

# Coalition for Derivatives End-Users

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April 11, 2011

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

*Via agency website*

**Re: Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants / 17 CFR Part 23 / RIN 3038-AC96**

The Coalition for Derivatives End-Users (the “Coalition”) is pleased to respond to the request for comments by the U.S. Commodity Futures Trading Commission (“CFTC”) regarding its proposed rule issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) entitled “Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants” to ensure that end-users are able to continue to efficiently manage their business risks, invest in our economy, and create jobs.

The Coalition represents companies that employ derivatives predominantly to manage risks. Hundreds of companies have been active in the Coalition throughout the legislative and regulatory process, and our message is straightforward: The Coalition seeks to ensure that financial regulatory reform measures promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy.

## **Introduction**

The Coalition believes proper documentation of swap transactions is important to ensure that both parties to a transaction agree on its terms. End-users long have used market-standard documentation, including the ISDA Master Agreement, Schedule, Credit Support Annex, and related swap documents. We appreciate the Commission’s recognition that “minimiz[ing] the burden on those parties that will not be registered with the Commission as swap dealers or major swap participants”<sup>1</sup> is an important goal and that the swap documentation requirements focus primarily on swap dealers (“SDs”) and major swap participants (“MSPs”). Nonetheless, the Coalition believes the proposed requirements will cause unintentional and unnecessary burdens on end-users that will increase hedging costs without mitigating systemic risk or increasing transparency in the over the counter derivatives market. We therefore urge the Commission to modify its proposed rule to minimize these burdens.

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<sup>1</sup> 76 Fed. Reg. 6716 (Feb. 8, 2011).

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In response to the proposed rule, the Coalition recommends the following:

1. That SDs and MSPs should be passive conduits of information for end-users and should not be required to verify that information from end-users is accurate or that an end-user is acting in good faith;
2. That the Commission should require end-users to confirm the basic transaction terms of a trade before execution, but allow complete documentation to wait until after trade execution;
3. That instead of requiring extensive pre-trade documentation of valuation methodology, an SD or MSP should provide commercially reasonable information to substantiate its valuations only when an end-user requests it;
4. That the Commission should avoid policy decisions that are intended to deter the use of customized derivatives or encourage the use of standardized derivatives;
5. That existing ISDA documentation should be deemed sufficient to comply with the requirement to document certain transaction terms; and
6. That the Commission should allow an implementation period of not less than two years for end-users.

## **Requirement that Swap Dealers and Major Swap Participants Must Confirm that End-Users Qualify for the Clearing Exception**

The proposed rule states that for swaps excepted from the mandatory clearing requirement, “[e]ach swap dealer and major swap participant *shall obtain documentation* sufficient to provide a *reasonable basis on which to believe* that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement.”<sup>2</sup>

We appreciate and support the straightforward “check-the-box” approach the CFTC has proposed for end-users to use to qualify for the clearing exception as outlined in the End-User Exception to Mandatory Clearing of Swaps<sup>3</sup> proposed rule. The Coalition is concerned, however, that the “reasonable basis” obligation now proposed by the Commission could undermine the simplicity of the check-the-box approach. If SDs and MSPs must verify end-user information, they may start to require unnecessary and costly documentation from end-users.

For example, to ensure their compliance with the “reasonable basis” obligation, SDs and MSPs may require end-users to provide a legal opinion that substantiates the end-user’s eligibility for the clearing exception. Especially for infrequent hedgers, such a requirement would increase end-user costs. Additionally, we anticipate that, without guidance, each SD and MSP may interpret what constitutes a “reasonable basis” differently, and thereby impose varying documentation requirements on end-users. This would increase the cost of hedging for end-users by creating a non-uniform set of documentation requirements that would change for each and every swap, depending on the counterparty.

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<sup>2</sup> 76 Fed. Reg. 6726 (Feb. 8, 2011) (emphasis added).

<sup>3</sup> 75 Fed. Reg. 80747 (Dec. 23, 2011).

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We believe there is a better approach. Instead of requiring SDs and MSPs to verify an end-user's eligibility for the end-user exception, SDs and MSPs should serve as passive conduits of information. Their role should be limited to reporting. Requiring SDs and MSPs to verify information is unnecessary: The proposed rule for the end-user clearing exception already binds end-users to ensure the truthfulness and accuracy of their end-user information. We believe that this responsibility should fall *only* on end-users.

