Alternative Investment Management Association

David A. Stawick,
Secretary of the Commission,
Commodity Futures Trading Commission,
Three Lafayette Centre,
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DC 20581

Submitted via the CFTC website

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Dear Mr Stawick,

Process for Review of Swaps for Mandatory Clearing – proposed Regulation 39.5

The Alternative Investment Management Association ('AIMA')[1] appreciates the Commodity Futures Trading Commission's (the 'Commission') invitation to comment on the proposed rulemaking in relation to the process for the review of swaps for mandatory clearing, implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the 'Dodd-Frank Act').

An important element of such implementation will be a workable regime for reviewing which swaps should be subject to the mandatory clearing requirements, and we are keen to ensure that as many swaps are possible are subject to the clearing requirements, to increase the risk-reducing benefits of the regime, but that categories of swaps are not required to be cleared if they would increase risks at derivative clearing organisations ('DCOs') and thus create new risks to financial stability.

We set out below our comments on the Commission's proposed Regulation 39.5 of the Commission's Regulations.

AIMA's comments

Eligible group, category, type or class of swap

The proposed rules firstly assume that any group, category, type or class of swap that is currently accepted for clearing by a DCO registered with the Commission will be deemed eligible for mandatory clearing. We believe that this is a sensible assumption, having regard to DCOs' current obligations under the Commodity Exchange Act ('CEA'), including the core principles for DCOs under section 5b(c)(2) of the CEA, such as the required financial resources and risk management procedures. Whilst the CEA requires continued compliance with the provisions, we believe it is important that DCOs continue to monitor the swaps they clear and it may be preferable to explicitly require ongoing monitoring of the suitability of a swap for its eligibility for mandatory clearing, as is required of the Commission for own-initiative reviews (see below).

For swaps which are not currently subject to clearing, or for those within a group, category, type or class not currently cleared, the Commission should ensure, when it is reviewing swaps to determine whether they should be subject to the mandatory clearing requirement, that full account is taken of the characteristics of the contracts. The terms "group", "category", "type" and "class" may be used to include overly broad groupings of swaps which do not consider the specific and individual risks of certain swaps. For example, interest rate swaps of a single 'class' may have different risk profiles, such that some might be suitable for clearing while others might not. Forcing all of them into a DCO under a single 'class' heading could undermine the DCO, resulting in it taking on unmanageable risk – i.e. by requiring clearing of swaps which are non-standardised and thus are difficult to price correctly for the purposes of determining appropriate collateral levels and for closing out

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,200 corporate bodies in 45 countries, with 11% based in the US and over 30% of AIMA members' total assets under management (AUM) managed by US investment advisers.

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positions; conversely, excluding all contracts within a 'class' based on the characteristics of a few would undermine the important benefits of the reforms.

Whilst we recognise that it may not be feasible for the Commission to fully consider all and specific swaps and their underlyings, the Commission should be able to safely determine as eligible for clearing those swaps which are sufficiently standardised or 'plain vanilla' and which, for example, can be more easily priced than certain bespoke trades. There are various methods that the Commission could use to make this determination, including whether the terms can be completely defined with a simple confirmation template[2] and the currency, floating index, day count, and frequency are from approved lists, and the end date is sufficiently short (e.g. less than 30 days). This solution is preferable to requiring the clearing of broad categories such as 'equity derivatives' or 'credit indices', within which there may be varying risk profiles.

Whilst we support the Commission's ability to propose that certain swaps be eligible for clearing (see below), we believe the public consultation mechanism and coordination with the registered DCOs will prove an important part of the process for determining which contracts should be eligible for mandatory clearing.

Submission of Swaps to the Commission for Review

We agree that the first stage in determining which swaps should be subject to mandatory clearing should be an assessment of whether the DCO proposing that the swap be eligible is itself eligible to clear such swaps and is meeting the core principles as set out in section 5b(c)(2) of the CEA. A short statement to this effect would be sufficient to establish this, as the Commission will already be monitoring registered DCOs for compliance with their existing obligations.

Following acceptance of such a statement, it will be important that the Commission reviews the swap, considering whether it being subject to mandatory clearing would increase or decrease overall risk to the financial system. This is one of the five criteria, set out in section 2(h) of the CEA as added by section 723 of the Dodd-Frank Act, which the Commission is required to consider. We believe, however, that it is this consideration which should override other considerations as it goes to the heart of the objectives of Title VII. The other four criteria[3] are also important for an effective clearing obligation and are factors which should be considered as regards whether risk may increase rather than be mitigated (e.g. sufficient trading liquidity) by clearing. When the Commission considers questions of, for example, what is a "significant" outstanding notional exposure or what is "adequate" pricing data, systemic risk should be the Commission's primary consideration. A further factor to consider may be the reduction of counterparty risk, rather than systemic risk (as not every DCO or counterparty will necessarily be systemically relevant), as the key benefit and justification for the buyside in paying more for central clearing is the reduction in their counterparty credit risk exposure to the swap dealers.

