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

3 November 2011

Dear Mr Stawick,

CFTC proposed rules on 'Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements Under Section 4s of the CEA' and 'Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA'

The Alternative Investment Management Association[1] (AIMA) appreciates the invitation of the Commodity Futures Trading Commission (the Commission) to comment on the proposed rule releases[2] that propose the compliance and implementation schedules for rules enacted under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act).

Summary of AIMA's comments

- AIMA supports the Commission's proposed phased compliance and implementation schedule for clearing;
- AIMA believes that 'active funds' is correctly defined by the use of a proxy of the average number of swaps funds have executed during the previous 12 months;
- To include active funds with third party subaccounts within the definition of a 'Category 3 firm', instead of a 'Category 1 firm', may upset the level playing field among funds active in the swaps market;
- Before firms are required to clear any swaps, the Commission must publish the final rules determining the various swaps definitions and the final rules on margin requirements;
- A phased compliance and implementation schedule for trade execution is unnecessary and need not be aligned with the compliance and implementation schedule for clearing; and
- For the purposes of the trade execution requirement, the Commission should give more consideration to when a swap can be considered to have been 'made available to trade' and allow time for swap execution facilities (SEFs) to be established and develop their internal rulebooks before the requirement is effective.

AIMA's comments

AIMA supports the Dodd-Frank Act reforms and, in particular, those moves to meet G20 commitments around clearing, trading and reporting of OTC derivative contracts[3]. We appreciate that the Commission has worked hard to consult with industry on these reforms via the 55 notice of proposed rulemaking releases and is seeking to finalise all required rules under the Dodd-Frank Act as expeditiously as possible. AIMA wishes to see such rules published as soon as is practicable and, ideally, in line with the provisional timetable announced by Chairman Gensler on 9 September 2011[4]. Once such rules are finalised, we support the implementation of the Commission's

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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, institutional investors, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in more than 40 countries.

2 We comment on the proposals common to both of the CFTC's proposed rules, except as otherwise stated.

3 The leaders of the G20 nations' commitment at the September 2009 summit in Pittsburgh that "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories."

4 http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement090811c

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proposed compliance and implementation schedule for clearing, which considers the time needed in practice for preparation for compliance with the clearing requirements. We do not believe that the Commission should consider setting a general compliance date of 31 December 2012 (i.e., the last date for compliance to meet the G20 commitments), unless such date is the first date at which firms are ready to meet their new obligations. We would hope that the compliance date for most rules is sooner than this date.

AIMA supports the Commission's proposal to have phased implementation of the obligation regarding clearing of 'eligible' swap contracts or groups, categories, types or classes of swap contracts with a derivatives clearing organisation (DCO) (the Clearing Obligation). We do not believe it is appropriate for the final rules regarding the mandatory trading obligation, swap trading relationship documentation and margin requirements to be phased in the same way as the Clearing Obligation.

Phasing of the Clearing Obligation by category of firm

The proposal states that there will be three phases of compliance dates for the Clearing Obligation of 90, 180 and 270 days after the publication of the final rules for mandatory clearing and, thereafter, a decision that a contract or group, category, type or class of contracts is deemed eligible for clearing by the Commission (a Commission Clearing Decision).

Such phasing will see those parties with the necessary experience and resources complying with the Clearing Obligation first. Those less able to comply with the Clearing Obligation within a short time frame after the publication of the final rules and a Commission Clearing Decision (the Clearing Trigger) should be given additional time. Swap dealers and major swap participants should be included within the first category of firms to be subject to the Clearing Obligation (Category 1 Firms). These firms will be counterparties to the greatest numbers of trades and are expected to be of a sufficient size that they will have the experience and resources to meet the Clearing Obligation in a short period of time after the Clearing Trigger. However, as proposed, it is important that suitable buy-side firms are also required to meet the Clearing Obligation as Category 1 Firms.

Hedge funds (Private Funds as defined in the Investment Advisers Act of 1940) are often active traders in the market and many will be of a sufficient size and have sufficient expertise that they will be able to be suitably included as Category 1 Firms. Further, buyside firms are looking to take an active role in how the cleared swaps market is shaped, such as through representation on CCP governing boards and risk-committees and, therefore, buyside firms wish to be represented in the market at the earliest stage possible.

Category 2 appears to include all other regulatory classifications of smaller or less active financial participants in the swaps market that are not subject to any exemption from the clearing or trading obligations (Category 2 Firms). Category 3 rightly includes all other types of counterparty who could be subject to Title VII obligations. These financial and non-exempt non-financial institutions (Category 3 Firms) would require the longest time to comply with the Clearing Obligation following the appropriate Compliance Trigger. The three categories of firm generally provide a level playing field for compliance with the new obligation among active, less active and occasionally active firms, ensuring that competing firms are subject to the same compliance timetable. However, we believe that the inclusion of those managing third-party subaccounts as a Category 3 Firm could upset this level playing field (discussed below). The Commission must also consider how the obligations would apply to non-US firms and, where they do, ensure that non-US firms are subject to the same phased implementation as US firms for the Title VII rules to maintain the level playing field between US and non-US participants in the US swaps market.

