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

13 February 2012

Dear Mr Stawick,

Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to provide comments to the Commodity Futures Trading Commission (the Commission) on the further notice of proposed Rulemaking regarding the 'Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade' (the Proposed Rule).

AIMA is supportive of the requirement, outlined in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), to trade suitable swaps contracts on designated contract markets (DCMs) and Swap Execution Facilities (SEFs) and believes it is important that a clear process is in place to so designate those swaps.

AIMA's comments

Swaps suitable for trading

The Proposed Rule establishes a process by which SEFs and DCMs should consider whether a swap has been 'made available to trade', looking at a number of factors and, where it has been made available to trade, the process by which that fact is communicated to the Commission for consideration of whether it should then becomes a mandatory trading obligation. Whilst making a swap available to trade improves transparency for the trading of that contract and could contribute to efficient price discovery, it is important that only certain suitable swaps are mandated for DCM and SEF trading. The eight criteria are important factors to be taken into consideration and can broadly be summarised as requiring the consideration of market liquidity and depth in trading of the swap. If a swap is illiquid, then mandating that it trades exclusively on a DCM or SEF is likely to create unnecessary volatility in the price of the swap and provide a market price that does not reflect the fundamentals of the contract or its supply and demand characteristics.

It is important that the determination process, looking at which swaps are eligible for the mandatory trading requirement, is a separate process from the one whereby derivative clearing organizations (DCOs) determine whether a swap is eligible to be cleared. Section 723(a)(3) of the Dodd-Frank Act lists the determination criteria for declaring swaps 'eligible' for clearing and these are different from the proposed criteria for determining whether swaps should be mandatorily traded. Whilst the clearing determination criteria include 'trading liquidity', the purpose in that instance is to ensure that the DCO can price the swap with sufficient certainty to

[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 1,300 corporate bodies in over 40 countries.

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calculate margin requirements. The necessary level of trading liquidity is lower than the liquidity needed to ensure that DCM and SEF trading of a swap is successful.

We agree that the eight proposed criteria for determining the mandatory trading requirement are broadly appropriate and that no single factor should be dispositive itself. However, it is important that, as part of the process for determining whether a swap has been 'made available to trade', all factors are considered and that a swap is not subject to mandatory clearing as a result of passing the subjective threshold on, for example, only one or two of the eight factors. Under proposed rules 37.10(b)(2) and 38.12(b)(2), we believe that the frequency and the size of the transactions on SEFs, DCMs and in bilateral transactions should be considered (cf frequency or the size of the transactions).

Currently, there is difficulty in providing comments on the suitability of the determination criteria, as the definition of a SEF has not been agreed by the Commission. If the definition includes a broad consideration of what types of trading venues may be considered a 'SEF', then it is likely that the level of necessary trading liquidity can be relaxed given that it will encompass more trading methods already undertaken in the market.

The terms 'group', 'category', 'type' and 'class' of swaps should not be interpreted in an overly broad manner and should ensure that they take into account the specific and individual characteristics of certain swaps. To include broad groups, categories, types or classes of swaps may subject some individual swaps to mandatory trading requirements, even if they do not trade frequently and would not be subject to the requirement on an individual assessment. Conversely, the Commission should not exclude all contracts within a 'class' based on the characteristics of a few, as this would undermine the important benefits of the requirement. The Commission should start with broad groupings of swaps that are submitted for consideration by DCMs and SEFs and identify any contracts which are particularly bespoke due to certain unique features, such that they might be 'outliers'. These outlier contracts within the group, category, type, or class should then be subject to individual assessment against the factors. The Commission should look in a granular manner at the common characteristics of groups, categories, types or classes of swaps.

DCM and SEF self-certification process under section 40.6

AIMA is concerned about the possible conflicts of interest that may exist with the 'made available to trade' self-certification process under section 40.6 of the CFTC Regulations. This process would see DCMs and SEFs sending a proposal, with appropriate explanations and analysis, to the Commission on the swaps they believe should be mandatorily traded. Next, those swaps would become subject to legally enforceable mandatory trading requirements after only 10 days following receipt of the application by the Commission, unless the Commission raises a stay of certification and opens the proposal up to a short public consultation. DCMs and SEFs could be incentivised to submit as many (or perhaps all) of the swaps they currently or would wish to trade to the Commission in the hope that market participants would be legally required to execute on their venues, regardless of the suitability of the particular requirement.

