Alternative Investment Management Association

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Dear Sirs,

Margin Requirements for Uncleared Swaps for Swap Dealers, Major Swap Participants and Covered Swap Entities

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's members are predominately hedge fund managers which would not typically fall within the definitions in the Release and Dodd-Frank Act of "covered swap entity", "swap dealer" or "security-based swap dealer" (Swap Dealers), "major swap participant" or "major security-based swap participant" (MSPs) (each hereafter, Swap Entities). The funds that AIMA's hedge fund managers manage may, instead, be a commodity pool (as defined in section 1a(5) of the Commodity Exchange Act) or a private fund (as defined in section 202(a) of the Investment Advisors Act of 1940) and, therefore, likely fall within the definition of "financial end user" in the Release. The proposed requirements of the Release do not apply directly to financial end users but are, nevertheless, important to AIMA members as significant users of swaps and security-based swaps (together, Swaps), because swap entities would be required to collect initial and variation margin from their counterparties, including financial end users.

AIMA's comments

AIMA supports the aims of the Dodd-Frank Act and the US authorities to require greater use of derivative clearing organisations (DCOs) to clear certain classes of Swaps. However, we also recognise that not all Swaps are suitable

[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, with 11% based in the US and over 30% of AIMA members' total assets under management (AUM) managed by US investment advisers.

[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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to be cleared with a DCO - for those Swaps which are not, bilateral clearing is necessary to reduce counterparty credit risk, including through the holding of capital or the exchange of collateral to cover counterparty exposure. Accordingly, we support the US Authorities' proposed rules setting requirements as to the minimum amount and types of acceptable collateral for uncleared swaps and wish to comment on certain details of the Release relevant to AIMA members.

In summary:

- AIMA supports proposed rules which set minimum requirements as to the amount and types of acceptable collateral;

- it should be permissible to apply initial margin requirements on a portfolio basis, including to pre-effective date swaps within the portfolio, provided sufficient time is given between proposed minimum margin requirements being specified and those requirements being applied;

- financially sound swap counterparties should have the benefit of an initial margin threshold, below which they are not required to provide collateral, which is reasonable and proportionate to their creditworthiness;

- rules proposed by the Commission and by the Prudential Authorities' should be as closely aligned as possible, including the proposed methods of calculating minimum margin requirements;

- eligible collateral should include US and non-US government securities and immediately-available cash funds denominated in US dollars or a foreign currency, even where such currency is not the currency in which payment obligations under the swaps are required to be settled;

- the US Authorities should each consult on the extraterritorial scope of their rules. Where some degree of extraterritorial application of the rules is unavoidable, the relevant rules should be framed, as far as possible, so that they do not subject firms' counterparties with overlapping and conflicting obligations. International coordination should be sought in order to minimise the possibility of market fragmentation. Further, requirements should only apply where the activities of Swap Entities "have a direct and significant connection with activities in, or effect on, commerce of the United States".

Scope

Swap Entities would be permitted to calculate initial margin requirements for swaps under a qualifying master netting agreement (where used) on a portfolio basis and calculate variation margin on an aggregate, net basis. We accept that this may result in certain pre-effective date swaps being included within the initial and variation margin requirements. However, we do not believe such a retroactive requirement is a concern for End Users, provided that they are given sufficient time between publication of initial margin models (by the US Authorities or by the Swap Entities) and the date at which they are required to post collateral. End Users will need time to consider the amount of margin that they will be required to post and to arrange the necessary collateral. If insufficient time is allowed, End Users may face difficulty in obtaining permitted types of collateral, which would result in the cost of that collateral in the market increasing.

Under the proposed rules, an End User is required to post initial margin and variation margin to the Swap Entity. Non-financial end users and certain financial end users, which (a) are subject to capital requirements; (b) predominately use swaps to hedge; and (c) do not have significant swaps exposure (low-risk financial end users), would not be required to post initial margin below an initial margin threshold. The US Authorities solicit comment on whether thresholds should be permitted at all and, if so, what entities should be eligible. We believe that the rules should give all financially sound swap counterparties the benefit of a threshold that is reasonable and proportionate to their creditworthiness, not just the non-financial end users and low-risk financial end users as currently proposed. Imposing collateralisation requirements without regard to a counterparty's creditworthiness would increase the cost of uncleared swap transactions beyond what is reasonably necessary to protect the parties to such transactions. For the purposes of the proposed rules, the creditworthiness of a counterparty could be determined by objective criteria set by the US Authorities, in consultation with industry

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participants, such as a minimum net asset value in the case of an investment fund. We believe that this is a preferable approach to creating categories of high-risk and low-risk End Users.

Amount of initial and variation margin

Although End Users will not be involved in developing models to determine the amount of initial and variation margin required to cover an exposure, they will have an interest in ensuring that the minimum margin requirements are set at reasonable levels, taking account of the actual level of risk. In particular, we are keen that initial and variation margin requirements build on current industry standards and practice and that any significant increases in the amount of margin required are justified and, where necessary, phased in over time to allow parties to adapt to new minimum margin levels.

