MEMORANDUM

TO: File
FROM: Margaret Rubin
RE: Meeting with Representatives of Alternative Investment Management Association
DATE: May 27, 2014

On May 20, 2014, representatives from the Securities and Exchange Commission ("SEC") participated in a meeting with representatives from the Alternative Investment Management Association ("AIMA") and K&L Gates LLP ("K&L Gates").

The SEC representatives participating at the meeting were Brian Bussey, Joshua Kans, Richard Gabbert, Eric Pan, Shaheen Haji, Kim Allen, Paul Leder, and Margaret Rubin. The AIMA representatives at the meeting were Jack Inglis (AIMA), Jiri Krol (AIMA), and Dan Crowley (K&L Gates). At the meeting, the AIMA representatives provided their views and observations on changes in the OTC derivatives market in response to ongoing implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

OTC Derivatives Reform: Dealing with overlap of rules

Alternative Investment Management Association

May 2014

Representing the global hedge fund industry

OTC derivatives: Globally convergent rules

- In September 2009, G-20 Leaders agreed in Pittsburgh that:

  "All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties .... OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements...."

- Overall, there is a **high degree of convergence** in terms of the substance of national/regional rules that have been developed in furtherance of the G20 agreement.

EU: EMIR & MiFID
Central clearing (EMIR)
Reporting (EMIR)
Trade execution (MiFID)
Margin for non-cleared (EMIR)

US: Dodd-Frank Title VII requirements
Central clearing
Reporting
Trade execution
Margin for non-cleared

But… lack of regulatory consistency

- G20 leaders also agreed on the **need to implement rules on a consistent basis:**

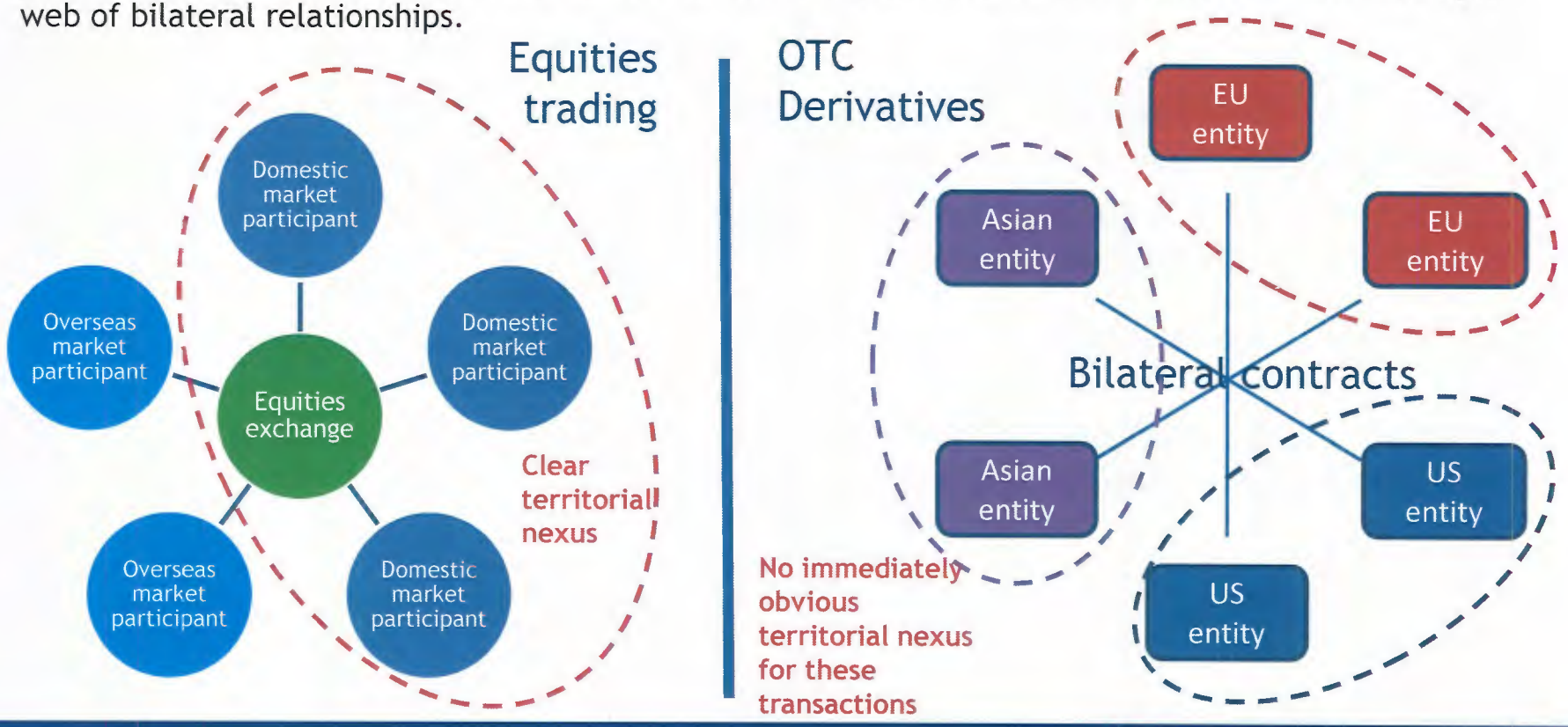
  "We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."

Despite rules being convergent in terms of their content, we have fundamental concerns that they have not been developed in a way that respects the overall consistency of the global regulatory framework. Specifically, there are manifest shortcomings in terms of the:

- Way in which individual jurisdictions define the scope of the rules; and
- Mechanisms available to deal with situations where the rules of one or more jurisdiction overlap (and potentially conflict).

