



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
USA

[Submitted via the CFTC website](#)

30 September 2011

Dear Mr Stawick,

Customer Clearing Documentation and Timing of Acceptance for Clearing

The Alternative Investment Management Association (AIMA)¹ welcomes the opportunity to provide comments on the Commodity Futures Trading Commission (the Commission) consultation on proposed rulemaking regarding Customer Clearing Documentation and Timing of Acceptance for Clearing (the Consultation).

AIMA's comments

AIMA is supportive of the goals underlying Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), to introduce important reforms to the regulation of swaps and security-based swaps and, in particular, the mandatory clearing requirement. The success of mandatory clearing depends on provisions that provide for open access for customers to derivatives clearing organisations (DCOs) and their services. Rules, documentation or other actions that unnecessarily reduce the ability of customers to access DCOs should be addressed. Consequently, AIMA is supportive of the Commission's proposals, which address: (i) limits on customer clearing and trading incompatible with open access, and potential conflicts of interest in how they are administered; and (ii) unnecessary delays between the time at which a swap is traded and the time at which a swap is cleared.

Customer Clearing Documentation

Specifically, we support the Commission's analysis regarding the FIA-ISDA Cleared Derivatives Execution Agreement (the Agreement) and the Commission's conclusion that certain aspects of the Agreement may be inconsistent with certain principles of the Dodd-Frank Act (discussed further below). As the Commission is aware, the Agreement has been put forward to address two specific points that arise from the clearing of a swap contract:

- the allocation of losses² relating to the rejection by an FCM or DCO of a trade, resulting in the counterparty cancelling the trade (known as "breakage"); and
- the creation of a bilateral agreement if a trade fails to be accepted for clearing (where agreed and permissible under law).

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 over 40 countries.

² e.g., losses caused by actions taken on the expectation that a trade would be cleared by a DCO and the need to replace that "failed" trade at a later point in time, where the market may have moved unfavourably.

The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA

Tel: +44 (0)20 7822 8380 Fax: +44 (0)20 7822 8381 E-mail: info@aima.org Internet: <http://www.aima.org>



Alternative Investment Management Association

AIMA is supportive of parts of the Agreement, which may usefully address these two points. However, AIMA members do not support the optional “trilateral” guaranteed clearing arrangement annex of the Agreement (the Trilateral Annex), which the Futures Industry Association (FIA) and the International Swaps and Derivatives Association (ISDA) have put forward³. Under the Trilateral Annex, the FCM places specific ‘sub-limits’ on the volume of transactions a customer may execute with each specific swap dealer, within the overall limits which FCMs already establish for their customers. These sub-limits will necessarily limit the range of counterparties a customer can execute with, impair a customer’s ability to access the widest range of liquidity and best available pricing, complicate block trades, and compromise risk management capabilities. Additionally, the Trilateral Annex will require the client to disclose the identity of its executing counterparties to its FCM, which undermines open, competitive markets, as detailed below.

We believe the Trilateral Annex is inconsistent with the principle of open access and other provisions of the Dodd-Frank Act and, therefore, we strongly support the proposed rules which would prevent such arrangements.

The importance of open access

Whilst AIMA supports the Dodd-Frank Act reforms around central clearing, we note that they will place obligations and, therefore, costs on our members who trade in the swaps market, either for investment or hedging purposes. For this reason, it is important that clients can gain access to central clearing services, otherwise they will be restricted or prevented from trading in certain markets.

As is clear from the notice of proposed rulemaking, the Trilateral Annex creates sub-limits for customers’ trades with different swap dealers. As customers’ total limits with an FCM can only be spread among so many swap dealers and remain meaningful (i.e., large enough to contain single trades), there is a serious risk to open access and competition.

As noted in the Commission’s notice of proposed rulemaking, open access is a specific requirement set out in the Dodd-Frank Act, as implemented in the Commodity Exchange Act and in other proposed CFTC rules. These include:

- Section 4s(j)(5) of the Commodity Exchange Act - The swap dealer and major swap participant shall implement conflict-of-interest systems and procedures that— (A) establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity or swap or acting in a role of providing clearing activities or making determinations as to accepting clearing customers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open access and the business conduct standards described in this Act.
- Section 4s(j)(6) of the Commodity Exchange Act - Unless necessary or appropriate to achieve the purposes of this Act, a swap dealer or major swap participant shall not— (A) adopt any process or take any action that results in any unreasonable restraint of trade; or (B) impose any material anticompetitive burden on trading or clearing.
- Section 2(h)(1)(B)(ii) of the Commodity Exchange Act - The rules of a derivatives clearing organization... shall— provide for non-discriminatory clearing of a swap ... executed bilaterally or on or through the rules of an unaffiliated designated contract market or swap execution facility.

