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Via Electronic Submission

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Re: Rules Implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Stawick, Ms. Murphy, Ms. Johnson and Mr. Feldman:

We are writing to the Commodity Futures Trading Commission (the "CFTC"), the Securities and Exchange Commission (the "SEC"), the Board of Governors of the Federal Reserve System (the

"Board of Governors") and the Federal Deposit Insurance Corporation (the "FDIC" and, together with the CFTC, the SEC and the Board of Governors, the "Regulators") regarding the adoption of rules implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). We would like to add our voice to those industry groups, members of Congress, leading experts and others who have urged the Regulators to repropose all of the core derivatives rules under the Act at a single time and to allow industry participants an opportunity to comment on the proposed new regulatory framework as a whole.[1] By this letter, we hope to provide the perspective of our institutional investor clients to the discussion regarding a sensible and effective approach to completing the rulemaking process. No less than the dealer community and other regulated entities, buy-side market participants have a material stake in the new regulatory systems being developed. The rules will not only directly affect their rights and obligations in respect of other market participants, but could also dramatically alter the markets in which they trade. Correspondingly, the markets themselves have an obvious stake in these investors not being unnecessarily discouraged from participation in the derivatives market as a result of unduly onerous, inconsistent or unintended regulatory barriers. To illustrate the difficulties with the current rulemaking from an institutional buy-side perspective, we have used as examples two issues of general concern – the risk measurement of options in different contexts and counterparty relationships under the business conduct standards.

We urge reproposal of the whole core set of derivatives rules, full well aware that the Regulators' rulemaking effort to this point has been enormous and the level of interagency cooperation has been unprecedented. We also recognize that the deadline prescribed by the Act for implementation of many of the derivatives rules under Title VII already has been extended by the Regulators and that further delay may entail continuation of risks that the Act was designed to eliminate.[2] Our clients remain concerned about existing risks in the markets and have taken steps themselves to reduce risks and uncertainty (*e.g.*, by posting initial margin to tri-party margin accounts and by maintaining significant liquidity buffers). We nevertheless believe that it is critical at this time to take a step back, carefully consider how the rulemaking has proceeded to this point, and determine how to move forward in order to provide a coherent and workable regulatory scheme. The discussion at last Thursday's open meeting of the CFTC points out the Regulators' own concerns with the proper staging of final rule adoptions. We would respectfully encourage the Regulators to follow these concerns all the way to their logical solution, which is comprehensive reproposal of the rules.

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[1] *See, e.g.*, testimony of Hal S. Scott, Director of the Committee on Capital Markets Regulation and Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School, before the Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, United States House of Representatives (April 13, 2011), *available at* http://agriculture.house.gov/pdf/hearings/Scott110413.pdf; *see also* Letter from the Futures Industry Association, The Financial Services Roundtable, Institute of International Bankers, Insured Retirement Institute, International Swaps and Derivatives Association, Securities Industry and Financial Markets Association, and U.S. Chamber of Commerce to the SEC (May 31, 2011), *available at* http://www.sifma.org/issues/item.aspx?id=25741.

[2] *See* Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, 76 Fed. Reg. 36287 (June 22, 2011); Effective Date for Swap Regulation, 76 Fed. Reg. 42508 (July 19, 2011).

In the interests of meeting the tight deadlines for rulemaking prescribed by the Act, the Regulators have employed multiple internal rulemaking teams, in many cases coordinated with a team working on complementary rulemaking at another agency, and in some cases coordinated with teams at several other federal financial regulatory agencies. Rules have been proposed, one by one, as they have been developed and approved for proposal by the respective Regulators. At several junctures in proposing a new rule, the CFTC and the SEC, in particular, have obviously taken into account the public comments already received with respect to a companion rule of the other agency. Despite demonstrable efforts at coordination, the process of numerous separate rulemakings does not – indeed, cannot – provide any assurance to market participants that the regulatory framework has been constructed and tested as a comprehensive whole. The Regulators may appropriately believe that they have been performing this function as each new proposed rule has been approved for comment. However, the proper fit of a new rule into an overall regulatory framework is also very much the business of public comment in accordance with the Administrative Procedure Act.[3]

While it has been hard work for the Regulators and their staff to draft so many rules in so short a time, it also has been hard work for market participants to follow not only the details but also the basic direction of some of the most directly pertinent rulemaking. There has been, and continues to be, significant confusion. Institutional investors are asking questions such as: Does a Regulator really intend the result described in a particular proposed rule, where it is proposing a different result in an analogous context in a related rulemaking? Does a Regulator understand that another Regulator seems to be taking a different tack on a question that, from the standpoint of a market participant, should not have different answers depending on whether the instrument traded is a swap or a security-based swap? How do I think about conduct rules when it is unclear whether I am to be treated as the regulated party providing protections (*i.e.*, a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant) or the unregulated party receiving protections? Is it sufficient to weigh costs and benefits on an individual-rule basis, when it is likely that they cumulate, offset and multiply across the overall scheme of regulation and, in the end, comprise a whole that is different from the sum of its parts?

