



## Alternative Investment Management Association

Commissioner Scott D. O'Malia  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW,  
Washington, DC 20581  
USA

Submitted via email to: [mandatoryclearing@cftc.gov](mailto:mandatoryclearing@cftc.gov)

14 September 2011

Dear Commissioner O'Malia,

### Review of Swaps for Mandatory Clearing under Section 723 of the Dodd-Frank Act

The Alternative Investment Management Association (AIMA)<sup>1</sup> welcomes the opportunity to provide comment on the questions posed in your letter dated 28 July 2011, 'Re: Review of Swaps for Mandatory Clearing under Section 723 of the Dodd-Frank Act (the Act)' (the Letter).

AIMA supports the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) reforms and, in particular, those moves to meet G20 commitments around clearing and reporting of over-the-counter (OTC) derivative and swap contracts<sup>2</sup>. AIMA's members are particularly interested to ensure that as many swaps as possible, that can be cleared safely and at reasonable commercial cost, are deemed eligible by the Commodity Futures Trading Commission (the Commission) and are subject to the clearing requirements as soon as feasible.

#### AIMA's comments

AIMA members, as well as many other buy-side market participants, will derive significant benefits from clearing of swap contracts with derivative clearing organisations (DCOs) that they do not currently experience in the bilateral market. These include the reduction in counterparty credit risk, more transparent and fairer margin requirements, better price transparency, more liquid markets, the ability to 'port' contracts to new parties upon failure of a Futures Commission Merchant (FCM), operational efficiencies of straight through processing and reduction in overall market systemic risks. AIMA members believe that these benefits can be brought to a wide range of swaps classes and they have expressed a willingness to pay necessary and commercially-reasonable costs on the basis that these benefits are realised in practice. Although it is not possible (or desirable) that the Commission should set such prices, it can ensure that such costs remain reasonable by providing for equal levels of competition to those seen in the futures market. Competition issues can be addressed by ensuring that, among other things, DCOs accept as clearing members any entities that meet basic minimum acceptance criteria and that buy-side firms are given representation on DCOs' risk committees and governing Boards.

We, therefore, believe that the mandatory clearing requirement should be introduced as broadly and as quickly as possible, as long as it is consistent with safety, efficiency, transparency and risk-reduction. We appreciate the significant size of the Commission's work-load, however, we believe the decisions as to which contracts should be subject to the clearing requirements should be made as expeditiously as possible after all of the rules are

<sup>1</sup> 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.

<sup>2</sup> 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."



## Alternative Investment Management Association

finalised (those necessary to allow the Commission to start designating swaps for clearing and for parties to be able clear those designated contracts). The decision should also await the outcome of the required public consultation.

AIMA is concerned with the slow pace with which clearing offerings by DCOs and their clearing members are coming to market. Where existing bilateral swap transactions continue to offer profitable business to swap dealers, we sense a reluctance to take forward new offerings which will bring new but uncertain profit streams for swap dealers. Since both the Dodd-Frank Act and the Commission's proposed and final rules contain limits that prevent the vast majority of our members from accessing clearing directly, our members must, instead, rely on having swap dealers and clearing members who are willing to offer the services they require. Whilst the number of DCOs in the market and the range of products being offered for clearing by those DCOs is increasing, the process is led by DCO clearing members and certain client clearing services are becoming available only slowly. There are many examples of commonly traded classes of swaps that seem obviously eligible for clearing but for which clearing services are currently unlikely to be available for a significant period of time. Whilst some delay in clearing new products is inevitable, the Commission should do what it can to encourage the roll out of products in the most liquid markets and suits of products that are linked with one another, which will have the least impact on current trading and hedging strategies.

