the Proposed Rules. Such a suggestion is extremely troubling. To begin with, a retroactive approach is not workable. SDs and MSPs cannot force counterparties who do not intend to enter into new trades with them to execute amendments to their existing documentation. A requirement to amend existing documentation would therefore lead to a choice between two bad options: unilaterally breaking trades with the counterparties before the compliance date, or accepting non-compliance. Unilateral terminations would be destabilizing for many reasons, not least because they would create default rights for counterparties. On the other hand, permitting non-compliant trades to continue would create very substantial legal uncertainty, including as to the enforceability of the relevant swaps.[39]

Even assuming that SDs and MSPs could in theory pressure their swap counterparties to amend terms and agreements applicable to existing transactions as a price of entering into new ones (an assumption that we do not accept), a regulatory approach that effectively requires them to do so would be extremely harmful to the marketplace. In this regard, we note again that a number of the Commission's proposed trading relationship documentation requirements, particularly those that relate to mandatory valuation agreements and collateral requirements, would materially affect the economic terms and values of individual transactions. Such an approach would improperly upset the benefits of freely struck bargains between the parties, chill

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[38] See the Documentation Release at 76 Fed. Reg. 6720.

[39] We note in this regard that enforceability would depend on the interaction of a number of elements, including the terms of the swap documentation and interpretation of new law, particularly Section 739 of the Dodd-Frank Act. For example, swap documentation typically contain representations as to transaction legality and termination rights tied to changes in law. Depending on the particular language of any given contract and its interpretation, these could potentially allow the SD/MSP's counterparty to terminate such a swap, effectively giving it a free option. However, the effectiveness of such an option would also depend on interpretation of Section 739 of the Dodd-Frank Act, which provides that neither a "requirement under that Act or an amendment made by that Act" may permit a party to terminate a swap (unless the swap "specifically" reserved for such a termination right). How Section 739 would apply to this context is both untested and uncertain.

the market for new transactions and potentially cause great harm to swap users. Indeed, retroactive documentation requirements could be no less harmful to the marketplace than retroactive illegality provisions.

Therefore, we submit that the Commission should clarify that any implementation requirement would be exclusively forward looking. That is, the Commission should specify in the final rulemaking that implementation of the documentation requirements will require SDs and MSPs to provide that new transactions entered into on or after the effective date are subject to trading relationship documentation requirements, but that it is not mandatory to amend terms or agreements that apply to transactions entered into prior to such date.

As to the Commission's request for industry feedback on a proper schedule for implementation, we appreciate the Commission's recognition that amending or supplementing swap trading relationship documentation for a broad range of SD and MSP trading relationships is a substantial undertaking. We would be pleased to provide the Commission with information pertinent to practical implementation requirements when feasible, and look forward to working with the Commission to develop an appropriate implementation schedule. However we respectfully submit that efforts to establish an implementation schedule are premature at this time for several reasons:

i. The resources and time required to implement the swap trading relationship documentation requirements will vary depending on the final form of the documentation rules. In particular, they are highly dependent on whether the final rules will include requirements to agree on valuation methods (and the form of the requirements). As we have stated above, the proposed requirements relating to agreed-upon valuation methods are impractical, and in fact some aspects of the proposal would likely be entirely unworkable. Putting aside for a moment the difficulties that would be presented by trying to meet the standards for valuation agreements proposed by the Commission, simply trying to put such agreements in place with counterparties would almost certainly involve very protracted negotiations. Therefore, to cover the range of contingencies that currently exist, any estimates would have to set a range of possible timing requirements that would be so broad as to be of very limited value.

ii. A number of the Commission's other proposed rules under the Dodd-Frank Act will also almost certainly require SDs and MSPs to amend swap trading relationship documentation in order to establish compliance. For example, Commission-proposed rules relating to business conduct, the confirmation process, confidentiality and privacy and collateral segregation requirements, may all directly or indirectly require SDs and MSPs to provide new notices, obtain counterparty representations and consents and agree with their counterparties as to trading procedures. For each separate rulemaking that may require amendments to existing relationship documentation, the range of counterparties for whom documentation would need to be amended and the level of difficulty of constructing and negotiating appropriate amendments will vary. It would obviously be extremely inefficient, time consuming and costly for SDs and MSPs to engage in separate rounds of amendments with their trading counterparties for each set of Dodd-Frank Act rulemakings. To the extent possible, SDs and MSPs should therefore be permitted to develop plans to update their agreements in an integrated manner for the full range of Dodd-Frank Act requirements, and implementation timelines should reflect the requirements of such an approach. Those requirements will not be known until the scope and terms of all of the relevant Commission regulations (and those of the Securities and Exchange Commission ("**SEC**")) are more clearly delineated.

iii. The statutory definitions of "swap" and "security-based swap" in the Act are exceptionally broad and create great uncertainty as to the potential scope of application of the Proposed Rules and other regulatory requirements. Many transactions that are not commonly thought of (or documented) as swaps may potentially be covered, depending on how statutory definitions are refined by the Commission and the SEC. Therefore, until such time as the Commission and SEC promulgate rules further defining these terms, the range of counterparties and transaction types for which SDs and MSPs will be required to revise documentation cannot be known.

