MEMORANDUM

TO: File

FROM: Judy Lee

RE: Meeting with Alternative Management Investment Association Limited (AIMA)

DATE: October 6, 2010

On October 6, 2010, Carlo di Florio, Gene Gohlke, Mavis Kelly, Mark Donohue, Jeff Dinwoodie, and Judy Lee of the Securities & Exchange Commission met with Todd Groome, Andrew Baker, and Stewart Hall of AIMA.

The AIMA representatives discussed the regulation of investment advisers. Additionally, they discussed the definition of "major swap participant" and "swap dealer." An agenda and public comment letters are attached to this memorandum.

Alternative Investment Management Association

Meeting to be held with
Securities & Exchange Commission (SEC)
and
Alternative Management Investment Association Limited (AIMA)

October 6, 2010

SEC

Carlo Di Florio, Director, OCIE
Norman Champ, Deputy Director, OCIE

AIMA Representatives

Todd Groome, Chairman
Andrew Baker, Chief Executive Officer
Stewart Hall, Policy Advisor

Agenda

1. Alternative Investment Fund Managers Directive (AIFMD)

2. Dodd-Frank Act reforms:-

    a. Multiple Advisor registration
    b. Periodic reporting and consistency
    c. Incentive-based compensation / remuneration
    d. OTC derivatives reform
    e. Volcker rule
    f. Comment letters (File Number S7-16-10 - Definitions)

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Alternative Investment Management Association

REVISED COPY

David A. Stawick,
Secretary,
Commodity Futures Trading Commission,
Three Lafayette Centre,
1155 21st Street, NW,
Washington,
DC 20581

Elizabeth M. Murphy,
Secretary,
Securities and Exchange Commission,
100 F Street, NE,
Washington,
DC 20549-1090

By email to: rule-comments@sec.gov and dfadefinitions@cftc.gov

24 September 2010

Dear Mr Stawick and Ms Murphy,

CFTC and SEC request for comment on Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act - File Number S7-16-10 - Definitions

The Alternative Investment Management Association (AIMA)[1] appreciates the opportunity to provide comment as part of the Commodity Futures Trading Commission (the CFTC) and the Securities and Exchange Commission's (the 'SEC') request for comments on the definitions contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (the 'Dodd-Frank Act').

At Annex 1, we set out our specific comments on the definitions under Title VII of the Dodd-Frank Act.

AIMA believes that the definitions in Title VII are essential to the application of an appropriate regime for the derivatives market which ensures financial stability concerns are addressed and provides transparency. As the definitions particularise the scope of the legislation, we are appreciative that the CFTC and the SEC are consulting fully on the definitions concerning the contracts and the parties that will be subject to the regime. We additionally look forward to continuing to contribute to the discussions around designing the new regulatory regime for the OTC derivatives market and will provide our thoughts to the CFTC and the SEC on other issues, such as ensuring the continued global nature of the OTC derivatives market, ensuring appropriate buyside involvement in central clearing and market position limits, in a separate letter.

Our first concern at this time is to ensure that the thresholds in the definition of 'swap dealer[2]' are properly clarified, so that only those entities that the industry would consider to be dealing in swaps are caught, as only such entities potentially give rise to the specific industry risks as swap dealers. In short, a swap dealer is one who offers

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[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 1,100 corporate bodies in over 40 countries, with 11% based in the US and over 30% of AIMA members' total assets under management (AUM) managed by US investment advisers.

[2] For the purposes of this letter, references to a "swap dealer" include equally a "security-based swap dealer" unless otherwise stated.

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two way prices, participating in both sides of the market to profit from providing liquidity to the market. AIMA's hedge fund manager members do not fall within this definition.

Our second concern is that the definition of 'major swap participant' ('MSP') (or, equally, 'major security-based swap participant') are consistent with the stated aim of the term, which is to enable regulators to monitor and oversee "entities that are systemically important or can significantly impact the financial system of the United States". For a number of reasons, we do not believe that many (if any) hedge fund managers in today's market should be subject to the MSP regime (except in extreme cases) including that all will be registered Investment Advisers and will be:

- overseen by the SEC[3];
- reporting data on their trades to swap data repositories; and
- collateralising their exposures.

Additionally, care should be taken to distinguish between a fund entity and its manager (where they are different) - the MSP regime is not appropriate for the business model of hedge fund managers (who, for example, may not have sufficient capital to protecting against the losses of the fund) and, in the rare situation in which a hedge fund itself could be seen as significant and thus might be classified as an MSP, it should be the fund that should be subject to the regime. Any threshold created to define a 'substantial position' maintained by a MSP should take account of only the important factors relevant to an entity's position and should be set at a level that does not capture an entity unless its exposure could reasonably be considered likely to cause financial instability to the economy of the United States, should that entity default. We have provided in Annex 1 the CFTC and the SEC with the factors we think should be considered when seeking to define an MSP, and we believe that this definition should be applied objectively and universally to all swap participants.

