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

November 9, 2009

The Honorable Neal S. Wolin
Deputy Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: MFA Comments to the "Over-the-Counter Derivatives Markets Act of 2009"

Dear Deputy Secretary Wolin:

Managed Funds Association ("MFA")[1] appreciates the work of the Obama Administration in preparing the "Over-the-Counter Derivatives Markets Act of 2009" ("DMA"). As policy makers continue to consider reforms to the regulatory framework underpinning the over-the-counter ("OTC") derivatives market and our capital markets generally, we appreciate opportunities to provide perspective on those issues and on our industry. Accordingly, we respectfully offer a number of comments to the DMA, which we believe are consistent with its public policy goals and will further enhance the benefits of OTC derivatives regulation.

MFA's members are among the most sophisticated institutional investors and play an important role in our financial system. They are active participants in the commodity, securities and OTC derivatives markets.

MFA supports many provisions of the DMA. In general, we believe that it is important for Congress to establish an overall framework for derivatives transactions. We are fully supportive of the DMA's public policy goals, including: (1) reducing systemic risk by mandating the use of central clearing houses; (2) requiring the segregation of initial margin or delivery of variation margin; (3) increasing public and regulatory transparency through trade and position reporting; and (4) providing the government with additional authority to institute more effective regulatory oversight over derivatives market participants to avoid financial turmoil. Nonetheless, we believe that there are some portions of the legislation that do not fully achieve these goals. We respectfully offer some suggestions on improvements to the DMA.

[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. For more information, please visit: www.managedfunds.org.

II. The Registration of Swap Dealers and "Major Swap Participants"[2]

MFA favors the registration and regulation of swap dealers along the lines provided by the DMA, with governmental oversight of swap dealers in a manner consistent with its oversight of securities dealers. We believe that such registration and the related requirements — such as trade and position reporting — will largely close the regulatory gaps that exist in the OTC derivatives market since virtually all swaps transactions are effected with a swap dealer. In particular, the reporting requirements imposed on swap dealers will do much to assure that all material information is available to the responsible regulators. We understand that the swap dealer registration requirement is part of a policy to ensure that regulators have effective oversight of the derivatives market and therefore may be able to forestall a major market event that could jeopardize the stability of the overall economy.[3]

For these reasons, the DMA also would impose a registration requirement on a new category of registrant, the "major swap participant".[4] Failure of such a market participant, such as AIG, could cause significant credit losses to other participants in the financial system. Although we do not necessarily agree with the idea of regulating major swap participants, we share the concern underlying this approach. In MFA's view, the public policy justification for regulating major market participants depends on the potential for harm that they could cause to counterparties by their failure, which in turn, could cause cascading economic failure. Accordingly, MFA believes that the definition of major swap participant should reflect this by focusing on market participants or end-users that have unsecured net exposure with respect to swaps on an aggregate basis across counterparties (*i.e.*, when a counterparty does not post initial or variation margin). Market participants that have fully collateralized their exposure on an initial and ongoing basis no longer present substantial risk to their counterparties. We believe it is important that the DMA narrow the term "substantial net position" by including the term "unsecured" (*i.e.*, "substantial unsecured net position") to limit the definition of a major swap participant to those entities that inject significant risk into the financial system. For example, because AIG had a AAA credit rating, it was able to establish enormous swap positions that were both uncollateralized and unsecured; and because its positions were uncollateralized and unsecured. A swap participant that does not post collateral or margin with its counterparties is a much greater risk to its counterparties and to the system, because its counterparties are unprotected in the event of the swap participant's default.

The DMA amends the Securities Exchange Act of 1934 (the "Exchange Act") and the Commodity Exchange Act (the "CEA") respectively to grant an extraordinary level of authority granted to the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") (together the "Agencies"), materially exceeding their existing

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[2] Unless the context otherwise requires, we use the term "swaps" to refer both to commodity "swaps" that would be regulated by the Commodity Futures Trading Commission under the DMA and to "security-based swaps" that would be regulated by the Securities and Exchange Commission.

