



September 23, 2011

Committee on Payments and Settlements Systems
C/o Bank for International Settlements
Centralbahnplatz 2
Basel, Switzerland CH-4002

International Organization of Securities Commissions
C/Oquendo 12
28006
Madrid, Spain

Re: Report on OTC Derivatives Data Reporting and Aggregation Requirements dated August 2011

Ladies and Gentlemen:

Better Markets, Inc.¹ appreciates the opportunity to comment on matters identified in the above-captioned Report on OTC Derivatives Data Reporting and Aggregation Requirements (the "Report") of the Committee on Payments and Settlements Systems (the "CPSS") and the International Organization of Securities Commissions ("IOSCO"). The Report was undertaken in response to the mandate of Recommendation 19 of the Financial Stability Board Derivatives Working Group Report submitted to the G20 finance ministers and central bank governors in October 2010 (the "FSB Report").

INTRODUCTION

In the Report, the CPSS and IOSCO have masterfully addressed the complex subject matter of over-the-counter derivatives trade data reporting, aggregation, analysis and dissemination. Pursuant to the FSB Report mandate, the CPSS and IOSCO have furthered the development of minimum data reporting standards and the methodology for the aggregation of data on a global basis.

The work of CPSS and IOSCO is crucial to preventing a recurrence of the events of 2008 which severely damaged the worldwide financial systems and economies, impacting the ability of these systems to provide the production needed to sustain the well-being of billions of people. As noted in the Report, "the lack of adequate information on OTC derivatives exposures is widely seen as having exacerbated the number of corporate distress situations in the recent crisis, including the demise of Lehman Brothers and the

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

near-default of AIG and Bear Stearns.”² The world is left to only imagine how Regulatory Authorities (as used herein, market regulators, central banks, prudential supervisors and resolution authorities) and political leaders might have prevented or, at a minimum, mitigated the disastrous consequences of uncontrolled derivatives trading had they had access to derivatives trade and portfolio data.

Many of the specific causes of the crisis have not yet been rectified, though some Regulatory Authorities around the world are diligently pursuing rules to address them. However, the effectiveness of rules has limits. It is undeniable that derivatives, characterized by uncapped and volatile liabilities, often obscure valuation and impenetrable complexity, were fairly characterized by Warren Buffet as “financial weapons of mass destruction.” Because of their diversity and flexibility, the ways in which derivatives can wreak havoc on the financial system are virtually limitless. The potential for profit is so great that there will always be incentives to create new products with unknown potential risks. Rules can be crafted to attempt to anticipate potential problems, but they will inevitably be imperfect. The most reliable way to empower Regulatory Authorities to *prevent* financial crises is to buttress substantive rules with a system which enables them to meaningfully monitor the trading markets and portfolios of risks.

Methods for executing derivatives transactions have proliferated over the last decade as the industry has seized the advantages offered by modern instantaneous communication and data management. The regulatory thrust to drive execution out of the shadow markets may well accelerate proliferation of execution platforms. Additionally, portfolio risk management through central counterparties, an important goal of financial market reform around the world, may also result in multiple platforms (and multiple CCP risk portfolios), as CCPs respond to the specific needs of the marketplace.

Moreover, the derivatives markets largely exist in cyberspace, defying the concepts of national sovereignty. Regulatory Authority monitoring of the markets over which they have direct legal authority is manifestly inadequate to the task at hand. We need only recall the events of 2008 to be reminded that a failure of confidence in the financial system of one jurisdiction can easily become uncontainable in today’s world.

Traders will inevitably seek opportunities to profit by creatively managing their use of these market infrastructures and regulatory regimes. As modern transportation can spread contagions rapidly around the world, the interconnection of market infrastructures through the traders themselves creates risks alongside the benefits they provide in terms of transparency and reliable risk management. And inadequately coordinated regulatory regimes pose enormous risks that the true viability of the financial system may be obscured, either purposefully by market participants or simply as a byproduct of compartmentalized information.

The Report wisely recognizes these issues and establishes helpful goals to address them. However, specific recommendations must be added to the observations and goals set

² Report, page 3.

forth in the Report to establish a system of information that can help protect the world economy from the inherent risks of the derivatives markets.