Any misapplications of these definitions to hedge fund managers or hedge funds, risks damaging an important US industry, with no discernible financial stability improvements or benefits.

Conclusion

We thank you for this opportunity to comment on the definitions contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act and are, of course, very happy to discuss with you in greater detail any of our comments.

Yours sincerely,

Andrew Baker

Andrew Baker
Chief Executive Officer

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3 We are aware that certain AIMA members are registered as Commodity Trading Advisers (CTAs) with the CFTC, however we understand these firms will be subject to equal oversight to that provided by the SEC.

ANNEX 1

"swap"
The list of contracts included within Section 721(a)(21) of the Dodd-Frank Act is inclusive of all of the contracts we would expect to see within the legislation. It is important that all contracts that could be considered "swaps" are included within the obligation to clear contracts, to ensure that there are no loopholes that could undermine this important initiative to bring risk reduction and transparency to the derivatives markets and to reduce the overall threat of financial instability. It is important that the interpretations of "swap" and "security-based swap" are similarly defined and are applied with respect to the provisions of Title VII of the Dodd-Frank Act in a consistent and coordinated manner. Equally, the CFTC and the SEC should be conscious of other, similar reforms arising in other jurisdictions since the September 2009 G20 leaders' statement calling for "All standardized OTC derivative contracts ... [to] be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest". Of particular importance is for the CFTC and the SEC to consider the extent to which its rules cover the same contracts as those subject to mandatory clearing in proposed European legislation, which makes reference to the contracts listed in Annex I, Section C of the Markets in Financial Instruments Directive (2004/39/EC). Any discrepancies between the CFTC and the SEC rules, or the SEC/CFTC's rules and those in the rest of the world, may provide opportunities for regulatory arbitrage, which could undermine the global financial reform efforts. To the extent that the Secretary of the Treasury, in consultation with the SEC and CFTC, believes that foreign exchange contracts should be excluded from the obligations of Title VII, this should only be done where there are strong policy arguments for their exclusion, giving due consideration to the costs and benefits and the potential systemic risk that may be caused by excluding this class of contracts. The SEC and CFTC should give equal consideration to any other class of contracts that may reasonably be considered for an exclusion from the provisions - for example, short maturity contracts that on this basis may not pass the cost benefit analysis conducted. Where possible, the CFTC and the SEC should seek to be as inclusive as possible in the classes of contract that are subject to the provisions applicable to swaps in the Dodd-Frank Act.
"security-based swap"
Security-based swaps that come under the jurisdiction of the SEC should be defined and applied in the same manner as swaps that come under the jurisdiction of the CFTC - as discussed above.
"swap dealer"
AIMA is concerned that some of its members, who will be required to register with the SEC as investment advisers, will incorrectly be classified as "swap dealers" under this very broad definition. If the first three limbs of the definition of "swap dealer" in Section 721(a)(21) are alternatives, then the third limb (which states that a swap dealer means any person who "regularly enters into swaps with counterparties as an ordinary course of business for its own account") would seem to include a huge number of small funds that trade in swaps but would not be considered "dealers" according to the common usage and understanding of the word. It would be more helpful if the first three limbs of the definition could be considered as having to apply collectively and not alternatively. AIMA believes appropriate clarification should provide that the business activity of an entity intended to come within the definition of "swap dealer" should involve taking both sides of the market, for the purposes of profiting from providing liquidity to counterparties. Alternatively, AIMA would like to see specific exclusions for entities that

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would not be considered dealers in the market. We do not believe that this concern can be adequately addressed by the 'de minimis' exemption provided within the legislation.

"security-based swap dealer"

The same arguments as for "swap dealer" - as discussed above - apply to "security-based swap dealer".

"major swap participant"

AIMA appreciates that the Dodd-Frank Act has tried to address a perceived concern about parties who are not dealers taking on large derivatives positions which, should they fail, could lead to market instability, so that they are, or become, systemically important. We understand that the key driver behind the MSP provisions is to capture entities such as the insurance company AIG, which accumulated large uncollateralised positions in CDS contracts before the crisis and then defaulted, requiring federal funding to stabilize the firm. Our concern, however, is that certain entities may be inappropriately classified as MSPs and, as such, be subject to burdensome and unworkable requirements. AIMA members require clarity as to whether this definition could apply to them and we believe that the requirements should only be applied where they are appropriate.

There are certain elements of the Section 721(a)(16) definition which are subjective and require detailed clarification to provide certainty to the industry, including:

- a "major" swap participant;
- a "substantial" position;
- swaps creating "substantial" counterparty exposure;
- a financial entity that is "highly" leveraged to the amount of capital it holds[4].

