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March 14, 2013

Melissa Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: The term "notional amount"

Dear Secretary Jurgens and Secretary Murphy:

We write on behalf of the Committee on Futures and Derivatives (the "Committee") of the New York City Bar Association (the "Association") to provide our comments to the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC" and, together with the CFTC, the "Commissions") in respect of the term "notional amount" as used in recent rulemaking promulgated by the Commissions.

The Association is an organization of over 23,000 members. Most of its members practice in the New York City area. However, the Association also has members in nearly every state and over 50 countries. The Committee consists of attorneys knowledgeable about the trading and regulation of futures contracts and over-the-counter derivative products, and it has a practice of publishing comments on legal and regulatory developments that have a significant impact on futures and derivatives markets.

Set forth below are the Committee's comments concerning the term "notional amount."

I. Use of the term "notional amount" in recent regulation.

The term "notional amount" appears, both as an independent term and as part of the term "effective notional amount," in (i) CFTC Regulation 1.3(ggg)(4), which contains the *de minimis* exception to the definition of "swap dealer;" (ii) CFTC Regulation 1.3(hhh), which contains the definition of "major swap participant;" (iii) SEC Exchange Act Rule 3a71-2, which contains the *de minimis* exception to the definition of "security-based swap dealer;" and (iv) SEC Exchange Act Rule 3a67-3, which contains the definition of "substantial position" that, in turn, is used in the definition of "major security-based swap participant."

Although the term "notional amount" is used in the foregoing rules, it is not defined. The Commissions have indicated that the lack of a definition is intentional and that industry standard practices should be consulted in order to define the term.[1]

II. Issues arising in the calculation of "notional amount."

Calculating the notional amount of a particular swap or security-based swap transaction can be a simple task, or it can be quite difficult. Standards for calculating notional amounts vary with the type of transaction being analyzed, so there is no universally accepted way to calculate the notional amount. Because the definition of the term "notional amount" is crucial to the determination of whether or not a person is a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant, we believe the Commissions should consider providing a safe harbor for calculations of notional amounts made reasonably and in good faith or, alternatively, define the term "notional amount" or provide guidance with respect to the calculation of notional amounts, deferring to published industry agreements where applicable.[2] We set forth below certain examples demonstrating that calculating the notional amount for a particular trade is not necessarily easy or intuitive, even if one defers to industry practices.

The 2006 ISDA Definitions (the "2006 Definitions"), published by the International Swaps and Derivatives Association, Inc. ("ISDA") define "notional amount" for transactions other than option transactions as "the amount specified as such" for the transaction.[3] In this case, the determination should be simple, provided that the notional amount is specified, and we note

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[1] The Commissions have stated that "...the final rules do not prescribe any particular methodology for calculating the notional amount or effective notional amount used in the calculation of potential future exposure, but instead contemplate the use of industry standard practices." *See, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contact Participant,"* 77 Fed. Reg. 30596, 30670, fn. 902 (May 23, 2012) ("Final Entities Definitions").

[2] We note that the CFTC has provided some guidance on how to calculate the term "notional value" for purposes of CFTC Regulation 4.13.

[3] 2006 Definitions, Section 4.7(a).

that form transaction confirmations published by ISDA include a line item for specifying a transaction's notional amount.[4]

For option transactions, the 2006 Definitions define "notional amount" in a bifurcated manner: (a) if the transaction involves one currency, the notional amount is the notional amount of the transaction or underlying transaction, as the case may be, or (b) if the transaction or underlying transaction involves more than one currency, the notional amount is the currency amount in respect of the buyer of the option.[5]

The 1998 FX and Currency Option Definitions (the "FX Definitions") published by ISDA, the Emerging Markets Traders Association and The Foreign Exchange Committee define "notional amount" based upon the type of transaction. In all cases under the FX Definitions, if the confirmation for a transaction specifies the notional amount, the notional amount for such transaction is the amount specified.[6] However, if no notional amount is specified, the notional amount is (i) with respect to non-deliverable forward exchange transactions, an amount of settlement currency equal to a specified reference currency amount divided by the forward rate applicable to such transaction, and (ii) with respect to non-deliverable currency option transactions, whichever of the call currency amount[7] or put currency amount[8] that is denominated in the settlement currency.[9]