## **Requirement that MSPs and SDs Document Trades Prior to or Contemporaneously with Execution**

The Coalition is concerned about the stringent timing requirement for swap documentation. The proposed rule requires that “*prior to or contemporaneously with* entering into a swap transaction with any counterparty, other than a derivatives clearing organization, the swap dealer or major swap participant executes written swap trading relationship documentation with its counterparty.”<sup>4</sup>

End-users frequently execute transactions through a competitive auction process with SDs. Any auction participant has only a small chance of winning the auction. Thus, an SD must weigh the cost of preparing to participate in a competitive auction against the potential benefit of participating. When an end-user and its SD counterparties already have swap documentation established, the burden for an SD to bid on a transaction is low. If the parties do not have swap documentation established, however, an SD's costs to prepare to participate in the auction could be high, outweighing any benefit gained from the SD's small chance of winning the auction.

Such situations are common. End-users often invite one or more SDs that have not previously participated in a competitive auction to do so. In other cases, a newly-formed legal entity—even one controlled by an end-user with established counterparty relationships—will not have any swap documentation already established. In situations like these, the parties often wait until the post-trade period to document legal terms. This practice encourages bidders that have a small chance of winning the trade to participate in the auction. Parties generally agree to transaction terms pre-trade (for example, by using pre-trade term sheets), but complete documentation post-trade, only after it becomes clear that a specific SD will serve as the trade counterparty.

The proposed rule requires extensive pre-trade documentation. This approach will reduce the competition in auctions by discouraging banks from participating in the process. While much of Title VII aims to increase transparency in the derivatives market to improve pricing for end-users, this requirement could work against those goals.

End-users also will be required to complete confirmations very quickly after trade execution,<sup>5</sup> which will require additional resources. The proposed documentation rules further compound

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<sup>4</sup> 76 Fed. Reg. 6725 (Feb. 8, 2011) (emphasis added).

<sup>5</sup> The CFTC's proposed rule regarding trade confirmations specifies that confirmations must be executed in as quickly as 15 minutes if the trade is electronically traded and processed, 30 minutes if the trade is only electronically processed, and by the end of the following business day if the trade is not electronically processed. Confirmation, Portfolio Reconciliations, and

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the documentation burden, increasing time and costs to hedge commercial risk. We therefore urge the Commission to allow end-users to agree to transaction terms pre-trade (for example, using pre-trade term sheets or other appropriate means), but to retain the ability to complete documentation post-trade.

## **Requirement that SDs and MSPs Must Specify Valuation Methods, Procedures, Rules, and Inputs in Transaction Documentation**

The proposed rules require that “parties agree on the methods, procedures, rules, and inputs for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap” including “alternative methods for determining the value of the swap in the event of the unavailability or other failure of any input required to value the swap.”<sup>6</sup>

While end-users recognize that this requirement could help clarify how SDs and MSPs value each swap, the Coalition is concerned that this provision will increase cost without a proportionate benefit. Clearly detailing valuation methodologies is theoretically favorable to end-users, but the valuation of most swap transactions already is subject to established market norms. It is thus unclear whether such a requirement would prove sufficiently useful to end-users. Moreover, we are concerned that the proposed valuation requirements could increase the operational burden associated with documenting hedging transactions and, consequently, increase the cost of hedging.

Depending on the type of trade, the best source for inputs may change over time. Defining the precise inputs and sources could prevent parties from using the best market data through the life of a swap. For example, when valuing an interest rate cap, the volatility data may be selected from one data source at the time of trade, but over time, another data source may provide better market data on volatility. Because data sources change and improve, it is not practical to require parties to agree to specific inputs and alternative inputs at the time of trade. In fact, the rigid documentation of valuation methods and data inputs could preclude market participants from rapidly adjusting their methodologies and inputs to the latest best practices.

Requiring parties to document valuation methodology for each trade would also increase end-user burden. For more standardized swaps, valuation methodologies are uniformly understood and variation from one participant to another is small. Repeatedly documenting uniformly understood methodologies for each trade would be redundant and unnecessary. For less standardized swaps, in which multiple valuation methodologies may be appropriate, parties can agree bilaterally on the most suitable methodology. For example, the ISDA Settlement Matrix<sup>7</sup> provides standards and choices for methods and fallbacks. Specific terms apply unless the parties agree otherwise. The Coalition believes the market has and will continue to develop standards and practices that further clarify valuation methodologies, where needed. We do not, however, believe that the Commission should prescribe any such requirements.

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Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81519 (Dec. 28, 2010).

<sup>6</sup> 76 Fed. Reg. 6726 (Feb. 8, 2011).

