



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

31 January 2011

Dear Mr Stawick,

Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy

The Alternative Investment Management Association ('AIMA')¹ appreciates the Commodity Futures Trading Commission's (the 'Commission') invitation to provide comment on the proposed rulemaking in relation to the 'Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy', implementing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the 'Dodd-Frank Act').

AIMA members, as significant users of swaps and security-based swaps (which we will term collectively 'swaps' in this letter) for investment and hedging purposes, will be among the many customers benefiting from the right to request protection of collateral provided to secure their obligations to swap dealers and major swap participants ('MSPs').

We support the Commission in its full implementation of section 724(c) of the Dodd-Frank Act, and make the following specific comments on the proposed rules.

AIMA's comments

For swaps that are not eligible for clearing with a derivatives clearing organisation (uncleared swaps), we believe that section 724(c) of the Dodd-Frank Act provides an important right for customers of swap dealers and MSPs. Initial margin is a payment made by a customer to a swap dealer or MSP as a form of security to protect the swap dealer or MSP against the risk that the customer might default and be unable to fulfil its obligations under the swap contract. The collateral is provided for the benefit of the swap dealer or MSP, and therefore the customer should not have to take an equal risk on the swap dealer or MSP by bearing the credit risk that they may become insolvent and include the margin paid or transferred within the assets of the swap dealer or MSP's insolvent estate. This is achieved by full legal segregation with an independent third party custodian. In the uncleared swaps market, counterparties currently negotiate such rights of segregation; however, the Dodd-Frank Act has sought to formalise the requirements to ensure this option is available to customers.

Definitions

AIMA agrees that the definitions of "initial margin" and "variation margin" provided are appropriate, and we agree that it is only initial margin which should be subject to the right of segregation. The distinction between initial margin and variation margin is such that whilst initial margin is provided as collateral to secure the

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.

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obligation of the customer, the variation margin covers the exposure caused by the change in market value of the position for which the counterparties have contracted and therefore does not require segregation.

We believe that the Commission has understood the term “segregate” by giving it its common sense meaning, namely that “to segregate two or more items is to keep them in separate accounts, and to avoid combining them in the same transfer between two accounts”.

Notification of the right to segregation

The Dodd-Frank Act does not provide for segregation of collateral for all uncleared swaps, and the choice of how collateral is held is left to the election of the customer. We are pleased that the Commission has interpreted this to mean that the swap dealer or MSP must notify the customer of its right to have its initial margin segregated, and the customer is then given the option of whether to choose segregation or to have its initial margin held in the swap dealer’s or MSP’s accounts. It is important that such notification includes all required details with which to make an informed decision on the options, including the additional cost, terms and details of the segregation option.

We appreciate the Commission’s view that requiring notification and election for each transaction may be burdensome, especially if the party is regularly transacting in swaps with the swap dealer or MSP. All parties should be asked to make an election on whether they wish to have collateral segregated after the enactment of the proposed rules. However, that election should then stand as the customer’s choice unless it notifies the swap dealer or MSP otherwise. This should be subject to a yearly review as proposed by the Commission. Although it is specified that only certain individuals employed by the customer may be notified of the right to segregate, and the Chief Executive Officer or Chief Risk Officer are likely to be the relevant parties, the customer should have the right and flexibility to specify at the start of the relationship between the counterparties any other individuals within its own firm who would have the authority to make such decisions. Confirmation of the decisions should be made in writing, and such confirmation should also be required yearly, to ensure the customer has considered its position, and may be subject to change at the customer’s election.

Election of a custodian

If a customer chooses segregation of the collateral with a third party, an important consideration is who that third party will be. The main concern is that the third party custodian should be legally independent of the swap dealer or MSP and, as such, that collateral will be fully protected should the swap dealer or MSP become insolvent. Affiliates may be acceptable, although there are remote risks of contagion between the firms if the swap dealer or MSP fails. Although the margin will be “held in an account designated as a segregated account for and on behalf of the counterparty” and should receive legal protection on insolvency, as a practical matter customers may prefer non-affiliates who would not necessarily be affected as the result of the swap dealer or MSPs failure, and would be able to return initial margin payments promptly.