Where some of AIMA's members are successfully clearing contracts with their counterparties through registered DCOs, they continue to be prevented from participating in the decision making processes of the DCOs which they use. Many of the decisions made by a DCO, including who may become a clearing member and which swaps the DCO will clear, are taken by the DCO's risk committee. AIMA believes that buy-side firms, who are mandated to use DCOs to clear their swaps, have the right to be represented in a meaningful way on the DCO's risk committee and the DCO's governing Board. Leaving the decision making in the hands of risk committees whose members are predominately swap dealers has not led to the development of derivative clearing services that our members had hoped for. Whatever the reasons for this slow progress may be, we believe that this position is unacceptable when DCOs are performing a quasi-public utility role and the DCO's services are required to be used by statute. We, therefore, argue that substantive proposals should be put forward which would guarantee appropriate buy-side representation on a DCO's risk committee. AIMA notes that the European Parliament has approved a version of the EMIR proposal<sup>3</sup> which states that risk committees shall be composed of, among other groups, representatives from clearing members and clients of clearing members, with no one group representing a majority of the committee (article 23).

The DCO and its risk committee will also play a role in setting both the applicable clearing fees and the margin requirements. It is possible that the take up of customer clearing may be significantly curtailed by excessive fees and charges. Again, given the quasi-public utility role of the DCO and the mandatory requirement to clear swaps, the costs charged for such services should be neither excessive nor structured in such a way as to discourage buy-side swap clearing. Margin requirements should be reasonable and should be set out in a clear and transparent manner, taking into account the minimum margin requirements to be detailed by the market regulators and the size of the exposure which the margin is designed to cover. We believe that the best way to encourage the setting of reasonable fees and margin levels is via market forces, i.e., competition among clearing members. To that end, it is vital that membership criteria for clearing members encourage the broadest possible range of applicants that is consistent with sound risk management.

We set out at Annex 1 our answers to the specific questions posed in the Letter. At Annex 2, we set out a list of the groups, categories, types, or classes of swap which we believe should, as a minimum, be subject to the mandatory clearing requirement.

### Conclusion

AIMA believes that the Dodd-Frank Act reforms in Title VII will benefit all participants in the market and we encourage the Commission to do all it can to ensure that as many swaps as can feasibly and safely be cleared are both made available for clearing and mandated to be cleared. The Commission should look at those swaps that

<sup>3</sup> Approved at a plenary session on 5 July 2011.



## Alternative Investment Management Association

are currently available for clearing in the market by CCPs (including CCPs which are safely clearing the same or similar contracts outside of the US), and should then seek to expand that list to include all swaps that currently trade in large numbers in liquid markets, such as those we list in Annex 2.

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 any of our comments with you in greater detail.

Yours sincerely,

Jiří Król  
Director of Government & Regulatory Affairs



# Alternative Investment Management Association

## Annex 1

### 1. How should the Commission consider the five factors?

The list of five factors provides a very broad framework for the Commission to consider different types of swap to determine whether they should be subject to a mandatory clearing requirement. The Commission must consider each of these factors in turn. From a risk management perspective, being able to price a swap to determine the appropriate margin requirements is important, and this can be best achieved in liquid markets where there is significant trading activity. However, trading liquidity is not a decisive factor and even swaps which trade in low volumes could be successfully cleared. The availability of the necessary framework, capacity, operational expertise and resources and credit support infrastructure is important; however, it seems likely that given a DCO's required size and experience with those factors for other contracts, these could be quickly adapted to new products without significant difficulty. The current lack of any of these items should not prevent the Commission making a decision that the swap should be subject to mandatory clearing once a DCO has prepared itself to clear that type of contract. The effect on mitigating systemic risk goes to the heart of the requirement to clear and this factor states the clearing reforms primary aim. It would seem that clearing of swaps will, in the vast majority of cases, pass this test - it is difficult to think of any examples of contracts traded today that would create further systemic risk by being subject to the new clearing regime. Like other parties, including corporate end-users, AIMA's members are particularly concerned about the fees and charges that will be applied to them when they clear contracts with a DCO. The number of DCOs that clear a contract and the fees and charges should not necessarily be a barrier to the mandatory clearing requirement. If the Commission allows it to be one, market users will be at the mercy of those who set fees and charges and only those contracts which are particularly profitable for sell side firms will be subject to clearing, rather than those contracts which require clearing in the greater interests of the market.

