MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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***Via* E-mail: markt-consultations-otc-derivatives@ec.europa.eu**

European Commission
Directorate General Internal Market and Services
Financial Services Policy and Financial Markets
B-1049 Bruxelles/Europese Commissie
Brussels, Belgium

Re: Public Consultation on Derivatives and Market Infrastructures

Dear Sir/Madam:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments on the European Commission's ("Commission") Public Consultation on Derivatives and Market Infrastructures ("Consultation"). MFA applauds the Commission's interest in considering varying market perspectives as it finalizes its draft legislative proposals and policies regarding central clearing, improved transparency and other aspects of the over-the-counter ("OTC") derivatives market.

These issues are of substantial importance to MFA members, as hedge funds are active participants in the OTC derivatives markets and have a strong interest in promoting the integrity and proper functioning of these markets. In addition, MFA believes that a well-functioning OTC derivatives market is essential to the restoration of capital flows within the global economy because that market plays a critical role in the investment and risk management activities of various market participants.

For your convenience, we have included the questions from the Consultation with our responses below. We did not respond to all of the questions presented in the Consultation, but rather focused on those questions relevant to MFA's members as non-dealer, OTC derivatives counterparties.

Clearing and Risk Mitigation of OTC Derivatives

1. *What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivatives contracts for mandatory clearing, and its application? Do*

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

MFA supports the clearing obligation set out in the Consultation, which provides that all financial counterparties (including those counterparties who enter into derivatives with non-European counterparties) should clear all eligible derivative contracts with registered central counterparties ("CCPs"), as either a clearing member or a client. We also agree with the Commission's view that certain OTC derivatives are not currently acceptable or appropriate for clearing and should continue to be transacted bilaterally, albeit with additional reporting requirements. Overall, we believe that increased clearing of OTC derivatives will lead to greater market transparency and competition, as well as diminished counterparty and systemic risks.

In general, MFA supports the "bottom-up approach" proposed in the Consultation with respect to central clearing. Under this approach, each CCP would decide which contracts it would clear and would then submit a list of such contracts to its competent regulator. The regulator would inform the European Securities and Markets Authority ("ESMA"), once such regulator approves the CCP's list of contracts for clearing. Then, ESMA would determine whether a clearing obligation should apply to those contracts based on objective criteria aimed at systemic risk reduction and following public consultation. In our view, this approach appropriately takes into account: (i) that minimizing systemic risk should be an important criterion in deciding which classes of derivatives products should be subject to a clearing obligation, and (ii) that CCPs and their risk committees (each a "Risk Committee") should be responsible for making such a decision.

Although MFA believes that the bottom-up approach is a sensible one, we have three concerns related to the approval process for central clearing. First, with respect to the timing of the different stages in the bottom-up approval process, it is not clear whether a client may compel a clearing member to clear its counterparties' derivatives contracts after the CCP's Risk Committee and competent national regulator approve the contracts for clearing, but before ESMA issues a final determination. We believe that the CCP's and national regulator's approval of a contract for clearing creates a strong presumption that a contract should be cleared, and thus, clearing members should be required to clear any such contracts at the request of a counterparty pending ESMA's final approval. If, however, ESMA makes a final determination that, despite the CCP's and national regulator's approval, such contracts should not be subject to the mandatory clearing obligation, only then should a clearing member not have to clear such contracts. Additionally, we would appreciate having more detail regarding the timing of the approval process once ESMA has determined that a contract should be cleared (*e.g.*, number of days until implementation).

Second, we are concerned that cases may arise where a derivative contract might be of the type that a CCP could clear, but such CCP's governance processes (as discussed in our response to question 4 below) might delay the CCP from permitting the clearing of such contract. In these instances, ESMA should, after due consultation with market participants and

confirmation that the contract may be suitably risk-managed by CCPs, be empowered to require that CCPs offer the product for clearing.

Third, we believe that the Commission should clarify whether under the bottom-up approach the submission of contacts would apply to a broad class of OTC derivatives (*e.g.*, credit default swaps generally) or a subset of such class (*e.g.*, index credit default swaps). MFA believes that CCPs and national regulators should explicitly define and approve the subset or class of OTC derivatives that are eligible for clearing. It is our understanding that a CCP's risk and margin systems are capable of measuring and addressing risk with respect to a subset of OTC derivatives and not a broad class.