The normal process would be that the self-certification would be effective after only 10 days and, thus, we are concerned that the Commission will not have sufficient time or resources to properly review all applications within that timeframe to ensure that they are appropriate. This will be a particular concern when the Proposed Rule first becomes effective and all DCMs and SEFs make their first proposals. 10 days is likely to be an exceedingly short period of time to give proper consideration to the explanatory information and analysis that DCMs and SEFs will provide. In the vast majority of cases, it could be expected that both the Commission and the users of the swaps markets will not have any opportunity to scrutinise these important proposed rules – in our view, this is not an appropriate method of imposing the mandatory trading requirement.

If the Commission intends to routinely stay applications and afford public consultation, then this makes procedure 40.6 more similar to 40.5. However, 40.6 would still only allow for a stay of the Proposed Rule which, if not specifically rejected, would become effective in less than 90 days. Given that made available to trade decisions are proposed to only be reviewed annually (discussed further below), this procedure could see many unsuitable illiquid swaps being subject to the mandatory trading requirement. To be clear, we do not believe that the

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procedure under 40.6 is appropriate and believe this should be removed from the final rulemaking (in place of procedure 40.5, with appropriate changes such as the introduction of a public comment period).

New rulemaking procedure

The section 40.5 procedure is an improvement over the procedure in section 40.6 in that it is (a) more transparent, through requiring publication of a proposal on the website of the DCM or SEF, as well as the Commission's website; and (b) the procedure does not presume that a submitted proposal to mandate a swap for trading is appropriate, but subjects the proposals to an appropriate 45 day (or 90 day, if extended) Commission review. Given the possibility for the aforementioned conflict of interest in the DCM or SEF making such a proposal, it is also important that as part of the 45 or 90 review, the Commission communicates the proposal widely to market participants and allows all market participants to contribute feedback on the DCM's or SEF's proposal. We believe that, at a minimum, industry participants would require 30 days to properly analyse the proposed rules and provide their feedback. Industry trade groups could assist the Commission in communicating notice of the proposed rule and request comments from among their members.

Information about a swap, which is considered against factors indicating whether or not it is suitable for trading, are dynamic in nature and will vary from time-to-time based upon demand for the product. Once a swap has been declared 'made available to trade' and is subject to the mandatory requirements, this should not be considered a final decision on the suitability of the swap for trading. It may be useful to develop objective standards or criteria by which swaps can be assessed by the Commission (in addition to the proposed annual reviews/assessments by SEFs and DCM) to see if they are no longer suitable for mandatory trading or, alternatively, for triggering an assessment of their continued suitability.

AIMA's principal objection to the 'made available to trade' process as proposed relates to the timing of the implementation of the mandatory trading requirement, which has (separately) been proposed to take effect in as little as 30 days following publication of the rule. There is a strong need to ensure that there is time after a swap is declared as suitable for DCM or SEF trading for market participants to prepare for compliance with the determination. Preparations would include ensuring that market participants can access these trading venues (either directly or through intermediaries); ensuring all applicable documentation and legal agreements are in place; and providing parties with time to plan their trading activities for the future. To provide a short notice period to the market will mean that many market participants will be unable to trade particular swaps for a time after the rule becomes effective. This may impact the market liquidity and depth in trading the swap. It will also impact a wide range of market participants, who may be unable to effectively hedge their exposures for a time after a rule becomes effective. AIMA believes that parties should be given at least the normal 90 days notice period from the time a swap is declared subject to the mandatory trade requirement to the date market participants must exclusively trade those swaps on DCMs and SEFs.

Where a swap is made available to trade and subject to the mandatory trading requirement, under either the section 40.5 or 40.6 procedures, the Commission should ensure that a full register of all swaps that are subject to the mandatory trading requirement is available on a publicly accessible website. This should either be maintained centrally by the Commission on its website or the Commission should help facilitate an industry operator's register of swaps subject to the mandatory trading requirement.

Economically equivalent swaps

AIMA echoes the many concerns raised at the Commission's 30 January 2012 roundtable regarding applying the 'made available to trade' determination to swaps that are 'economically equivalent' to swaps already assessed and declared subject to mandatory trading. This provision means that there will be significant uncertainty among market participants about which swaps are subject to the trading requirement and which are not. The level of 'equivalence' is extremely difficult to assess and each party could take a more or less conservative reading of this term.

