Alternative Investment Management Association

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Submitted via the CFTC website: http://comments.cftc.gov/

Elizabeth M. Murphy,
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Securities and Exchange Commission,
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Submitted via the SEC website: http://www.sec.gov/rules/proposed.shtml

22 February 2011

Dear Sir/Madam,

CFTC and SEC request for comment on Further Definition of "Swap Dealer,""Security-Based Swap Dealer,""Major Swap Participant,""Major Security-Based Swap Participant" and "Eligible Contract Participant"

The Alternative Investment Management Association (AIMA)[1] appreciates the opportunity to provide comment as part of the Commodity Futures Trading Commission (the 'CFTC') and the Securities and Exchange Commission's (the 'SEC') (together, the 'Commissions') request for further comments (the 'Release') on the definitions contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (the 'Dodd-Frank Act').

AIMA submitted a comment letter to the Commissions on 24 September 2010 in which we highlighted our main concerns as being finding a definition of 'swap dealer' (and equally, 'security-based swap dealer') that reflects the essential characteristics of a dealer and the market understanding of the term, and defining 'major swap participant' ('MSP') (or, equally, 'major security-based swap participant') such that it captures only entities that are systemically important or can significantly impact the financial system of the United States by their swap trading activities. We do not believe that any hedge fund manager in today's markets should be mistakenly classified as a 'swap dealer', and we believe that it is unlikely that many hedge fund managers in today's market would be subject to the MSP regime.

We are pleased that the Commissions have considered our comments and carried forward many of our suggestions regarding how these terms should be defined. Our members will instead be subject to general oversight as market users and subject to regulation and oversight by the CFTC or SEC as commodity trading advisers or investment advisers (where appropriate). We do, however, have certain specific suggestions in

[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 1,100 corporate bodies in over 40 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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relation to these definitions and we request further clarifications. Our main concern with regards to the further definitions defined in the Release is in relation to the amendment to the definition of 'eligible contract participant' (ECP) and the Commissions' proposal to further revise the definition in relation to other categories of ECP – a step not required by the Dodd-Frank Act.

We set out below our comments on each of the definitions discussed in the release.

AIMA's comments

"Swap Dealer" and "Security-Based Swap Dealer"

In our September 2010 letter, we raised the concern that the definitions of "Swap Dealer" and "Security-Based Swap Dealer" (collectively, "swap dealer") as read in the Dodd-Frank Act may be misinterpreted and may accidentally capture certain parties who would not be considered "swap dealer" based on their activities and the market's understanding of their activities. In particular, as the definitions in section 721(a)(21) are disjunctive, the third limb – a person who "regularly enters into swaps with counterparties as an ordinary course of business for its own account" – could capture a number of funds that enter into swaps for their own account but in no sense would otherwise be considered dealers (as recognised by the Commissions).

The Commissions have taken on board feedback in this regard and appear to be considering more specific criteria that might indicate that a party is a swap dealer, such as accommodating demand for swaps and security-based swaps from other parties, facilitating other parties' interests, proposing terms of trade, developing new types of swaps, marketing that indicates the party is a swap dealer and other criteria. Whilst we agree that each of these factors may be appropriate for the Commissions' consideration, we are concerned that the definitions that will be added as an amendment to the General Regulations under the Commodity Exchange Act at 17 CFR Part 1 do not contain such additional factors. We would like to see those factors included within the legal definitions or in some form of binding interpretive guidance that will provide comfort to parties in arriving at a determination that they will not have to register with the Commissions as swap dealers.

"Major Swap Participant" and "Major Security-Based Swap Participant"

In our September 2010 letter, we raised concern regarding the definition of the new terms of "Major Swap Participant" and "Major Security-Based Swap Participant" (collectively, "MSPs"). We recognised that the intention of the Dodd-Frank Act was to capture certain parties in the swaps market that hold positions of such size and have such an exposure that they create a risk to financial stability and thus require additional regulatory oversight. Many of the issues with the definitions contained in the Dodd-Frank Act arise in relation to the subjective terminology used, including whether a party has a "substantial" position and whether the swaps create "substantial" counterparty exposure. It is our belief that if these terms are not properly defined then they may be inappropriately applied to certain parties and imposes on them a burdensome and unworkable regulatory regime.