Determining the territorial nexus

- For some products and markets, it is relatively straightforward for regulators to determine the scope of their rules. For example, regulating transactions that take place on a domestic equities exchange is relatively straightforward because there is an obvious 'nexus' with the jurisdiction in which the exchange is established. For other markets, it is less straightforward to define jurisdiction. This is the case for OTC derivatives markets, which were historically characterised by a web of bilateral relationships.



Scope with respect to Funds

- The inherent challenge of regulating OTC derivatives markets calls for **close cooperation between regulators** when it comes to determining the scope of their rules. Unfortunately, effective cooperation on this has been lacking.

- **Specifically, the 'entity scope' of EMIR and CFTC rules overlap in many situations. This is driven to a large degree by the broad approach taken by the CFTC in developing a US person definition:**

  - **CFTC:** A fund is treated as a US Person if it has a "principal place of business" in the US or **if it is majority-owned by US Persons.**

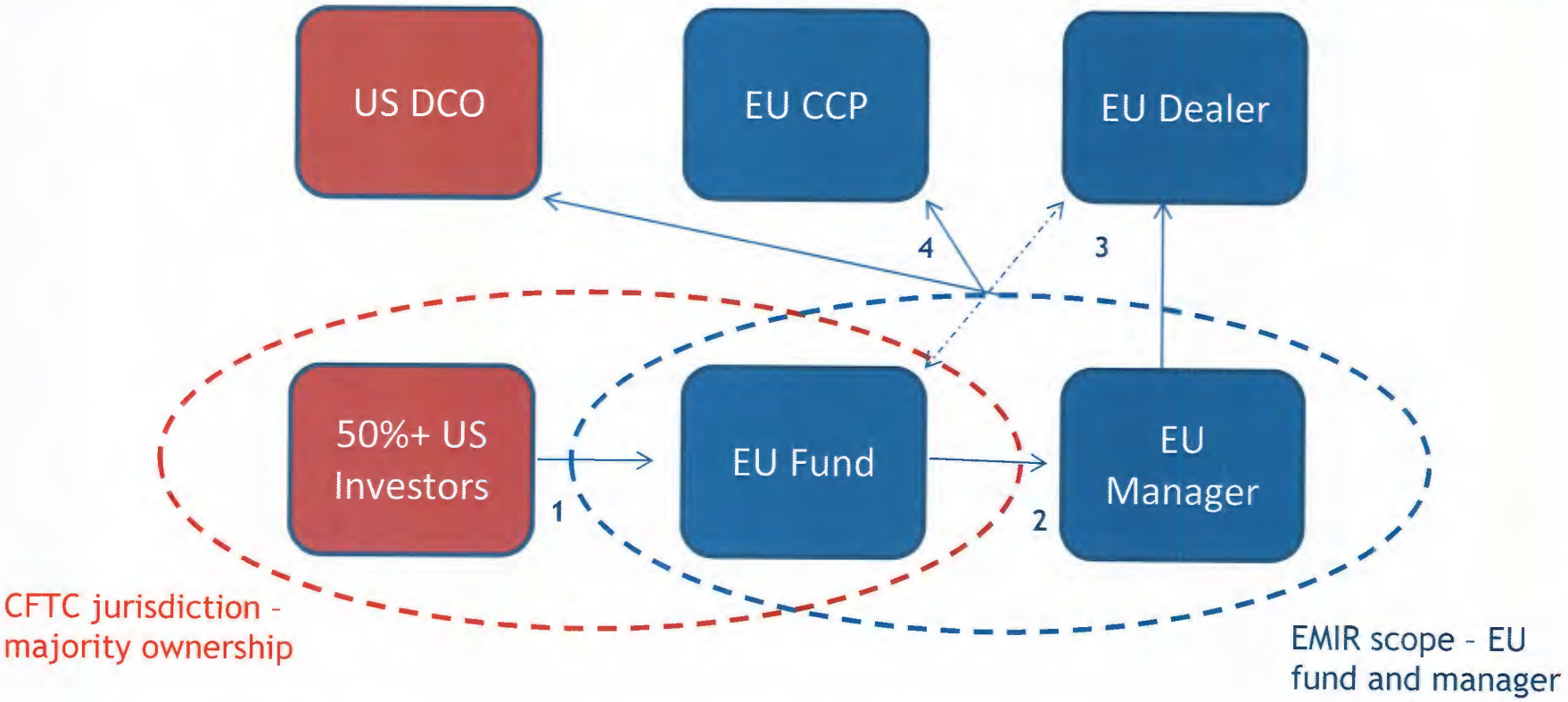
  - **EMIR:** A fund is subject to EMIR if the fund or its investment manager is domiciled in the EU.

- **Example:** A fund is domiciled in Ireland and **is majority-owned by US investors**[1]. The fund is managed by an investment manager based in London. It enters into a derivatives transaction with a European investment bank. The fund is a **US person** by virtue of being majority-owned by US Persons, making the transaction subject to CFTC rules. The transaction is also subject to EMIR by virtue of the fund having a European investment manager.

- As a result, there is significant potential for overlap with respect to the substantive obligations of such US person, who is also a European investment manager, under CFTC rules and EMIR.

1 This may be particularly difficult to determine if a fund is publicly traded or if shares are held by persons who are non-responsive or in omnibus accounts.

An illustration of overlap



1. An EU fund is majority-owned by US investors. CFTC requirements apply.
2. The EU fund has an EU investment manager. EMIR applies.
3. The investment manager enters into an OTC derivatives contract with an EU dealer bank on behalf of the fund.
4. The fund is subject to competing clearing rules - does it choose the EU or US rules?