Under the 2002 ISDA Equity Derivatives Definitions published by ISDA (the "Equity Definitions"), the notional amount for equity swaps is analogous to the "equity notional amount" for the transaction, which is an amount specified by the parties.[10] However, for equity options and equity forwards, neither the term "notional amount" nor the term "equity notional amount" is used. Rather, in such cases, the size of the transaction is typically characterized by the number of options or shares subject to the transaction. With equity options and equity forwards, then, in order to determine the notional amount, the person making the determination would have to multiply a share number or option number by a per share price, but there is no clear rule that provides guidance as to what per share price should be used. Additionally, with respect to equity options, the premium, delta and direction of such option might reasonably be expected to impact the determination of the notional amount with respect to such options.

Under the 2003 ISDA Credit Derivatives Definitions published by ISDA (the "Credit Definitions"), the concept of a notional amount is not used, although analogous calculation

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[4] *See*, Exhibits to 2006 Definitions.

[5] 2006 Definitions, Section 12.5. The currency amount is an amount specified by the parties. Section 4.6 of the 2006 Definitions.

[6] FX Definitions, Section 1.17.

[7] The "call currency amount" is an amount specified by the parties, or, if not specified, an amount equal to the put currency amount (defined in the following footnote) multiplied by the applicable strike price. FX Definitions, Section 3.1(c).

[8] The "put currency amount" is an amount specified by the parties, or, if not specified, an amount equal to the call currency amount divided by the applicable strike price. FX Definitions, Section 3.1(e).

[9] FX Definitions, Section 1.17(b).

[10] *See*, Equity Definitions, Section 1.24.

amounts are used.[11] However, these calculation amounts may not necessarily reflect the potential payment obligation of the seller of protection because there can be additional parameters established for any transaction that potentially limit or expand the payment obligations of the parties (such as parameters designed to make a party responsible for only a range of losses in respect of a default by the issuer of a bond underlying the credit derivative). It would be reasonable to expect that these additional parameters should affect the calculation of the notional amount.

Commodity derivatives documented using the 2005 ISDA Commodity Definitions published by ISDA (the "Commodity Definitions"), depending upon the type of transaction, may use the term notional amount (which is an amount determined by the parties, in the case of weather derivatives),[12] may use the term notional quantity (which is a term designed to capture a quantity of physical units for purposes of commodity swaps, basis swaps and commodity options, and is analogous to a notional amount)[13] or may not have any such designation. Many of the concerns raised above with respect to calculating notional amounts similarly apply to this section of the market.

While the staff of the CFTC has provided some public guidance with respect to some physical commodity trades, the staff guidance only covers a few of the many possible transactions that may be effected and it does not have the force or effect of a CFTC regulation.[14] For example, the staff of the CFTC has stated in the FAQ that when "calculating the notional amount of a physical commodity swap, the value of the physical underlying is the fair market value of the physical underlying at the time of the execution of the swap."[15] The staff of the CFTC has also stated that in "swaps with physical underlyings, the notional amount is calculated using the fair market value of the underlyings at the time of the execution of the swap, even if there are price fluctuations in the underlyings subsequent to the execution of the swap."[16] While that approach may be workable for trades where the quantity of commodity never changes during the term of a transaction, there are trades which schedule different quantities of physical commodity during different calculation periods. If a swap provides for a declining quantity over time, for example, it is reasonable to expect that the notional amount should be recalculated in accordance with the scheduled terms. And if the notional amount is recalculated, it is reasonable to expect that the value of the physical commodity at the time of recalculation (and not the time of execution) would be used to determine the notional amount. Similarly, we believe that the CFTC staff's approach to locational basis swaps in one physical commodity is reasonable,[17] but