The parties should be free to negotiate which custodian is used, and it may be useful for the swap dealer or MSP to let the customer know which custodians it has relationships with and has conducted appropriate due diligence on, including affiliates and non-affiliates, and thus its preferred choices of custodian. One way to achieve this would be to require swap dealers or MSPs to offer a choice of, for example, five custodians on whom they have conducted due diligence examination, including both an affiliate (if applicable) and a non-affiliate. The requirement to offer a choice of custodians should also require swap dealers or MSPs to provide full details of the costs and services provided by the custodian, so that an informed decision can be made.

It would seem sensible to require custodians to meet a minimum standard of safety, for example by requiring them to meet certain regulatory standards or have certain credit ratings.

Once a custodian is elected to hold the initial margin, the custodian would join the customer and swap dealer or MSP as a signatory to a tri-partite custodian agreement that clearly sets out the rights of the individual parties. The Commission raises an important practical issue of how the customer or swap dealer/MSP may retrieve money from the custody account should it be entitled to it. The requirement for an authorised person to sign a



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statement setting out their right to remove assets from the account 'under penalty of perjury' will provide for strong criminal penalties for those who falsely try to remove funds from the account. Proof of the right to remove funds could also be used, for example: a statement of the bankruptcy court evidencing acceptance of a filing under the bankruptcy code for the swap dealer/MSP (for the customer's benefit) or contractual documentation of the swap contract and proof of fulfilment of the terms of the contract (for the swap dealer or MSP's benefit).

Right to invest segregated collateral

To ensure large amounts of funds are not locked up and are productively used, the Dodd-Frank Act permits initial margin to be invested "as the Commission may permit by rule or regulation". The main concern is that collateral should retain its value when invested and should not leave the position under-collateralised as a result of the investment. The requirements of Regulation 1.25 of the CFTC Regulations², to invest only in a number of investments which have minimal credit, market and liquidity risk, likely strikes the right balance between flexibility and the protection of the value of the collateral. The counterparties should be able to specifically agree in writing, if they so choose, to invest segregation initial margin in other investments as long as the agreement on how the margin will be used is made clear and is freely accepted by the parties.

Non-segregated collateral

If the customer chooses not to have its initial margin payments segregated, the swap dealer or MSP must undertake back-office procedures to ensure that the margin is properly recorded and that records note the current value of collateral held at any one time. As proposed, responsibility for such procedures should rest with one individual to ensure accountability and proper compliance with the proposed rule. Whilst we agree that reporting in this regard should occur on a regular basis, such as the six month intervals proposed, we believe it should also occur immediately following the entering into the swap contract (or at the beginning of the relationship between the parties if multiple trades are envisaged).

Portfolio margining accounts

We support the proposed changes to the definition of "customer" and of "customer property" in the sub-provisions of Regulation 190 that would permit portfolio margining and ensure that securities held in a portfolio margining account carried as a futures account are customer property and that the owners of those accounts are "customers" for these purposes.

Additionally, we support the proposed technical amendments to Regulation 190 regarding statutory time periods that would align provisions under Regulation 190 with those of the amended US Bankruptcy Code.

Conclusion

AIMA believes that the Commission has proposed rules that would properly implement the right for customers to elect segregation with an independent third party as required by the Dodd-Frank Act, and has given due consideration to practical consequences of the reforms, including who should elect an independent custodian. 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 sincerely,

Mary Richardson
Director of Regulatory & Tax Department

² Regulation 1.25, Part 1 - General Regulations under the Commodity Exchange Act, Chapter 1 - Commodity Futures Trading Commission, Title 17 - Commodity and Securities Exchanges, Code of Federal Regulation.