Alternative Investment Management Association

David A. Stawick,
Secretary of the Commission,
Commodity Futures Trading Commission,
Three Lafayette Centre,
1155 21st Street,
NW., Washington,
DC 20581

Submitted via the CFTC website

18 January 2011

Dear Mr Stawick,

Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies

The Alternative Investment Management Association ('AIMA')[1] appreciates the Commodity Futures Trading Commission's (the 'Commission') invitation to provide comment on the protection of cleared swaps customers before and after commodity broker bankruptcies, as provided for in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the 'Dodd-Frank Act').

AIMA members, as significant users of swaps and security-based swaps (collectively 'swaps' hereafter) for investment and hedging purposes, will be among the many customers benefiting from the protections being provided under these reforms and we support the Commission in its task of finding workable, cost-efficient models and solutions to protect customers before and after a commodity broker bankruptcy.

We set out below a summary of our key points and then address the benefits and risks in the models proposed in the advanced note of proposed rule-making ('ANPR').

Summary of key points

AIMA supports the move to central clearing in the swaps market and wishes to stress the importance of this aspect of its implementation. We believe it is an important aspect of the clearing reforms which, only if implemented correctly, will bring the systemic risk reducing benefits Congress intended.

AIMA believes that the Commission should introduce full segregation of collateral with independent third parties, as only under this model will customers have confidence that their margin will be fully protected. Should a lesser level of protection be introduced, customers could face greater risks under a centrally cleared model than they currently do in the uncleared swaps market (where they often choose full segregation at relatively low cost).

This is important as a lack of confidence in the system in which client collateral is inadequately protected can cause customers to seek to avoid losses by liquidating or moving their positions in stressed market conditions, causing 'runs' on the futures commission merchants ('FCM'), greatly exacerbating market stress and contributing to wider financial instability. Introducing models which offer less protection than full segregation could therefore significantly reduce the systemic risk benefits associated with the move to mandatory central clearing of OTC swaps.

[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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AIMA's comments

AIMA is pleased that the Commission has decided to give full consideration to possible models that may be used to protect customers' margin payments[2] for cleared swaps. The Commission's notice correctly identifies several possible models that may be used to successfully implement the provisions of section 724 of the Dodd-Frank Act, and recognises that there is a trade-off between levels of asset protection (including the presence of 'fellow-customer risk' in some models) and cost. However, we believe that full physical segregation of collateral is the most suitable model that reflects the landscape of today's market and the developments in the uncleared swap space, and thus (at a minimum) must be an available option.

The Commission should also consider the international implications when implementing protection of customer collateral, and should continue to work with the Commission's international counterparts to ensure consistent protection where possible[3].

Full physical segregation

Under this proposed model, the assets of a customer provided as initial margin will be held as customer assets with an independent third party legally separate from a FCM but for their benefit under a tri-party contractual arrangement between the customer, the FCM and a derivatives clearing organisation ('DCO'). Assets would be independent of and held separately from the FCM and other customers of the FCM. There is therefore no fellow customer risk on the customer and all margin is held only to secure the obligations of the customer and would not be used to make up any short fall of amounts that are required to be paid to other customers or used to be paid to the FCM on another customers' default.

Full physical segregation provides customers with the maximum level of protection and thus confidence that their resources are protected after the default of an FCM, putting it on par with what many customers now have in the uncleared market. Its use in the uncleared market to date has shown that it is an affordable and practical option for many customers who desire it. To now require customers who receive this high level of protection for uncleared swaps to move to a cleared market where they receive less protection would codify an advantage to those trading uncleared swaps, which would seem an unusual result and out of keeping with the aims of the reforms. The maximum level of protection means the lowest level of risk and the maximum level of confidence for customers that assets will be protected, even in severely distressed marketed conditions. This confidence may mean that customers are more likely to stay in their positions (which can be ported) in distressed markets and not withdraw their business. This is a desirable goal that contributes to the financial stability objectives set out in other parts of the Dodd-Frank Act.

It additionally has other benefits such as allowing a simple transfer of obligations to a new clearing member or closing out of the position without having to reconcile the position with any other customers (we understand that under some models proposed by industry this could be achieved in no greater than 48 hours after default[4]).

