Alternative Investment Management Association

Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

2 December 2014

Dear Mr. Kirkpatrick,

Re: Proposed Regulations Concerning Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – CFTC RIN 3038-AC97

The Alternative Investment Management Association Limited[1] (AIMA; we) welcomes the opportunity to submit the following comments on proposed Commodity Futures Trading Commission (CFTC) Regulations 23.150-23.159 (Part 23, Subpart E) (the Proposal), which would establish margin requirements for uncleared swaps for swap dealers (SD) and major swap participants (MSP).[2] AIMA appreciates that the CFTC reproposed these requirements in light of the publication of the final framework for margin requirements for non-centrally-cleared derivatives by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO).[3] That document is the product of the BCBS/IOSCO joint Working Group on Margining Requirements (WGMR).

AIMA recognizes that the CFTC has tried to follow the international framework, but notes that the Proposal diverges from the international framework in certain respects. These deviations may be particularly burdensome to AIMA members, the majority of which operate globally, with a significant presence both in the U.S. and in jurisdictions other than the U.S.. AIMA also respectfully requests that the CFTC clarify the requirements in certain respects before adoption.

Our principal area of interest relates to the cross-border application of the Proposal. We believe that the most effective way to define to the scope of the CFTC margin framework would be to adopt the "entity-level approach" described in the Proposal.[4]

Under that approach, if a hedge fund enters into a swap with a non-U.S. swap dealer that is not guaranteed by a U.S. person, then substituted compliance would be possible if the parties to the trade mutually agree to follow the foreign jurisdiction's regime, irrespective of whether the hedge fund is a U.S. person.

If the CFTC elects not to adopt the "entity-level" approach, we believe that the approach set out in the Prudential Regulators own margin proposal[5] might be workable, although we have reservations about situations in which elements of different jurisdictions' regimes would apply to the same transaction, as described in the Proposal.

---

[1] Founded in 1990, the Alternative Investment Management Association (AIMA) is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry – including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. Our membership is corporate and comprises over 1,400 firms (with over 8,000 individual contacts) in more than 50 countries. AIMA's manager members manage a combined $1.5 trillion in assets (as of March 2014).

[2] 79 Fed. Reg. 59897 (October 3, 2014) (the Proposal). The Proposal would impose requirements on SDs and MSPs for which there is no "prudential" regulator, *i.e.*, banking regulators, and the Proposal refers to such entities collectively as "covered swap entities" or CSEs.

[3] The document is available on the website of the Bank for International Settlements, www.bis.org.

[4] 79 Fed. Reg. 59897 (3 October 2014).

[5] 79 Fed. Reg. (24 September 2014).

At the same time, we would strongly caution the CFTC against adoption of an approach based on the CFTC's Interpretative Guidance.[6] The approach taken in the Interpretative Guidance has become a significant driver of conflict between U.S. and European regulatory requirements, and is undermining the goal of a globally coordinated regulatory framework.

In the annex that follows, we also recommend that:

- the CFTC permit cash in any major currency, not just U.S. dollars, to be used for variation margin payments;
- the CFTC make clear that non-U.S. public and private employee benefit plans are not financial end users for purposes of margin requirements for uncleared swaps;
- if a hedge fund enters into a swap with a non-U.S. swap dealer that is not guaranteed by a U.S. person, the U.S. regulations should not apply, irrespective of whether the counterparty hedge fund is a U.S. person;
- employee benefit plans should not be required to post margin on uncleared swaps that are used primarily for hedging or mitigating risks directly associated with plan operations;
- the CFTC conform its definition of "material swaps exposure" with the international framework;
- the CFTC limit the application of the new margin requirements to post-effective date swaps;
- the CFTC allow for margin exchange according to comparable foreign rules;
- the CFTC clarify that a dealer counterparty can use unsegregated initial margin in order to make a variation margin payment to its client in such situations; and
- the CFTC use the same criteria as the BCBS/IOSCO Standards as the basis for determining fund-level application of IM thresholds, rather than adopting a separate definition of control.

In conclusion, AIMA would like to reiterate the need for a globally consistent framework, particularly in the area of margin for uncleared swaps, where an international framework has been developed. AIMA respectfully requests that the CFTC conform its regulations for margin on uncleared swaps to the international framework as described above and make the other recommended changes. AIMA would, of course, be happy to discuss the points raised in this submission in further detail with CFTC staff. Please feel free to contact the undersigned or Adam Jacobs on +44 20 7822 8380 if you have any questions or we can be of assistance.