The Report recognizes that a system which reliably collects and stores trade data for retrieval, while an improvement, leaves the world economies in great peril. To date, the efforts of existing trade repositories (“TRs”) and much of the regulatory effort have focused on methodologies for collection, storage and retrieval. The daunting obstacles to achieve these functionalities should not be underestimated. However, as observed in the Report, the financial markets cannot be made secure unless the scope of information is broadened and the aggregation of data for meaningful analysis is provided for:

The Task Force recommends that, at a *minimum*, transaction level data be reported to TRs and that *such data include at least* transaction economics, *counterparty information*, underlier information, operational data and *event data*. The Task Force found that *certain information, such as that contained in master agreements and credit support annexes*, will be helpful for assessing systemic risk and financial stability but that presently such information is not supported by TRs. [Emphasis Added]³

The responsibilities of TRs must be adjusted and a system of integration must be established if this minimum standard is to be met.

This comment letter seeks to advance the discussion of methodologies for data collection and, perhaps most important, aggregation and analysis by proposing specific concepts. It seeks to further the goals and recommendations of the Report, not critique them. In particular, it will point out common industry practices for recording and valuing illiquid swaps, options and complex transactions which are actually multiple commonplace derivatives packaged together (often referred to as “bespoke”). Too often, these contracts are seen as posing difficult obstacles. In fact, there are common sense and commonplace methodologies which provide solutions. This is to be expected, since financial institutions throughout the world have had to address the same issues for years.

SUMMARY OF COMMENTS

The CPSS and IOSCO have requested comments on three broad areas addressed in the Report: data gaps, international legal identifiers and a standard international product classification system. This comment letter will address these issues in that order. Our comments include the following:

- **Aggregation is more than compilation.** It involves the organization of raw transaction data into categories using a common language so that the

³ Report, page 2.

derivatives markets can be meaningfully monitored, analyzed and, in the event of insolvencies, protected by orderly resolution of portfolios. Systems which enable efficient and comprehensive aggregation of data are essential to achieving the goals set by the G20. Aggregation requires the organization of data across product and jurisdictional lines so that an accurate representation of the marketplace will be available to all Regulatory Authorities. Specific and known processes can be used to fulfill these needs. Worldwide financial systems are interconnected; without doubt, the information systems used to monitor them should also be interconnected.

- The narrow scope of TR activity that has evolved in the marketplace and has become the focus of many Regulatory Authorities leaves substantial and critically important gaps in information required to meet the goals of the G20. Importantly, information relating to counterparty exposures in uncleared derivatives is not adequately captured. There are relatively straightforward and low-cost mechanics for the capture and organization of this information and for tying it to the basic trade data.
- Valuation, an inherently inexact process, requires the organization of raw transaction data and the application of procedures that are commonly used in the financial services industry. Complex transactions must be disaggregated into measureable units for valuation. Measurable risk positions must be grouped into hedge-equivalent categories so that less liquid positions can be valued usefully. Options must be valued using delta-equivalent methodologies. It is essential that valuation not be left as the responsibility of individual market participants.
- Recordation and measurement of current, netted bi-lateral exposures and collateralization are essential to monitoring of the most critical risks embedded in derivatives. Uniform procedures for reporting and measurement are required. Important steps can be taken to improve and standardize the quality, valuation and availability of margin collateral.
- Uniform legal entity identifiers are essential to achieving the goals of the G20. The tasks are not technologically complex, but must accommodate a rigorous analysis of real parties in interest, especially given the multiple layers of international financial institutions. A central registration agent is essential to maintaining reliable and uniform system of entity identification. A principal obstacle is the voluntary approach taken to date. Far more direction is needed from the Regulatory Authorities to resolve disputes and motivate decisions.
- A standard international product identification system, capable of disaggregation of transactions into substantive risk units, is needed to enable Regulatory Authorities to monitor markets across products and jurisdictions. As with legal entity identifiers, a single point of responsibility is required.

While the undertaking requires many and diverse categories of information, the process has been successfully accomplished by many large financial institutions and central counterparties. Regulatory Authorities must assert leadership and provide direction to achieve a useful system, rather than relying on voluntary implementation by market participants.

- With multiple TRs organized according to products and jurisdictions, the most efficient way forward is a central, non-profit aggregator which serves the needs of multiple Regulatory Authorities on a shared cost basis and which can also serve as registration agent for legal entity and standard product identifiers.