We proposed that, when considering a 'substantial' position and 'substantial' exposure, the Commissions should set an appropriately high objective threshold for each that would be used to consider the actual risk of loss that would arise for a counterparty, separately detailed by category of swap (recognising that different swaps have different risk profiles). The position and exposure should be exempt or discounted if the contract is cleared (to recognise the value of, and promote, central clearing), should be off-set by the value and quality of any collateral provided against the individual positions, and should consider, along with the characteristics of the contract, the direction it takes in the market. We are pleased that these proposals appear to have been taken up in the Commissions' proposal and that, importantly, the value of the exposure is to be discounted by any collateral posted to the counterparty. This does, however, raise the issue of how over-collateralised positions are counted for these purposes (i.e. collateral which has value greater than the exposure). AIMA's members are required, in almost all cases, to post initial margin with their derivative dealer for the purpose of reducing their future exposure and in most cases do so in excess of the current exposure level, leading to over-collateralisation. We would seek to have any over-collateralisation applied to reduce potential future exposure

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for the purposes of the proposed thresholds as the purpose of over-collateralisation resulting from posting of initial margin is to mitigate the impact on a dealer of a counterparty default.

In considering the exposure of any party, we are pleased that the Commissions have recognised the benefits of clearing and provided a substantive discount from the exposure calculation. However, whilst we support a substantive discount for bilateral clearing and the use of daily mark-to-market margining, we believe that central clearing provides additional protection and near elimination of counterparty credit risk, in addition to the ability of the central counterparty to transfer the assets and positions of a client to a second clearing member derivatives dealer or liquidate the client's positions on default of the derivatives dealer. For these reasons, AIMA has been fully in support of the introduction of central clearing, for its systemic and counterparty risk reducing effects. Therefore, in this context we believe it would be useful to both incentivise and differentiate central clearing and believe this can be done by excluding centrally cleared swaps entirely from this calculation.

Exposure and positions implemented using credit default swaps (CDS) are inherently different from other swaps, in that the protection buyer pays (relatively) small premiums in return for a large payout should a reference entity experience a credit event. Therefore, the exposure that the buyer creates for the seller should be capped at the loss of the premiums that the buyer has agreed to pay the seller and not by any threshold that relates to the payment it would receive if a credit event occurs. In calculating this exposure for a protection buyer, future unpaid premiums should be discounted based on a LIBOR/swap curve for the applicable currency, as is consistent with market practice. Additionally, we would recommend that a further discount be applied as the maximum loss for a buyer of CDS protection would be experienced in a credit spread tightening environment. If such a spread tightening were to take place and the holder of the CDS protection were to default due to inability to post margin, we think it would be unlikely that this would coincide with a period of high systemic risk in which a dealer would be put in danger. In the case of the seller, the exposure will be the payment it has agreed to pay the buyer, which is significantly greater. CDS sellers would be in the majority swap dealers who are able to offer such products, and will thus not be defined as MSPs, although to the extent that the seller is not a swap dealer its exposure should be counted towards the threshold – this should be made clear in the Commissions' proposed rules.

Further, it should be recognised that there is a difference between single name CDS (one reference entity) and other 'credit derivatives', e.g. derivatives based on CDS indices. An index-linked CDS has a much lower volatility and jump-to-default risk profile than a single name CDS as its exposure is related to the value of a diversified index of reference entities rather than the potential idiosyncratic risk of a single name. Accordingly, we propose that index-linked CDS should have a lower discount factor than single name CDS. Additionally, CDS referencing high yield entities would be expected to have greater volatility than those referencing investment grade entities. Although the Dodd-Frank Act prohibits the use of credit ratings, we propose that credit spreads be used to distinguish high yield credit from investment grade credits. For example, those entities whose 5 year credit spread is less than 500 bps could be considered investment grade while others would be considered high yield. A lower discount factor should be applied to those swaps referencing investment grade entities than to those referencing high yield entities. Various types of credit derivatives may require individual assessment to assess whether the exposure on each is properly and accurately accounted for in the Commissions' proposed rules.