Overlap and inconsistency

- Despite the high level of convergence between the EU and US frameworks and the near-identical regulatory outcomes (central clearing, organised trade execution, reporting etc.), this overlap is problematic because there **are many legal differences between the regimes when it comes to their detailed parameters.**

- In some instances it is possible to follow two sets of subtly different rules, although this would obviously generate unnecessary compliance costs, as well as problems for regulators to avoid double-counting. For example, a participant could report the same transaction to different trade repositories if it were required to do so.

- In other situations, the **rules might be irreconcilable.** This is the case with central clearing. Despite the overall clearing requirements being comparable, there are important differences:

  - **Segregation:** EU and CFTC rules set different segregation standards. The CFTC's regime is based on a Legally Segregated, Operationally Comingled structure (LSOC). In the EU, a higher standard of segregation is possible (individual segregation).
  - **Collateral:** EU and CFTC rules set different standards on eligible collateral for clearing.
  - **Margin requirements:** Margin requirements may be different in different jurisdictions, depending on the contract.

- Therefore, even if a clearing house is registered with both the CFTC and ESMA (**"dual registration"**), it cannot necessarily provide a clearing structure that satisfies both sets of rules for an individual trade.

Existing relief mechanisms

- The CFTC framework and EMIR both recognise that overlap of rules can arise and that relief should be available for transactions that are subject to such overlap where the requirements are comparable.

- However, **neither framework is currently sufficiently comprehensive** to be able to deliver relief in all scenarios in which overlap of rules currently arises:

  - The European **equivalence** framework only provides relief when one or more parties to the trade is established in an equivalent jurisdiction. In the example on the previous slide, both counterparties are established in the EU.

  - The CFTC's **substituted compliance** framework is not available to US Persons.

- AIMA believes that there are a number of solutions that could be pursued. The following slides set out some possibilities.

Possible solutions

Solution	Discussion
Amend scope of EMIR and CFTC rules to reduce range of situations in which rules overlap	- AIMA has previously suggested narrowing the scope of the CFTC's US Person definition to exclude funds that are majority owned by US Persons. This would reduce the scope for overlap with EMIR or other regional legislation. **We believe that this change could readily be effected as part of the CFTC reauthorisation process (see next slide)**
Broaden scope of substituted compliance and equivalence	- CFTC substituted compliance is not available to US Persons. It would be possible to broaden the scope of substituted compliance to include US Persons. - EMIR equivalence determinations will benefit entities established in an equivalent jurisdiction. AIMA has argued that this should extend to entities that are subject to the rules of an equivalent jurisdiction (e.g. a fund that is established in the Cayman Islands, but that is majority-owned by US Persons and therefore subject to CFTC rules)
Provide targeted (no-action) relief for funds that are subject to overlap	- In October, AIMA wrote to the CFTC requesting targeted relief for EU and offshore funds: (1) whose assets are managed by an EU investment manager; and (2) who are transacting with European dealer banks. We believe that in this situation the most meaningful regulatory nexus is with the EU. The CFTC can take comfort from the fact that the major EU CCPs will be registered as DCOs as well, so there is no additional risk associated with permitting clearing under EU rules.

Swaps reform - CEA reauthorisation

- We propose that as, part of the CEA reauthorisation process, Congress should direct the CFTC to adopt a formal rulemaking on its U.S. person definition adopting the amendment set forth on the following slide.

- Under our proposed approach, a fund with a principal place of business in the United States or a fund that is incorporated in the United States would be deemed to be a U.S. person under the CFTC framework. This would ensure that the broad policy objectives of Dodd-Frank would be met, whilst at the same time providing an appropriate level of deference to the rules that have been put in place in other jurisdictions, most notably the European Union.

- Assuming that a fund's principal place of business for these purposes would be the jurisdiction from which it is managed, we note that around 90% of the global hedge fund assets under management are managed in the United States and the European Union, which have both implemented comprehensive rules to regulate over-the-counter ('OTC') derivatives markets.

Swaps reform - Proposed US Person definition

(X) Section 2(i) of the Commodity Exchange Act (7 U.S.C. § 2(i)) is amended to read as follows:

"(3) Within 180 days of the enactment of this Act, the Commission shall issue regulations that address those transactions that have a direct and significant connection with activities in, or effect on, commerce of the United States. As used in this section and for purposes of the regulations issued pursuant to this section, the following shall be considered to be a "U.S. person":

(i) any natural person who is a resident of the United States;

(ii) any estate of a decedent who was a resident of the United States at the time of death;

(iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in prongs (iv) or (v), below) (a 'legal entity'), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States;

(iv) any pension plan for the employees, officers or principals of a legal entity described in prong (iii), unless the pension plan is primarily for foreign employees of such entity;

(v) any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;

(vi) any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity; and

(vii) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), or (vi)."

Conclusions

- CFTC rules and EMIR overlap and conflict. This will potentially put asset managers in an impossible position when the EU clearing obligation goes live (Q4 2014).

- There are mechanisms to deal with overlap - EU equivalence framework and CFTC substituted compliance regime - but these are currently insufficiently used on the part of CFTC (EU is expected to deem the US rules equivalent for EMIR purposes).

- Relief from CFTC requirements should be available to firms that are subject to European requirements covering the clearing obligation, trade reporting and trade execution.

- If relief is not granted, it will have a profound impact on the global financial services industry, as well as EU affiliates of US dealer banks - clients are likely to avoid trading with affiliates of US dealers if there is no relief mechanism available for those trades.

- ISDA's recent study 'Cross-Border Fragmentation of Global OTC Derivatives: An Empirical Analysis' (January 2014) demonstrates that the market is already fragmenting along regional lines, despite the comparability of regulatory outcomes.

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CEA reauthorisation: Proposed amendments

Alternative Investment Management Association

May 2014

Representing the global hedge fund industry

Swaps reform - CFTC extraterritorial approach

- On July 26, 2013, the CFTC published its Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations (the 'Guidance'), which uses the term "U.S. person" to identify those persons who, under the CFTC's interpretation, could be expected to satisfy the jurisdictional nexus under section 2(i) of the CEA and who would therefore be subject to CFTC swaps requirements.