COMMENTS

Aggregation

An over-arching concept of the Report is aggregation. Regulatory approaches to date have centered their attention on ways to capture trade data from the markets effectively. The Report points out that existing TRs are organized along asset class lines, dividing data which is inter-related in many ways, including measurement of bi-lateral risk.⁴ It is reasonable that Regulatory Authorities have explored approaches involving derivatives trade data capture by multiple TRs which can respond to the many segments of the derivatives markets.

However, the ultimate goal of regulation is not to capture the data or even to make it literally available to the authorities. The body of trade data must be meaningful and useful. Effective aggregation is an important factor in reaching the G20 goals of monitoring systemic risk through derivatives market transparency.⁵ The current effort constitutes a tremendous opportunity to establish a system in which derivatives markets are truly transparent to the Regulatory Authorities and the public. A vast sea of information may actually be completely non-transparent if it omits important information or is not organized to reflect the inter-relationship of various categories of derivatives.

Aggregation is the process of making sense of the mass of information. It is not merely compiling the trade data. Instead, it is a process of organizing data so that it fulfills the G20's goals of assessing systemic risk, conducting market surveillance and enforcement, aiding resolution, transparency and enhanced market supervision.⁶ It requires classification systems as well as interconnection of classifications. In reality, derivatives market segments, such as interest rates, currencies, equities, credit and commodities, do not exist in a vacuum. Similarly, market forces are not defined by national borders.⁷ The system which

⁴ Report, page 8.

⁵ Report, page 33.

⁶ Report, pages 21-22.

⁷ "To maximise their ability to carry out their respective mandates, market regulators, central banks, prudential supervisors, overseers and resolution authorities may need a global view of OTC

includes the work of TRs must reflect the interconnectedness of markets if these goals are to be achieved.

Further, aggregation must group data which is related on a rational basis, regardless of the source of the data. “[Product] aggregation would involve the aggregation of OTC derivatives activity in one product with other OTC derivatives products sharing common risk factors.”⁸ In the Report, the complexity of this process is cited. However, these relationships are essential to valuation (see discussion of hedge equivalents, below) and portfolio risk calculations. The process is well understood by financial institutions and central counterparties. Although implementation poses a challenge, the pathway is well travelled.

Therefore, the systems which enable the Regulatory Authorities to access the trade database must enable analysis across markets and jurisdictions if it is to be truly successful. Such systems must employ a common language. The use of common legal entity and product codes is but a start. Common language also requires common interpretative tools for valuation, risk disaggregation and classification and other matters.

There are two ways to approach this. The systems developed by the Regulatory Authorities can enable comprehensive analysis by independent systems. This would require that the information transmitted from multiple sources use precisely the same language so that it can be compiled by the regulator and then more easily analyzed and shared among Regulatory Authorities. Alternatively, translation systems must be interposed to standardize the language of the data.

The other approach is to establish a disinterested, reliable aggregator, tasked by multiple Regulatory Authorities to harmonize multiple data streams and maintain a uniform database and monitoring and analysis protocols. In addition, the aggregator would serve as the registration agent for legal entity and product identifier systems, discussed in the Report. Various Regulatory Authorities would have a common view of interconnected markets and access to monitoring and ad hoc analysis. This is completely consistent with the Report.

Efforts to enhance authorities’ ability to aggregate OTC derivatives data face a number of notable challenges. A principal challenge lies in the need to achieve global consensus on methods of data aggregation and the tools that would facilitate these methods of data aggregation. A common international approach, despite the difficulties inherent in achieving international agreement, would significantly increase the likelihood of meeting the G20 objectives. A common approach would also reduce the possibility of undesirable regulatory arbitrage.⁹

derivatives markets through effective and practical access to relevant data, as well as an ability to aggregate it efficiently.” Report, page 16.

⁸ Report, page 23.

⁹ Report, page 6.

Governance of such an entity is a critical concern.¹⁰ Optimally, the aggregator should be a not-for-profit entity whose costs are shared by the Regulatory Authorities of multiple jurisdictions.

Use of an aggregator is completely responsive to the realities of a derivatives market which is fundamentally interconnected in terms of product and operates outside of jurisdictional boundaries. In terms of costs, efficiency and reliable and comparable analysis, this alternative is the most sensible. It must be recognized, however, that political, organizational and funding issues would be raised by this approach.