Yours sincerely,

Jiří Król
Deputy CEO,
Head of Government and Regulatory Affairs

[6] 78 Fed. Reg. 45292 (26 July 2013).

Annex 1: Detailed Comments

A. The CFTC Should Adopt the International Framework for Assets that Could be Used for Variation Margin

The CFTC would require variation margin payments to be paid in cash, either U.S. dollars or the currency in which payment obligations under the swap instrument are required to be settled.[7] Previously, the CFTC also would have permitted U.S. Treasury securities as payment for variation margin, but that would not be permitted under the Proposal.[8] The international framework makes no distinction between the assets that could be used for initial margin and those that could be used for variation margin.[9] AIMA recommends that the CFTC should conform to the international framework regarding assets permitted to be used for variation margin. Alternatively, AIMA recommends that the CFTC should at least permit U.S. Treasury securities to be used for variation margin, as originally proposed in 2011, and that the CFTC should permit cash in any major currency, not just U.S. dollars, to be used for variation margin payments.

B. Margin on Uncleared Swaps Should be Treated as an Entity-Level Requirement

We believe that the most effective way to define to the scope of the margin framework would be to adopt the "entity-level approach" as described in the Proposal.[10]

Under that approach, if a hedge fund enters into a swap with a non-U.S. swap dealer that is not guaranteed by a U.S. person, then substituted compliance would be possible if the parties elect to follow the rules of a foreign regime, irrespective of whether the hedge fund is a U.S. person (see row 7 in the table below)[11]; this should be by mutual consent, in order to ensure that both counterparties have the necessary compliance infrastructure to adhere to another jurisdiction's rules:

Counterparty A	Counterparty B	Applicable requirements
1. U.S. SD/MSP	U.S. person	U.S. (All).
2. U.S. SD/MSP	Non U.S. person guaranteed by a U.S. person	U.S. (All).
3. Non-U.S. SD/MSP guaranteed by a U.S. person.	U.S. person not registered as an SD/MSP	U.S. (All).
4. Non-U.S. SD/MSP guaranteed by a U.S. person.	Non-U.S. person guaranteed by a U.S. person	U.S. (All).
5. U.S. SD/MSP	Non-U.S. person not guaranteed by a U.S. person.	U.S. (Initial Margin collected by U.S. SD/MSP). Substituted Compliance (Initial Margin collected by non-U.S. person not guaranteed by a U.S. person). U.S. (Variation Margin).
6. Non-U.S. SD/MSP guaranteed by a U.S. person.	Non-U.S. person not guaranteed by a U.S. person.	U.S. (Initial Margin collected by non-U.S. SD/MSP guaranteed by a U.S. person). Substituted Compliance (Initial Margin collected by non-U.S. person not guaranteed by a U.S. person). U.S. (Variation Margin).
7. Non-U.S. SD/MSP not guaranteed by a U.S. person.	U.S. person not registered as an SD/MSP	Substituted Compliance (All).
8 Non-U.S. SD/MSP not guaranteed by a U.S. person.	Non-U.S. person guaranteed by a U.S. person	Substituted Compliance (All).
9. Non-U.S. SD/MSP not guaranteed by a U.S. person.	Non-U.S. SD/MSP not guaranteed by a U.S. person.	Substituted Compliance (All).
10. Non-U.S. SD/MSP not guaranteed by a U.S. person.	Non-U.S. person not registered as an SD/MSP and not guaranteed by a U.S. person.	Substituted Compliance (All).

This would obviate the need to determine whether the investors in the hedge fund are U.S. persons, which is a relevant consideration under the CFTC's cross-border guidance definition of the term U.S. person (discussed

[7] 79 Fed. Reg. at 59932.

[8] 76 Fed. Reg. 23732, 23747 (April 28, 2011).

[9] The international framework would permit the following to be used as collateral for initial or variation margin, in addition to cash: high-quality government and central bank securities; high-quality corporate bonds; high-quality covered bonds; equities included in major stock indices; and gold. Various haircuts would be applied to the different forms of collateral, with an extra haircut if the collateral were denominated in a currency that differed from the currency in which payment obligations under the swap are required to be settled. The international framework also noted in bold type that its list should not be viewed as exhaustive, provided that the key principle of acceptable collateral were satisfied, *i.e.*, that the assets should be highly liquid and able to hold their value in a time of financial stress, after accounting for an appropriate haircut.