Swaps should be subject to the mandatory clearing requirement in nearly all cases, despite the lack of competition or high fees. The Commission should endeavour to ensure that charges and fees are commercially reasonable and are not designed to prevent buy-side access to clearing. It is not entirely clear how the existence of reasonable legal certainty in the event of the insolvency of the DCO or a clearing member relates to a specific type of swap in the determination. The Dodd-Frank Act rules, promulgated by the Commission, should provide a structure which details and requires DCOs and clearing members to implement procedures so that there is reasonable legal certainty upon insolvency. This should apply equally to all types of swaps cleared by the DCO and, therefore, we fail to see how this relates to a specific swap determination.

A further way to consider the five factors is as a method of determining which contracts should be subject to clearing, as a matter of priority. In our opinion, those contracts which are currently commonly traded in large numbers, with significant outstanding notional exposures, should be cleared first. It is less important to clear those that are less liquid and have smaller notional exposures since these do not create significant systemic risk concerns. These latter contracts should, however, be subject to clearing when possible.

### 2. What criteria should the Commission consider when evaluating whether the DCO has properly categorized "group, category, type, or class of swaps"?

The terms 'group', 'category', 'type' and 'class' may be used to include overly broad groupings of swaps which do not take into account the specific and individual risks of certain swaps. For example, interest rate swaps of a single 'class' may have different risk profiles, such that some might be suitable for clearing while others might not. Forcing them all into a DCO under a single 'class' heading could undermine the DCO, resulting in it taking on unmanageable risk - i.e., by requiring clearing of swaps which are non-standardised and, thus, are difficult to price correctly for the purposes of determining appropriate collateral levels and for closing out positions. Conversely, excluding all contracts within a 'class' based on the characteristics of a few would undermine the important benefits of the reforms.

The Commission should look at the common characteristics within a group and decide broadly whether contracts



## Alternative Investment Management Association

of that group, category, type, or class should be subject to the clearing requirement. It should then 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 five factors.

### 3. Should the Commission accord more weight to one or more of the factors than others? If so, why?

As discussed in response to question 1 above, all the factors are important for consideration of whether a swap is suitable for clearing. We believe that factor 3 (i.e., whether clearing would mitigate systemic risk) is particularly important as, if the contract does not reduce systemic risk but instead increases it, the swap should not be subject to clearing, regardless of the other factors. Factor 1 (existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data) is also of key importance as those swaps with significant trading liquidity will be the easiest to clear. Further, large outstanding notional exposures indicate that there is a greater need to mandate clearing of a particular group, category, type, or class of swaps and available pricing data ensures that margin levels can be set appropriately in order adequately to mitigate the risks of clearing.

Factor 4 (the effect of competition and prices and fees) is also an important characteristic - where a lack of competition in the market, combined with excessively high charges and fees means that certain swap contracts can only be cleared at excessive cost, parties will not want to enter into such types of swap contracts and the goal of mitigating systemic risk in those contracts will not be achieved. However, as we state above, the number of DCOs that clear a contract and the fees and charges should not necessarily be a barrier to the mandatory clearing requirement. The Commission should, instead, seek to improve competition in the market through ensuring that new parties can freely enter the market and provide clearing services, as happens in the futures market.

Whilst factors 2 and 5 are important considerations, as stated, it is likely that they will be more of a binary nature. When elements of the factors reach a certain point (e.g., a rule framework is in place, firms are certain of the position upon insolvency), subject to other considerations, they indicate that a swap should be mandated for clearing.