Additionally, as discussed below, the voluntary approach to development of a legal entity and standard product identification system has constituted an obstacle to progress. A central aggregator could establish common identifiers and publish an API (“application program interface,” or code which provides the syntax of a data system to which multiple information providers can write conforming code), requiring market participants and TRs either to write to the API or to conform their system syntax to international standards. This would be an effective way to assert needed leadership by directing progress toward a meaningful data capture and aggregation system.

Data Gaps

The Report identifies the tremendously important role of TRs in the effort to move derivatives out of obscure and dangerous shadow markets:

Reporting OTC derivatives data to a TR enables authorities to have accurate information concerning an OTC derivatives contract shortly after it is entered into, as well as information concerning any changes to the contract throughout its existence. In addition, given their centralised role, TRs are in a position to provide information on OTC derivatives markets that could serve to (i) enhance the transparency of information to relevant authorities and the public, (ii) promote financial stability, and (iii) assist in the detection and prevention of market abuse.¹¹

The Report proceeds to examine initiatives undertaken to date to create and implement TRs, noting that the efforts have been asset-class focused and primarily limited in reach to national or regional marketplaces.¹²

¹⁰ In relation to the LEI system, Report page 3 and Annex 3.

¹¹ Report, page 4.

¹² Report, pages 4-5.

The breadth of capability of TRs to date is completely inadequate to fulfill the objectives of the Regulatory Authorities as described in the FSB Report: (i) assessing systemic risk and financial stability; (ii) conducting market surveillance and enforcement; (iii) supervising market participants; and (iv) conducting resolution activities.¹³ Systemic risk has been defined as “the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy.”¹⁴ The weaknesses in the financial markets which contributed to the systemic risk that came to fruition in 2008 have been described as the build-up of large and mis-managed counterparty exposures, interconnectedness of market participants leading to risk contagion and lack of transparency.¹⁵ Capture of basic trade data does not address these issues (not even transparency), unless the data is aggregated so as to be meaningfully useful.

The capture of descriptive trade data at the point of execution is helpful, but if it is stored in electronic asset-class silos on a jurisdiction-by-jurisdiction basis, its usefulness is severely restricted. Markets for individual asset classes do not exist in a vacuum; rather they are inter-related. If a major financial institution organized its business so that those responsible for individual derivatives asset classes or regional markets conducted their operation without regard to other derivatives activities, the institution would be considered dangerously flawed because it would be operating blindly in key areas. The information available to the public and Regulatory Authorities must be comparable across both asset classes and borders just as private market participants now do for their own businesses.

Similarly, the Report identifies two separate approaches to data collection.¹⁶ The snapshot approach envisions data collection at the inception of a transaction followed by periodic updates to reflect the current state of the contract. In contrast, in a lifecycle approach data is continuously collected post-inception. The lifecycle approach is far superior for several purposes, including continuous monitoring. Financial institutions clearly monitor positions continuously and there is no reason that Regulatory Authorities should have a lesser level of capability.

Current Market Values of Individual Open OTC Derivatives Transactions

While valuation of OTC derivatives is not an art form, it is also not a process which seeks a single, incontrovertible solution. The true value of a derivative is the price at which it can be transacted at a given point in time. Prior transaction prices provide information which is helpful, but they are out-of-date as soon as they are available. Furthermore, all

¹³ See FSB Report, page 8.

¹⁴ See *Report on Consolidation in the Financial Sector*, at 126; G-10 (January 2001), available at <http://www.bis.org/publ/gten05.pdf>.

¹⁵ FSB Report, page 1.

¹⁶ Report, page 13.

pricing markets are subject to influences which limit the reliability of prior transacted prices. In other words, markets are inherently imperfect. As a result, all valuation is a process of estimation in which the parameters are a matter of judgment and analysis that optimally is well-suited to the characteristics of the marketplace.

Generally, prices transacted in markets which are highly liquid and transparent, such as some anonymous central order book exchanges, are considered to be relatively more reliable. However, all prices on an exchange are not equal. This is especially true if the influence of high-frequency algorithmic traders who seek to profit from (and induce) intra-day volatility is prevalent. Often, prices transacted at the close of trading and in size are considered more “transactable.”

As a result, reference to prices derived from liquid and transparent exchanges is desirable for purposes of valuation, provided that exchanges have rules in place to address trading strategies that distort price.