³ The Trilateral Annex is designed to manage the risk that a customer: (i) breaches an imposed credit or position limit, resulting in a trade being rejected by an FCM or DCO for clearing; and (ii) fails to meet its obligations to compensate their counterparty for any breakage incurred. It does this by requiring (i) the customer, (ii) the futures commission merchant (FCM) as clearing member and (iii) the swap dealer as counterparty, to sign the Trilateral Annex to agree that the FCM will be held jointly and severally liable with its customer for any breakage owed by its customer to the swap dealer.



Alternative Investment Management Association

- CFTC proposed Regulation 1.71 - Implementation of conflicts of interest policies and procedures by futures commission merchants and introducing brokers.
- CFTC proposed Regulation 23.605(d)(1) - Implementation of conflicts of interest policies and procedures.
- CFTC proposed Regulation 39.12 - Participant and product eligibility.

Anonymity

We are not aware of any existing cleared derivative market which involves the trilateral annex or which allows the FCM to discover the identity of the executing counterparty, as it is not an important or relevant consideration. The FCM only faces the DCO in the trade, who guarantees performance of the counterparty's obligations. Such anonymity is important. Under the trilateral arrangement, where anonymity of a customer's executing counterparties would not be available, there is a risk that the FCM would steer how the sub-limits are allocated. This is particularly a concern when a number of the large FCMs will be affiliated with large swap dealers, giving rise to the possibility that an FCM may allocate larger sub-limits to their own trading desks, at the expense of others dealers, particularly non-incumbent swap dealers and alternative liquidity providers that would like to enter the market. Such barriers to entry are anti-competitive and prevent customers from gaining best execution for their investors.

Choice of executing counterparty

It is important that clients have choice over which parties they trade with and which parties they clear with. Choice in clearing services will help encourage competition and will lead to greater take up of clearing services, improving financial stability. Free choice of the counterparties (e.g., swap dealers) a customer may execute trades with will equally lead to competition in the swaps market. Such freedom of execution allows new swap dealers to enter the markets and compete with existing market participants, which will narrow bid-ask spreads, help bring down the cost of entering into swap contracts, and improve market depth and liquidity.

Under a Trilateral Annex, a customer will not be able to trade with the full universe of potential counterparties, and will not have full discretion over how to allocate its FCM imposed credit limit among its permitted counterparties. It is likely that, instead, the customer of an FCM will have to fragment its total credit limit for swaps transactions among a handful of counterparties. Such restrictions on the allocation of the credit limit will lead many parties to simply deal only with the largest, well established swap dealers, since they presently control the vast majority of liquidity. Again, in the case of asset managers, this may result in not being able to gain the best quality service at the best prices, preventing performance of fiduciary duties to investors, including the obligation to achieve best execution.

Single limits for customers

The premise for the Trilateral Annex is that (i) a trade is not accepted for clearing, (ii) breakage is incurred, and (iii) the customer defaults on its obligation to pay breakage to its trading counterparty. To cover this remote contingency, a customer's FCM agrees to be jointly and severally liable with its customer to the trading counterparty for any breakage incurred with respect to any trades that are within the FCM's prescribed sub-limits. This premise is flawed on multiple levels. First, breakage is an extremely rare occurrence in other cleared derivatives markets. Second, instances of breakage will be virtually eliminated in a market that has real-time acceptance of trades for clearing. Third, the size of any breakage (in dollar terms) should be minimal, since under the low-latency solutions being implemented, the time elapsed between execution acceptance / rejection for clearing will be tiny, thus, the amount of potential losses from market movements within this short time window would be small. Fourth, a trading counterparty would nonetheless still have a contractual claim against a customer for any breakage that was incurred. Fifth, and finally, customers are highly incentivised, for



Alternative Investment Management Association

reputational and other reasons, to ensure that their trades do clear, and are highly unlikely to enter into trades in the first place that are outside their FCM's prescribed clearing limits. Thus, the purported benefits of the Trilateral Annex are based on a flawed premise, and at best, solve for extremely remote contingency, while the adverse market consequences of loss of anonymity of executing counterparties and the imposition of trading sub-limits are far graver.