We therefore request that the Commission defer the question of an implementation timeline until such time as Commission and SEC rules relating to trading relationship documentation are fully developed. We also request that the industry be given an opportunity to address implementation issues with the Commission at that time. Ideally, we would ask that implementation be addressed in a separate rulemaking conducted at the end of the substantive rulemaking process, with a full notice and comment period.

IX. The Orderly Liquidation Termination Provision Should be Limited to a Simple Notice

In the separate OLA Provision Release, the Commission proposes adding paragraph (b)(5) to proposed §23.504, which would require swap trading relationship documentation to include a written agreement between the parties providing that certain rights and restrictions will apply in the event that one of the parties to the swap becomes a "covered financial company" subject to a FDIC receivership under Title II of the Dodd-Frank Act. The written agreement would also include a consent to transfer of swaps by the FDIC in such a circumstances. In the OLA Provision Release, the Commission states that the purpose of the agreement requirement is to put parties on notice of the treatment of swaps in the event of a liquidation pursuant to Title II, and to minimize litigation in the event that the swaps are transferred by the FDIC.

We generally support the goals of the Commission to reduce uncertainty and litigation, but submit that they can best be achieved through an informative notice requirement rather than a binding agreement requirement intended to parallel statutory provisions. Requiring parties to agree to particular treatment under Title II creates the risk of a discrepancy between the FDIC's actual powers under Title II and the treatment consented to by the parties. Any such discrepancy would engender confusion and could operate to strip parties of legal rights. Moreover, even if the proposed contractual terms corresponded perfectly to the FDIC's statutory powers under Title II, requiring their inclusion in swap documentation would potentially raise due process concerns by limiting parties' rights to challenge their treatment under the statute.

To the extent that the Commission's goal is to minimize litigation by reducing the likelihood that parties may enter into a swap without understanding the risks of a Title II receivership, such an objective could be accomplished through a simple requirement for SDs and MSPs to provide a standardized notice describing such risks. For accuracy, such a notice should point out that the definition of "swap" for purposes of the Dodd-Frank Act (and particularly Title VII) differs from the definition of "swap agreement" for purposes of Title II, and that the two definitions may not be coextensive. In this way, the required notice would alert swap parties to their potential treatment under Title II, but would not create the false impression that they would necessarily benefit from the rights of parties to "swap agreements." Additionally, such a notice should include other points relevant to the rights of counterparties to swap agreements, such as (i) suspension of the counterparty's obligation to make payments to the covered financial company during the 1-day stay under Section 210(c)(8)(F)(ii) and (ii) differences between the treatment of cleared and uncleared swap agreements.

By contrast, we submit that a requirement to enter into a binding agreement could actually increase litigation risk by overlaying inconsistent contractual rights and obligations over those provided in Title II. We note in this regard that, in addition to conflating CEA "swaps" with Title II "swap agreements," the OLA Provision Release imperfectly adapts statutory language from Title II and removes it from its statutory context. For example, the section of Title II replicated in the Proposed Rules, when read in statutory context, provides that the FDIC can transfer swap agreements without the consent of the counterparty, but only to *one financial institution* and only as part of a transfer of *all qualified financial contracts* of that counterparty. By contrast, proposed §23.504(b)(5), lacking such context, could be read as a consent for the FDIC to transfer swaps without transferring other qualified financial contracts, and does not specify that all swap agreements must be transferred to a single financial institution. Whatever the FDIC's rights under Title II, all swaps executed in compliance with the Proposed Rules would arguably give the FDIC a contractual right to transfer swaps on the terms set forth in the parties' agreements. In such a way, the Proposed Rules could expand the FDIC's power beyond the limits set by Congress.

While any discrepancy between the Proposed Rules and the FDIC's powers under Title II may be inadvertent, the possibility that the FDIC's powers would thereby be expanded raises serious questions about whether the adoption of the Proposed Rules would be a proper exercise of the Commission's rulemaking authority. Moreover, even if §23.504(b)(5) were to track the statutory language perfectly, it would arguably undermine parties' due process rights. Parties to swaps are entitled to challenge FDIC action under the Title II on the grounds that it conflicts with Title II (read as a whole), other statutes, or the Constitution, but they could be prevented from making such challenge if the FDIC were able to assert a contractual waiver. While the Commission may desire to foreclose legal challenges to the FDIC's power under Title II, it is not within the Commission's legal mandate to do so.

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The Associations appreciate the opportunity to provide comments on the Documentation Release and the OLA Provision Release, and look forward to working with the Commission as you continue the rulemaking process. Please feel free to contact us or our staff at your convenience.

Sincerely,

Robert Pickel
Executive Vice Chairman
ISDA

Kenneth E. Bentsen, Jr.
Executive Vice President
Public Policy and Advocacy
SIFMA

Appendix A

Example: Valuing a Hypothetical Vanilla OTC Swap After Trade Date

(1) The value of an OTC swap involving periodic payments and that is not an option is given as the sum of the net present value of each individual expected future cashflow that occurs in that swap.[40]

(2) For example, consider a vanilla fixed for floating interest rate swap with five years to maturity, having a fixed rate of 5%.