When considering the conversion factors (page 42 of the proposed rules) for those swaps that are not subject to daily mark-to-market margining and are not cleared by a registered clearing agency or a derivatives clearing organisation, potential outward exposure is proposed to equal the total notional principal amount of those positions, adjusted by certain multipliers that reflect the type of swap and residual maturity. Although we believe that the numbers used are broadly acceptable for other types of swaps, we question why residual maturity is not a relevant factor for the purposes of credit derivatives. The risk of a party defaulting and leaving its counterparty exposed will vary, as with other swaps, with the maturity of the contract, i.e. risks of payment will reduce as the remaining maturity decreases.

The Commissions have further defined 'highly leveraged' within the MSP definition to means "the existence of a

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ratio of an entity's total liabilities to equity in excess of [8 to 1 or 15 to 1] as measured at the close of business on the last business day of the applicable fiscal quarter". We believe this is an appropriate definition of highly leveraged for these purposes, but would encourage the Commissions to adopt the higher 15 to 1 threshold until an assessment on the impact of the MSP definition can be done.

We support the Commissions' understanding of the 'MSP' definition in relation to asset managers and investment advisers and that the relevant thresholds should be looked at in relation to the separate legal entities of the funds – those that "maintain" the substantial position - and not the manager of those funds. It is the fund to whom the rights and obligations of a swap fall, and only they should be considered to "maintain" the position. In any event, we believe that the obligations should be limited in their territorial scope and should only apply to US funds or those otherwise regulated in the US. The Commissions should consider possible anti-evasion measures if they believe these to be necessary but the proposed rules should be constructed such that they recognise the method with which asset managers and investment advisers structure their businesses, with separate, individually managed funds.

"Eligible Contract Participant"

In the Dodd-Frank Act, we understand that Congress has made a decision to try to protect retail investors by amending the definition of ECP under Section 1a(12) of the Commodity Exchange Act to include that, for a commodity pool to qualify as an ECP under sub-section (A)(iv), the pool's underlying participants must also qualify as ECPs under section 1a(12). The Commissions believe that commodity pools may still be able to rely on sub-section (A)(v), which applies to a "corporation, partnership, proprietorship, organization, trust, or other entity" which, *inter alia,* has a net worth exceeding $1,000,000 and "enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business". The Commissions therefore propose to take Congress' intention further and additionally require that if a commodity pool does not qualify as an ECP under sub-section (A)(iv) it will equally not be entitled to qualify under sub-section (A)(v).

We believe that this approach goes too far and imposes a requirement that is not required by the Dodd-Frank Act, will be difficult for commodity pools and their advisers to comply with and will adversely affect investment. Whilst Congress has had both the motive and opportunity to make the simple amendment the Commissions have proposed, it has not done so. In light of the consequences of the amended definition for commodity pools and the difficulty for commodity pools in assessing the status of their underlying investors (see below), we would encourage the Commissions to retain this legitimate exemption for parties who meet the sub-section (A)(v) criteria.