[10] 79 Fed. Reg. 59897 (3 October 2014).

[11] 79 Fed. Reg. at 59917.

below). AIMA further suggests taking this approach to the clearing question, so that, if that the SD were non-U.S. and not guaranteed by a U.S. person, the clearing requirement of the SD's jurisdiction would then apply, again obviating the need for a hedge fund to determine its level of U.S. investors. We have previously commented extensively on issues relating to jurisdiction of the swaps transactions of globally active hedge fund managers, and refer to our request for no-action relief to the CFTC for EMIR-covered funds, dated 9 October 2013.[12] In this, we sought to identify specific scenarios in which the meaningful jurisdiction nexus was the EU, rather than the U.S., such that the parties should be able to elect to clear under the European framework if they mutually consent to this.

If the CFTC elects not to adopt the entity-level approach, then we believe that the approach set out in the Banking Regulators' margin proposal could be workable, although we have reservations about situations in which elements of distinct regimes would apply to the same transaction, as described by the Banking Regulators in their release:

> *[I]f a U.S. bank that is a covered swap entity enters into a swap with a foreign hedge fund that is subject to a foreign regulatory framework for which the Agencies have made a comparability determination, the U.S. bank must collect the amount of margin as required under the U.S. rule, but need post only the amount of margin that the foreign hedge fund is required to collect under the foreign regulatory framework.*[13]

For this reason, we believe that the CFTC's entity-level approach is preferable.

At the same time, we strongly caution the CFTC against adoption of an approach based on the CFTC cross-border Interpretative Guidance.[14] The CFTC's approach is a principal driver of the issue of overlap of and conflict between U.S. and EU swaps rules[15], leading CFTC Commissioner J. Christopher Giancarlo to call for the CFTC to "replace its cross-border Interpretative Guidance with a formal rulemaking that recognizes outcomes-based substituted compliance for competent non-US regulatory regimes".[16]

The issue of overlap arises for funds due to the fact that the CFTC deems a fund to a be U.S. Person if it is majority-owned by U.S. Person investors, even if the entity in question is organized, managed and trading in a foreign jurisdiction. Accordingly, a fund could have its principal place of business in the EU and no meaningful operational nexus in the U.S. and yet still be subject to CFTC requirements – without possibility of substituted compliance – if it has a majority of U.S. investors.

In such scenarios, foreign jurisdictions do not necessarily provide for the option to defer to U.S. requirements, given that the fund would not be operating on a cross-border basis, beyond the fact of having U.S. investors. Commissioner Giancarlo describes such situations as involving the CFTC dictating "that non-US market operators and participants must abide by the CFTC's peculiar, one-size-fits-all swaps transaction-level rules". For these reasons, we strongly believe that the CFTC's cross-border framework is having a harmful impact on the global swaps market, as evidenced by recent fragmentation trends[17], and should not be emulated in the context of margin rules.

Whatever approach the CFTC ultimately adopts, then it is essential that substituted compliance is broadly available, given the diverse situations in which U.S. rules might overlap with those of another jurisdiction.

---

[12] See http://www.aima.org/objects_store/aima_request_for_time-limited_no-action_relief_10092013.pdf

[13] 79 Fed. Reg. at 57380.

[14] 78 Fed. Reg. 45292 (26 July 2013)

[15] See http://www.aima.org/download.cfm/docid/64772F11-F066-414B-974E5CC984BEAE42

[16] Keynote Address of CFTC Commissioner J. Christopher Giancarlo at The Global Forum for Derivatives Markets, 35th Annual Burgenstock Conference, Geneva, Switzerland, 'The Looming Cross-Atlantic Derivatives Trade War: A Return to Smoot-Hawley' (24 September 2014). Available online at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlos-1

[17] ISDA, 'Revisiting Cross-Border Fragmentation of Global OTC Derivatives: Mid-year 2014 Update'(24 July 2014). Available at: http://www2.isda.org/attachment/NjY0NQ==/Fragmentation%20study%20FINAL.pdf