But this first principle by no means addresses the problem of valuation of OTC derivatives. This market often involves derivatives which have one or both of the following characteristics: the underlying product may be illiquid to the point that a timely and transparent transaction-based price is unavailable, and the terms of the transaction may be so complex or idiosyncratic that the transaction is unique or rare.

The Report recognizes these concerns, but the discussion must be advanced far beyond this point. Valuation which is both as accurate as possible and comparable is essential to the ongoing monitoring of derivatives portfolios. The following concrete recommendations address the issues in a practical way.

Reporting of valuation by individual market participants must be eliminated or strictly constrained. The Report clearly envisions that valuation will be periodically reported by market participants to TRs.¹⁷ It then catalogues the potential pitfalls in such a process.

Ultimately, reliable and comparable valuation for an asset class can only be achieved if it is the responsibility of a single entity using consistent and prudent rules for estimation. The range of discretion is so great that a participant-based system can never avoid the potential for biased results which enable trading strategies. It may be that the development of independent valuation entities is a process which must be implemented over time. However, this goal is centrally important to achieving a reliable system of protections.

Valuation of less liquid contracts must rely on liquid, hedge-equivalent contracts. Predominantly, less liquid contracts do not exist in a vacuum. Their pricing is related to contracts that are exchange traded and relatively liquid. Identification of these exchange traded contracts is largely a matter of examining market practices. For instance, less liquid

¹⁷ Report, page 14.

swap positions are often hedged with futures contracts using quantity ratios based on price-change correlations. Options are often valued based on delta-equivalents to futures positions. Valuation of less-liquid positions by referencing hedge equivalents and valuation of options by referencing delta equivalents is the predominant practice of market participants, and should in no way be considered a novel methodology.

The TR or aggregator must be enabled to use these liquid equivalent contract prices as a foundation for valuation. Delta equivalents can then be derived for options. For swaps, basis differentials to liquid reference prices can be used as available (which may be less frequent than changes to the hedge equivalent contract), but changes to liquid reference prices cannot be ignored.

This is not a novel proposition. It is precisely the procedure used by financial institutions to value their positions (This will be the case for many of the recommendations set forth in this comment letter). This methodology should in no way be considered to be difficult to achieve; it is simply the accepted and sensible way that virtually every market participant values these types of positions. The goal of the Regulatory Authorities should be to develop independent valuation processes which, at a minimum, employ the techniques universally used in the financial services industry.

Hedge equivalency parallels important elements of portfolio risk assessment and netting. The price movement relationships among categories of derivatives can be an important guide to the essential task of developing appropriate product taxonomy of general applicability.¹⁸

Valuation must be driven by the substantive risks embedded in a given transaction, not the form of the transaction. Throughout the deliberative process for reform of the financial systems, the specter of the “non-standard” or “bespoke” transaction has been raised as an obstacle to regulation and data capture. While it is admitted that the volume of such transactions is low compared to the large, liquid markets such as interest rate swaps, the relative risk embedded in each transaction is very high.

The discussion is puzzling in many ways. If it is practically impossible to record, value and manage the risks associated with these transactions—as the industry would have us believe and as is the logical extension of so many of their arguments—how is it remotely possible or defensible for a financial institution to enter into them. Such trading activities would make internal risk management, including capital commitment decisions and monitoring, virtually impossible, which everyone knows is not true. In essence, these industry arguments amount to an admission that they are gambling rather than entering into hedgeable financial transactions.

¹⁸ Report, page 33.

In reality, financial market participants are, for the most part, not gambling (or at least not doing so intentionally). As it relates to TRs, the issue is simply being posed incorrectly.

In a recent roundtable on unique identifiers and other topics sponsored by the Commodity Futures Trading Commission (“CFTC”), one of the industry’s representatives described how composite derivatives are broken down into more conventional units or legs for purposes of internal recording and monitoring a market participant’s portfolio.¹⁹ His analysis of the need for disaggregation is correct. Often dealers structure derivatives which are composites of straightforward swaps. They may bridge asset classes or be composed of different products within asset classes. Execution in a single transaction rather than multiple transactions is irrelevant; only the component risks matter, and they are well known at the time of the transaction, at least to the party hedging them.