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[11] *See*, Exhibits to Credit Definitions.
[12] *See*, Commodity Definitions, Sub-Annex C.
[13] *See*, Commodity Definitions, Exhibits to the 2005 ISDA Commodity Definitions.
[14] *See*, *Frequently Asked Questions (FAQ) – Division of Swap Dealer and Intermediary Oversight ("DSIO") Responds to FAQs About Swap Entities* (the "FAQ").
[15] *Id.*
[16] *Id.*
[17] *Id.* The staff of the CFTC has state that for "locational basis swaps referencing only one physical commodity, the notional amount should be calculated using the difference in fair market value of the physical commodity at the two locations, multiplied by the number of units referenced in the swap."

believe that the rationale underlying that approach should be codified in a rule and applied in a consistent manner to all basis swaps.

Furthermore, derivative transactions may be subject to knock-in or knock-out features, spreads, caps and floors. It is unclear if the Commissions believe that these features should affect the calculation of the notional amount of the transaction, but it is reasonable to expect that these features should affect the calculation of the notional amount. We note that the CFTC received a letter, dated September 20, 2012 (the "September Letter"), from the American Petroleum Institute, Commodity Markets Council, Edison Electric Institute, Electric Power Supply Association, Independent Petroleum Association of America and Natural Gas Supply Association. The September Letter identifies certain industry approaches to determining the notional amount of certain trades and in particular notes the issues with determining notional amounts for basis trades and options. While we refrain from taking industry positions because we are a committee of a bar association, we agree that the manner in which the notional amount is calculated for a basis swap or an option should be qualitatively different from the manner in which the notional amount is calculated for a plain vanilla swap (such as a fixed to floating interest rate swap on a specified dollar amount, where one party pays a fixed amount of interest on the specified dollar amount and the other party pays a floating amount of interest on the same dollar amount). The CFTC staff appears to agree with this approach, at least with respect to locational basis swaps in one physical commodity.[18]

Lastly, we note that the Commissions have acknowledged potential issues with using the notional amount concept without considering other aspects of a transaction, concluding that the notional amount for a particular transaction should be adjusted for leverage or enhancement in order to reflect the "effective notional amount."[19] On a related point, many swaps and security-based swaps contain adjustment provisions pursuant to which the original notional amount as well as other terms of the transaction may be reset or adjusted. Such resets or adjustments may have the effect of increasing or decreasing the notional amount of a transaction. We would expect that, in such event, the notional amount for regulatory purposes should be recalculated and market values of the underlyers at the time should be used for valuation purposes. Continuing to utilize the notional amount and market values that existed at the time the swap or security-based swap was originally executed does not appear to provide an accurate description of notional amount or effective notional amount for purposes of the regulatory tests identified above.

In light of the foregoing, and the possibility that the term "notional amount" may be used in future rulemaking by the Commissions or other agencies, we encourage the Commissions to adopt a safe harbor for calculations of notional amounts made reasonably and in good faith or, alternatively, define the term "notional amount" or provide guidance with respect to the calculation of notional amounts, deferring to published industry agreements where applicable.

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[18] *Id.*

[19] *See*, Final Entities Definitions, 77 Fed. Reg. at pp. 30630 and 30670 (discussing the effective notional amount). *See also*, the FAQ (discussing what constitutes leverage and how leverage affects the calculation of notional amounts).

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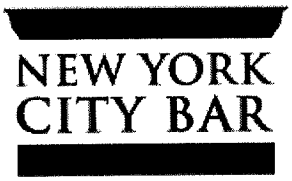
We appreciate the opportunity to present our views to you on this matter of importance to us as practitioners in the area of futures and derivatives and our members are available to discuss any of the above at your convenience.

Respectfully yours,

Thomas D'Ambrosio, Chair
The Committee on Futures and Derivatives,
New York City Bar Association



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§ These members of the Committee constitute the working group for this letter.

* These members of the Committee did not participate in the preparation of this comment letter.

The opinions expressed by members of the Committee in this letter are the individual opinions of the members and not necessarily the opinions of any organization with which they may be employed or affiliated.