In the proposed rules around 'Trading Documentation and Margining Requirements Under Section 4s of the CEA', there is a very similar phasing regime to that for 'Clearing and Trade Execution Requirements under Section 2(h) of the CEA'. One difference in the proposed trading documentation and margining requirements rules is that those funds with third-party subaccounts are put in an additional category 4. We would appreciate any clarification from the Commission regarding why these rules have a fourth category and, if there is no reason for it, we would suggest (subject to our comments below) aligning the rules and moving Category 4 Firms into Category 3.

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Defining the categories of firm

The number of swap contracts currently being executed by certain funds, based on the average number of swaps executed during the previous 12 months, is a good proxy for determining who should be an 'active fund' and, thus, fall to be classified as a Category 1 Firm. We have considered whether an alternative measure could be used as an appropriate proxy in this instance, however, we do not believe there are other more suitable proxies. As questioned in the rule releases, we considered whether the amount of assets-under-management (AUM) of a fund is a suitable proxy for its sophistication in the swaps market. Although this could be used, it is possible that, for example, an investment adviser to a fund with greater than $150,000,000 AUM may invest predominately in other types of financial instrument and may not have the experience or resources to quickly comply with new obligations in the swaps market.

The size of the fund's AUM would be irrelevant for these purposes if only a small percentage of their assets were allocated to investments in the swaps market. It is unclear from the rule releases why the definition for an 'active fund' was set at 20 or more swaps per month, instead of a greater or lesser amount of swaps. AIMA does not necessary dispute that 20 swaps is the correct threshold for deciding who is an active fund, but we would be interested to know why the Commission has decided this number and how many private funds the Commission expects will be classified as Category 1 Firms at this level. Among our members, we believe that those considering themselves to be active in the swaps market would be executing 20 or more swaps per month based on a monthly average over the previous 12 months.

We note that the Commission states "many commodity pools meet the definition of private funds under section 202(a) of the Investment Advisers Act of 1940" but we question why the Commission has not included commodity pools executing 20 or more swaps per month directly within the definition of an active fund. Commodity Pools are just as likely to be established to invest in the swaps market as private funds and, if they are equally active in the markets, it would seem to create a regulatory arbitrage opportunity (where they are not also private funds) by excluding them from the definition of a Category 1 Firm.

The definition of an 'active fund' also excludes private funds that meet the definition of a third-party subaccount. We do not disagree with the definition of a 'third-party subaccount'. However, we note that such private funds may be very active swaps market participants and in direct competition in the market with other private funds without third-party subaccounts. To provide these types of private funds with six additional months for compliance with their obligations may upset the level playing field of the swaps market in the short term. Although a large majority of private funds are in favour of central clearing and support the proposals, all acknowledge that the reforms come at a cost for individual private funds, particularly the cost of paying higher amounts of margin. To provide private funds with third-party subaccounts with an exemption from compliance for half a year may allow them to operate more cheaply in the market over those six months compared with other private funds.

It is likely that large asset managers who have large numbers of subaccounts will have sufficient resources and infrastructure to handle the agreement of new documentation between the managed account owners and the manager in a short period of time. We would propose that the words "that is not a third-party subaccount and" be deleted from the proposed rules and that all active funds be given 90 days to meeting their obligations following a Clearing Trigger. However, if the Commission decides that it is not feasible for private funds with third-party subaccounts to comply with the Clearing Obligation in 90 days, we would urge the Commission not to consider a compromise that sees all funds being subject to the clearing obligation after 270 days. As stated above, we believe it is desirable for active funds to be subject to the clearing obligation as a Category 1 Firm.

Compliance dates

AIMA believes that the time provided of 90, 180 and 270 days after the Clearing Trigger for Category 1, 2 and 3 Firms (respectively) is sufficient to allow for preparation ahead of meeting new Clearing Obligations. We support the Commission in proposing this reasonably tight timetable for compliance with the new obligations. Some

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parties will be in a position to begin clearing under the new regime ahead of the dates indicated in the compliance timetable and these parties should be allowed to clear under the new regime on a voluntary basis in this instance. We believe that phased implementation should be used, with the option to comply earlier on a voluntary basis, for all final rules and decisions of the Commission. To approach this on a case-by-case basis is likely to cause confusion for market participants and create additional work for the Commission in reviewing whether it is necessary to used phased implementation as proposed or require some other implementation schedule in each case.