AIMA rejects any notion that that "over-mandating clearing is worse than under-mandating clearing". We believe that, given that approval of a group, category, type, or class of swaps is subject to review by the Commission staff and is subject to a public consultation, it is very difficult to see how contracts that are genuinely unsuitable for clearing (over-mandating) could be mandated. In our opinion, the real risk is of under-mandating clearing, caused by delays in the designation process and actions taken that prevent DCOs submitting clearing proposals.

The Commission should only be need to give detailed consideration against the five factors to swaps which are not part of a group, category, type, or class of swaps that currently trade in large volume or are already being cleared by a DCO (or a non-US equivalent). Swaps trading in large volumes or already being cleared by a DCO should clearly be subject to the mandatory clearing requirement. However, in the interest of promoting clearing of swaps, the Commission should not reject a submission from a DCO that proposes the clearing of a group, category, type, or class of swaps without giving that submission full consideration.

### 4. Should the Commission consider the factors differently depending on asset class (e.g., interest rate swaps, credit default swaps, and physical commodities)? If so, how should the Commission consider the factors for each asset class (or instruments therein)?

Each asset class will have its own unique features and may, thus, affect the analysis with regard to the five factors. The Commission should consider each type of asset class individually and have consideration for any specific features that are unique to that asset class. For example, credit-default swaps (CDS) contain unique risks not found with other types of swap contracts, including jump-to-default risk (the risk that a default will



## Alternative Investment Management Association

suddenly occur before the market has had time to factor its increased default risk into current spreads).

5. To what extent should the Commission take into account, in its consideration of the five factors, the connection between (i) mandatory clearing under Section 2(h)(1) through (4) of the CEA and (ii) the trade execution requirement under Section 2(h)(8) of the CEA?

The relationship between the mandatory trading and the mandatory clearing of swaps is important. However, it is worth noting that although all swaps which are traded on a swap execution facility (SEF) are also likely to meet the eligibility requirements for clearing with a DCO, not all swaps that are cleared on a DCO must be first traded on a SEF. Section 723 (8) of the Act provides that swaps subject to the clearing requirement must be traded on a SEF or a designated contract market (DCM), except where no DCM or SEF makes the swap 'available to trade'. This may occur if no SEFs are yet registered that could list the trade, or if a SEF is registered but has not yet made the swap available to trade. CFTC rule 37.10 states that a swap shall be 'available to trade' where certain conditions are met and, where those conditions are met, the SEF certifies to the Commission that the swap is then available to trade.

Overall, we believe that clearing of trades provides the greatest benefit to the market and is most important in reducing and monitoring systemic risks. If a swap is not currently being traded on a SEF, this does not prevent the swap from being cleared and subject to the clearing requirement. Many DCOs are established and ready to clear a wide variety of contracts. The establishment of SEFs, as a new concept in market infrastructure, will take some time to become operational and successful and this should not prevent or slow down the important clearing reforms.

6. Final regulation 39.5(b)(3) sets forth a list of documents that each DCO must submit in its request for a mandatory clearing determination. What, if any, additional information should the Commission routinely obtain to aid in its consideration of the five factors? Please indicate the specific factor (and element therein) that such information would help the Commission evaluate.

Final regulation 39.5(b)(3) sets a comprehensive list of documents that a DCO must submit in its request for a mandatory clearing determination. We are unable to suggest other documents that may be useful in this regard. The Commission should endeavour to collect any additional information from any market participants that it believes will be useful in making its determination. The Commission may wish to collect figures and statistics on various markets that will aid its determination, such as those collected by the Bank for International Settlement (BIS) and data on similar products which are traded in other jurisdiction's markets, which may be indicative of whether a swap could successfully be cleared and whether it should be subject to the mandatory clearing requirement.

7. Section 2(h)(3)(A) of the CEA states: "After making a determination..., the Commission, on application of a counterparty to a swap or on its own initiative, may stay the clearing requirement.. until the Commission completes a review of the terms of the swap (or the group, category, type, or class of swaps) and the clearing arrangement." What criteria should the Commission employ to determine whether staying the clearing requirement would be appropriate?