- As highlighted by the CFTC when it issued the Guidance, many commenters had stressed that its proposed approach to U.S. person interpretation "presented significant interpretive issues and implementation challenges," calling on the CFTC "to consider how the proposed interpretation could be stated in a simpler and more easily applied manner."

- AIMA has detailed such concerns at length in a number of submissions to the CFTC, highlighting the fact that the definition is likely to lead to significant instances of overlap and conflict with the rules of other jurisdictions, including those applicable in the European Union.

- In particular, we question the approach adopted under prong (vi) of the U.S. person definition[1], and believe that defining a non-U.S. fund as a "U.S. Person," because of the proportion of U.S. investors, is inconsistent with the stated aims of Dodd-Frank. In our view, an ownership test alone is not indicative of whether the activities of a non-U.S. fund would have a direct and significant effect on the U.S financial system, particularly in situations when transactions entered into by the non-U.S. fund are subject to comparable regulatory requirements.

1 (vi) any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. Persons.

CEA reauthorisation - new CFTC mandate

- We propose that, as part of the CEA reauthorisation process, **Congress should direct the CFTC to adopt a formal rulemaking on its U.S. person definition** and adopt the amendment set forth on the following slide.

- Under our proposed approach, **a fund with a principal place of business in the United States or a fund that is incorporated in the United States would be deemed to be a U.S. person** under the CFTC framework.

- Assuming that a fund's principal place of business for these purposes would be the jurisdiction from which it is managed, we note that around **90% of the global hedge fund assets under management are managed in the United States and the European Union**, which have both implemented comprehensive rules to regulate over-the-counter ('OTC') derivatives markets, covering: mandatory central **clearing** of standardised contracts; organised **execution** of derivatives contracts on trading venues; **reporting** of derivatives transactions to trade repositories; and **margin and capital** rules for uncleared transactions.

- Accordingly, we believe that this approach **balances the delivery of the key policy provisions of Dodd-Frank with the need to provide an appropriate level of deference to the rules that have been put in place in other jurisdictions**, most notably the European Union.

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Dodd-Frank, Commodity Interests and the Impact on Commodity Pool Operators

Dodd-Frank and Hedge Fund Advisers

- Dodd-Frank had two direct impacts for investment advisers to hedge funds:
  - The definitions of commodity pool operator ('CPO') and commodity trading advisor ('CTA') were broadened to include most types of swaps, including most over-the counter derivatives as "commodity interests," thus increasing the numbers of hedge fund advisers who needed to be either registered as CPOs or CTAs or fit within a relevant exemption; and
  - The primary exemption hedge fund managers had been relying on in order to not have to register as investment advisers was removed and replaced with a few much narrower exemptions, including two exemptions which have redefined the extraterritorial reach of the Securities and Exchange Commission with respect to registration

Dodd-Frank and the CFTC

- Although Congress did expand the number of CPOs and CTAs subject to the jurisdiction of the CFTC by changing the definitions of CPOs and CTA to include swaps as a form of "commodity interest," it did not direct the CFTC to amend or rescind the previously adopted CPO/CTA registration exemptions and exclusions as part of Dodd-Frank
- Nevertheless, following the adoption of Dodd-Frank, the CFTC rescinded Rule 4.13(a)(4), the exemption relied on by many CPOs to commodity pools offered solely to qualified eligible persons, citing a desire to avoid regulatory arbitrage
- That rescission became effective at the end of December 2012

Commodity Pool Operator Status

- CFTC Rule 4.13(a)(4) was only available for CPOs to funds whose investors were all sophisticated institutions and natural persons
- As hedge funds commonly rely on Section 3(c)(7) of the Investment Company Act of 1940, which requires all investors to be qualified purchasers, and since qualified purchasers met the relevant sophistication requirements, the exemption provided under CFTC Rule 4.13(a)(4) was straightforward to use
- Due to the rescission of that rule, many CPOs who were previously exempt had three primary choices:
  - Qualify for an alternative exemption where possible
  - Register and perhaps rely on the regulatory relief provided by CFTC Rule 4.7(b)
  - Stop operating a commodity pool, which was usually accomplished by having the fund redeem all of the US person investors

Impact on CFTC Staff Resources

- The inclusion of swaps as "commodity interests" for purposes of the definition of CPO (and the consequential increase in the number of CPOs subject to CFTC jurisdiction) and the rescission of CFTC Rule 4.13(a)(4) have put a strain on CFTC staff resources in the form of:
  - Strained budgets,
  - Stretched enforcement resources, and
  - Backlogs of requests for relief from certain provisions of existing rules that do not adequately address issues that arise for small and non-US CPOs who were previously exempt
- As a result, AIMA is proposing a variety of amendments to the Commodity Exchange Act primarily designed to:
  - Align the extraterritorial scope of the CFTC's jurisdiction with that set for the SEC in Dodd-Frank,
  - Ease the constraints on CFTC resources by providing exemptions for small and non-US CPOs, and
  - Reducing the backlog of requests for relief by eliminating certain points of friction affecting CPOs and CTAs

AIMA's Proposals

- Introduce exemptions from the requirement for CPOs to register
  - Following most of the requirements imposed previously by CFTC Rule 4.13(a)(4)
  - Along the same lines as the SEC's "foreign private adviser" exemption
  - Along the same lines as the SEC's "private fund adviser" exemption
  - Where the obligation to register is from the relocation of investors to the US or a secondary market transaction not involving the fund or its agents
  - Where a CPO is delegating to a registered CPO

AIMA's Proposals (continued)