[3] *See* DMA sections 717 and 753(d).

[4] *See* DMA section 711(a)(4), which provides that "[t]he term 'major swap participant' means any person who is not a swap dealer and who maintains an effective hedge under generally accepted accounting principles, as the Commission and the Securities and Exchange Commission may further jointly define by rule or regulation.".

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authority. The amendments would provide the Agencies with the authority fully to regulate end-users as if they were dealers, including the authority to regulate end-user capital.[5]

With respect to the registration of non-dealer entities, a definition that is focused more precisely on credit risk will better serve the Administration's objectives of reducing risk to the economy while preserving the availability of OTC derivatives as appropriate risk-management tools. Under the DMA's overly broad definition—which does not hone in on credit risk—the users regulated as major swap participants could potentially include insurance, energy and airline companies, utilities, private funds, pension plans and local governmental entities. Developing and imposing regulations, including capital regulations[6], on entities engaged in such diverse tasks, and doing so without impairing the new registrants' ability to operate, would be difficult, if not impossible, to implement. Accordingly, the Agencies should not undertake to require the registration of non-dealer entities as a routine matter. Should there be a situation where the Agencies believe it prudent and materially beneficial to require the registration of a non-dealer entity as a major swap participant, we believe that the Agencies should not be required by the DMA to impose capital restrictions on such major swap participant.

In sum, while we would generally regard the registration of non-dealer entities as an extraordinary measure, and one difficult to implement, we understand that the regulators seek the authority to do so under appropriate circumstances. In our view, these circumstances might potentially arise when a swap market participant becomes of such importance and dominance that it is effectively able to dictate to other market participants, including to swap dealers, that they accept the dominant market participant's credit risk arising from swap transactions. Accordingly, we believe the definition of major swap participant in the DMA should allow the Agencies to address the credit risk that may be created by a dominant market participant's demand for unsecured credit, whatever type of entity that dominant market participant may be; *e.g.,* whether a private fund such as a Long Term Capital Management, a corporation such as an Enron Corporation, or a thrift and insurance holding company such as an American International Group.

In order to assure that major swap participants can be identified, we would propose to require that registered swap dealers be required to report to their relevant regulators any counterparty, other than another swap dealer, to which they have unsecured current credit exposure and the amount of such exposure. By aggregating the reports that they receive from swap dealers, the regulators will be readily able to determine if there is any entity whose registration they ought to consider as a major swap participant.

III. Central Clearing, Segregation and Portability Requirements

We support the mandatory clearing of standardized swaps entered into after the date that the DMA is enacted.[7] The primary purpose of derivatives clearing organizations is to lessen systemic risk by reducing the interconnectedness that results from too much credit exposure

[5] *See* DMA sections 711, 717, and 753.

[6] Capital and margin serve the same purposes: to prevent losses to counterparties. Both are tools intended to prevent credit losses from directly creating losses to counterparties that ultimately lead to systemic risk. The imposition of capital requirements on non-banking market participants, however, may impair the ability of these participants to operate effectively and efficiently.

[7] *See* section V. of this letter for a discussion of the definition of "standardized" and "standardization".

flowing through a limited number of dealers. Central clearing reduces the number of obligations throughout the derivatives market and establishes a new center of risk management. MFA believes that the DMA should encourage broader use of derivatives clearing organizations by all market participants. In our view, non-dealer market participants should have access to clear their OTC derivative transactions either directly as clearing members (to the extent they satisfy the membership standards of the derivatives clearing organization), or indirectly vis-à-vis a clearing member.

In addition, we strongly support requiring that registered derivatives clearing organizations hold initial margin of their participants and that the DMA prohibit clearing organization members from having access to the initial margin of their customers or commingling their proprietary assets with those of their customers. We recommend that the DMA include a legal framework that protects those assets from the insolvency of a clearing member. It is also critical that if a clearing member becomes insolvent, the regulatory framework permits customer positions held at the insolvent clearing member be portable to another, solvent clearing member.