The CFTC and the SEC should conduct appropriate studies to ensure that the threshold for substantial positions and exposures are set at levels that focus on the actual risk of loss from the default of an entity, and thus only capture the entities for which such a risk of loss significantly threatens financial stability. This should be the only consideration of what a "major" swap participant is. When making this determination, cleared swaps should almost certainly be excluded because the existing long-standing and well-known regulations covering clearing entities will ensure that these positions are transparent to regulators, properly managed and controlled in respect of market, counterparty and systemic risks. The criteria that should be considered with regards to whether a position or exposure is "substantial" are:

- for cleared derivatives, if they are included at all, a large position relative to the threshold for uncleared derivatives
- counterparty exposure, adjusted for the amount and quality of collateral posted
- for uncleared derivatives:
  - net market exposure in an asset class overall
  - net market exposure in an asset class per counterparty

When measuring market exposure, potential loss should be the measure used rather than notional exposure, because

[4] The first limb of the MSP definition includes any entity that maintains a 'substantial positions' whether leveraged or not, and therefore we do not see this limb as being relevant for the CFTC and the SEC's determination. However, if the CFTC and the SEC do consider the definition of leverage, they should ensure that the definition is in line with international agreements with what "leverage" is and how it is calculated, and its threshold level should be objectively defined at an appropriate level.

it is always financial loss that drives systemic risk and for many derivatives (including for example options and CDS, where loss depends critically on whether the contract has been bought or shorted) the potential loss cannot be gauged from the notional.

When considering how to define an MSP, the first consideration should be whether or not the entity's position includes centrally cleared swaps. The requirement for mandatory clearing is designed to significantly reduce an entity's credit risk, and thus its exposure to its counterparties through the use of a supervised and regulated, well-funded and capitalised derivatives clearing organization (DCO) that sits between the counterparties, as buyer to each seller and seller to each buyer.

The related requirements that all centrally cleared exposures should be collateralised through the use of segregated high quality initial and variation margin payments also significantly mitigates counterparty credit risk. The provision of collateral reduces the impact that default on a contract would have on a counterparty, with initial margin payments reducing counterparty credit risk and variation margin reducing market risk from fluctuations in prices. It will be a requirement for those mandated to use DCOs to post collateral in this way, and thus those who participate in central clearing may therefore be less systemically relevant. It is essential that the amount and quality of collateral provided are both taken into account when assessing an exposure. The DCOs themselves are required to have high levels of capital and other funding sources provided by clearing members to protect themselves against member defaults that cause losses in excess of collateral provided, and are thus designed not to be significantly impacted by the default of even a large counterparty. Moreover, existing long-standing and well-known regulations covering clearing entities will ensure that centrally cleared positions will be transparent to regulators and properly managed and controlled in respect of market, counterparty and systemic risks.

For these reasons, all swaps cleared with DCOs should be excluded from the determination of MSP (or, if they must be included, the benefits of clearing should be reflected in much higher thresholds or much lower risk assessments).

For uncleared swaps, entities may (just as for cleared derivatives) provide collateral under a bilateral agreement with a counterparty - this is nearly universally the case in the hedge fund industry, where funds post initial margin with swap dealers and each party also posts variation margin to the other, although we understand it is not universally applied for other buy-side (non-hedge fund) firms. The type of collateral posted by hedge funds under bilateral trading is typically highly rated, low risk securities such as US T-Bills or cash. Again, it is essential that this collateral is taken into account when assessing the risks of these positions.

For uncleared swaps, the second consideration for the CFTC and the SEC should be as to the types of swaps which comprise an entity's aggregate position. Each type of swap has a different risk profile and each has a different risk of loss. Whilst, for example, an interest rate swap may have a large risk of loss if held in a large uncollateralised position, the buyer of a credit default swap (CDS) is unlikely to create a large risk of loss through a large position, due to the characteristics of the contract. A further consideration is the directionality of a contract - for example, a buyer of a CDS contract has a small outlay in its premium but a large upside on the reference entity's default, but a seller of a CDS contract has a small and regular income on the contract but a potentially very large outlay, should the reference entity default. One direction on a contract may create a big risk of loss; the other direction may not. Accordingly, the CFTC and the SEC should assess each type of asset of an entity, and the assets' characteristics, to determine if the positions in that asset class breach an appropriate threshold. If the entity passes one asset class threshold, it should be considered an MSP for all its swap positions. Each type of contract should have a fair and objective, individually calculated substantial position threshold.