We note that the Commission and Prudential Authorities have separately proposed different methods of setting minimum margin requirements, certain of which require approval from the US Authorities. As counterparties, the main concerns of our affected members are that margin models are risk based and that they are aligned, as much as possible, between the Commission and Prudential Authorities. Lack of alignment in this regard may lead to the market favouring trading with certain types of financial entities, regulated by either the Prudential Authorities or the Commission, without a valid reason and, thus, a reduction in competition in the market. For example, if the Commission's minimum margin requirements require End Users to post less collateral than under the Prudential Authorities' rules, End Users would be expected to trade predominately with Swap Dealers and MSPs. Reduced competition may lead to higher fees for End Users and increase the cost of hedging positions with uncleared swaps. One area where the proposed rules are not aligned is in relation to benchmarking of uncleared swap margin models to those margin models used by DCOs and other clearing agencies. The Commission would require that margin models are aligned with 'identical' products cleared by a DCO, whilst the Prudential Authorities would only require that margin models are aligned with 'similar' products cleared by a DCO. As the idea of benchmarking is to align the models as much as possible, we would prefer the more flexible approach of the Prudential Authorities and would hope that the US Authorities would align margin models with similar products cleared on a DCO or with another clearing agency.

Whilst the Prudential Authorities have experience in prudential regulation and have existing regulatory relationships with Swap Entities, the Commission does not have a long history of prudential regulation and will be regulating Swap Dealers and MSPs for the first time following implementation of the Dodd-Frank Act. It is also likely that, whilst the Commission is addressing many new areas of regulatory responsibility under the Dodd-Frank Act, the Prudential Authorities will have greater resources to scrutinise and approve minimum margin models. For this reason, the Commission may wish to consider the extent to which it is able to fully scrutinise and approve Swap Dealer and MSP margin models and, where it cannot, it should consider requiring those parties to use models already approved by the Prudential Authorities.

The Release poses the question of whether Swap Entities should equally post initial margin to their counterparties (i.e., the End Users). Although there are benefits in requiring this, including that it is likely to reduce counterparty credit risk resulting from the potential failure of a Swap Entity and reduce resulting losses that may be felt by the End User, it is unlikely to be a practical requirement. Requiring Swap Entities to provide 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. To require Swap Entities to provide margin to End Users would significantly increase Swap Entities' costs of doing business and may result in those costs being passed on to End Users through increased fees. As Swap Entities will require initial and variation margin from their counterparties and will be required to hold sufficient amounts of capital, the benefits of also requiring the Swap Entities to provide initial margin do not outweigh the costs. Both Swap Entities and End Users should be required to post variation margin, as is industry practice and as is proposed in the Release.

Eligible collateral

AIMA supports the US Authorities' proposed requirement that Swap Entities must only accept as collateral cash and highly-liquid, high quality financial instruments, such as debt instruments guaranteed by the US Government

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(e.g., US Treasury securities). However, in the case of collateral for initial margin, if the proposed rules permit End Users to post senior debt obligations of certain specified Federal agencies and insured obligations of Farm Credit System Banks then we believe other similar types of high-quality senior government guaranteed debt should be considered as eligible collateral as well. For example, the proposed rules should be amended so that Swap Entities may accept as collateral highly rated non-US government securities, which will have similar characteristics to US government debt securities and, thus, would not be expected to deteriorate in value during periods of financial market stress. Further, as cash represents the most liquid form of collateral, the proposed rules should certainly include immediately-available cash funds denominated in a foreign currency, even where such currency is not the currency in which payment obligations under the swaps are required to be settled. We recognise that there is a difference between initial and variation margin and believe that, as variation margin is exchanged between the Swap Entity and End User on a frequent basis, based on changes to the market value of the position, variation margin should be limited to cash and US government securities.

Beyond non-US government securities and immediately-available cash funds denominated in foreign currencies, we agree that listing all types of possible financial instruments that could be give as collateral and their appropriate haircuts is not feasible and that End Users could instead make separate arrangements to convert those financial instruments into eligible collateral by, for example, secured financing arrangements, where necessary.

Segregation of initial margin

We agree with the US Authorities' view that it is necessary to segregate funds and collateral posted as initial margin with an independent third party custodian from the outset of a swap contract between two Swap Entities, for the protection of the Swap Entity providing the funds and collateral and the wider financial system.

AIMA has submitted comments separately to the Commission on the protection of collateral of counterparties to uncleared swaps, where one of the counterparties is not a Swap Entity[4], in which we supported the Commission's view that segregation of funds and collateral belonging to a counterparty should be offered to that counterparty at the outset of the contract.

Extraterritorial application

It is important that the US Authorities find an appropriate balance in their rules between (i) ensuring competitive equality among US and foreign firms in the US and (ii) ensuring that the extraterritorial scope of the rules are not so wide that they cannot be enforced in the US and provide multiple overlapping and possibly conflicting rules for firms based outside of the US. The G20 has undertaken to "take action at the national and international level to raise standards so that national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage"[5]. AIMA believes that limiting the extraterritorial scope of the proposed rules and coordinating closely in setting margin requirements with international counterparts is an extremely important element of the global regulatory reform agenda.

We agree with the approach that the Prudential Authorities take, which seems to comply with the guidance at section 722 of the Dodd-Frank Act[6]. We are also concerned that the Commission's release does not propose rules or consult on extraterritorial application and AIMA would call on them to do so, especially if they would propose different rules to those of the Prudential Authorities.

Conclusion

AIMA supports the US Authorities' proposed rules but believes that the US Authorities should reconsider certain elements of the proposal that impact End Users as counterparties, where the provisions providing risk reducing

[4] AIMA letter to the Commission on 'Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy', dated 31 January 2011.

[5] G20 leaders' statement, Pittsburgh Summit, September 2009.

[6] The provisions of the Commodity Exchange Act relating to swaps "shall not apply to activities outside of the United States unless those activities … have a direct and significant connection with activities in, or effect on, commerce of the United States."

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benefits can be improved or maintained whilst the cost and negative impacts are reduced. 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 faithfully,

Jiří Król
Director of Government & Regulatory Affairs

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