<sup>7</sup> [http://www.isda.org/c\\_and\\_a/pdf/Settlement-Matrix20110107.pdf](http://www.isda.org/c_and_a/pdf/Settlement-Matrix20110107.pdf)

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The Commission has stated that the need for specifying the valuation methodology and inputs would work in connection with the reconciliation requirements under the proposed rules for “Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants.”<sup>8</sup> Many end-users, however, use internal or third party systems to value their derivatives transactions. It would be impractical for parties to change their valuation methodologies and inputs to match the specifics of each swap dealer’s document on each transaction. Instead, parties typically apply a consistent valuation methodology across their swap portfolio. Moreover, the market has established means for resolving material differences. For example, parties can competitively bid the termination value of a swap in an assignment auction if the parties cannot resolve valuation differences. Such processes ensure competitive, transparent valuations.

Additionally, the Commission requested comment regarding whether the valuation methodology provision in the proposed rule should expressly prohibit use of internal or proprietary inputs and methods. Proprietary inputs are used only when non-proprietary inputs are unavailable. Although end-users often use transactions that do not depend on proprietary inputs, we believe parties should retain the ability to use swaps that depend on internal or proprietary inputs. Our belief is based on the presumption that the swaps address the parties’ risk management needs.

Instead of *requiring* extensive pre-trade documentation of valuation methodology, we propose that if an end-user requests the valuation methodology for a swap, the SD or MSP should provide commercially reasonable information to substantiate its valuations upon the end-user’s request.

## **Swap Standardization**

In the proposed rule, the Commission states that “[t]he purpose of these provisions is to encourage the standardization of swaps . . . .”<sup>9</sup> We strongly oppose this policy approach and believe the Commission should avoid deterring end-users from using customized swaps. Customized swaps are central to end-users’ risk management needs, as they allow end-users to conform their hedges to their specific risks. We believe a policy approach that deters end-users from customizing hedges to match their risks is at odds with the legislative intent of the Dodd-Frank Act of stabilizing the market.

Specifically, the decision to use a standardized swap to hedge a customized risk requires an end-user to accept basis risk—that is, the risk that a mismatch between a hedge and the underlying risk will result in loss to the end-user. End-users are adept at weighing the costs and benefits associated with using customized products. Because standardized trades often require end-users to incur basis risk, a policy that encourages standardization could encourage worse risk management. Therefore, we urge the Commission to avoid policy decisions that are intended to deter the use of customized derivatives or to encourage the use of standardized derivatives. While the Coalition does not believe that a push toward swap standardization is the right policy

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<sup>8</sup> 75 Fed. Reg. 81519 (Dec. 28, 2010).

<sup>9</sup> 76 Fed. Reg. 6719 (Feb. 28, 2011).

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approach, we support the goal of increased transparency in the swap markets, which the Dodd-Frank Act seeks to accomplish.

## **Documentation of Specific Transaction Terms**

The Commission's proposed rule requires the documentation of "terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures."<sup>10</sup> The Coalition believes this requirement simply codifies existing market practice. Specifically, existing ISDA Master Agreements already address the Commission's requirements. It is unclear why regulation is needed to codify existing market practice, especially when such regulation limits the flexibility of market participants. The Commission should clarify that existing ISDA documentation is sufficient for documenting these terms. Additionally, we urge the Commission to exempt trades entered into before the enactment of the Dodd-Frank Act from this requirement.

The Commission asked for comments about whether "the requirement for agreement on events of default or termination events [should] be further defined" and whether the proposed rules should "specifically delineate the types of payment obligation terms that must be included in the trading relationship documentation."<sup>11</sup> We believe ISDA documentation sufficiently addresses these issues and that parties should be allowed to negotiate these terms bilaterally.

## **Implementation Timeline**

With regard to timing of implementation, it is unclear how each SD and MSP would seek to implement changes to comply with swap documentation rules for both existing and new swaps. Therefore, the Coalition proposes a period of not less than two years for implementation for end-users. This period of time will allow for discussions and negotiations across all swap counterparty relationships.

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<sup>10</sup> 76 Fed. Reg. 6715, 6726 (Feb. 8, 2011).

<sup>11</sup> 76 Fed. Reg. 6715, 6720 (Feb. 8, 2011).

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## Conclusion

We thank the Commission for the opportunity to comment on these important issues. We also want to express our appreciation for the willingness of Commission officials to meet with us in order to share perspectives on implementation of the derivatives title. The Coalition looks forward to working with the Commission to help implement rules that will strengthen the derivatives market without unduly burdening business end-users and the economy at large. We are available to meet with the Commission to discuss these issues in more detail.

Sincerely,

Business Roundtable  
National Association of Corporate Treasurers  
National Association of Real Estate Investment Trusts  
U.S. Chamber of Commerce