Despite our concerns with the bottom-up approach discussed above, MFA agrees that in principle access to a CCP should be granted on a non-discriminatory basis, regardless of the venue of execution. We believe, however, that the Commission should clarify whether the mandatory clearing obligation will apply to OTC derivatives contracts with any European nexus (*i.e.*, where one counterparty is European-based and/or the underlier is a European entity or index). In addressing this concern, we urge the Commission to coordinate with non-European policy makers and regulators with respect to such obligation in order to avoid market segmentation based on jurisdiction.

2. *Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?*

If the Commission's legislative process results in non-financial counterparties (*e.g.*, corporate end-users) being exempt from the clearing obligation, then MFA believes that it is critical that such an exemption be limited solely to non-financial counterparties' hedging of risks that occur in the conduct of their ordinary course, non-financial businesses. Indeed, we believe that such an exemption should be sufficiently narrow in scope and size to exempt only those non-financial counterparties with a demonstrable, non-financial interest for whom the operational requirements of clearing would cause a material hardship.

To prevent abuse of this exemption, and to install safeguards against the build-up of systemically risky exposure, we support the creation of clearing and information reporting thresholds for non-financial counterparties. We agree that non-financial counterparties that take positions exceeding the clearing threshold should be subject to the clearing obligation for eligible OTC derivatives contracts. In addition, we agree that OTC derivatives contracts qualifying for the clearing exemption must be subject to the same reporting requirements as all other OTC derivatives contracts to provide supervisors with a comprehensive view of each participant's risk to the system.

3. *Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?*

MFA agrees that all OTC derivatives counterparties should employ robust, resilient and auditable processes to electronically trade and monitor their non-cleared derivatives contracts. We believe, however, that it is essential that any legislation take into account the different roles and risk mitigation techniques of derivatives dealers as compared to their non-dealer counterparties. Currently, dealers, banks and other depository derivatives counterparties are on the same side of all bilateral OTC derivatives contracts. These market participants generally reserve capital with respect to their OTC derivatives contracts for the purpose of protecting their customers and counterparties from the risk of loss in the event of such dealer, bank or depository institution's failure.

In contrast, non-dealer, OTC derivatives counterparties such as MFA's members post collateral with their dealer counterparties at levels that reflect the risks of each member's failure. As a result, MFA believes it would be inappropriate and misplaced to impose capital requirements on non-dealer, OTC derivatives counterparties.

Moreover, MFA believes that dealers to which collateral is posted should receive offsets to their capital requirements; provided that, such collateral is segregated from the dealers' assets and the dealer does not rehypothecate such collateral. These requirements, along with proper capital levels defined by the dealers' prudential supervisors, would ensure that there is an adequate reserve held at all times against bilateral OTC derivatives positions, while also ensuring appropriate, risk-based incentives for clearing of transactions.

Requirements for Central Counterparties

4. *Do stakeholders share the general approach set out above on organizational requirements for CCPs? In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest; stringent outsourcing requirements; and participation and transparency requirements.*

MFA agrees, in part, with the general approach specified in the Consultation on organizational requirements and governance processes for European CCPs. Specifically, we agree that, among other things, CCPs should have a clear and transparent organizational structure, adequate policies and procedures, a clear separation between reporting lines for risk management and those for other operations of the CCP, transparency related to a CCP's pricing structure, as well as appropriate levels of management independence from board members and from clearing members. Ultimately, we believe that CCPs should have appropriate resources and infrastructure to prevent its failure.

MFA believes, however, that legislation should mandate that the composition of a CCP's Risk Committee include non-dealer, client representatives, instead of the approach provided in

the Consultation, whereby a Risk Committee only includes representatives of clearing members and independent administrators, while limiting clients to an advisory role. Without such a mandate, a CCP may not take into account the views of all market participants. Given that the non-dealer, OTC derivatives counterparties represent effectively 50 percent of the OTC derivatives market in terms of trading volume,[2] their absence from a CCP's Risk Committee would be material, with critical decisions being made without the input of such a significant group. In our view, these measures will foster confidence in the CCPs and their governance structure, and further encourage clients and other end users to centrally clear their derivatives contracts. These measures will in turn reduce the interconnectedness that results from excessive credit exposure caused by transacting through a limited number of derivatives dealers.