AIMA members are keen to ensure that they are able to utilise DCO clearing services as soon as possible and, therefore, we believe that in a majority of cases there will be no need for a significant stay on the clearing requirement beyond a short period following publication of a determination, whereby the DCOs and clearing members can ready themselves for clearing. A stay may be most appropriate, however, following an own initiative determination of the Commission that a certain group, category, type, or class of swaps should be clearable. The Commission should stay the requirement until a new or existing DCO (or a non-US equivalent) is able to provide the required services. Those parties should be encouraged to provide new services as soon as is feasible. Any stays imposed should include publication of a reasonable and specific timetable which will lead to buy-side clients being able to submit contracts for clearing.



## Alternative Investment Management Association

The Commission should not impose a stay on the effect of a clearing determination made by the Commission simply as a result of a party raising a question as to the correctness of that determination. Such determinations will have undergone CFTC staff scrutiny and public consultation and should not be subject to further delays by frivolous and self-serving challenges. The mandatory clearing decision may, however, be reversed following full consideration of genuine issues, where necessary.

The Commission may also consider whether to conduct a periodic review of swaps for clearing to see if the eligibility determination is still appropriate. However, we do not believe that a stay should be imposed in these circumstances. This opens the possibility to interrupt the business of all market participants who have acted upon the assumption that a mandatory clearing decision is, and will remain, in effect.



# Alternative Investment Management Association

## Annex 2

AIMA members believe the following types and categories of swap contracts should be considered eligible by the Commission and subject to the mandatory clearing requirement. This list is non-exhaustive and there are likely other products which could reasonably be included, to ensure that the broadest possible range of swap types is subject to the requirements.

### Interest Rate Swaps

All interest rate swaps contracts that are currently eligible for clearing at LCH.Clearnet<sup>4</sup>, or other clearing offerings, should be subject to the clearing requirement.

In addition, the following should be clearable:

- Rates in additional currencies: ILS, KRW, MXN, BRL, CLP, CNY, HUF, TWD
- Vanilla swaptions, caps and floors (with the same final maturity limit as swaps in the relevant currency)
- Currency swaps
- Basis swaps (e.g., between different LIBOR tenors)
- Constant maturity swaps (CMS), options and spread options
- Forward rate agreements (FRA)

### Foreign Exchange (FX) Swaps

- FX vanilla options and first-generation barrier options on any currency with maturities <5y for majors and <2y for other currencies, with the exception of the least liquid currencies<sup>5</sup>.
- FX forwards with the same maturity limits

### Credit Default Swaps

- All major indices in the US and the EU, at all maturities
- Options on the major indices
- Tranches of the major indices
- All underliers of the major indices (~300 names)<sup>6</sup>
- Sovereign credit default swaps (CDS)<sup>7</sup>
- Certain products closely linked to the above, such as First-to-Default Baskets<sup>8</sup>

<sup>4</sup> [http://www.lchclearnet.com/swaps/swapclear\\_for\\_clearing\\_members/products.asp](http://www.lchclearnet.com/swaps/swapclear_for_clearing_members/products.asp)

<sup>5</sup> We note that the US Treasury has proposed and consulted on an exemption from the clearing requirement for FX swaps and forwards. No exemption has been proposed for options. It is essential that any CCP that clears options is also able to clear forwards, so that option positions can be efficiently hedged if required.

<sup>6</sup> Noting that credit swaps on single securities would be classified as subject to the authority of the Securities and Exchange Commission (SEC) as 'security-based swaps'.

<sup>7</sup> Noting also that a 'security-based swap' covers single issuer credit default swaps, including sovereign CDS.

<sup>8</sup> Noting that for some less frequently-traded products, CCP risk committees may adopt more a conservative risk management approach via margin requirements, volume restrictions or other measures