Principal Traders Group

December 20, 2012

Gary Barnett, Director
Division of Swap Dealer and Intermediary Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Request for Confirmation on Notional Amount Calculation Methodology for Swaptions

Dear Mr. Barnett:

The Futures Industry Association Principal Traders Group ("FIA PTG") submits the following comments regarding the appropriate methodology for calculating "notional amount" with respect to certain options and swaptions (collectively "options"), as such term is used in the de minimis exception to the definition of "swap dealer" in the Final Rule, Further Definition of "Swap Dealer," *et al.*, 77 Fed. Reg. 30596 (May 23, 2012).

FIA PTG, a division of the Futures Industry Association, is comprised of over 30 firms that trade their own capital in the exchange-traded markets. Members of FIA PTG are a critical source of liquidity in the exchange-traded markets, allowing those who use these markets to manage their business risks to enter and exit the markets efficiently. We strongly support the CFTC's efforts to reduce systemic risk, increase pre-trade and post-trade transparency, and to promote market integrity.

As the markets for cleared swaps develop, there will be a need for market participants, such as FIA PTG member firms, to provide liquidity. In order to actively participate in these markets, consistent with registration requirements, we must have confirmation of the acceptable methods of notional amount calculation to monitor trading under the de minimis thresholds. We feel the industry received this guidance for swaps in the *Division of Swap Dealer and Intermediary Oversight ("DSIO") Responds to FAQs about Swap Entities*[1] document issued on October 12, 2012. We are seeking

[1] http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf

further guidance for options, which we believe were not fully addressed in that FAQ.
FIA PTG believes the methodology for computing the notional value of options must include the following three components if it is to most accurately and efficiently reflect the market impact of option trades:

1. Delta equivalents;
2. Use of end-of-day deltas and prices;
3. Netting of all legs of the transaction.

Standard & *Poor* defines delta as "the relationship between an option's price and the price of the underlying"[2]. FIA PTG maintains that the guidance provided by the Commission in the *Division of Swap Dealer and Intermediary Oversight ("DSIO") Responds to FAQs About Swap Entities* issued on October 12, 2012 that "the notional value of a swaption looks through the option contract to the underlying swap for purposes of determining the notional"[3] is incomplete. With the addition of a delta equivalent component, this computation better reflects the market impact of that option transaction, and is also more consistent with industry practice and, importantly, with Commission standards and guidance in other contexts. For the purpose of calculating the notional value of a swaption, FIA PTG recommends multiplying the notional value of the underlying swap by the delta of the swaption with respect to that underlying as demonstrated in the following example.

Example 1:

- March WTI Crude Oil is trading at 85
- Buy 1 call option with a strike of 95 on 1000 barrels of March WTI Crude Oil. The delta on this option is +0.20.
- The notional of this transaction would be:
  (+0.20 delta) * (1 * 1000 barrels * $85 per barrel) = $17,000.

FIA PTG further recommends that Designated Clearing Organization ("DCO") published end-of-day deltas and prices be used when computing the notional value of options. Market participants including FIA PTG member firms often run their own proprietary intraday delta and pricing models for position management and to assess risk and market exposure. These proprietary models could be used for the notional value computation, but the costs involved in capturing, recording and computing these values at time of trade, as well as the variance in models used by individual market participants lead us to recommend the use of end-of-day DCO published values instead. The notional value computation done in connection with the de minimis exclusion does not require the precision of real-time valuation and would be adequately measured using these published end-of-day values, which would promote consistency and facilitate Commission monitoring.

Finally, because options are generally traded as spreads or more complex strategies, it does not make sense to compute each component of the transaction individually as if it were a standalone trade. For purposes of calculating the notional value of a transaction which includes multiple

[2] Morris, Virginia and Morris, Kenneth (2007). *Standard & Poor's Dictionary of Financial Terms,* McGraw Hill.
[3] http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf (p. 10 #VI Options and Swaptions)

options legs (call spread / put spread / straddle / strangle / butterfly) we believe the notionals of all options that were executed as part of that transaction should be added together. This is consistent with the guidance given on computing the notional for a collar[4]. Furthermore when a trade containing multiple legs is executed the exposure of the trade is not the two legs evaluated separately but the net of the two legs. This is consistent with standard netting of cash flows in OTC swaps and with the notional calculation for locational swaps.