- Amend the definition of "mixed swap" to clarify that a compo equity swap is not to be considered a commodity interest
- Amend the definition of "foreign exchange forward" to include non-deliverable forwards
- Require the CFTC to adopt a rule to provide relief for CPOs to non-US listed funds that is substantially similar to the relief available to CPOs of commodity pools offering units of participation on the basis of an effective registration statement under the Securities Act of 1933
- Direct the CFTC to amend CFTC Rule 3.10(c)(3)(i), which provides registration exemptions where both the intermediary and its customers are located outside the United States, even if the trading occurs on US markets
- Require the CFTC to implement rules to facilitate use of the JOBS Act

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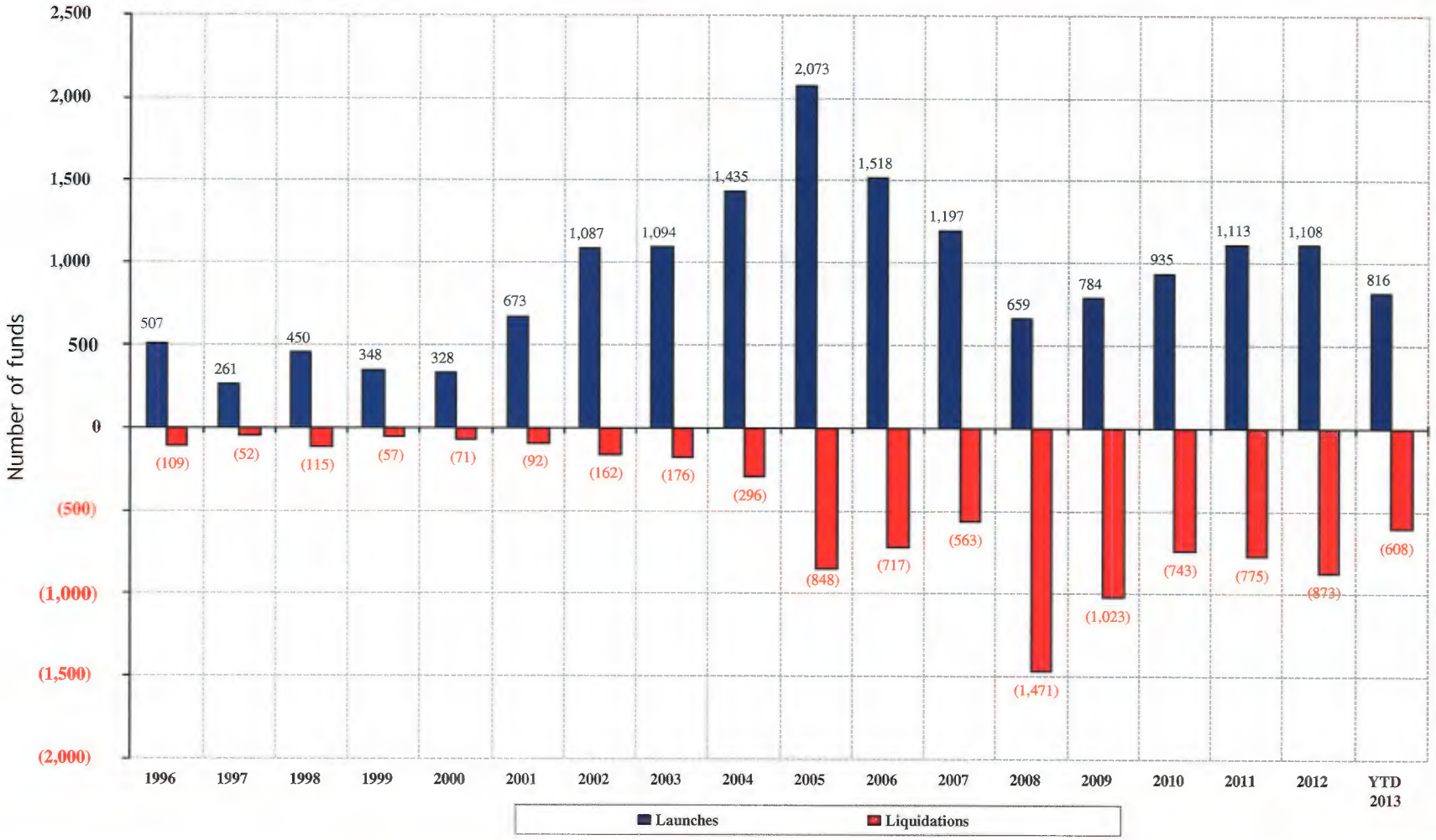
IOSCO-FSB Proposed Assessment Methodologies for Identifying NBNI G-SIFIs

General points

- The hedge fund sector has experienced a robust real-life stress test in recent years and has passed (thousands of funds failed without causing systemic disturbances)
- The financial system has undergone substantial reforms which make it unlikely that a single hedge fund failure could be of systemic relevance
- Systemic risk measures/metrics/criteria should be as consistent across financial sectors as possible (and so far they are not)
- Gross notional derivatives exposure is not a useful metric as it exaggerates activity in the largest and single most liquid derivatives market (interest rate swaps)

Hedge fund sector has experienced a robust real-life stress test in recent years and has passed

Number of fund launches vs. liquidations



The financial system has undergone substantial reforms which make it unlikely that a single hedge fund failure could be of systemic significance