It is understood that the Administrative Procedure Act provides no guarantees to interested persons or trade organizations that their comments will be reflected in an agency's final rules. However, the rulemaking process should in all events provide reasonable notice to stakeholders of what the issues are likely to be and the range of probable solutions. This is difficult to provide in the case of a multi-variable equation, with a large number of variables still unknown.

As the Regulators push ahead toward an increasing number of final rules, we would hope that they would identify a core group of rules that relate directly to daily transacting in the derivatives markets, coordinate and homogenize these rules in final rule proposals, and then repropose all of them together. From the standpoint of an institutional investor, we believe that this core should include rules relating to: the registration and regulation of swap dealers, major swap participants, security-based swap dealers and major security-based swap participants; the external business conduct of regulated intermediaries; margin; position limits; trade reporting and market

[3] Administrative Procedure Act, 5 U.S.C. §§ 551-559.

transparency responsibilities; the business of clearing, including customer documentation, clearing member risk management and protection of customer collateral; and the functioning of swap execution facilities.

Illustrated below are but two examples of moving targets within the rulemakings and the difficulties they pose for providing effective and thoughtful comments to the Regulators. The first relates to the proper measurement of risk inherent in options. The second relates to the duties of dealers and "MSPs" (defined below) to special entities. We note that these are topics on which we and others have provided extensive prior comments – and will likely provide further comments, given the necessarily iterative process of the rulemaking.[4]

The Act effectively requires risk to be measured for several purposes, including:

- the reporting of risk on proposed Form PF to the Financial Stability Oversight Council ("FSOC") to aid in its assessment of systemic risk,[5]
- the determination of whether a market participant is required to register and be regulated as a "major swap participant" or "major security-based swap participant" (collectively referred to herein as an "MSP"),[6] and
- the setting of initial margin.[7]

These are complex topics, and the treatment of options in these schemes is only a sub-topic for most in the dealer community. It is nevertheless a major issue for several of our institutional investor clients. Options -- including deep out-of-the-money options -- are often used to implement hedging strategies, such as capping the interest rate risk of the holder of a portfolio of mortgages or allowing an investor to protect against possible "tail risks" or "black swans." Additionally, options are frequently the instrument of choice for conservative investors who buy options as a means of

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[4] *See, e.g.*, Letter of Christopher A. Klem, Ropes & Gray LLP, to the CFTC and the SEC (Feb. 22, 2011) (commenting on proposed definitions of "Major Swap Participant" and "Major Security-Based Swap Participant"), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27807&SearchText=klem; Letter of Christopher A. Klem and Molly Moore, Ropes & Gray LLP, to the CFTC (Feb. 22, 2011) (commenting on proposed business conduct standards for Swap Dealers and Major Swap Participants), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27805&SearchText=klem; Letter of Christopher A. Klem and Molly Moore, Ropes & Gray LLP, to the SEC (Aug. 29, 2011) (commenting on proposed business conduct standards for Security-Based Swap Dealers and Major Security-Based Swap Participants), *available at* http://sec.gov/comments/s7-25-11/s72511-12.pdf.

[5] *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (Feb. 11, 2011) [hereinafter "Proposed Form PF Regulations"] (Joint Proposed Rulemaking of the CFTC and SEC).

[6] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," and "Major Security-Based Swap Participant," 75 Fed. Reg. 80174 (Dec. 21, 2010) (Joint Proposed Rulemaking of the CFTC and SEC).

[7] *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (May 11, 2011) (Joint Proposed Rulemaking of the Department of the Treasury, Office of the Comptroller of the Currency; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration; and the Federal Housing Finance Agency (collectively, the "Prudential Regulators")).

investing for potential upside while limiting their downside risk. They do so by giving up some of the potential upside in exchange for the limit. It is thus important to institutional investment that there continue to be broad and deep markets across the spectrum of optionality for hedging, arbitrage and risk positions.

While it is hard to discern any major difference of fact, law or policy that would lead to different measures of the risk inherent in options under the three regulatory schemes listed above, that is exactly what is currently proposed. Thus, proposed Form PF provides that, for purposes of the FSOC performing the critical task of assessing overall systemic risk, options are to be reported on a "delta-weighted" basis.[8] By contrast, for purposes of identifying MSPs and determining margins to be posted to prudentially regulated entities, options are not delta-weighted.[9] Thus – while the proposed Form PF recognizes that the risk presented by options is often inherently different from that of stocks, bonds, swaps, futures and other linear products, the proposed MSP rules and the Prudential Regulators' proposed margin rules equate all such financial instruments. The reason for this difference does not appear to be one of overarching policy, but may instead lie in the possibility that different teams of regulators drafting different rules used different models as their starting points.