Cost is expected to be higher for full segregation over other options, firstly from the point of view of the additional administration of opening and managing individual accounts for each of the customers. However, the main cost, as is identified in the ANPR, may be the removal of customer margin from the default resources of a

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2 Where we refer to segregation of margin in this letter, we are primarily referring to initial margin (an amount calculated based on anticipated exposure to future changes in the value of a swap), rather than variation or mark-to-market margin (margin collected to offset losses (if any) that have already been incurred on the positions held by a firm). Although the ANPR does not, in the main, make a distinction between the two types of margin, we believe it is unnecessary to segregate variation margin and that this should be available to the recipient for any use.

3 For example, the Commission should seek to ensure that the proposed segregation models are 'equivalent' to those proposed in the European Union to allow US DCOs to offer clearing services within the European Union. Article 23 of the European Commission's proposed European Market Infrastructure Legislation (EMIR) provides that "a CCP established in a third country may provide services to clearing members and their clients established in the Union only where that CCP is recognised by ESMA". Such recognition may be given where the third country CCP complies with "legally binding requirements which are equivalent to the requirements resulting from [the] Regulation".

4 http://www.lchclearnet.com/swaps/swapclear_for_clients/portablilty_of_client_trades_2.asp

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DCO (the default waterfall) which may be drawn upon by the DCO if the clearing member is in default. The solutions proposed in the ANPR are to either increase the amount of collateral posted by the clearing members (with corresponding increases in customer margin), or increase the size of the default fund contribution of the clearing member, the cost of which may be passed to customers. By how much these costs would increase is unclear however, and it remains to be seen what the actual level of margin costs and default fund contributions would be.

We believe that commonly quoted estimates of the likely percentage increase in costs over a baseline model may be over-exaggerated being based purely on anecdotal evidence and that the estimates misunderstand the amount of resources that will be required in default resources. If a customer defaults and fails to pay margin into an omnibus account, the FCM will have to fund the loss themselves. If the loss is large enough it is possible that the FCM will be unable to fund the loss and will itself default (a double-default). Under a double-default scenario the DCO would be entitled to use the resources of all customers of the defaulting FCM. We believe that estimates of the additional cost have merely seen the loss of customer resources within the default waterfall as a dollar figure which must be made up by increased margin levels or default fund contributions. However, it has not been shown that existing resource levels are necessary, especially when you consider the very low probability of a double-default scenario occurring[5] – some parties have mistakenly believed all customer resources to be available on the default of just the FCM, which we understand is not permitted by any of the currently operating DCO's clearing rules.

If it is proposed by the clearing members and the DCOs that margin payments will increase, we have seen little evidence to date that would justify such large increases as are estimated[6]. If there are increases in cost, which we accept there might be, we believe that this would reflect the current level of under-pricing in risk, and that parties who wish to have full segregation will be willing to assume reasonable additional costs to gain the added protection.

Costs may also be reduced over time if the provision of clearing services becomes a competitive market. The Commission should seek to encourage a competitive market for clearing by, for example, requiring full publication of the clearing models offered and their costs, and by ensuring that new firms have fair access to become clearing members of a DCO (providing they meet minimum prudential standards).

Full physical segregation therefore might cost more than other models of segregation, but the costs may be reduced anyway as mandatory clearing increases customers' willingness to enter the market and the costs become scalable. For example, FCMs will see a reduction in their capital requirements as a result of facing DCOs instead of customers directly[7], and new entrants to the market will bring increased liquidity and lower volatility helping to reduce costs caused by stressed market conditions. We believe that full segregation, if not made mandatory, should be an available and affordable option for customers based on the actual cost to the FCM of providing the service.

Legal segregation with commingling

This option would allow customer margin to be commingled and held in a single customer account at the DCO or an independent third party for the benefit of the FCM. Each customer's position is recorded and communicated to the DCO and the DCO requires collateral for the full amount of outstanding positions on a gross basis. On default of a clearing member the customer's margin would be firstly segregated from the FCM and thus not

[5] In the history of FCM defaults, we understand that a double-default situation has occurred on only a handful of occasions, and no double-defaults have occurred since the financial crisis.

[6] We believe it would be beneficial for the purposes of proposed rules if the Commission were to conduct its own, independent review of the potential costs of clearing, and we would be happy to discuss with them how they may go about this.