FCMs maintain their right to set a unitary credit limit for their customers that can be adjusted at their discretion, and to reject any customer trades that exceed such a limit. Thus, FCMs' risk management abilities are not dependent upon a Trilateral Annex. If anything, the operational complexity of administering a sub-limit regime, coupled with the added joint and several liability required by the Trilateral Annex, would complicate FCM risk management.

A far better solution to the issues the Trilateral Annex is purported to address is to ensure real-time acceptance of transactions for clearing (discussed below).

Other consequences of the Trilateral Annex

We note that, aside from the reasons given in the proposed rules, the Trilateral Annex and the setting of sub-limits creates further complications for parties. Customers are given further limits on their ability to trade in addition to the overall credit limit normally imposed. From an operational standpoint, this is a further item that will need to be monitored when a customer enters into a trade with a counterparty. There is the possibility for the FCM to adjust limits for any number of reasons and customers will face an ongoing burden of monitoring their individual limits to different counterparties. The sub-limits are also likely to be restrictive, given the current number of counterparties which large hedge fund managers trade and the overall size of those trades. The sub-limit becomes a particular problem for managers attempting to execute block trades, which may not fit within the given sub-limit. Even where FCMs are willing to be flexible and extend sub-limits to permit block trades, this creates further burdens on requesting such extensions and awaiting approval. Particularly active customers in the market, such as hedge fund managers, will seek to transact with multiple parties as part of diversifying their exposures and good risk management. Restricting the number of parties a customer may execute trades with via sub-limits will prevent parties from managing risk through diversification. These sub-limits and restricting customer trading to a limited number of counterparties would lead to fragmentation of market liquidity, increased cost of trading, and more volatility of prices within those markets.

Overall, the Trilateral Annex is mostly advantageous to the large incumbent dealers who have FCM operations and will create a barrier to entry for new dealers seeking to enter the market, including multiple negative consequences for customers and only negligible additional comfort regarding breakage losses, which are rare and may be reduced altogether by real-time acceptance of trades for clearing.

Addressing common defences of the Trilateral Annex

Some have tried to argue that the Trilateral Annex is a product of industry consensus. Whilst it is true that various parties provided input for the creation of the Agreement, the content (as well as the process by which the agreement was "finalised" and published) was very much led by the largest and most active swap dealers. As we state above, we wish to point out that the Trilateral Annex was not supported by buy-side firms in its development. As a template agreement produced by two independent trade organisations, it has been argued that concerns regarding the agreement are unjustified as it is an optional agreement that firms need not sign, if there are objections. However, we believe that it is the intention of those on the sell-side of the industry that the Agreement will become standardised industry documentation. The bargaining power between buy-side and sell-side firms is not equal and if sell-side firms wish this agreement to be executed, perceiving it to be instrumental to protect their interests, it will be signed by buy-side counterparties if they wish to trade. The concentration in the market today of a small number of large sell-side counterparties means that, except in the rare circumstances of the largest buy-side firms, the Trilateral Annex is likely to be made mandatory for parties



Alternative Investment Management Association

wishing to trade and will become the industry norm unless the Commission stands firmly by the principles laid out in the proposed rules.

Sellside firms have argued the need for the Trilateral Annex, to protect themselves from large losses caused by breakage of executed trades that are not accepted for clearing. As we've discussed above, the better solution to that problem is accelerated pace of real-time acceptance of transactions through implementing available technologies. As we've discussed above, instances of breakage, which occur rarely now, will be virtually eliminated if trades are accepted for clearing in real-time. Under a real-time acceptance of trades regime, the size of any instances of loss that did occur would also be negligible upon the executing counterparty (see below).

FCMs may also argue that they would not seek to place sub-limits in a manner that strategically allocates the ability of the customer to trade with only certain counterparties or its own swap dealer affiliate. Given that the Trilateral Annex would require some division of the overall limit between certain firms, it is difficult to see how this could ever be done fairly and there would always be a suspicion that FCMs were allocating the limits in a way that favoured their business over the interests of the customer. The only way to ensure that the customers' interests are upheld is to have complete anonymity at the FCM level of who the customers' counterparties are, allowing them to trade with any party they wish, up to the full amount of their single limit with the FCM.