(3) The future cashflows and dates (in this case semi-annually) of the fixed leg of the swap are known and can be calculated.

(4) The expected future cashflows of the floating leg (quarterly payments of 3-month Libor) can be found using a curve construction methodology where the input is market observed at-the-money (ATM) rates for swaps of different maturities.

(5) The output of the curve construction methodology is a set of expected future Libor rates that are consistent with the market observed ATM rates. From these rates the expected future cashflows of the floating leg of the swap can be calculated.

(6) Proprietary smoothing and interpolation techniques are used in the curve construction and therefore the expected future Libor rates may differ between market participants. Therefore two exactly identical swaps, using the same inputs, could result in different expected future cashflows depending on the curve construction technique used.

(7) In order for the cashflows to be arbitrage free the discount rate used to present value the future cashflows will be a function of the collateral terms in the CSA. Therefore two exactly identical swaps, using the same inputs but traded under different CSA terms would have different discount rates and therefore different valuations.

(8) Where swaps are fully collateralized, the discount rate would be given by the secured funding rate of the underlying collateral, *e.g.* the interest rate payable on USD cash, where USD cash is the only type of collateral in the CSA.

(9) For unsecured or partially collateralized swaps, the discount rate must also take into account the credit and unsecured funding risks associated with not being fully collateralized.

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[40] ISDA and SIFMA members use a variety of valuation methods and approaches, even for straightforward fixed-for-floating interest rate swaps. The description set forth in this Appendix is intended to be illustrative and does not reflect the approach taken by every ISDA or SIFMA member or even a consensus of ISDA or SIFMA members.

(10) For swaps that are not vanilla, the curve construction method becomes a more complicated model, and only providing a dealer's proprietary model code and inputs would allow a third party to replicate that dealer's valuation.

Appendix B

Example: Valuing a Hypothetical Swap Referencing a Mortgage-Backed Security

(1) The value of a swap referencing a mortgage-backed security is a function of the present value of expected cash flows on the security.[41]

(2) Projections of the future expected cash flows for the security are impacted by the following parameters.[42]

(a) **Future default rates for underlying mortgages:** Mortgage default rates are determined by multiple factors including unemployment levels, interest rates, underwriting standards for individual mortgages, and levels of home prices.[43] The weighting given by investors to all these factors is subjective, and can change over time.

(b**) Future prepayment rates on underlying mortgages:** Mortgage prepayments are predominantly impacted by interest rate levels. However, the state of the economy and levels of home prices are also important factors.

(c) **Correlation of default between mortgages from different geographic areas, borrower type and underwriting standards**. Historical correlations proved to be a poor metric of actual correlations between different types of mortgages during the financial crisis. Investors therefore needed to make their own assumptions of what future correlations would be.

(d) **Mortgage put-back litigation**. The ability of investors to "put back" improperly documented mortgages to the underwriters could materially impact the value of MBS.

(e) **Timing of servicers taking action on defaulted mortgages.** Depending on when the servicer decides to foreclose on a mortgage, the cashflows to the holders of MBS securities will change, and the distribution of cashflows between senior and junior noteholders in the waterfall will be impacted.

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[41] ISDA and SIFMA members use a variety of valuation methods and approaches. The description set forth in this Appendix is intended to be illustrative and does not reflect the approach taken by every ISDA or SIFMA member or even a consensus of ISDA or SIFMA members.

[42] Due to the wide variety of subjective inputs, market participants had very different views about the value of mortgage-backed securities, and swaps referencing these securities, during the financial crisis. It would also be impossible to agree ahead of time how to establish the values of all these inputs over the life of the trade. While market participants attempt to use market prices of similar securities as proxies, the bespoke nature of these instruments means any such approximations are quite subjective.

[43] Investors use varying models to forecast home price appreciation.

(f**) Manager differences**. MBS and ABS deals are actively managed, with full reinvestment rights, and the value of individual deals will vary widely by investors' individual views of the quality of the manager, even if the underlying collateral pools are largely similar.

(g) **Over-Collateralization and Interest Coverage Tests.** These structural protections for investors vary from deal to deal, and the probability of a trigger being hit will materially impact the value of a note. These probabilities will be driven, among other factors, by future default rates, timing of recoveries, and future levels of interest rates.

(h) **Structure of Event of Default and Ratings Triggers**. Significant non-linearities are created in the value of a note, based on the likelihood of a deal hitting an event of default (EOD), and the actions that can be taken in such a situation. In many cases EOD triggers are ratings driven, which makes their timing extremely difficult to model.

(3) The future expected cash flows must then be discounted to arrive at a present value for the swap. The discount rate will be impacted by the level of interest rates and the curve construction methodology used (see Appendix A). In addition, a funding basis between where the swap referencing the tranche of a CDO and the underlying cash instrument will trade may also apply. The basis arises because of varying funding costs between market participants, and different liquidity characteristics of a swap and the cash instrument.