C. The CFTC Should Conform its Requirements for Netting Margin Payments to the Requirements of the Banking Regulators

The CFTC would permit netting of margin payments with a particular counterparty. A pre-requisite for netting is that the swaps are subject to an eligible master netting agreement (EMNA), which is a defined term.[18] The U.S. banking regulators' definition of EMNA permits a stay or avoidance in receivership, conservatorship, or resolution under certain U.S. statutes, "or similar laws of foreign jurisdictions that provide for limited stays to facilitate the orderly resolution of financial institutions." The CFTC definition of the term does not include similar language, but the CFTC specifically "requests comment on whether the proposal provides sufficient clarity regarding the laws of foreign jurisdictions that provide for limited stays to facilitate the orderly resolution of financial institutions. The Commission also seeks comment regarding whether the provision for a contractual agreement subject by its terms to limited stays under resolution regimes adequately encompasses potential contractual agreements of this nature or whether this provision needs to be broadened, limited, clarified, or modified in some manner." AIMA recommends that the CFTC should conform its definition of EMNA with that of the U.S. banking regulators to encompass laws of non-U.S. jurisdictions, but that the master netting agreement should not encompass contractual agreements for a stay or avoidance that are outside of a statutory framework.

D. The CFTC Should Exempt Employee Benefit Plan Hedging Positions

The Proposal appears to define employee benefit plans as financial end users. Accordingly, such plans would be subject to initial and variation margin requirements for all of their uncleared swaps with SDs and MSPs. At the same time, commercial end users would not be subject to margin requirements for uncleared swaps. The international regulators made the latter determination in part because commercial end users that are not systemically important were "viewed as posing little or no systemic risk." In determining whether an entity is an MSP, positions that may be excluded are (1) positions held for hedging or mitigating commercial risk; and (2) positions maintained by any employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan. If these two types of positions are not viewed as posing systemic risk for purposes of the MSP determination, these positions should be treated similarly for purposes of margin on uncleared swaps, and, therefore, not be subject to posting margin. The Proposal would not require margin on uncleared swaps of commercial end users, but would require margin for uncleared swaps of employee benefit plans, even if those swaps are used primarily for hedging or mitigating risks directly associated with plan operations. AIMA believes that such disparate treatment is inconsistent and that employee benefit plans should not be required to post margin on uncleared swaps that are used primarily for hedging or mitigating risks directly associated with plan operations.

E. The CFTC Should Clarify the Treatment of Non-U.S. Employee Benefit Plans

AIMA believes that there is some ambiguity in the Proposal regarding whether non-U.S. public and private pension plans would be treated as financial end users. The regulatory text as proposed by the CFTC includes within the financial end user definition "[a]n employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 [ERISA] (29 U.S.C. 1002)."[19] When the CFTC issued regulations defining the term "Special Entity" under Dodd-Frank, it determined that non-U.S. public and private pension plans should not be designated as Special Entities, because they are not subject to Title 1 of ERISA.[20] However, when the CFTC subsequently adopted regulations that defined the term "major swap participant," it did not take a position as to whether non-U.S. public and private pension plans are employee benefit plans as defined by section 3(3) of ERISA.[21] The CFTC cross-border guidance definition of "U.S. person" refers only to pension plans, not employee benefit plans, and only includes in that definition a pension plan for the employees, officers or principals of a legal entity organized or incorporated under the laws of a state or other U.S. jurisdiction, or having its principal place of business in the U.S. (if such a plan were primarily for foreign employees of such a U.S. entity, that plan would be excluded from the U.S. person definition).[22] AIMA recommends that the CFTC make clear that non-U.S. public and private employee benefit plans are not financial end users for purposes of margin requirements for uncleared swaps.

---

[18] 79 Fed. Reg. at 59926.

[19] 79 Fed. Reg. at 59927.

[20] 77 Fed. Reg. 9734, at 9776 (17 February 2012).

[21] 77 Fed. Reg. 30596, at 30682 & n. 1042 (23 May 2012).

[22] 78 Fed. Reg. 45291, at 45316-17 (26 July 2013).

F. The CFTC Should Conform its Definition of "Material Swaps Exposure" to the International Framework

The CFTC would impose initial margin requirements in circumstances where an SD's counterparty has a "material swaps exposure." That term is defined as an average daily aggregate notional amount of uncleared swaps, security-based swaps, foreign exchange forwards and foreign exchange swaps, for an entity and its affiliates, calculated during June, July and August of the prior calendar year, that exceeds $3 billion. (That amount would be the relevant amount when the margin requirements for uncleared swaps become fully effective, which is projected to be December 1, 2019.) That U.S. dollar amount is well below the international regulators' standard of €8 billion, which would translate to more than $10 billion at current exchange rates. This is a rather substantial gap and would appear to be a target for regulatory arbitrage. AIMA recommends that the CFTC conform its definition of "material swaps exposure" for these purposes with the international framework.