[7] Under the capital requirement rules as coordinated internationally by the Basel Committee on Banking Supervision and applied by the US Banking regulators, the banks are entitled to use a zero-rated risk-weighting for their transactions with central counterparties, which would be much higher for direct transactions with a variety of customers with different (and lower) credit ratings. The impact therefore should be a reduction in the amount of capital that the FCM must hold which offers a significant offset to the additional costs of providing default resources and other costs of central clearing.

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forming part of the insolvent estate, and secondly is returned without risk that it may be used as part of the default resources. One concern for AIMA members with this model is that the customer faces the risk that the value of the collateral provided may be reduced by market fluctuations and that any resulting short-fall will be attributed *pro rata* among the customers (re-investment risk) as margin is held without regard to the customer to whom any particular asset belongs. AIMA members, under current arrangements, are generally required to provide the highest quality capital, e.g. US Treasury securities or cash, but other parties may not be and may provide collateral with lower credit ratings such as corporate bonds and securities. Our concern therefore is that collateral provided by other counterparties may be of lower quality and suffer greater risk of deterioration in value, and a *pro rata* allocation would erode the benefit of providing that high-quality collateral. This can partly be remedied by requiring counterparties to only provide collateral of sufficiently high quality.

The administration of this option is slightly reduced over full segregation due to the ability to operate a single 'pot' rather than multiple accounts, however it would still require daily reporting on individual positions and would remove potential resources from the default resources and thus may be more expensive than the baseline model (as discussed above). The other main issue is the reduced speed with which positions can be 'ported' to another clearing member or closed-out, caused by having to assess the current total value of collateral in the pot and reduce that value *pro rata* on the calculated positions of each customer to take account of the loss of value in the collateral. When considering valuating position for the purposes of porting, it should also be recognised that the swap market is not as liquid as the futures market, and that a less liquid market may makes it harder and more time consuming to price positions and assess risks. It is unclear how long in practice this would take compared to the process for full segregation (relying significantly on robust, accurate, and real time books and records), however there is an increased market risk at this time, that prices may move significantly whilst the positions are being prepared to be ported or closed out. Overall it could be expected to offer a much greater degree of protection than the baseline model however.

"Back of the waterfall" model

It is our understanding that this model is similar to the 'legal segregation with commingling' model as it has many of the same benefits and drawbacks/risks discussed in the ANPR and above. Additionally, the model adds that the customers' margin will take a place in the DCOs default resources behind the FCM's own contribution to the guarantee fund at the DCO and the contributions of all other members of the DCO to the default fund. Whilst this appears as the third option in the ANPR, we note that the 'back of the waterfall' model offers greater customer protection than the 'legal segregation with commingling' model.

We recognise that the customer's margin is exposed to some double-default risk in this model but that in practice substantial resources of the DCO in the guarantee fund should prevent the customer's margin from ever being used. However, it is currently unclear how large the DCO guarantee funds will be, and whilst in systemically important DCOs the resources will be sufficient to cover the default of the two largest clearing members, for non-systemically important firms it may be substantially less and is thus unclear whether it will be 'substantial' and sufficient. Assuming the default resources are set sufficiently high this option would offer improved levels of customer protection over the baseline model and may be a robust cheaper option for customers.

"Baseline" model (i.e. the futures model)

The baseline model is the model that has been used in the US futures market for many years and has received praise for its operation during the financial crisis and the collapse of Lehman Brothers. However, the risks of this model are clear – each of the customers of a FCM will have their money commingled in an omnibus account and should any of the customers fail to provide sufficient margin to cover their position at the time of default of the FCM, the resources of all customers will be used ahead of any of the DCO resources. Short-falls in the omnibus account would be paid *pro rata* among the customers.

The futures model was introduced in the 1930s when markets were smaller, traded less frequently, when technology to allow segregation was not as advanced, and when risk management practices were not as

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sophisticated. Whilst the futures model is an improvement over unsegregated accounts, it is not clear whether the architects of the futures model appreciated the fellow customer risk inherent in the system, and it is unlikely a model designed from scratch today would accept this risk.