Within the uncleared swap asset classes, the CFTC and the SEC should next consider the actual risk of loss of the positions. Notional sizes do not accurately indicate the risk of any particular contract and can be misleading. A fair estimation of a protection buyer's maximum risk of loss (for example, with CDS contracts) would be points paid upfront by the buyer on the position plus the present value of any future spreads that the buyer would need to pay for the position. However, a protection seller's maximum loss on a position would be the notional amount of the

position less the points paid upfront to it by the buyer. The risk of loss may be reduced in aggregated positions held or in positions held in one asset classes by off-setting and netting of exposures. However, netting may not be appropriate in all cases and a large one way position may be significant, even if combined with others makes the entity's position flat - the best example of this being Lehman Brothers who were approximately flat in position at the time of collapse but had large individual exposures which caused failures and affected the stability of the markets. The length that the position remains open may also be a relevant factor, as may be the ease with which a position can be unwound in unfavourable market conditions.

The CFTC and the SEC should therefore be setting a threshold that takes account of:

1. whether the contract is centrally cleared;
2. the value and quality of collateral provided for individual positions;
3. the position in a single asset class and its characteristics, including direction in the market; and
4. the actual risk of loss (after reductions from items 1 to 3).

The calculation of the position (taking account of the actual risk of loss discussed above) should then be assessed against a fair and objective threshold. Such a threshold could be calculated in a number of ways including as a percentage of the relevant market or could be calculated taking in to account its relative size in comparison to other entities trading in the same asset class. The consideration of the exposure threshold could be calculated as exposure to individual counterparties but this would require the CFTC and the SEC to know the size of the counterparty and their ability to absorb losses as well as the risk for those potentially considered to be MSPs. The CFTC and the SEC could look at the counterparties' balance sheets and calculate a threshold that takes account of the impact that a default on a contract could have on the other entity given the size of its balance sheet and factors such as the amount of capital that entity holds against exposures. We believe that on fair prescription of both thresholds, after consideration of relevant risk of loss factors, no hedge fund is likely to be classified as an MSP.

The CFTC and the SEC may not wish to consider the number of counterparties an entity has as a relevant factor since, although interconnectedness can be a relevant systemic risk consideration more generally, this is not a relevant consideration when deciding whether an entity is likely to fail or whether an entity's exposure or its failure would be significant. An entity that has only a small number of counterparties may only affect a small number of entities directly, should it fail, but the impact could be significant if the position is large and the counterparty is a systemically important entity. A diversified exposure to multiple entities could affect more entities but is likely to be smaller and thus shares the losses in the industry and having less systemic impact. To set a number of counterparties threshold also risks concentrating all risk with (for example) the top five or so dealer counterparties creating five too-big-to-fail institutions. An assessment of counterparty numbers also creates issues around who are the counterparties, and unreasonable outcomes may be found if the CFTC and the SEC were to consider a single counterparty to be one of a number of sub-funds of a hedge fund, or one of many legal entities of a dealer banking group. The problem of counting counterparties is further highlighted in the FX market where parties can trade using Electronic Broking Services (EBS) (or equivalent services from other electronic platforms) which gives an entity the ability to trade with hundreds of potential counterparties.

When an entity is above the substantial position threshold, to assess whether the entity is thus "systemically important or can significantly impact the financial system of the United States", the CFTC or the SEC should then enter into a dialogue and collect information on the entities to assess whether the entity should be required to register as an MSP. The MSP requirements are significantly burdensome and may not reflect all factors relevant to the entity's potential systemic importance, and thus a second stage of discussion and information gathering would allow classification as a MSP only where this is justified. The determination of whether entities above the substantial position threshold should be done periodically, and on no greater than a quarterly basis. More frequent assessment and re-categorisation of entities would be disruptive for entities' business models and would be administratively burdensome for the CFTC and the SEC.

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AIMA believes that the MSP 'label' would not apply to the vast majority of hedge funds; nevertheless, objective criteria should be used, so that any one type of entity is not specifically targeted. AIMA members will generally be required to register with the SEC under Title IV of the Dodd-Frank Act, as Investment Advisers regulated by the provisions of the Investment Advisers Act of 1940. As such, all relevant entities will already become subject to a general level of oversight and monitoring in their business by the SEC, and will be required to keep records and report to the SEC in a number of respects provided in the Dodd-Frank Act and as will be determined by SEC rules. The Dodd-Frank Act also requires all entities to report their uncleared swap and security-based swap transactions to swap data repositories, and for DCOs to report similarly for cleared swaps, so that regulators will also be aware of both entities' trading positions and related information and aggregated data, to achieve their goal of effectively monitoring the market.