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

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

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

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

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

¹⁹ CFTC Roundtable, January 28, 2011. Swap Data Recordkeeping and Reporting, Comments of Adam Litke commencing on Transcript page 187; available at http://cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission17_012811-transcri.pdf

- A power swap at the delivery point (Pepco) with a quantity equal to the quantity of assumed power sold fixing the price at \$55.47/mwh.

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

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

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

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

Regardless of the actual reason(s), *the market data available to the TRs must be at least as useful and decipherable as the data currently available to dealers as they measure and monitor their own positions, as they must and do every day for economic, compliance, business and legal reasons.* The reporting entity must assign a market-based price to the components of a composite derivative. Likewise, derivatives within asset classes, but involving different products or temporal terms, must be assigned component prices. In addition, virtually all of these trades and positions are hedged, which would provide Regulatory Authorities with a wealth of existing information.

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

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

Current exposure, netting and collateralisation information on bilateral portfolios of OTC derivatives transactions

Every bi-lateral derivative is, in reality, two separate transactions. First, it is a derivative on the price of the underlying product or security. Second, because it is a bilateral executory contract requiring financial performance, it is a credit transaction based on counterparty credit exposures to price moves. To the extent that the credit exposure is margined using reliable procedures and secure collateral, the exposure should be minimal. To the extent it is not so margined, the credit exposure could be material. Therefore the only rational analysis based on true value is that compensation for the extension of credit is paid to the party incurring the exposure.²⁰

If there were ever any doubt about this, the discussion of this issue in the recent Dodd-Frank Act implementation roundtable sponsored by the CFTC and the Securities and Exchange Commission should put it to rest.²¹

Basic Information. The terms governing the credit exposure portion of the transaction are typically governed by a Master Swap Agreement and Credit Support Annex between the counterparties. The existence and effectiveness of bi-lateral netting agreements is a threshold issue.²² If netting in the event of insolvency is effective, the proper measurement is net exposure rather than gross.

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

The Report recognizes the need to address the gap in information which arises from the credit aspect of derivatives transactions.

The Task Force found that certain information, such as that contained in master agreements and credit support annexes, will be helpful for assessing systemic

²⁰ Professor John Parsons of MIT and Professor Antonio Mello of the University of Wisconsin have written extensively on the forborne derivatives collateral and the embedded loan. Some of these materials can be found at:

<http://bettingthebusiness.com/2010/10/25/otc-5-the-collateral-boogeyman-%E2%80%93-packaging-credit-implicitly-and-explicitly/>

<http://bettingthebusiness.com/2010/10/07/otc-3-the-collateral-boogeyman-%E2%80%93-the-delusion-of-%E2%80%9Cfree%E2%80%9D-credit-from-your-friendly-neighborhood-derivatives-dealer/>.

²¹ CFTC and SEC Implementation Roundtable Transcript, First Day, pages 190, line 4 through page 193, line 11; available at

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/csjac_transcript050311.pdf.

²² Report, page 24.

risk and financial stability but that presently such information is not supported by TRs.²³

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

Recommendations. Current information relating to the credit exposures is critical to fulfilling the purposes of TRs relating to resolution of defaults. As a threshold matter, information necessary to evaluate net bi-lateral portfolios must be captured by TRs.²⁴ We recommend that the following reporting to TRs be required:

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

²³ Report, page 2

²⁴ Report, page 15.

- Whether the terms permitting revocation of any thresholds have been triggered.

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

The systems of each TR must allow Regulatory Authorities to pull reports for each market participant listing by counterparty, including:

- Net value of portfolio positions;
- Threshold consumed and available; and
- Margin held (see discussion of valuation below).

Information on collateral assets that are applied to collateralised OTC derivatives portfolios, including the valuation and disposition of these collateral assets

Collateral limitations, valuation and disposition should be relatively uniform for each market. At least some Regulatory Authorities have proposed specific requirements for uncleared swaps.²⁵ While separate affirmative reporting in other jurisdictions along with the summary terms described above will prove useful, we recommend a different approach which could enhance uniformity.

The Regulatory Authority in each jurisdiction would establish standard limitations, valuation and disposition terms. Any divergence from these standards would be reported to the TR for recordation in the appropriate sub-file described above. By articulating a standard, the Regulatory Authority would create an impetus toward uniformity.

International Legal Entity Identifiers (“LEIs”)

Any observer of the crisis which beset the global financial system in 2008 must conclude that the interconnectedness of the derivatives markets across international boundaries is a critical element of systemic risk.²⁶ The derivatives markets of one jurisdiction are intertwined with those of other jurisdictions.