The instances of double-default may be rare, but equally in times of financial instability, the same external factors which cause the FCM to fail may also cause some customers among the pool to equally fail (and *vice versa*). Whilst AIMA members conduct extensive analysis of the risk of dealing with their counterparties, such as the FCM, they would be unable to conduct proper analysis of the risks of other customers failing under stressed market conditions. Customers have no right to any information about who the FCM's other customers are, and thus how likely they are to fail or not provide their required margin, and are therefore unable to properly protect themselves or understand their risks under this model. This is seen as a major problem for AIMA members, and is the reason many have opted to pay for additional protection under the full segregation model for uncleared swaps.

As discussed above, the futures model additionally suffers the re-investment risks in relation to the loss of value in the collateral. Whilst the baseline model offers improved protection over FCM's holding collateral on their own account, as stated above, it would seem a strange result if full segregation was permitted for uncleared swaps, but not for cleared swaps, thus codifying an advantage to the uncleared swaps market.

Optionality

Whilst we would like to see the full segregation model being adopted universally by the DCOs, it is important that customers at least are able to choose and negotiate with their FCM a level of segregation that is suitable for them, including full segregation. This would bring it in line, to some extent, with the optionality available in the uncleared swaps market.

However, one of the issues raised with the optional model is that if some parties are opting for full segregation, those left in an omnibus account will have to share out the losses among a smaller group of customers on a double-default and thus they face greater *pro rata* fellow-customer risk and have to absorb greater losses. The use of multiple segregation models could increase the administration of running the various models and could increase the complexity of returning assets on the default of the FCM. However, we do not think that such challenges are insurmountable and solutions can be reached by which the FCM is able to fairly distribute the cost of risk among customers, with certain customers paying a premium to gain greater risk protection. A further concern is that if optionality is introduced, full segregation may not be economically viable for customers in comparison to the cheaper options, where full segregation will not benefit from reductions in costs due to its wide application. If this is the case, as we've stated above, the risk reducing benefits of centrally clearing may not be realised. Whilst wide use of full segregation over the wide use of the baseline model may not be significantly more expensive (see below), under optionality full segregation is likely to be significantly more costly and therefore unlikely to be used except by the largest customers.

Moral Hazard

The ANPR raises an important issue of moral hazard which may be present if customers become less reliant on the credit worthiness of their FCM, and thus FCMs are not put under any pressure to hold greater levels of resources against loss (capital) than the minimum required. Whilst this incentive is important, we believe that the pressure will come instead from the DCOs and their members whose capital and funds (respectively) will form part of the default resources of the DCO. To the extent that they are not encouraged to hold adequate levels of capital, it should be imposed upon FCMs by the Commission and the DCO and they should be required to hold greater levels of capital if thought prudent. Further, there will still be some degree of uncertainty in porting a portfolio of position to a new clearing member during a financial crisis, and thus clients will still be concerned about their FCM failing and will put pressure on their FCMs to hold all necessary resources against default.

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Customers risk-managing their FCMs

Customers to a large extent suffer from a lack of information about the FCM and how it manages its risk on an ongoing basis, and thus may lead to difficult decisions about whether they should pay a premium for a greater standard of segregation under an optionality model. Such risk may better be assessed were the customers to have more information about the FCM and their fellow customers. However we appreciate that information on positions and levels of margin will need to be kept confidential. FCMs should be fully transparent about their risk management policies and the basic margin methodology, and may additionally be able to provide some anonymised data regarding the size of their largest exposures. It may additionally be useful for FCMs to conduct stress testing of likely defaults among their customers upon their own insolvency and thus make it clear that should the occurrence materialise the possible extent of losses each customer may face on the return of their assets. Such information will help customers understand the risk management and their exposures for different FCMs, and should provide comparability in a competitive market. Therefore, this should create some degree of encouragement to improve standards. However, we believe that the Commission plays the most important role in ensuring that FCMs are keeping sufficient resources and are prudently managing their risk – if the standards are assessed to be too low, the Commission may consider requiring improved standards for firms.

Conclusion

AIMA believes that mandatory segregation of collateral for cleared swaps under any of the proposed models will bring benefits to the market, however to be effective and reduce counterparty and systemic risks the full segregation model is preferable and should be supported by the Commission. If multiple models are used on an optional basis, full segregation must be an available option to be funded at the customers' own (reasonable) expense.

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,

Mary Richardson
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