As the Commission has recognised, there is a need to first have in place final rules necessary for understanding what the obligation would be after the phased implementation. As proposed, these should include the rules on the end-user exemption, the definitions (particularly, "swap", "security-based swap", "swap dealer", "security-based swap dealer" and "major swap participant") and details of the regime for protection of customer collateral. We believe that the final rules regarding margin requirements, including the calculation of initial and variation margin and custody arrangements, must be also be in place before the Clearing Obligation compliance date. These final rules for the margin requirements do not require the same amount of preparation for compliance as the Clearing Obligation, such that they would particularly burden certain categories of firm. As such, the compliance date for the margin requirements need not be phased in by type of counterparty but should, instead, be set equally for all parties to ensure a level-playing field.

Another clarification needed before the obligations can be effective is the treatment of non-US firms trading with US firms and trading between two non-US firms that may be caught within the scope of the Dodd-Frank Act. It is not, however, necessary to wait for the finalisation of all other rules under Title VII. To have to wait for the publication of all rules under Title VII is likely to delay the implementation of clearing longer than is necessary.

The trading obligation

We do not believe it is necessary or desirable to link the compliance dates for trading and clearing and that to do so may unnecessarily delay the take-up of clearing for certain swaps. Whilst trading and clearing will become part of the same process in due course, it is important for the market to adopt a robust clearing infrastructure for swaps first, which will then pave the way for, and ensure confidence in, the execution of swaps on SEF and designated contract markets (DCM). As SEFs are a new type of trading platform and are yet to be authorised and established in the market, there will need to be specific and detailed consideration of new policies, procedures and rulebooks for SEFs and DCMs, which will take time to develop. By contrast, clearinghouses are operating today and the industry has made significant progress to date in preparing for the transition to central clearing for all market participants. Thus, implicitly linking the phase-in of clearing and execution may have the unintended consequence of slowing the market's transition to central clearing.

We agree with Commissioner Sommers' statement at the end of the rule releases that it is still unclear what making a swap available for trading on a SEF or DCM means and we believe that the Commission must also make proposals on this concept before the trading obligation is effective. Our understanding is that the meaning of the term "made available to trade" is distinct and subject to higher thresholds than a swap simply being listed for trading on a SEF. We encourage the Commission to consider a more active role in the determination of which swaps are "made available to trade", rather than relying on SEFs to make periodic assessments to determine this. This can and should be akin to the role the Commission plays in the review of swaps for mandatory clearing, and should, likewise, include a public notice and comment period. We believe the Commission has this authority under section 733 of the Dodd-Frank Act, which states that the "Commodity Futures Trading Commission may promulgate rules defining the universe of swaps that can be executed on a swap execution facility".

In addition, the Commission and SEFs should consider additional factors beyond the frequency of transactions and the open interest when deciding whether a swap has been "made available to trade". Such factors should be objective and transparent and include, among other factors: (i) minimum trading volumes; (ii) minimum numbers of transactions over time; (iii) the sustained presence of a two-way market; and (iv) the depth of the market.

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If the above process is followed, particularly the public notice and comment period, a 30 day timetable for compliance following a swap being 'made available to trade' is likely to be the correct length of time for all market participants. The phase-in of the execution mandate thus does not need to rely on the three categories of market participants. Rather, once the market has transitioned to central clearing, and the Commission and SEFs have together made a determination as to which swaps that are being cleared should be "made available for trade", the execution mandate should be implemented. Prior to this, the Commission should finalise its rules regarding execution of swap trading relationship documentation. However, for the same reasons given above with regard to the final rules on margin requirements, the final rules for execution of swap trading relationship documentation need not be phased in by category of firm.

The proposed rule releases question whether the phased implementation should be different for the approval for trading and/or clearing of individual swaps from approval for trading and/or clearing of groups, categories, types or classes of swap. The releases further question whether different treatment should be given to swaps depending on the manner in which the swaps were executed – i.e., OTC or on a SEF/DCM. Subject to our comments above, we do not believe there are any reasons why unique treatment would be needed in either of these situations.

Conclusion

AIMA supports the Commission's proposed phased implementation schedule for the Clearing Obligation and believes that the Commission should seek to finalise its final rules as soon as it is able to and should require compliance with the Clearing Obligation shortly thereafter. There are, however, certain areas where the proposed rules could be refined and we have highlighted in particular the definition of 'active funds' and not necessarily linking the phased implementation of the trading obligation with that for the clearing obligation. We believe the mandatory trading obligation and, in particular, the meaning of 'made available' to trade needs further consideration by the Commission. It should not, therefore, be subject to the proposed phased implementation and, equally, should not be linked to the Clearing Obligation in a way that would further delay the compliance date for the Clearing Obligation.

We thank you for this opportunity to comment on the Commission's proposed rules and are, of course, very happy to discuss with you in greater detail any of the issues we raise above.

Yours sincerely,

Jiří Król
Director of Government & Regulatory Affairs

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