If data captured by TRs is to be as useful as possible to avert another crisis, this interconnectedness must be addressed. Any impediment to viewing the positions and market activities as a whole must be avoided. Multiple identifications across TRs could

²⁵ See Commodities Futures Trading Commission, Proposed Rule, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Federal Register 23732.

²⁶ For example, see Baba and Packer, “From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers,” BIS Working Papers No, 285, July 2009.

mask the substantive identities of market participants, and this potential could actually be used purposefully to avoid desired regulatory results.²⁷ The first step is a common language which allows the broadest possible access to data.

The Report recognizes that legal entity identifiers are central to this result:

[A] standard system of LEIs is an essential tool for aggregation of OTC derivatives data. An LEI would contribute to the ability of authorities to fulfill the systemic risk mitigation, transparency, and market abuse protection goals established by the G20 commitments related to OTC derivatives, and would benefit efficiency and transparency in many other areas. As a universally available system for uniquely identifying legal entities in multiple financial data applications, LEIs would constitute a global public good.²⁸

The LEI system is not merely a method of hanging tags off of entities for tracking purposes. The complex world of international financial institutions is an environment in which entity interest is often obscure and complex. Rules will emerge to aggregate the activities of multiple legal entities such as affiliates and branches based on pragmatic standards. "For example, an authority could aggregate the activity of a counterparty to an uncleared OTC derivatives product with the activity of the counterparty's guarantors, its credit support providers, or its affiliates or other 'specified entities' under the applicable master agreement(s)."²⁹ In application, the LEI system must be designed to accommodate these rules.

The Report identifies two distinct functions related to LEIs.³⁰ A registration agent would be responsible for issuing LEIs, verifying identities and maintaining information related to verification. An international standards body would provide oversight and assure that appropriate principles were followed.

Two approaches to the registration agent function are identified in the report. It could be a central entity, serving all markets as a non-profit utility. Alternatively, a federated or decentralized model could be pursued under which jurisdictions governed the actual issuance of LEIs, subject to adherence to the international standards body.

Data availability to the Regulatory Authorities is critical to monitoring markets so as to avoid risks of catastrophic crises. OTC derivatives markets are not defined by national borders and the information systems must not be either. Uniformity of language

²⁷ Report, page 10.

²⁸ Report, pages 36-37.

²⁹ Report, page 23.

³⁰ Report, Appendix 3, page 54.

is the threshold step toward achieving access to information which gives the Regulatory Authorities an accurate and comprehensive view of the marketplace.

The centralized approach to the registration agent role is by far the better alternative. The assignment of entity identifiers is closely related to the issue of defining an entity for regulatory purposes. For example, an international financial institution may have affiliated organizations of various forms. These may include subsidiaries operating in jurisdictions different from the institution's primary location, foreign branches and jointly owned undertakings. Categorizing the many entities of such an organization may be critical to understanding the systemic risk impact of its overall activities. Introducing variance in the process of assigning LEIs based on jurisdictional rules risks that the aggregation of data will obscure actual OTC positions and exposures rather than illuminate them.

It should be noted that the role of registration agent is functionally synergistic with an aggregator of information. As discussed above, the most efficient and cost-effective approach would be to combine these functions in an organization which serves the needs of multiple Regulatory Authorities.

It is recognized that a fundamental obstacle to implementation of a workable LEI system is that efforts to date have been voluntary.³¹ As illustrated in the Report, the choices may involve costs, but they are not technologically challenging or complex and, in the intermediate term, they will be valuable to the private sector as well as the Regulatory Authorities. It is obvious that deadlines, consequences of delay and strong leadership from the Regulatory Authorities are important ingredients of a successful LEI system.

Development of a Standard International Product Classification System

The CPSS and IOSCO have characterized the effort to develop a product classification system by referring to "the OTC derivatives landscape, that consists of a broad and heterogeneous set of instruments involving a range of asset classes, referenced underliers and varying communities of users and intermediaries."³² While this sounds like a daunting task, it is more feasible than such descriptions suggest. For example, the Chicago Mercantile Exchange offers over 1300 separate contracts, each with its own descriptive code.³³ It may require resources, time, experience and organizational skills, but it is very much within the capability of existing systems and knowledge bases.