Commodity pools and their trading advisers utilise a number of structures to suit the needs of their business and their underlying investors. This may include a commodity pool owned and managed by a trading adviser that is of the same company or group of companies, but it may also include a commodity pool which is independent of the trading adviser who makes the investment decisions of the pool. In the second case, the trading adviser would need to be sure that the commodity pool and the participants in the pool are each ECPs before it is able to make its investment decisions as to whether to invest in foreign exchange forward contracts outside of designated contract markets (DCMs) or non-spot contracts in compliance with the CFTC 'retail forex rules'[2]. The trading adviser would be required to obtain verification and rely on the view of the owner of the independently owned pool (e.g., a managed account operated by an investment bank) before proceeding. This task becomes more difficult where independent managed accounts are themselves invested in by other groupings of investors, such as investors in a nominee account which invest in the managed account[3]. In that example, the trading adviser must rely on the account manager to look not only at its direct investors but to the indirect investors within nominee accounts who invest with its account. Where the trading adviser cannot be sure that all participants in the pool are ECPs, then the adviser must take a cautious position and must either register as a

[2] Reauthorization Act of 2008 and the related CFTC regulations.

[3] Other structures and legal vehicles are likely to face the same issue with underlying investors as described here for managed accounts.

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CPO and comply with the retail forex rules or decide not to trade. Although parties may be willing to register with the CFTC as commodity pools (all of our members active in this sector, where required, already are so registered), the retail forex rules provide severe restrictions on many commodity pools/trading adviser businesses such that they would not be able to invest freely in the market. By excluding certain parties from the market, the rules risk reducing liquidity and creating volatility in these important markets and preventing hedging of other investments, increasing risks for those parties.

Additionally, it should be noted that the Dodd-Frank Act specifically recognises the importance of foreign exchange contracts and in defining the new regulations that will be applicable to swaps, states[4] that in defining a 'swap', the Secretary of the Treasury may make a written determination that foreign exchange swaps and foreign exchange forwards shall not be considered swaps for the purposes of the Dodd-Frank Act. The ability of the Secretary of the Treasury to make such a determination provides further evidence that Congress was unconvinced that foreign exchange swaps and foreign exchange forwards needed to be subject to new rules and protections for market participants, and thus the Commissions are justified in retaining the legitimate exemption for parties who meet the sub-section (A)(v) criteria.

A further concern is the lack of clarity surrounding the extraterritoriality of the CEA rules that are affected by this amended definition. When considering commodity pool participants, do the rules require that only the US participants be ECPs or do they apply to all participants as investors, wherever in the world they are located? The concept of being a 'US participant' also raises questions of whether underlying investors of those participants must also be US participants. We believe that it is unnecessary to extend the scope to protect possible retail investors outside of the US, especially where it may be a commodity pool that has not marketed its offering in the US and does not otherwise have any US investors. The Commissions should consider which measures are necessary to protect only US investors and as the Dodd-Frank Act does not set a territorial scope for this provision the Commissions should consider the US Supreme Court's ruling in *Morrison v. National Australia Bank Ltd*[5] that "when a statute gives no clear indication of extraterritorial application, it has none".

[4] At section 721(a)(2), which amends Section 1a of the Commodity Exchange Act by adding a new definition of 'swap' as (42). See paragraph (E) on the power of the Secretary of the Treasury to determine that a 'swap' does not include foreign exchange swaps and foreign exchange forwards.

[5] Robert MORRISON, et al., Petitioners, v. NATIONAL AUSTRALIA BANK LTD. et al. 130 S.Ct. 2869 (2010)

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Conclusion

AIMA believes the views expressed in the Commissions' Release generally reflect the market understanding of who a 'swap dealer' is and what a 'major swap participant' could be, and that neither term should capture parties for which these definitions are inappropriate, including AIMA members. We ask the Commissions to ensure that their intentions expressed in the Release are carried into the proposed rules, or at least into binding technical guidance. In addition, we believe that the clarifications and suggestions we propose, such as those regarding excluding cleared swaps fully and the distinctions between the treatment of indices versus single name CDS and high-yield versus investment grade CDS, are important inclusions. The proposed change to the definition of an ECP should be reconsidered and the Commissions should recognise the potential issues this amendment could cause, especially in light of having no specific requirement in the Dodd-Frank Act to make this change.

We thank you for this opportunity to comment on the definitions contained in Title VII of Dodd-Frank Act and are, of course, very happy to discuss with you in greater detail any of our comments.

Yours faithfully,

Mary Richardson
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