United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

July 3, 2014

VIA EMAIL (davisjz@sec.gov)

Mr. Kevin M. O'Neill
Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Proposed Rule on Recordkeeping and Reporting Requirements for Security-Based Swap Deals (File Number S7-05-14)

Dear Deputy Secretary O'Neill:

The purpose of this letter is to express support for and suggest enhancements to the proposed rule of the U.S. Securities and Exchange Commission (SEC or Commission) to establish new recordkeeping, reporting, and notification requirements for security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs). This rule, which is long overdue, is critical to preventing SBSDs and MSBSPs from taking on excessive risk at the potential expense of American taxpayers, as well as promoting fairer and more efficient markets.

In addition to supporting the proposed rule, this letter offers three suggestions for improvements:

(1) including requirements for contemporaneous hedging documentation;
(2) adding guidance on the valuation of security-based swaps; and
(3) replacing the references to "unique counterparty identifiers" for SBSD and MSBSP swap counterparties with references to Legal Entity Identifiers.

To the extent that these suggestions may be applicable to proposed Regulation SBSR, this letter suggests that the Commission make similar improvements to that rule as well.

Importance of Recordkeeping. The proposed recordkeeping and reporting requirements for security-based swaps represent an important advance in addressing the concerns that led Congress to pass the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010. Paramount among the Act's goals was to identify and reduce systemic risks attributable to swaps. The Act recognized that to address systemic risks associated with swaps, federal regulators need access to robust and standardized swap data. Among other steps, it empowered the Commission to impose swap reporting and recordkeeping requirements

as the foundation of its regulatory efforts. All of the reporting and recordkeeping elements identified in the proposed rule are aligned with and support the Commission's regulatory and enforcement obligations under the Dodd-Frank Act. Moreover, the proposed rule is an efficient manifestation of Congressional intent because it coordinates those reporting and recordkeeping requirements with existing practices as well as the requirements in the proposed Rule 901 under the proposed Regulation SBSR.[1]

Over the past decade, the U.S. Senate Permanent Subcommittee on Investigations, which I chair, has conducted multiple investigations into abusive or troubling practices involving swaps.[2] These investigations required the review of voluminous documents that disclosed, among other issues, how specific swap transactions were structured, which parties played roles in those transactions, and how individual swaps were valued. The investigations demonstrated the critical importance of accurate and useful recordkeeping related to swaps, including security-based swaps. For that reason, this letter strongly supports the Commission's proposed rule and its efforts to construct a reporting and recordkeeping infrastructure for security-based swaps that is comparable to or better than its current system for securities. In addition, it is respectfully suggested that the proposed rule could benefit from improvements in three areas.

Hedging Documentation. While the proposed rule addresses numerous reporting and recordkeeping issues, one surprising omission involves reporting and recordkeeping obligations related to hedging. Many swap instruments, including security-based swaps, were developed to reduce risk. Others have been used, not to hedge risk, but to speculate on asset values, including with respect to bonds and other securities. In some cases during and after the financial crisis, disputes have arisen over whether, in specific instances, swap instruments were being used to reduce risk or take risk. One product of the concerns about swap activity was the Volcker Rule, which seeks to stop the participation of banks and their securities affiliates in proprietary trading activities, including speculation in high risk security-based swaps, while preserving their ability to utilize swaps to reduce risk and make markets in swap instruments for their clients.

Because of the dual nature of swaps as risk-reducing or risk-inducing instruments, the many ways in which they can be used, and the regulatory difficulties involved with monitoring and analyzing specific swap transactions, the proposed rule should be strengthened by including

---

[1] See "Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants," 78 Fed. Reg. 30968, 31212–13 (May 23, 2013) (proposed for codification at 17 CFR § 242.901).

[2] See, e.g., "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks & Abuses," S. Hrg. 113-96, vols. 1–2 (March 15, 2013), available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg80222/pdf/CHRG-113shrg80222.pdf and http://www.gpo.gov/fdsys/pkg/CHRG-113shrg85162/pdf/CHRG-113shrg85162.pdf; "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," (April 13, 2011), S. Hrg. 111-675, vol. 5, and related hearings, S. Hrg. 111-671 - 674 (April 13, 16, 23, 27, 2010), vols. 1-4, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:57319.pdf; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:57320.pdf; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:57321.pdf; http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57322/pdf/CHRG-111shrg57322.pdf; "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends," S. Hrg. 110-778 (Sept. 11, 2008), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_senate_hearings&docid=f:45575.pdf; Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions, S. Rep. No. 107-82, available at http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT83559/pdf/CPRT-107SPRT83559.pdf.

reporting and recordkeeping requirements related to hedging activities. At a minimum, the proposed rule should provide guidance about the types of contemporaneous information that should be recorded by an SBSD or MSBSP when initiating a security-based swap to hedge risk. The rule should also consider developing a standardized form to facilitate regulatory oversight and analysis.