In addition, MFA supports the requirement that CCPs establish categories of admissible clearing members and non-discriminatory, transparent and objective admission criteria. This requirement will ensure that all market participants have fair, objectively risk-based and open access to CCPs. We also believe that client access must be supervised to allow the clearing of transactions executed both between clients and CCP clearing members, as well as between clients and executing brokers that are not CCP clearing members.

5. *Do stakeholders share the approach set out above on segregation and portability?*

MFA generally supports the Commission's rule requiring each clearing member to distinguish and segregate in accounts with the CCP the assets and positions of that clearing member from those of its clients. We believe that this rule must be mandatory for all cleared derivatives contracts.

MFA has consistently advocated for the protection of client positions and collateral (specifically, initial margin), as well as for the portability of cleared client contracts (as discussed in the paragraph immediately below).[3] MFA believes that the protection of customer positions and collateral in a central clearing regime is critical to the success of central clearing initiatives and the reduction of counterparty risk and systemic risk. MFA urges the Commission to impose rules that would require: (i) derivatives dealers and CCPs to segregate initial margin in accounts that are separate and apart from the assets of such dealer or CCP and completely remote from the insolvency of such dealer or CCP; and (ii) CCPs to move client positions in the event of the

[2] *See* Bank of International Settlements, OTC Derivatives Market Activity in the First Half of 2009 at 8 (2009), http://www.bis.org/publ/otc_hy0911.pdf?noframes=1. A large portion of dealer-to-dealer volume does not represent risk taking by the dealers, but rather trades used by dealers to offset risk assumed in dealer-to-client trades, or for price discovery. If the concentrated group of dealers traded only with each other, they would be engaging in trading activity with no financial benefit. Stated differently, a significant level of dealer trading activity is motivated by the dealers' ability to earn profits from their non-dealer, OTC derivatives clients.

[3] *See* MFA's letter to the U.S. Securities and Exchange Commission, U.S. Treasury and U.S. Commodity Futures Trading Commission dated December 23, 2008; MFA's written statement before the U.S. House of Representatives Committee on Financial Services' hearing entitled, "Reform of the Over-the-Counter Derivatives Market: Limiting Risk and Ensuring Fairness" on October 7, 2009; MFA's letter to the U.K. House of Lord's dated February 1, 2010; MFA's letter to the U.S. Treasury dated February 12, 2010. All of these materials can be viewed on MFA's Web site at www.managedfunds.org.

insolvency of a clearing member. In our view, these rules would greatly reduce counterparty and systemic risk associated with the trading of OTC derivatives through a CCP. Additionally, we encourage the Commission to take steps to ensure that the insolvency regimes of European and third party countries do not interfere with the access of clients in the event of a CCP, dealer or defaulting client insolvency.

In addition, positions and initial margin should be portable, without incurring "unwinding costs", at all times, not only in the event of a clearing member's insolvency. Portability of positions and margins achieves critical systemic risk reduction goals by allowing clients to swiftly collapse offsetting positions, and thus, secure optimal netting of their portfolios at any point in a derivatives contract lifecycle. Portability also allows counterparties to timely transfer risk away from clearing members they view as having increased counterparty risk.

Lehman Brothers' failure demonstrates the reasons why a rule requiring segregation of client collateral would reduce counterparty and systemic risks. In our view, a requirement for clearing members to segregate client collateral would have lessened the impact of Lehman Brothers' bankruptcy. At that time, Lehman Brothers and other derivatives dealers did not segregate client collateral, and instead used it as an inexpensive source of financing. As a result, when Lehman Brothers collapsed, its clients' collateral was absorbed as part of its bankruptcy estate and its derivatives clients became general creditors. Lehman Brothers' failure tied up hundreds of millions of dollars of its clients' collateral for an indefinite period of time, limiting the amount of working capital available in the financial system during a critical period and resulting in uncertainty as to when and/or how much collateral would be returned to its clients. In addition, Lehman's failure caused broader market fear as OTC derivatives market participants became concerned about the safety of their collateral held by other dealers, which used practices similar to those of Lehman Brothers. These concerns weakened market stability as derivatives market participants acted quickly to protect their assets from further counterparty exposure, removing even more capital from the system.