Where entities are determined to be MSPs, in the case of an asset manager, the specific requirements relating to being an MSP should fall to the specific funds on whose behalf the manager is managing the money, rather than on the manager itself - in the case of a typical corporate structure in Europe, for example, the manager is independent from the fund company and not a partner of the fund such as is common in the US. It would cause significant burden if those managing funds were required to hold capital against their exposures, as managers who do not act as principal are not highly capitalised and do not have large amounts of shareholder capital, as banks do, due to their business model. The fund on whose behalf the manager is acting also does not have capital, as it is merely a vehicle for pooling investment capital. However, such funds are able to draw down on the money in their funds to provide high quality collateral in the form of margin payments, which achieves the same goal as capital in securing the exposure and protecting against defaults on the contract. For this reason, AIMA believes that it should be funds, who are the legal swap counterparties, not their managers, that should be subject to the MSP requirements, and their prudential requirements should be fulfilled via appropriate levels of margin payments rather than capital. Further, the reporting and record-keeping requirements applicable to MSPs can be delegated to the fund's manager (or administrators) if necessary and, where they are independent, both parties agree to this arrangement. To have managers as the MSPs and subject to the requirements opens up the requirements to difficulties in determining when the MSP threshold is breached; questions would then arise, such as: what happens if a manager's aggregate position across all funds makes it an MSP? And what happens when one fund has multiple managers - are all managers of that fund MSPs? Having to aggregate the independent funds and accounts of fund managers, which may be independently managed by the management firm, would create an unjustified burden for asset managers. The CFTC and the SEC in any case will be able to gain manager by manager information on their total positions through the managers' registration with the SEC and from swap data repositories.

AIMA would also like to see a further clarification as to the extra-territoriality of the MSP requirements and whether it will be applied to entities outside of the US if the non-US counterparty is contracting with a US registered swap dealer or trading swaps denominated in US dollars or referencing US securities or other underlyings.

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"major security-based swap participant"
AIMA does not believe there are any specific issues that relate to "major security-based swap participants". We would, however, like to see consideration of the same factors for determining thresholds, and similar thresholds for substantial positions in the MSP and MSBSP definitions, if appropriate. The CFTC and the SEC should also jointly clarify the position where an entity has positions in swaps and security-based swaps, and whether it is possible for an entity to be both an MSP and an MSBSP, and whether this would lead to duplicative requirements.
"eligible contract participant"
AIMA has no comments on this definition.
"security-based swap agreement"
AIMA has no comments on this definition.
"mixed swaps"
AIMA feels that, in the majority of situations, a mixed swap will be predominately of one nature rather than another: either closer to a swap or security-based swap than not. The CFTC and the SEC should, therefore, as far as possible, propose a predominance test for mixed swaps and make arrangements for the SEC to take responsibility for all contracts that could most reasonably be considered security-based swaps, and similarly the CFTC to take responsibility for all contracts that could most reasonably be considered swaps. In rare instances of dispute, the SEC and the CFTC should agree appropriate resolution mechanisms for deciding which regulator should be overseeing that type of contract. The rules for swaps and security-based swaps should be as closely aligned as possible, and mixed swaps should not be subject to duplication via the application of two different regulatory regimes. The two regulators should also not commit duplicative resources to monitoring the same contracts, as this is clearly wasteful.

Alternative Investment Management Association

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Elizabeth M. Murphy,
Secretary,
Securities and Exchange Commission,
100 F Street, NE,
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DC 20549-1090

By email to: rule-comments@sec.gov and dfadefinitions@cftc.gov

20 September 2010

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Yours sincerely,

Andrew Baker

Andrew Baker
Chief Executive Officer

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ANNEX 1

"swap"
The list of contracts included within Section 721(a)(21) of the Dodd-Frank Act is inclusive of all of the contracts we would expect to see within the legislation. It is important that all contracts that could be considered "swaps" are included within the obligation to clear contracts, to ensure that there are no loopholes that could undermine this important initiative to bring risk reduction and transparency to the derivatives markets and to reduce the overall threat of financial instability. It is important that the interpretations of "swap" and "security-based swap" are similarly defined and are applied with respect to the provisions of Title VII of the Dodd-Frank Act in a consistent and coordinated manner. Equally, the CFTC and the SEC should be conscious of other, similar reforms arising in other jurisdictions since the September 2009 G20 leaders' statement calling for "All standardized OTC derivative contracts ... [to] be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest". Of particular importance is for the CFTC and the SEC to consider the extent to which its rules cover the same contracts as those subject to mandatory clearing in proposed European legislation, which makes reference to the contracts listed in Annex I, Section C of the Markets in Financial Instruments Directive (2004/39/EC). Any discrepancies between the CFTC and the SEC rules, or the SEC/CFTC's rules and those in the rest of the world, may provide opportunities for regulatory arbitrage, which could undermine the global financial reform efforts. To the extent that the Secretary of the Treasury, in consultation with the SEC and CFTC, believes that foreign exchange contracts should be excluded from the obligations of Title VII, this should only be done where there are strong policy arguments for their exclusion, giving due consideration to the costs and benefits and the potential systemic risk that may be caused by excluding this class of contracts. The SEC and CFTC should give equal consideration to any other class of contracts that may reasonably be considered for an exclusion from the provisions - for example, short maturity contracts that on this basis may not pass the cost benefit analysis conducted. Where possible, the CFTC and the SEC should seek to be as inclusive as possible in the classes of contract that are subject to the provisions applicable to swaps in the Dodd-Frank Act.
"security-based swap"
Security-based swaps that come under the jurisdiction of the SEC should be defined and applied in the same manner as swaps that come under the jurisdiction of the CFTC - as discussed above.
"swap dealer"
AIMA is concerned that some of its members, who will be required to register with the SEC as investment advisers, will incorrectly be classified as "swap dealers" under this very broad definition. If the first three limbs of the definition of "swap dealer" in Section 721(a)(21) are alternatives, then the third limb (which states that a swap dealer means any person who "regularly enters into swaps with counterparties as an ordinary course of business for its own account") would seem to include a huge number of small funds that trade in swaps but would not be considered "dealers" according to the common usage and understanding of the word. It would be more helpful if the first three limbs of the definition could be considered as having to apply collectively and not alternatively. AIMA believes appropriate clarification should provide that the business activity of an entity intended to come within the definition of "swap dealer" should involve taking both sides of the market, for the purposes of profiting from providing liquidity to counterparties. Alternatively, AIMA would like to see specific exclusions for entities that