Timing of Acceptance for Clearing

AIMA agrees with the Commission that minimising the time between trade execution and acceptance for clearing by a DCO is very important for mitigating the risk that a trade may be executed but not permitted to clear. Having prompt, efficient, and accurate processing of trades is, therefore, broadly supported, although we believe that it may be possible to do better than this and require real-time and immediate acceptance of a trade for clearing upon execution of a trade (sometimes referred to as a 'perfect settlement' solution). By requiring acceptance for clearing "as quickly as would be technologically practicable if fully automated systems were used" is a good standard and will help encourage certainty in the market for customers. This in turn will prevent long delays between execution and acceptance for clearing where parties are unsure whether their exposure will be with a DCO or will be with the counterparty. This uncertainty creates issues for risk management and hedging of the risk. Removal of such uncertainty and efficient processing of trades will encourage the take up of clearing with all its corresponding benefits for the market.

The Commission notes three methods by which the market can deliver prompt, efficient, and accurate processing of trades: (i) pre-screening of trades before execution against clearing rules and credit limits and, therefore, simultaneous execution and acceptance of a trade for clearing; (ii) screening of trades against information held by the DCO and, thus, acceptance for clearing shortly after execution; and (iii) the DCO requests information from the FCM who will respond with relevant data to allow screening of a trade before acceptance for clearing shortly after execution. It is accepted that a DCO cannot accept a swap for clearing until it is checked whether the swap is eligible for clearing, it complies with the clearing rules, the swap is within the credit limits of the customer and the FCM is within its limits set by the DCO. These checks can be made automatically using computerised confirmation. Option 1, perfect settlement, will ensure that it is impossible to have losses caused by breakage, as the trade is only executed once approved for clearing. Further, it will make it impossible in due course for there to be an eligible swap that is required to be cleared to be traded if it is not able to clear. This will allow parties to have free choice as to which counterparties they transact with, without the need to restrict trading to only large swap dealers. This will create competition in the market and lower barriers to entry, reducing prices and fees, promoting liquidity and encouraging innovation, as already discussed above.

Options 2 and 3, as proposed, may result in some continued bilateral risk, although through the use of highly automated approval after execution, where breakage does occur through rejections by the DCO, the losses are likely to be negligible, for example, where trades are accepting for clearing "in a matter of milliseconds or seconds" as in other existing cleared derivatives markets. Under such options, parties may elect to sign documentation such as the Agreement (although not the Trilateral Annex), but we expect that the Agreement should not have relevance. We note again that other existing cleared derivative markets do not impose the legal

5

The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA

Tel: +44 (0)20 7822 8380 Fax: +44 (0)20 7822 8381 E-mail: info@aima.org Internet: <http://www.aima.org>

Registered in England as a Company Limited by Guarantee, No. 4437037. VAT registration no: 577 5913 90. Registered Office as above



Alternative Investment Management Association

burden of execution agreements on participants, and see no basis for OTC derivatives clearing to function differently.

Importantly, even these less “perfect” but still prompt options do not provide the opportunity for the DCO and counterparty to delay acceptance of a trade and have a second late opportunity to reject a trade after execution. Such an option would be extremely disruptive to market participants.

Conclusion

AIMA supports the Commission’s proposal, which effectively prohibits the use of the Trilateral Annex and other types of agreements that would remove the anonymity of a customer’s executing counterparties and would place unnecessary and restrictive limits on the size of trades and the number of counterparties a customer may execute trades with⁴. Further, AIMA believes that the Commission should provide that trades are accepted (or rejected for clearing) immediately upon execution of a trade, or immediately or very shortly thereafter.

We thank you for this opportunity to comment on the Consultation and we are, of course, very happy to discuss with you in greater detail any of our comments.

Yours sincerely,

Jiří Król
Director of Government & Regulatory Affairs

⁴ We do, however, urge the Commission to clarify that customers are permitted to voluntarily disclose certain information (including the identity of the customer’s executing counterparty) to their swap dealers / FCMs on a post-trade basis (e.g., at month end) to facilitate commercial discussions between customers and swap dealers / FCMs.