Regulatory and market changes

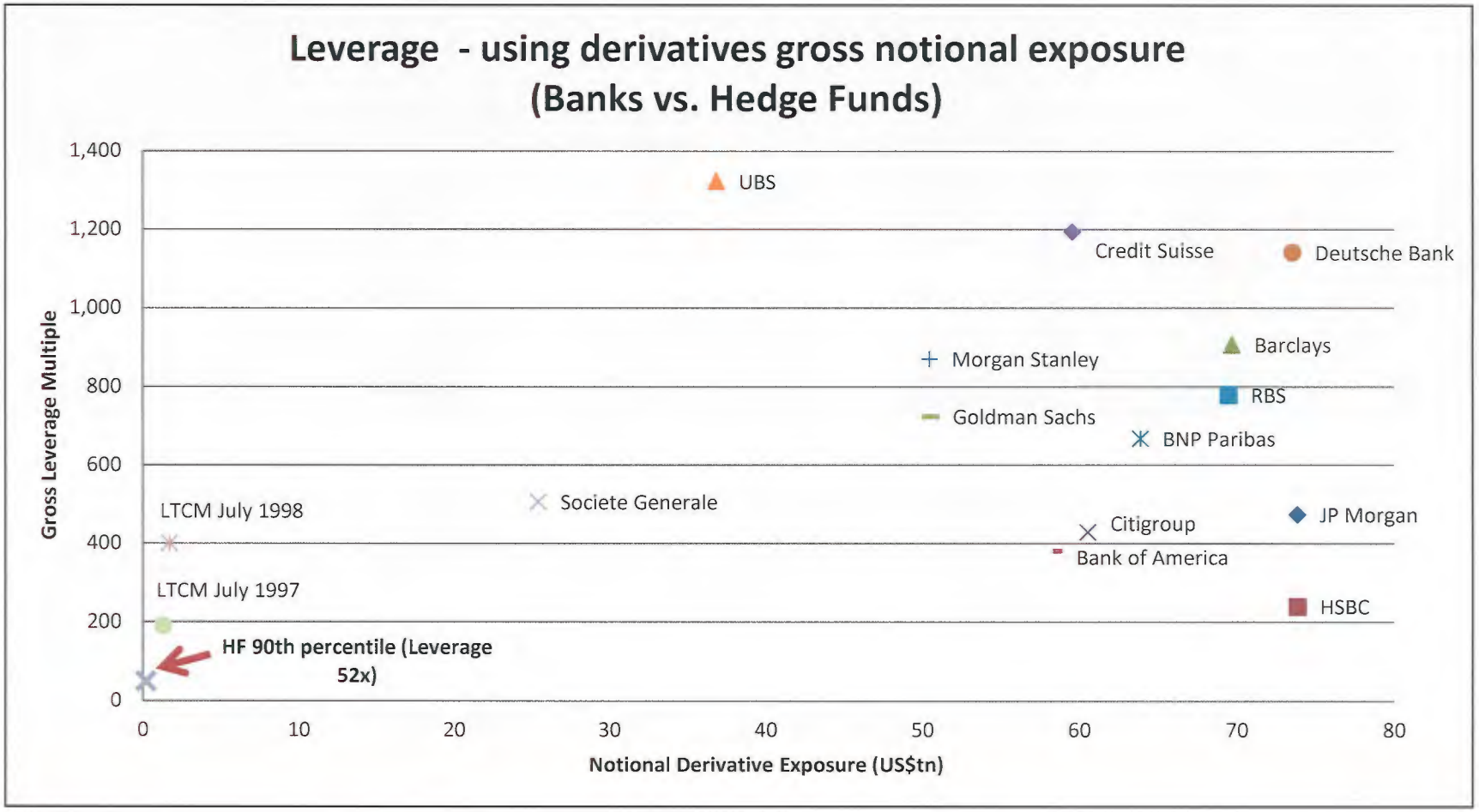
- Banking and markets
  - capital requirements
  - counterparty credit risk capital framework
  - central clearing (EMIR/Dodd-Frank Title VII)
  - margin requirements for non-centrally cleared derivatives
  - mark to market, trade confirmation, relationship documentation, valuation procedures, portfolio reconciliation and compression in respect of all non-centrally cleared derivatives transactions
- Regulation of asset managers (AIFMD/Dodd-Frank Title IV)
- Improved market practice
- Consequences of regulatory and market changes

Systemic risk measures/metrics/criteria should be as consistent across sectors as possible (and so far they are not)

Criteria appear inconsistent

	Finance Companies	Market Intermediaries	Investment Funds	Banks
Size	Balance sheet assets, plus "regulators should also consider off-balance sheet assets, including derivatives, to the extent possible"	Balance sheet assets, plus "national authorities should also consider off-balance sheet assets to the extent possible"	$100bn AUM; $500bn Gross Notional Exposure ("GNE") of all derivatives (futures, cleared OTC & non-cleared OTC)	Total exposures as defined for use in the Basel III leverage ratio
Inter-connectedness	Leverage: "calculated as: total shareholder equity divided by the sum of on balance sheet assets and off-balance sheet exposures". No definition of "exposure" but presumably this means mark to market (standard GAAP definition).	Leverage: "calculated as: total shareholder equity divided by the sum of on balance sheet assets and off-balance sheet exposures. For consistency, national authorities should consider off-balance sheet items as defined by the BCBS in the Basel III framework."	Leverage: calculated as GNE of the fund/NAV of the fund	Leverage: Total assets (including net exposures to off-balance sheet items) as a percentage of total equity
Complexity	OTC derivatives notional amount - GNE of "OTC derivatives that are not cleared through a central counterparty"	OTC derivatives assets and liabilities: "Where possible, national authorities should undertake a qualitative review of the risk posed by a firm's derivatives activity"	OTC derivatives trade volumes: "Funds that engage in a significant volume of OTC derivatives in comparison to their total trading activity potentially could be exposed to higher counterparty risk."	(i) Notional amount of OTC derivatives; (ii) Level 3 assets; and (iii) trading and available-for-sale securities.