would not be considered dealers in the market. We do not believe that this concern can be adequately addressed by the 'de minimis' exemption provided within the legislation.

"security-based swap dealer"

The same arguments as for "swap dealer" - as discussed above - apply to "security-based swap dealer".

"major swap participant"

AIMA appreciates that the Dodd-Frank Act has tried to address a perceived concern about parties who are not dealers taking on large derivatives positions which, should they fail, could lead to market instability, so that they are, or become, systemically important. We understand that the key driver behind the MSP provisions is to capture entities such as the insurance company AIG, which accumulated large uncollateralised positions in CDS contracts before the crisis and then defaulted, requiring federal funding to stabilize the firm. Our concern, however, is that certain entities may be inappropriately classified as MSPs and, as such, be subject to burdensome and unworkable requirements. AIMA members require clarity as to whether this definition could apply to them and we believe that the requirements should only be applied where they are appropriate.

There are certain elements of the Section 721(a)(16) definition which are subjective and require detailed clarification to provide certainty to the industry, including:

- a "major" swap participant;
- a "substantial" position;
- swaps creating "substantial" counterparty exposure;
- a financial entity that is "highly" leveraged to the amount of capital it holds[4].

The CFTC and the SEC should conduct appropriate studies to ensure that the threshold for substantial positions and exposures are set at levels that focus on the actual risk of loss from the default of an entity, and thus only capture the entities for which such a risk of loss significantly threatens financial stability. This should be the only consideration of what a "major" swap participant is. The criteria that should be considered with regards to whether a position or exposure is "substantial" are:

- for cleared derivatives, an extremely large position
- counterparty exposure, adjusted for the amount and quality of collateral posted
- for uncleared derivatives:
  - net market exposure in an asset class overall
  - net market exposure in an asset class per counterparty

When measuring market exposure, potential loss should be the measure used rather than notional exposure, because it is always financial loss that drives systemic risk and for many derivatives (including for example options and CDS, where loss depends critically on whether the contract has been bought or shorted) the potential loss cannot be gauged from the notional.

[4] The first limb of the MSP definition includes any entity that maintains a 'substantial positions' whether leveraged or not, and therefore we do not see this limb as being relevant for the CFTC and the SEC's determination. However, if the CFTC and the SEC do consider the definition of leverage, they should ensure that the definition is in line with international agreements with what "leverage" is and how it is calculated, and its threshold level should be objectively defined at an appropriate level.

When considering how to define an MSP, the first consideration should be whether or not the entity's position includes centrally cleared swaps. The requirement for mandatory clearing is designed to significantly reduce an entity's credit risk, and thus its exposure to its counterparties through the use of a supervised and regulated, well-funded and capitalised derivatives clearing organization (DCO) that sits between the counterparties, as buyer to each seller and seller to each buyer.

The related requirements that all centrally cleared exposures should be collateralised through the use of segregated high quality initial and variation margin payments also significantly mitigates counterparty credit risk. The CFTC and the SEC are permitted by the Dodd-Frank Act to take into account the value and quality of collateral held against counterparty exposures, an important and relevant consideration. The provision of collateral reduces the impact that default on a contract would have on a counterparty, with initial margin payments reducing counterparty credit risk and variation margin reducing market risk from fluctuations in prices. It will be a requirement for those mandated to use DCOs to post collateral in this way, and thus those who participate in central clearing may therefore be less systemically relevant. Entities may also provide collateral where a contract is bilaterally cleared with a counterparty - this is nearly universally common for the hedge fund industry, where parties post collateral with swap dealers, although we understand it is not universally applied for other buyside (non-dealer) firms. The type of collateral posted by hedge funds under bilateral clearing is typically highly rated, low market risk government securities or cash. It is expected that DCOs will require similar quality for collateral payments. The amount and quality of collateral provided should both be relevant considerations for the CFTC and the SEC when assessing an exposure. The DCOs themselves are required to have high levels of capital and other funding sources provided by clearing members to protect against default, and are thus designed not to be significantly impacted by the default of even a large counterparty.