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For example: If a three month swap contract, requiring settlement on the 15th of a given month, is subject to the mandatory trading requirement; is a similar swap contract which settles on the 1st of a given month an 'economically equivalent swap'? It may be similar, but a small change to the terms of the contract may be significant (e.g., given the time value of money) and specifically designed to ensure market participants' risks can be hedged. Market participants may be willing to pay more and trade more frequently a swap that is settled on the 1st of the given month if that more accurately hedges the risks they run. It is further questioned what would happen if the swap contract that settles on the 1st of the given month was not currently listed by a DCM or SEF. Would DCMs or SEFs be obliged to list the economically equivalent swap for trading too or would parties not be able to trade that specific swap? If it is the later, this reduces the ability for market participants to customise contracts to meet their needs and will likely leave many parties with poorly hedged risk exposures. If it is the former, DCMs and SEFs will need sufficient clarity and notice of exactly what they are required to offer on their trading platforms.

To provide certainty to the market, it is important that the Commission maintains a register of exactly which swaps are subject to mandatory DCM or SEF trading, which market participants can consult. Although we sympathise and understand the reasons for proposing this requirement, we believe a preferable alternative to including 'economically equivalent swaps' with the 'made available to trade' determination would be to have an anti-evasion provision to capture parties who are purposefully subtly amending swap contracts to avoid the mandatory trading obligation. If the Commission does decide to require mandatory trading of economically equivalent swaps, then it must publish clear guidelines as to what it considers 'economically equivalent' to mean. However, it is possible to question how much clarity can be given on economic equivalence given the multitude of factors impacting the economic terms of a swap – we believe that the use of an anti-evasion provision provides much greater clarity and certainty for market participants.

Commission's power to certify swaps for trading

AIMA notes the Commission's comment on page 4 of the Proposed Rule release that "as it gains experience with its oversight of swaps markets, it may decide, in its discretion, to determine that a swap is available to trade" and, in principle, supports such a proposal. It is important that, if trading of a swap on a DCM or SEF truly would improve transparency in the market, efforts should be made to ensure that this is possible. If the Commission proposes this in its rulemaking, we believe that the Commission should determine clear, objective criteria or metrics, set out in rulemaking or guidance, as to which swaps, not currently traded on DCMs or SEFs, should be traded on DCMs and SEFs. Public comment should also be requested where the Commission proposes to initiate a mandatory trading requirement for a certain swap. The Commission should assess its proposal against the criteria/metrics, the public comments received and all available evidence before making its determination. The Commission must also detail which steps would follow a mandatory trading determination if the swap is not currently traded on a SEF or DCM, to avoid situations where a swap contract cannot be entered into due to there being no platform on which to trade it.

AIMA believes that the Commission should also consider whether it would be desirable for it to initiate a review of the swaps that should be subject to the mandatory trading requirement when the proposed rule first becomes effective. We believe that when DCMs and SEFs are first permitted to submit their applications under the 'made available to trade process', the Commission will be overwhelmed with applications for consideration. Where these require public consideration, there may be too many applications for sensible and thorough reviews to be conducted. Going forward, the Commission will be collecting a wide range of data from the market on which swaps are currently traded (via its swaps reporting requirement) and, therefore, should have a good overview of the liquidity of various swaps across numerous trading venues. If the Commission were then to publicly consult on a proposed initial universe of swaps suitable for mandatory DCM and SEF trading, it would have an agreed starting point and list of suitable swaps, providing clarity to the market. After this, any additional swaps that may become suitable for mandatory trading could be subject to the section 40.5 rulemaking procedure as proposed. In the interests of efficiency, we believe that this proposal should be given consideration by the Commission.

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Conclusion

AIMA supports the broad outline of the process for making a swap available to trade; however, we urge caution on ensuring that only suitable contracts are subject to the mandatory trading requirement. The determination process should also be undertaken separately and only after the clearing determination process, as there are separate considerations for each. AIMA has concerns about the suitability of the section 40.6 rulemaking process, given incentives for DCMs/SEFs to maximise the number of swaps that are 'made available to trade.' We believe the section 40.5 rulemaking process is more appropriate, although we would ask that the Commission consult publicly before making its determinations.

To provide certainty, all swaps that are subject to the mandatory trading requirements should be listed on a central register (with the use of anti-evasion provision, if necessary, in lieu of a provision extending the requirement to economically equivalent swaps). It is also particularly important that market participants are given sufficient time to prepare for mandatory DCM or SEF swaps trading once a determination has been made by the Commission.

We thank you for this opportunity to comment on the Proposed Rule 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

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