While the effort will be overwhelmingly a function of organization and critical path management, it is eminently achievable with really no more than a commitment of will and resources.

³¹ Report, page 29.

³² Report, Cover Letter, page 3.

³³ For a list of CME product codes, see <http://www.cmegroup.com/product-codes-listing/>.

The ability to adequately complete this task is in no way subject to question. However, the collective will to complete it adequately most certainly is. In a recent roundtable sponsored by the CFTC, an industry representative was pressed on the issue of progress toward product identification. He replied that financial industry professionals have busy schedules and have trouble finding a time to meet.³⁴ This comment illustrates the fundamental obstacle: insufficient will to make progress. This process involves operational costs to the financial services industry which they, quite naturally, seek to defer or avoid. Market participants will simply not be motivated to expend the time and resources needed to accomplish the task based on persuasion and a desire to mitigate systemic risks.

Motivation must include a coercive element. Regulatory Authorities must not only participate in the process, they must lead it. And an essential element is the establishment of clear and firm deadlines with consequences. Regulatory Authorities must be willing to impose product classifications if the industry cannot reach consensus.

The threshold requirement is that unambiguous goals and deadlines must be established by Regulatory Authorities and policy makers. As referenced above in connection with LEIs, product identification systems constitute a global public good. Achieving this good requires the direct and determined involvement of those who are responsible for serving the public interest.

It is clear that this is an organic process which must respond to an ever-changing marketplace. Products will change and the system for identifying them must be able to evolve. At the same time, it is clear that the vast majority of transaction volume in each class of derivatives is relatively identifiable. A phased approach is not only a practical solution, it is virtually inevitable.³⁵ While it may be that the process can never provide identifiers for every product that the financial market can create, it can clearly reach a critical mass in a reasonable time period.

We recommend that several principles be adopted:

- While the involvement of financial services professionals is needed, there must be a central entity representing the public's interest which is tasked to oversee and implement the process. It must be recognized that such an entity will serve this purpose on a continuous basis, recognizing that derivatives markets will change and the product identification systems must evolve.

³⁴ CFTC Roundtable, Swaps Data Recordkeeping and Reporting Requirements. June 6, 2011 Remarks of Mr. Demaria at page 100; available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dsubmission/dsubmission17_060811-trans.pdf

³⁵ Report, pages 33-34.

- Regulatory Authorities from various jurisdictions must be committed to a common set of product identifiers. It is in the interest of all if the data from all markets can be viewed as a comprehensive whole. This addresses the basic issue of interconnectedness in a way which responds to the modern derivatives markets.
- Each class of derivatives must be addressed separately. Not only are they distinctive, but separate working groups can reduce the overall time required to achieve practical solutions. Nevertheless, there are general principles which must be developed and implementation must be guided by them. A central entity would be responsible for identifying these principles and assuring that the groups developing product identifiers for individual derivatives classes adhere to the principles.
- It must be made clear that there is a distinction between transactions and risks as the product identifier systems are constructed. (See the discussion of valuation, above.) A transaction may consist of a single product/risk component. A transaction can also consist of an infinite number of combinations of product/risk. From the perspective of portfolio risk analysis, there is no difference between derivatives entered into separately and compound derivatives. The system for product identifiers must allow for disaggregation and reporting on a component product/risk basis. Trade Identifiers are called for in the Report.³⁶ These are important because disaggregated risk may need to be re-aggregated for certain types of analysis. However, to value positions, evaluate portfolio risk properly and create a data base which reflects reality, identifiers for component risks are required.

CONCLUSION

The Report addresses a set of issues that may well define the most important bulwark against the recurrence of the 2008 global financial crisis. Derivatives do not involve owning real estate, companies or oil in the ground. They are defined by information flows. Rules which guard against unacceptably risky and predatory behavior are important. However, the constant mutation of a marketplace that is so conceptual and subject to manipulation is a challenge to all Regulatory Authorities. By definition, unlike an investment in which one's losses are capped at the amount invested, derivatives pose seemingly boundless risks to the financial system. Regulatory Authorities must be enabled to view the global, integrated market in "real" time if the goals of the G20 are to be achieved.

³⁶ Report, page 34.

We hope that our comments are useful to CPSS and IOSCO as the effort to implement the systems and protections envisioned in the Report move forward.

Sincerely,



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