6. *Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular: […] Should the default fund be mandatory and what risks should it cover?*

MFA believes that the Commission's legislation should require all CCPs to establish a default fund. A default fund would help ensure that CCPs have the appropriate financial resources to minimize risk of such CCP's failure. By definition, CCPs are systemically significant entities, and therefore, it is essential that the Commission impose rules to ensure the viability and proper functioning of CCPs that operate in Europe. MFA also believes each CCP's methodology for determining margin and pricing should be transparent, objectively risk-based and publicly available to all market participants.

7. *Do stakeholders share the general approach set out above on the recognition of third country CCPs? Are the suggest criteria sufficient?*

MFA has a strong interest in ensuring that any regulatory reform in the European Union addresses counterparty and systemic risk, while permitting competition among CCPs organized in non-European countries. For that reason, we believe that the Commission's three criteria for the recognition of non-European CCPs to provide clearing services in the European Union are sufficient and will balance the Commission's desire to mitigate risks while permitting competition. Specifically, we agree that, before CCPs based in non-European countries are permitted to provide clearing services in the European Union: (i) those CCPs should be authorized and subject to effective and stringent supervision by non-European regulators; (ii) the Commission should be able to formally decide whether to recognize the OTC derivatives regulatory frameworks of non-European countries; and (iii) appropriate cooperation agreements must be in place between the relevant competent authorities.

8. *Do stakeholders agree with the extension of the clearing obligation to contracts cleared by third country CCPs to ensure global consistency?*

MFA supports the Commission's proposal allowing third country-based CCPs to provide clearing services to entities established in the European Union. We believe that legislation should not force segmentation of the market based on jurisdiction, and we do not believe it is appropriate to place jurisdictional-based requirements on central clearing.

Reporting Obligation and Requirements for Trade Repositories

9. *What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories?*

MFA strongly supports the reporting of non-cleared, OTC derivatives contracts to trade repositories. However, MFA does not support either option presented in the Consultation with respect to trade reporting. Instead, MFA believes that, when entering into, modifying or terminating a trade between a derivatives dealer and an end user, the dealer should be obligated to report each derivatives contract to a trade repository. As a function of their role as market makers and as noted above, in general, there is a derivatives dealer counterparty in every derivatives transaction. In addition, each derivatives dealer already has established robust systems for reporting and risk management, which could be utilized for regulatory reporting to the extent that these systems are not already used in this regard. Requiring individual end users to report these trades to a trade repository is not efficient by comparison, since individual end users generally do not have similar reporting systems in place. In practice, a reporting requirement for derivatives dealers could be easily and quickly implemented. We believe that in the rare instance of a trade between two end users, both participants to the trade should be required to report.

Although not explicitly discussed in the Consultation, MFA believes that legislation should require public end-of-day reporting of cleared and non-cleared transaction data. Specifically, CCPs and trade repositories should report transaction volumes, CCP settlement prices and, for non-cleared trades, weighted average transaction prices for each traded instrument and tenor, subject to exceptions or delays if reporting could expose the positions of individual holders or impair trading in a given instrument due to the size of a trade or the illiquidity of the market in that instrument. We also believe, however, that any publicly disclosed transaction data be subject to such confidentiality protections as are permitted by law and only be released in a manner that will not reveal individual proprietary trading information.

Finally, we believe that the Commission should establish a "reasonable threshold" or "nexus" requirement for European Union member states to gain access to data from a trade repository. Such a requirement would appropriately balance the proprietary nature of market transactions with the Commission's overall goals and objectives.

Conclusion

MFA appreciates the opportunity to provide comments in response to the Consultation. MFA supports efforts to create more efficient OTC derivatives markets, reduce risks and protect the stability of the global financial system. We are committed to being a constructive participant in the regulatory reform discussions in the European Union and to working with the Commission as it continues its legislative process. Please feel free to contact Carlotta King or the undersigned if you have any questions or would like to discuss the foregoing.

Respectfully submitted,

/s/ John G. Gaine

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/s/ Stuart J. Kaswell

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