For these reasons, all swaps cleared with DCOs should either be excluded from the calculation of a position / exposure for determining whether it meets a determined significant position / exposure threshold, or heavily discounted. Recognising that cleared swaps are not entirely free of risk of loss, a much higher threshold for cleared swaps may be appropriate.

For uncleared swaps, the second consideration for the CFTC and the SEC should be as to the types of swaps which comprise an entity's aggregate position. Each type of swap has a different risk profile and each has a different risk of loss. Whilst, for example, an interest rate swap may have a large risk of loss if held in a large uncollateralised position, the buyer of a credit default swap (CDS) is unlikely to create a large risk of loss through a large position, due to the characteristics of the contract. A further consideration is the directionality of a contract - for example, a buyer of a CDS contract has a small outlay in its premium but a large upside on the reference entity's default, but a seller of a CDS contract has a small and regular income on the contract but a potentially very large outlay, should the reference entity default. One direction on a contract may create a big risk of loss; the other direction may not. Accordingly, the CFTC and the SEC should assess each type of asset of an entity, and the assets' characteristics, to determine if the positions in that asset class breach an appropriate threshold. If the entity passes one asset class threshold, it should be considered an MSP for all its swap positions. Each type of contract should have a fair and objective, individually calculated substantial position threshold.

Within the uncleared swap asset classes, the CFTC and the SEC should next consider the actual risk of loss of the positions. Notional sizes do not accurately indicate the risk of any particular contract and can be misleading. A fair estimation of a protection buyer's maximum risk of loss (for example, with CDS contracts) would be points paid upfront by the buyer on the position plus the present value of any future spreads that the buyer would need to pay for the position. However, a protection seller's maximum loss on a position would be the notional amount of the position less the points paid upfront to it by the buyer. The risk of loss may be reduced in aggregated positions held or in positions held in one asset classes by off-setting and netting of exposures. However, netting may not be appropriate in all cases and a large one way position may be significant, even if combined with others makes the entity's position flat - the best example of this being Lehman Brothers who were approximately flat in position at the time of collapse but had large individual exposures which caused failures and affected the stability of the

markets. The length that the position remains open may also be a relevant factor, as may be the ease with which a position can be unwound in unfavourable market conditions.

The CFTC and the SEC should therefore be setting a threshold that takes account of:

1. whether the contract is centrally cleared;
2. the value and quality of collateral provided for individual positions;
3. the position in a single asset class and its characteristics, including direction in the market; and
4. the actual risk of loss (after reductions from items 1 to 3).

The calculation of the position (taking account of the actual risk of loss discussed above) should then be assessed against a fair and objective threshold. Such a threshold could be calculated in a number of ways including as a percentage of the relevant market or could be calculated taking in to account its relative size in comparison to other entities trading in the same asset class. The consideration of the exposure threshold could be calculated as exposure to individual counterparties but this would require the CFTC and the SEC to know the size of the counterparty and their ability to absorb losses as well as the risk for those potentially considered to be MSPs. The CFTC and the SEC could look at the counterparties' balance sheets and calculate a threshold that takes account of the impact that a default on a contract could have on the other entity given the size of its balance sheet and factors such as the amount of capital that entity holds against exposures. We believe that on fair prescription of both thresholds, after consideration of relevant risk of loss factors, no hedge fund is likely to be classified as an MSP.

The CFTC and the SEC may not wish to consider the number of counterparties an entity has as a relevant factor since, although interconnectedness can be a relevant systemic risk consideration more generally, this is not a relevant consideration when deciding whether an entity is likely to fail or whether an entity's exposure or its failure would be significant. An entity that has only a small number of counterparties may only affect a small number of entities directly, should it fail, but the impact could be significant if the position is large and the counterparty is a systemically important entity. A diversified exposure to multiple entities could affect more entities but is likely to be smaller and thus shares the losses in the industry and having less systemic impact. To set a number of counterparties threshold also risks concentrating all risk with (for example) the top five or so dealer counterparties creating five too-big-to-fail institutions. An assessment of counterparty numbers also creates issues around who are the counterparties, and unreasonable outcomes may be found if the CFTC and the SEC were to consider a single counterparty to be one of a number of sub-funds of a hedge fund, or one of many legal entities of a dealer banking group. The problem of counting counterparties is further highlighted in the FX market where parties can trade using Electronic Broking Services (EBS) (or equivalent services from other electronic platforms) which gives an entity the ability to trade with hundreds of potential counterparties.