It is important that all parties involved in the swaps market are able to contribute their views, concerns and expertise to the Commission when a decision on the eligibility of a swap for the clearing obligation is required. It is important that members of a DCO are consulted as key stakeholders in the process, but it is equally important that clients of clearing members are given a chance to input, as they generally represent 50% of the market activity and are among the groups of parties the measures are designed to protect. The Commission should therefore require that clearing members pass on to their clients all details about a submission by a DCO to the Commission for review of eligibility for mandatory clearing; those clients should be encouraged to participate. The Commission must have due regard to all comments received but should ensure that it is giving primary consideration to the five criteria set out in the CEA, rather than personal views of counterparties as to whether it is desirable for other reasons to clear a type of swap (e.g. on the grounds of cost, which is not a relevant

[2] Such a template may include simple descriptive fields such as: Notional, Pay/Receive, Currency, Start Date, End Date, Frequency, Coupon, Floating Index, Start or End Stub, Day Count. There terms may completely define a 'plain vanilla' trade.

[3] 1. The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.
2. The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded.
...
4. The effect on competition, including appropriate fees and charges applied to clearing.
5. The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or 1 or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

consideration). Only when the Commission has all the information that it needs to make the required assessment should it commence its review – we believe the 90 days proposed should be sufficient in that regard.

In the proposed rule release, the Commission states that it "would impose terms and conditions on the requirements as appropriate". We appreciate that terms as to the date from which a swap must be cleared and other such practical matters may be imposed but we would like to know what other terms and conditions the Commission envisages may be appropriate and must be stated when making a determination.

Commission-initiated Review of Swaps

The right of the Commission to initiate a review of which swaps could be cleared is an important element of the reforms, and a strong counter-weight to any industry participants who may not favour mandatory central clearing for some swap contracts. As is provided, we believe that the Commission's obligations should be ongoing, and it may be desirable to have a set frequency of reviews that the Commission must carry out, so that participants can be sure that reviews of new swaps are conducted at least periodically – e.g. quarterly. It may additionally be desirable for the Commission to have in place processes and procedures that allow parties other than DCOs to request that the Commission initiates a review of a particular group, category, type or class of swap.

When the Commission conducts its review, it must be able to obtain such data as it requires to fulfil such obligations, and this should, if necessary, include data other than information already obtainable pursuant to Commission regulation. The Commission should use the same criteria to assess a swap under a Commission-initiated review as it would were it proposed by a DCO.

Once a swap is investigated and determined to be eligible, but where no DCO is currently able to clear the swap, we agree that the Commission should then consider how best to encourage a DCO to offer such services. However, it is important that, in considering what actions may be appropriate to encourage a DCO to clear such contract, the Commission does not seek to force a DCO to clear a contract – to do so is likely to create additional systemic risk by requiring a party to clear a contract for which it is not in a position to manage or mitigate the risks of clearing it. Likewise, it is undesirable for any prohibitions to be placed on trading a swap which would be subject to a mandatory clearing requirement if a DCO existed to clear the contract – removal of a swap choice from the market may prevent a market counterparty from entering into an appropriate contract to offset a business risk it is required to take, thus increasing overall risk in the system. It may also be the case that whilst no US-based DCO is available to clear a contract, a central counterparty (CCP) based outside of the US may be able to clear the contract safely, and in that case that CCP should be approached if to do so would improve financial stability. We would appreciate greater clarity as to possible solutions the Commission considers may be appropriate in such a situation, to encourage a DCO or other CCP to begin clearing a new class of swap.

One suggestion is the establishment of margin or capital requirements for parties to a group, category, type or class of swap. Whilst the Dodd-Frank Act requires parties to an uncleared swap contract to collateralise their positions with margin payments, it is common practice for many clients to be required by their swap dealers to provide margin payments to secure their performance of their obligations. We agree that margin requirements should be imposed to limit the exposure to potential losses from default where a swap is not cleared with a DCO, but it is important that such payments are set at a level sufficient to cover potential exposures in normal market conditions, and are not used punitively. It must also be recognised that capital requirements are not appropriate for all types of counterparty (e.g. private funds), and that margin payments may be more suitable as they address the same risks as capital holdings for uncleared swaps. Where the Commission considers it appropriate to establish margin requirements for uncleared swaps, clients should be given the option to have their margin segregated with an independent third party to limit its counterparty credit exposure to their swap dealer – AIMA intends to submit comments to the Commission separately on this issue.

International coordination

As part of its ongoing review of swaps that may be subject to mandatory clearing, we encourage the Commission to continue its cooperation and coordination with its international regulatory counterparts, especially on the topic of which contracts will be subject to these obligations. The derivatives market is a global one and is

inhabited on the dealer and (to a lesser extent) client side by multi-national firms. Should the Commission's decisions on what is required to be cleared deviate significantly from the decisions made in other major trading jurisdictions, such as the European Union, regulatory arbitrage opportunities will arise and some firms will be incentivised to potentially move their business to other jurisdictions where these obligations will not apply. Whilst we expect similar sets of rules from the G20 countries to reach similar decisions about which swaps are suitable for central clearing, it is important that all make a concerted effort to ensure, where possible, international consistency on this issue.

Conclusion

AIMA believes that the Commission has proposed a sensible process for the review of swaps for mandatory clearing, and we are pleased that a framework is being put in place to encourage clearing of all suitable swap contracts and to assist the Commission in making the important review decisions. We thank you for this opportunity to comment on these important provisions of the Dodd-Frank Act and we are, of course, very happy to discuss with you in greater detail any of our comments.

Yours sincerely,

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