Comparing size and leverage



Accounting for derivatives exposures differs

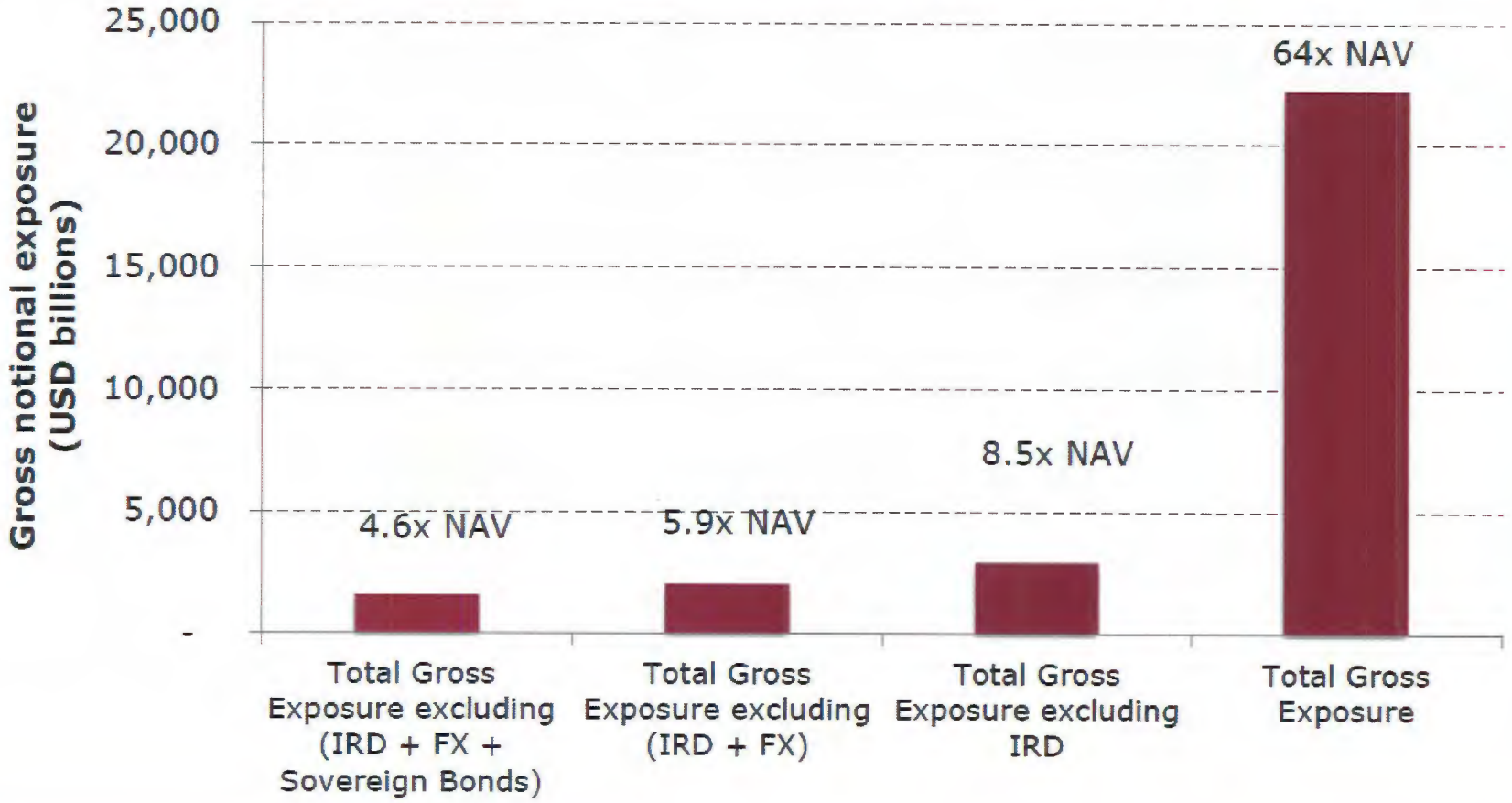
	Interest rates	FX and gold	Equities	Precious metals except gold	Other commodities
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over one year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%

- For banks, gross notional derivatives exposures in the interest rate swap market essentially amount to zero while they count in full for hedge fund managers
- For other derivatives exposures are heavily discounted (between 85% and 99%)

Gross notional derivatives exposure is not a useful metric as it exaggerates activity in the largest and single most liquid derivatives market

FCA Hedge Fund Survey

Figure 19 - Effect of select instruments on exposure and leverage



Size of derivatives markets

	OTC notional outstanding at end June 1998 ($trn)	OTC notional outstanding at end June 2013 ($trn)
FX	22	73
Interest rate	48	561 (of which swaps are $425trn)
Equity	-	7
Commodity	-	2
CDS	-	24
Other	2	-
Total	**72**	**693**

	Listed notional outstanding at end June 1998 ($trn)	Listed notional outstanding at end June 2013 ($trn)
Interest rate		63
Equity		6
Total	**14**	**70**

Thresholds proposed by FSB too low

FSB Proposed GNE thresholds as a % of derivative markets

- $400bn as a % of $763 trn = 0.05%
- $600bn as a % of $763 trn = 0.07%

LTCM OTC and listed derivative notional amounts as a % of the relevant markets at the time

- $800bn as a % of $48 trn (LTCM OTC) = 1.6%
- $600bn as a % of $14 trn (LTCM Listed) = 4.2%

Conclusion

- The approach to NBNI SIFI designation appears to be inconsistent with the process on the banking side – size and leverage approached radically differently
- Thresholds and criteria for designation which have been proposed seem to be 'reverse-engineered' to result in funds and managers included rather than application of objective risk thresholds
- The hedge fund industry today is heavily regulated and cannot obtain high levels of leverage due to restrictions related to derivatives and banking regulation, therefore it is difficult to see how a hedge fund could become systemically relevant

