Alternative Investment Management Association

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Submitted via the CFTC website

11 July 2011

Dear Sirs/Madam,

Margin Requirements for Uncleared Swaps for Swap Dealers, Major Swap Participants and Covered Swap Entities – further comments from AIMA

The Alternative Investment Management Association (AIMA)[1] appreciates the invitation of the Commodity Futures Trading Commission (the Commission) and the US Prudential Regulatory Authorities[2] (the Prudential Authorities) (together, the US Authorities) to provide comments on the proposed rulemaking in relation to the 'Margin Requirements for Uncleared Swaps' (the Release)[3], implementing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

AIMA submitted comments to Prudential Authorities and the Commission, on 27 and 28 June respectively, regarding certain elements of the Release (AIMA's first letter). In light of the Commission's extension of the

[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.

[2] The Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

[3] We comment on the proposals common to both the Commission's proposed rule release of 28 April 2011 (17 CFR Part 23) and the Prudential Authorities proposed rule release of 11 May 2011 (12 CFR Part 45), except as otherwise stated.

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deadline for comments, we now wish to provide you with further comments on certain other aspects of the Release.

AIMA's comments

Timing of Implementation

AIMA has been very supportive of the move to the clearing of eligible swaps and security-based swaps through derivative clearing organisations (DCOs), which will reduce risk and enhance efficiency in the market. The Dodd-Frank Act calls for higher margin requirements for uncleared swaps when compared to cleared swaps, which the US Authorities have proposed as 2 times the amount of margin required on comparable cleared swaps (and 4.4 times the amount of margin required for comparable cleared futures). This is designed to incentivise financial and non financial end users (End Users) to trade in cleared products, which offer improved price transparency and reduced counterparty credit risk. However, this option is not meaningfully open to End Users as the US Authorities are still finalising the rules for DCOs and related swap execution facilities (SEFs) and many new entities, which have expressed an intention to provide clearing services as DCOs, are not yet established in the market.

Until the DCO registration rules are finalised and DCO offerings are brought to the market, the requirement for higher uncleared swap margin requirements is unable to incentivise parties to choose cleared over uncleared swaps. For this reason, rules on minimum margin requirements for uncleared swaps should be considered in tandem with similar rules for cleared swaps and should not be implemented until the relevant End Users have the option to clear those trades with a DCO registered and established in the market.

Exchange of variation margin

In AIMA's first letter, we stated that "both Swap Entities and End Users should be required to post variation margin, as is industry practice". We wish to expand on this important point and highlight the possible consequences if both Swap Entities[4] and End Users are not required to have trades marked-to-market and to post appropriate amounts of variation margin.

The Prudential Authorities have proposed only that Swap Entities *collect* initial and variation margin from their counterparties but not *post* initial and variation margin, except in the case where both counterparties are Swap Entities. The Commission has also proposed collection but not posting of initial and variation margin by Swap Entities to End Users, giving two reasons for this decision:

- to provide consistency with the Prudential Authorities' proposals in this regard; and
- financial entities are not subject to capital requirements and payment of variation margin would necessitate money flowing from a regulated entity to an unregulated one.

We addressed and supported this position, with regard to initial margin, in AIMA's first letter stating "Requiring Swap Entities to provide [initial] margin is not common market practice and End Users rely on the fact that Swap Dealers are required to hold sufficient capital to cover their exposures and that the margin the End User posts may be segregated with a third party custodian if agreed". However, two-way exchange of *variation* margin serves a different purpose and is common market practice. Although we agree that the proposals should be consistent between the Prudential Authorities and the Commission, we would strongly encourage all of the US Authorities to require two-way exchange of variation margin between Swap Entities and End Users. We do not believe that the arguments that capital requirements, in this regard, are sufficient or that variation margin would

4 Covered swap entities, swap dealers, security-based swap dealers, major swap participants and major security-based swap participants (hereafter, Swap Entities).

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necessitate money flowing from regulated entities to unregulated ones (presumably stated as a negative consequence, although why is not explained[5]) are valid.

Instead, posting of variation margin plays an important role in covering mark-to-market exposure and reducing counterparty credit risk. Two-way exchange of variation margin is today considered best practice in the industry. If a Swap Entity enters into a swap with an End User and collects, but does not post, variation margin, default on the part of that Swap Entity risks creating losses at the End User on the uncovered mark-to-market exposure. This uncovered exposure effectively leads to financial contagion in which the financial stability of the End User is reduced, perhaps, in turn, causing the End User to default on its own obligations to other counterparties. This financial contagion risk should be a major financial stability concern for the US Authorities.