Does anything turn on the differences in regulatory approach? Delta weighting is, of course, the standard, widely-used adjustment process whereby the risk inherent in an option is stated on a comparable basis with the risk inherent in the instrument or financial measure that underlies the option (*e.g.*, a stock, bond or index), as well as with linear derivatives in respect of the same underlying instrument or measure (*e.g.*, a swap or forward). It reflects the fact that an option with a strike price that is out of the money (which would typically have a calculated delta of less than 0.5) has less financial risk than, say, the futures contract or swap with respect to which the option relates (which has a delta of 1). Delta-weighting is employed in any standard Value at Risk calculation and can readily be calculated each day. Failure to employ delta-weighting for purposes of setting margins and determining MSP status has the effect of overstating the risk (often, dramatically so) of options when compared to a future or swap in respect of the same underlying instrument. It is contrary to the risk and valuation metrics used in the market and, in fact, contrary to the way in which options are generally hedged. For example, an interest rate swaption with a notional amount of $100,000,000 and a delta of 0.10 will typically be hedged with a $10,000,000 swap (having the same terms as the swap underlying the swaption) because the anticipated one-day price move of

[8] *See, e.g.*, Proposed Form PF Regulations, question ("Q")11, Q23, Q25, Q27, Q38, Q47, definition of "Turnover Rate", definition of "Foreign exchange derivative", definition of "Interest rate derivative", definition of "Listed equity derivatives", definition of "Other derivatives", and definition of "Unlisted equity derivatives."

[9] It is possible that a different result will be reached under the CFTC's margin rules for non-prudentially regulated dealers and MSPs. The method for determining initial margin proposed by the CFTC as the alternative to a regulator-approved model is to multiply (x) the initial margin requirement for a comparable cleared swap or futures contract (which would almost certainly give effect to delta-weighting) by (y) a multiplier. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (April 28, 2011). This differs from the alternative measure of initial margin proposed by the bank Regulators, which is an unweighted percentage of the transaction's notional amount. We note this difference in approach between the respective "default rules" of the bank Regulators and the CFTC as another potentially troublesome inconsistency in the proposed rules.

these two instruments – with very different notional amounts – is roughly the same. The regulatory bias in favor of swaps and other linear products seems unwarranted and cannot be regarded as trivial as to its potential effects on behavior. No system of risk measurement will be perfect, but the imperfection in this case provides significant incentives for institutional investors to eschew other than short-dated, deeply in the money options (for which deltas are close to 1), with serious implications for their ability to hedge and for liquidity in both the options markets and the markets for the securities that are the subject of these options.

As noted above, it is possible to guess at the origins of this anomalous difference. Proposed Form PF would appear to be modeled on the FSA Hedge Fund Survey. This survey expressly requires the delta weighting of options and other non-linear products in each place where it asks for a measure of exposure or risk.[10] The proposed MSP and margin rules, by contrast, appear to be based on the simplest of the three permissible methods for estimating credit risk set out in Annex 4 to Basel II,[11] the international accord on bank capital and risk. This particular methodology, which does not contemplate delta-weighting (unlike the other two), seems principally intended to provide a simplified measurement for non-money-center banks with small derivatives books limited to simple linear products and no meaningful options exposure.[12] In the Basel II context, banks may *choose* which model to use, so a bank with material exposure to the options markets (or, in fact, any derivatives market) would likely never choose the third model. However, in the context of the proposed MSP rules, institutional investors have no choice as to model. Similarly, under the proposed margin rules, the choice as to model lies with the dealers. While a regulatory goal of simplifying the calculation is undoubtedly a good one, the proposed conflation of options with swaps and other linear derivatives for MSP and margin purposes appears to err too far in the direction of simplicity. In the name of simplicity, the rules ignore a standard and routine adjustment to notional amount and, as a result, significantly increase the risk of adverse market and liquidity impact. Helpfully, this issue can be mitigated by providing for the delta-weighting of option notional amounts across the regulatory spectrum. This is but one illustration of the need to consider the rules as a comprehensive set, rather than on a piecemeal basis.

The Regulators may or may not agree with these particular judgments on this particular subject. But what is troubling here is the process by which this kind of point has to be made in response to individual rulemakings. For delta weighting to be effective in eliminating asymmetrical incentives to invest in suboptimal ways, it has to be the general rule for measuring risk, reporting risk,

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[10] *See* Financial Services Administration, Hedge Fund Survey (Sept. 2010), Section 1, Question 6 (product exposure for hedge fund assets, for which the long market values and short market values of options are to be reported as delta-weighted notional amounts); Section 2, Question 22 (market and Product Exposure, for which long market values and short market values of options are to be reported as delta-weighted notional amounts); Section 2, Question 31 (net equity delta, which requests the impact on a P&L basis of a 1% increase in equity prices).