About the Alternative Investment Management Association

Representing the global hedge fund industry

Global Reach

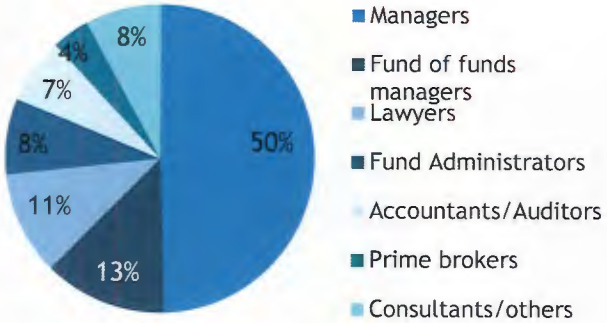
Global Network

* AIMA National Groups

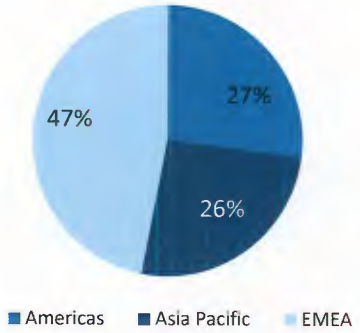
Membership Profile

AIMA members manage approximately 50% of global hedge fund assets

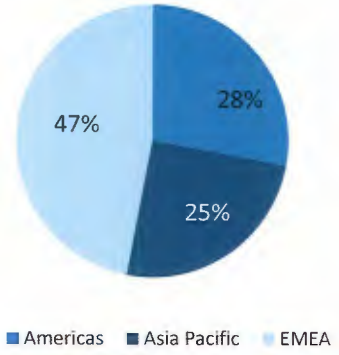
Members by firm type



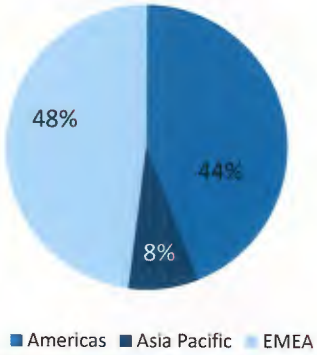
Members by region



Membership by manager *(by number)*



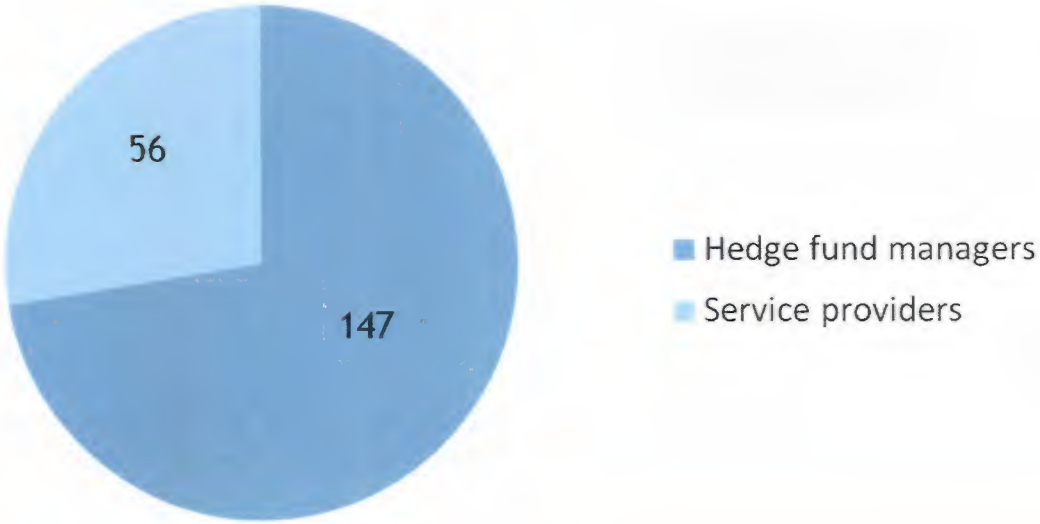
Manager members *(by Regional AUM)*



Data as at February 2014. These numbers are estimates.

US Membership Profile

- AIMA currently has 203 member firms in the US
- Of which 147 are hedge fund manager members
- US manager members manage close to US$ 1 trillion



Sponsoring Members

AIMA Council

Name	Organisation	From	Region
Kathleen Casey	Patomak Global Partners	2012	Chair
Jack Inglis (CEO)	AIMA	2014	Executive
Jamie Dinan	York Capital Management	2010	Americas
Simon Lorne	Millennium Management, LLC	2014	Americas
Tim O'Brien	Pine River Capital Management LP	2014	Americas
Phil Schmitt	Summerwood Capital Corp	2012	Americas
Henry Smith	Maples and Calder	2012	Americas
Robert De Rito	Private Investor	2012	Americas
Stuart Fiertz	Cheyne Capital Management (UK) LLP	2014	EMEA
Paul Sater	EY (UK)	2007	EMEA
Olwyn Alexander	PricewaterhouseCoopers	2012	EMEA
Andrew Bastow*	Private Investor	2010	EMEA
Phil Tye	Nighthawk Capital	2009	Asia-Pacific
Christopher Pearce*	Marshall Wace Asia	2010	Asia-Pacific
Mark O'Sullivan	EY (Australia)	2012	Asia-Pacific

Current Council term is from Sep 2012 to Sep 2014
**Deputy Chairmen*

AIMA's 'Four Pillars'

Government & Regulatory Affairs	External Affairs	Sound Practices	Education
• Asset Management Regulation • Markets Regulation • Tax Affairs	• Media Relations • Member Communications • Membership Services • Events	• Sound Practice Guides • Due Diligence Questionnaires	• Guides for Institutional Investment • Briefing Notes for Policymakers • Research

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