Requiring two-way exchange of variation margin also has other positive market benefits. Requiring posting of variation margin ensures that Swap Entities are conducting proper risk management and are properly monitoring their exposures. Swap Entities would not be able to hide losses from their counterparties without detection, as they would be required to pay variation margin, a measure of the gains and losses with respect to the swap, on a frequent basis. Should they seek to hide further losses, a margin dispute would occur raising the issue for the attention of the US Authorities. Two-way posting of variation margin will be mandated in the cleared swaps market (*i.e.* both counterparties of a trade have to post to a DCO), recognising the benefits of posting variation margin and the consequences of not doing so. As the Dodd-Frank Act seeks to move a large number of swap transactions from the uncleared to the cleared market, it would be beneficial if this aspect of the regulatory rules was the same, making transition between the markets less burdensome and operationally easier.

Under the proposed rules, it is possible for End Users to negotiate with Swap Entities, such that they agree to full two-way exchange of variation margin. However, unless mandated, this practice is unlikely to become common except among the largest End Users who have the market clout to demand it, as it will equate to an extra cost on a trade for Swap Entities. It is more likely that an optional two-way exchange of variation margin will equate to most Swap Entities only realising some of the mark-to-market losses periodically and may mean them posting no variation margin at all.

We do not believe either that mandating two-way exchange of margin would be burdensome, as it is common market practice. We would strongly urge the US Authorities to reconsider their proposal and mandate two-way exchange of variation margin between Swap Entities and End Users.

<u>Margin model transparency</u>

As part of setting appropriate minimum margin levels, we accept that certain large Swap Entities will wish to use their own proprietary margin models. However, we believe it is necessary for certain details about the basic functionality of initial margin models to be disclosed to their counterparties[6].

AIMA is concerned that, if there is no disclosure of this basic functionality, it will be difficult for End Users to predict what margin calls they are likely to face in the future. Therefore, End Users will find it hard to conduct capital planning and they will likely have to hold significant amounts of additional capital to meet the margin calls as they come due. Alternatively, if they do not hold sufficient capital, this may lead to default, severely impacting their own businesses, investors and their counterparties. A second concern is that, without some level of transparency, it is difficult to assess whether initial margin models are being applied equally by a Swap Entity to all of its counterparties for contracts of the same level of risk.

We believe that margin requirements should be risk-based, taking account of the level of risk inherent within the type of transaction and likelihood of the End User's default. However, that aside, initial margin models of each

[5] We further note that although certain End Users are unregulated, the majority of financial end users will be regulated by the Commission, the Securities and Exchange Commission or other US federal regulators.

[6] Our comments only relate to initial margin requirements. Since all participants are trading the same markets, variation margining models should be the same for all parties and not require disclosure.

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Swap Entity should otherwise be objective and calculated using the same basic functionality so that the same initial margin amount is required on the same type of swap with counterparties of similar risk-levels. Without objective margin models, there is concern that a Swap Entity will give favourable treatment to, and provide lower margin requirements for, particular counterparties or class of counterparties. Of course, different margin models are likely to be necessary for different classes of swap. Further, different Swap Entities may each have their own proprietary margin models and require different amounts of margin of End Users from other Swap Entities, which we see as reasonable and in line with competition in the market.

Objective and fair margin models can only be ensured if a Swap Entity is required to disclose the basic functionality of its margin methodology. A further benefit would be that End Users are able to ensure that, with large Swap Entities having complex portfolio-margin systems, they are paying the correct amounts of margin. Transparency provides a safeguard against incorrect margin calls, whether accidental or deliberate, being made by the Swap Entity.

Erroneous or abusive margin calls are a particular concern for End Users, as excessive payment may benefit the Swap Entity to the detriment of the End User. Although, as stated, transparency of the basic functionality of initial margin methodology may enable End Users to monitor the appropriateness of margin calls, other measures may usefully be proposed by the US Authorities. We would urge the US Authorities to consider mandating certain safeguards, should there be reasonable belief that margin calls are incorrect. These may include giving a right within the proposed rules for End Users to dispute possible incorrect margin calls and for there to be a form of statutory standstill agreement, preventing further margin calls, until a dispute is resolved.

Conclusion

AIMA supports the US Authorities' proposed rules but believes that certain elements need to be revised to provide for mandatory two-way exchange of variation margin and for required transparency of Swap Entity proprietary initial margin models' basic functionality. We also believe that the timing of implementation of the proposed rules must be aligned with the implementation of proposed rules on clearing swaps with DCOs and the ability of End Users to use DCOs established in the market.

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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Director of Government & Regulatory Affairs

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