[11] *See* Basel Committee on Banking Supervision: International Convergence of Capital Measurement and Capital Standards – a Revised Framework, Comprehensive Version (June 2006), Annex 4 (Treatment of Counterparty Credit Risk and Cross-Product Netting) [hereinafter "Annex 4"], sections 91 - 96.

[12] *See, by contrast*, Annex 4, Section 42 (requiring adjustment for the nonlinearity of option value under the "Internal Model Method") and Sections 76 and 77 (requiring delta weighting of OTC derivatives with non-linear risk profiles, including options and swaptions, under the "Standardised Method").

determining MSP status and setting margins. This requires the point to be pressed at least three times – and likely more given the companion jurisdictions of the Regulators. There is a natural concern that the individual rulemaking teams, in their good effort to complete their particular tasks on an ambitious time schedule, will not assume responsibility for tracking a common issue through all of the relevant rulemakings. This would be the completely understandable consequence of having broken the rulemakings up into manageable pieces in order to launch them. And, it is why the core rules should be brought back to the public as a whole for final comment. Only in this way can a structural point of broad applicability be properly heard and weighed.

Our second illustration highlights the inter-agency aspect of the ongoing rulemaking. As the CFTC and the SEC (together, the "Commissions") are well are, the Act directs the Commissions to consult with one another in connection with the rulemaking process "for the purposes of assuring regulatory consistency and comparability, to the extent possible."[13] Following this direction, the SEC, in proposing conduct rules for security-based swap dealers and major security-based swap participants, has taken into account the comments received by the CFTC on its previously proposed companion set of conduct rules for swap dealers and major swap participants.[14] In this regard, in that part of its rule setting forth special conduct rules for swap dealers and MSP's in their dealings with "special entities," the CFTC had proposed to define the circumstances of an intermediary "acting as an advisor" to a special entity as the intermediary "making a recommendation" to the special entity.[15] We and others have argued against this particular equation as being too broad a test – marketing constantly happens in all of its forms, including suggesting a particular trade as a good thing, and to confuse it with an advisory relationship of trust and confidence appears to set a dangerous course. Seemingly in response to these comments, the SEC has suggested in its companion rule proposal that the intermediary and the special entity be able to establish by contract that the intermediary is not "acting as an advisor."[16] Clearly, this is responsive to the comments and a positive development.

Still, issues abound in thinking about and potentially commenting on the SEC's treatment of "acting as an advisor." Does the SEC proposal at this point reflect the shared thinking of the Commissions? Clearly, the SEC cannot speak for the CFTC, so that doubt must remain on this question. From the point of view of the development of the law, it would be most desirable in an ideal world to persuade the Commissions that the proposed "makes a recommendation" standard should be abandoned or at least narrowed. But whether one argues this point again depends on whether the Commissions have collectively provided the question their best thought and judgment, at the proper levels within the agencies. If the Commissions are not together on this subject, it may not be wise to encourage the SEC to pursue a refined version of its more practical contractual solution to the

[13] § 712(a)(1)-(2).

[14] Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 42396 (July 18, 2011) [hereinafter "SEC Business Conduct Rules"] ("In developing the rules proposed herein, the Commission staff has, in compliance with Sections 712(a)(12) and 752(a) of the Dodd-Frank Act, consulted and coordinated with the CFTC and the prudential regulators" (citations omitted)).

[15] Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80638 (Dec. 22, 2010).

[16] *See* SEC Business Conduct Rules, *supra* note **Error! Bookmark not defined.**.

definitional issue, if the CFTC is going to reject the approach in favor of no changes to its original proposal. Again, it is hard to tell what the audience for particular comments is and whether it is the right audience. And again, it does not suffice to come to a workable solution with one agency and not the other. Business in the overall derivatives market will in all likelihood be transacted in accordance with the more onerous of two competing schemes of regulations on a particular topic of common interest.

We note here that the question of "acting as an advisor" is but one of several differences now existing in the current state of rulemaking on intermediary conduct rules. Issues of the type considered above are amplified across this set of differences.

We are impressed by the progress that the Regulators have made to date in the derivatives rulemaking. We believe, however, that the effectiveness, persuasiveness and intellectual legitimacy of the new rules will still depend on the procedures followed from here by the Commissions in adopting them. In this regard, we strongly believe that the benefit of putting forth the body of core derivatives rules as a whole for public comment will dramatically outweigh any incremental delay in the time of effectiveness as a result of doing so.

Sincerely yours,

/s/ Christopher A. Klem

Christopher A. Klem