When an entity is above the substantial position threshold, to assess whether the entity is thus "systemically important or can significantly impact the financial system of the United States", the CFTC or the SEC should then enter into a dialogue and collect information on the entities to assess whether the entity should be required to register as an MSP. The MSP requirements are significantly burdensome and may not reflect all factors relevant to the entity's potential systemic importance, and thus a second stage of discussion and information gathering would allow classification as a MSP only where this is justified. The determination of whether entities above the substantial position threshold should be done periodically, and on no greater than a quarterly basis. More frequent assessment and re-categorisation of entities would be disruptive for entities' business models and would be administratively burdensome for the CFTC and the SEC.

AIMA believes that the MSP 'label' would not apply to the vast majority of hedge funds; nevertheless, objective criteria should be used, so that any one type of entity is not specifically targeted. AIMA members will generally be required to register with the SEC under Title IV of the Dodd-Frank Act, as Investment Advisers regulated by the provisions of the Investment Advisers Act of 1940. As such, all relevant entities will already become subject to a general level of oversight and monitoring in their business by the SEC, and will be required to keep records and

report to the SEC in a number of respects provided in the Dodd-Frank Act and as will be determined by SEC rules. The Dodd-Frank Act also requires all entities to report their uncleared swap and security-based swap transactions to swap data repositories, and for DCOs to report similarly for cleared swaps, so that regulators will also be aware of both entities' trading positions and related information and aggregated data, to achieve their goal of effectively monitoring the market.

Where entities are determined to be MSPs, in the case of an asset manager, the specific requirements relating to being an MSP should fall to the specific funds on whose behalf the manager is managing the money, rather than on the manager itself - in the case of a typical corporate structure in Europe, for example, the manager is independent from the fund company and not a partner of the fund such as is common in the US. It would cause significant burden if those managing funds were required to hold capital against their exposures, as managers who do not act as principal are not highly capitalised and do not have large amounts of shareholder capital, as banks do, due to their business model. The fund on whose behalf the manager is acting also does not have capital, as it is merely a vehicle for pooling investment capital. However, such funds are able to draw down on the money in their funds to provide high quality collateral in the form of margin payments, which achieves the same goal as capital in securing the exposure and protecting against defaults on the contract. For this reason, AIMA believes that it should be funds, who are the legal swap counterparties, not their managers, that should be subject to the MSP requirements, and their prudential requirements should be fulfilled via appropriate levels of margin payments rather than capital. Further, the reporting and record-keeping requirements applicable to MSPs can be delegated to the fund's manager (or administrators) if necessary and, where they are independent, both parties agree to this arrangement. To have managers as the MSPs and subject to the requirements opens up the requirements to difficulties in determining when the MSP threshold is breached; questions would then arise, such as: what happens if a manager's aggregate position across all funds makes it an MSP? And what happens when one fund has multiple managers - are all managers of that fund MSPs? Having to aggregate the independent funds and accounts of fund managers, which may be independently managed by the management firm, would create an unjustified burden for asset managers. The CFTC and the SEC in any case will be able to gain manager by manager information on their total positions through the managers' registration with the SEC and from swap data repositories.

AIMA would also like to see a further clarification as to the extra-territoriality of the MSP requirements and whether it will be applied to entities outside of the US if the non-US counterparty is contracting with a US registered swap dealer or trading swaps denominated in US dollars or referencing US securities or other underlyings.

"major security-based swap participant"

AIMA does not believe there are any specific issues that relate to "major security-based swap participants". We would, however, like to see consideration of the same factors for determining thresholds, and similar thresholds for substantial positions in the MSP and MSBSP definitions, if appropriate.

The CFTC and the SEC should also jointly clarify the position where an entity has positions in swaps and security-based swaps, and whether it is possible for an entity to be both an MSP and an MSBSP, and whether this would lead to duplicative requirements.

"eligible contract participant"

AIMA has no comments on this definition.

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"security-based swap agreement"
AIMA has no comments on this definition.

"mixed swaps"
AIMA feels that, in the majority of situations, a mixed swap will be predominately of one nature rather than another: either closer to a swap or security-based swap than not. The CFTC and the SEC should, therefore, as far as possible, propose a predominance test for mixed swaps and make arrangements for the SEC to take responsibility for all contracts that could most reasonably be considered security-based swaps, and similarly the CFTC to take responsibility for all contracts that could most reasonably be considered swaps. In rare instances of dispute, the SEC and the CFTC should agree appropriate resolution mechanisms for deciding which regulator should be overseeing that type of contract. The rules for swaps and security-based swaps should be as closely aligned as possible, and mixed swaps should not be subject to duplication via the application of two different regulatory regimes. The two regulators should also not commit duplicative resources to monitoring the same contracts, as this is clearly wasteful.