Example 2:

- March WTI Crude Oil is trading at 85.
- Buy 1 call option with a strike of 95 on 1000 barrels of March WTI Crude Oil **AND** Sell 1 call option with a strike of 100 on 1000 barrels of March WTI Crude Oil. The delta on the 95 call option is +0.20. The delta on the 100 call option is -0.08.
- The notional of this transaction would be:
  [(+0.20 delta) * (1 * 1000 barrels * $85 per barrel)] + [(-.08 delta) * (1 * 1000 barrels * $85 per barrel)] = $10,200.

For purposes of calculating the notional value of a transaction which includes both swaps and options, we believe the notionals of the swaps should be added to the notionals of the options that were executed as part of that transaction. Again when a trade containing multiple legs is executed the exposure of this trade is not the two legs evaluated separately but the net of the two legs. This is consistent with standard netting of cash flows in OTC swaps.

Example 3:

- March WTI Crude Oil is trading at 85
- Buy 1 swap on 100 barrels of March WTI Crude Oil **AND** Sell 1 call option with a strike of 100 on 1000 barrels of March WTI Crude Oil. The delta on the 100 call option is -0.08.
- The notional of this transaction would be:
  [(+100 barrels * $85 per barrel)] + [(-.08 delta) * (1 * 1000 barrels * $85 per barrel)] = $1,700.

The Large Trader Reporting for Physical Commodity Swaps: Division of Market Oversight Guidebook for Part 20 Reports provides the following note on notional value "for swaptions, the delta-adjusted long and/or short position should be multiplied by the relevant settlement price for that particular exposure of the swaption. Typically the relevant price will be the settlement price of the underlying on that report date"[5]. FIA PTG requests the Commission provide this same guidance in connection with the computation of notional value of options for purposes of the de minimis exception to the definition of "swap dealer". At the end of this letter we have provided a table of additional examples of typical option transactions and the resultant notional computation using the FIA PTG proposed methodology. We look forward to hearing from you on this matter.

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[4] http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf (p. 10 #VI Options and Swaptions)

[5] http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/ltrguidebook053112.pdf

Please contact Mary Ann Burns (maburns@futuresindustry.org) if you have any questions regarding this request.

Respectfully,

Futures Industry Association Principal Traders Group

Walt Lukken
President and Chief Executive Officer
Futures Industry Association

Additional Examples of Proposed Methodology

- **XYZ Underlying Price = $95**
- **Option Underlying Size = 1,000 barrels**
- *Premium value and options strike are not used in the calculation. However, strike price is a component of the calculation for Contract Delta.*

Example	Details	Notional Value	Calculation Steps
Plain vanilla call	Buy 1 XYZ 90 Calls @ $7.50, Delta = +0.60	57,000	[(+0.60)*(1*1000*95)]
Plain vanilla call w Underlying Hedge	Buy 10 XYZ 90 Calls @ $7.50, Delta = +0.60 Sell 6 XYZ Underlying @ $95, Delta = (1.00)	-0-	[(+0.60)*(10*1000*95)] + [(-1.00) *(6*1000*95)]
Call Spread	Buy 1 XYZ 90 Calls @ $7.50, Delta = +0.60 Sell 1 XYZ 95 Calls @ $5.00, Delta = (0.50)	9,500	[(+0.60)*(1*1000*95)] + [(-0.50)*(1*1000*95)]
Time Spread	Buy 1 XYZ Jan 90 Calls @ $10.00, Delta = +0.65 Sell 1 XYZ Dec 90 Calls @ $7.50, Delta = (0.60)	4,750	[(+0.65)*(1*1000*95)] + [(-0.60)*(1*1000*95)]
Straddle	Buy 1 XYZ 90 Calls @ $7.50, Delta = +0.60 Buy 1 XYZ 90 Puts @ $2.50, Delta = (0.40)	19,000	[(+0.60)*(1*1000*95)] + [(-0.40)*(1*1000*95)]
Collar	Buy 1 XYZ Underlying @ $95, Delta = +1.00 Sell 1 XYZ 100 Calls @ $2.00, Delta = (0.35) Buy 1 XYZ 90 Puts @ $2.50, Delta = (0.40)	23,750	[(+1.00)*(1*1000*95)] + [(-0.35)*(1*1000*95)] + [(-0.40)*(1*1000*95)]