G. The CFTC Margin Rules Should Apply Only to Post-Effective Date Swaps

We note that swaps in existence when the Proposal goes into effect will be subject to the new rules if they are documented in the same agreement as a party's post-effective date swaps. If a party that uses ISDA master agreements wants to avoid that result, it will have to create separate new agreements for its post-effective date swaps (although these new agreements would presumably be exact clones of its original master agreements). The use of two master agreements will prevent optimal netting of swap risks. We do not believe that this is a desirable outcome, and request that the CFTC limit the application of the new margin requirements to post-effective date swaps.

H. The CFTC should permit netting of initial margin and variation margin

It is common for funds that are parties to uncleared swaps transactions to provide initial margin to bank counterparties by way of an ISDA Credit Support Annex ("CSA"). Under the CSA, the bank as recipient of the initial margin is typically free to then make use of the collateral, meaning that the fund has credit risk on the bank.

The fund's right to call for variation margin is typically on a net basis with the initial margin obligation. To show how this operates:

> Suppose that a fund is below the "material swaps exposure", but nevertheless has an agreement to post initial margin to its counterparty and has not elected to segregate that amount with a third-party custodian. Under its CSA the initial margin for an OTC derivative is $10 on trade date (when the value of the swap is zero). In consequence the fund must give the bank $10 of cash collateral. If the value of the trade then moves to be $3 in favour of the fund then the bank must return $3 cash under the terms of the CSA, leaving the net collateral as $7 cash posted by the fund to the bank. Although the fund has had some collateral returned, on a net basis it is posting $7 and has no net collateral received despite the mtm of the swap being in favour of the fund.

Considering this scenario in light of the obligation under the Proposal that Covered Swap Entities pay variation margin to swap entities or financial end users[23], then it is questionable whether the obligation would be considered to have been fulfilled in such a scenario. In order for the fund to both post initial margin *and* receive variation margin without netting, the initial margin would arguably have to be segregated – for example, the fund could deliver $10 of T-Bills to a segregated custody account in the name of the client, pledged in favour of the bank. This would require additional documents, such as a custody agreement and often a new security interest document as well or at the very least amendment to the existing security interest or CSA. These would all need to be in place for 1 December 2015.

The possibility that segregation might be required for entities that are below the material swap exposure was not referred to in the public proposals, which we take as an indication that this result was not intended.

We recommend that the CFTC provide that a return of collateral held as unsegregated initial margin be treated as satisfying the requirement to obtain variation margin for entities that are below the material swap exposure, despite the fact that on a net basis the recipient of the variation margin is not holding margin equal to the full mark-to-market of the derivative. To provide otherwise will, we believe, cause a significant burden that is out of

[23] 79 Fed. Reg. at 59907.

proportion to any practical benefit, as the documentation and operational costs will be created for even the smallest derivative relationship that involves initial margin, but the amounts of collateral that are required to be segregated will in almost every case be far below amounts that could be considered systemically important.

I. The CFTC Should Adopt the BCBS/IOSCO Approach to Assessing the IM Threshold

The Proposed Rules define "affiliate" to mean "any company that controls, is controlled by, or is under common control with another company"[24], with "control" of another company defined as: (i) ownership, control, or power to vote 25% or more of a class of voting securities of the company, directly or indirectly or acting through one or more other persons; (ii) ownership or control of 25% or more of the total equity of the company, directly or indirectly or acting through one or more other persons; or (iii) control in any manner of the election of a majority of the directors or trustees of the company.[25]

We are concerned that this approach could lead to consolidated treatment of funds in a firm's structure for purposes of applying the IM thresholds and would not allow separate treatment of funds in the same manner as described in the BCBS/IOSCO Standards. We recommend that the CFTC instead use the same criteria as the BCBS/IOSCO Standards as the basis for determining fund-level application of IM thresholds, rather than adopting a separate definition of control.

[24] 79 Fed. Reg. at 59926.
[25] 79 Fed. Reg. at 59926.