The types of information that should be recorded include the nature and date of the hedge being initiated, who initiated it, the counterparty, the specific assets being hedged, how the hedge lowers the risk associated with those assets, how and when the hedge will be tested for effectiveness and size, and how and when the hedge will be unwound and by whom. This type of information would not only improve the hedging process itself, it would eliminate disputes about whether a hedge was, in fact, undertaken and what exactly was being hedged. In addition, it would provide a practical audit trail for more efficient and effective regulatory oversight and analysis, and assist in the implementation of specific rules such as the Volcker Rule.

By mandating clear identification of hedging transactions at the time they are initiated, providing hedge-specific information, and creating a clear audit trail, the proposed rule would offer powerful tools to enable the Commission to carry out its oversight and enforcement responsibilities under the law.

Swap Valuation. A second set of concerns involves issues related to swap valuation. While the proposed rule requires SBSDs and MSBSPs to report the value of the security-based swaps they hold and trade, it does not specify or provide guidance regarding the valuation methods they should use to produce that data. Adding that guidance would address an ongoing valuation problem and strengthen both swap valuation practices and the rule's regulatory usefulness.

An investigation conducted by the Subcommittee into the 2012 JPMorgan whale trades showed that current swap valuation methods are flawed and can be easily manipulated to hide losses.[3] The investigation examined in detail the process used by JPMorgan traders charged with performing a daily valuation of credit derivatives in the bank's Synthetic Credit Portfolio (SCP). The facts showed that, prior to the onset of losses in the portfolio, the traders had marked the dollar value of each credit derivative at or near the midpoint of the bid-ask spread for that derivative. But after the derivatives began losing value, the traders changed their practice and began using dollar values at the extreme ends of the bid-ask spread to minimize losses caused by the falling prices. While that shift in methodology typically involved only a few pennies or dollars per derivative, due to the size of the positions in the SCP, it produced major changes in the portfolio's overall value. For example, one trader calculated that, on March 16, 2012, the year-to-date losses in the SCP portfolio would have been $593 million using the traditional valuation method, but were only $161 million using the new method — a 73% decrease. After the whale trade losses became public, the bank restated its first quarter earnings, reporting additional losses of $660 million.

---

[3] See "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks & Abuses," hearing before the U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 113-96, vols. 1–2 (March 15, 2013), available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg80222/pdf/CHRG-113shrg80222.pdf and http://www.gpo.gov/fdsys/pkg/CHRG-113shrg85162/pdf/CHRG-113shrg85162.pdf.

The ability of trading personnel to hide hundreds of millions of dollars of swap losses over the span of months, despite several internal valuation reviews, exposed how imprecise, undisciplined, and open to manipulation the current process is for valuing swaps. Because swaps represent an increasingly important portion of some financial institutions' assets, the whale trades exposed not only the valuation problems at a single institution, but also a systemic weakness in the swap valuation process, including for security-based swaps. The proposed rule could address this vulnerability by providing guidance on swap valuation practices, such as indicating that the preferred method for security-based swap valuations is to use amounts at or near the midpoint of the appropriate bid-ask spread or use valuations provided by an independent pricing service. The rule could also require SBSDs and MSBSPs to quantify and explain any material deviations from midpoint prices, and warn against making methodology changes to conceal or minimize losses.

Counterparty Identifiers. Finally, the Commission should consider replacing references in the proposed rule to "unique counterparty identifiers" for SBSD and MSBSP swap counterparties with references to Legal Entity Identifiers (LEIs).[4] The rule's proposed requirement for identifying security-based swap counterparties in recordkeeping materials is a simple yet important feature of the proposal. Following the financial crisis, one startling discovery was that, due to similar or confusing names, it sometimes became very difficult to determine the true parties involved in specific swap transactions, to aggregate a financial institution's financial exposure to related parties, and to perform reliable evaluations of counterparty risk. Requiring unique swap counterparty identification numbers would not only address that problem, but also contribute to efficient and effective data analysis by individual financial institutions. It would also facilitate the creation of useful audit trails for regulators and support data analysis of systemic risk for the Office of Financial Research and Financial Stability Oversight Council.

The CFTC has already adopted a similar requirement in its recordkeeping rule.[5] While the CFTC's recordkeeping proposal originally referred to "unique counterparty identifiers" in the same manner as the SEC's proposed rule, commenters and roundtable participants suggested replacing that phrase with an explicit reference to the new global LEI system endorsed and overseen in the United States by the Federal Reserve. The LEI system assigns unique identification numbers to entities on a global basis, and provides public access to basic identification information about each such entity at no cost and with no proprietary barriers. The CFTC agreed with the recommendation and now requires swap participants to include counterparty LEIs in their records.[6] Unless the Commission's proposed rule is intended to include identifiers beyond LEIs, for the sake of clarity and consistency, the Commission should also replace its reference to "unique counterparty identifiers" with "Legal Entity Identifiers" for security-based swap counterparties.

---

[4] See § II(A)(2).

[5] See 17 CFR § 45.6 ("Legal entity identifiers") and § 46.4 ("Unique identifiers").

[6] See "Swap Data Recordkeeping and Reporting Requirements," Commodity Futures Trade Commission, 82–85, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister122011b.pdf.

Thank you for this opportunity to comment on the proposed rule.

Sincerely,

Carl Levin
Chairman
Permanent Subcommittee on Investigations