We hope that all market participants would be permitted to move their "legacy" standardized swaps (*i.e.*, those positions that customers establish before the date of enactment) to central clearing organizations. Nonetheless, we are concerned that the parties may have entered into these trades on the basis of understandings and economic arrangements that reflected then current law. We believe that if Congress mandates central clearing before addressing these concerns, such a requirement may be very disruptive to the market. For example, the initial margin requirements for a standardized, cleared trade may be linked (or "hedged") to the initial margin requirements for a non-standardized, non-clearable trade. In this instance, if this hedged trade was disrupted by a *post facto* change in law, we think there is the potential for market disruption that would outweigh the advantages of mandatory clearing for this existing business. For these reasons, we suggest that the DMA do the following: (1) exempt from the clearing requirement any new swap contracts that hedge legacy swap contracts, but would otherwise be clearable, until the legacy contracts mature or are unwound; and (2) expedite the transition of legacy trades into centralized clearing by creating inducements (*e.g.*, substantially better capital treatment for cleared trades), but any such provision should not penalize end-users relative to dealers.

Finally, with regard to clearing organizations, we agree with CFTC Chairman Gensler and others that for central clearing organizations: (1) governance arrangements should be transparent and take account of the views of all market participants; and (2) membership standards should be fair and open, including with respect to access by non-dealers.[8]

IV. Segregation of Customer Assets for Non-Cleared Transactions

Even if Congress imposes mandatory clearing of standardized swaps, MFA believes that there a market will continue to exist for customized products that cannot be centrally cleared. We believe that the DMA should include provisions to regulate appropriately non-cleared products.

The case in point is the failure of Lehman Brothers. The losses resulting from the failure of Lehman Brothers are astronomic. A large share of the money that was lost by the failure of Lehman Brothers was not that of Lehman Brothers' shareholders or even of its ordinary creditors

[8] *See*, for example, Remarks of Chairman Gensler, Regulatory Update, Natural Gas Roundtable Luncheon (October 27, 2009).

who had made an investment decision to lend money to that firm. Rather, the money lost was that of Lehman Brothers customers, including its swaps customers, who had posted collateral with Lehman Brothers that was not segregated.[9] MFA believes custodial customers should be protected from the imposition of investment risk. In this regard, MFA believes that initial margin posted by end-users on swaps is intended as a safeguard against failure; it ought not to be transformed by a swaps dealer into a disguised and forced investment by a customer into the assets of the swaps dealer.

To protect end-users against dealer default resulting in the loss of customer assets and collateral, the DMA should require that swap dealers offer their customers the availability of collateral segregation. We recommend the DMA require that customer collateral: (1) not become part of the estate of the registered swap dealer in the event of the insolvency, liquidation, reorganization, or similar event with respect to the registered swap dealer; and (2) be available for prompt return to the counterparty that provided such collateral and shall not be available to creditors of the swap dealer. We believe that the custodian holding the customer collateral should be an entity that is legally distinct from the swap dealer and, if such custodian is an affiliate of the swap dealer, such custodian must be able to demonstrate that it would be able to continue its custodial operations even in the event of the insolvency, liquidation, reorganization, or similar event with respect to the registered swaps dealer (*i.e.*, such entity would be bankruptcy-remote).[10]

Lastly, although we believe that adding provisions to the DMA that protect customer collateral would do much to reduce contagion and the systemic risk that arises from a dealer failure, the securities, commodity and banking laws would still not provide a consistent approach to the unwind of an insolvent swap dealer. For that reason, we believe it is necessary for Treasury and Congress to review and amend the Bankruptcy Code, the Securities Investor Protection Act, the Exchange Act, the CEA and the Federal Deposit Insurance Corporation Improvement Act in order to fully effectuate the protection of customer collateral.

V. Broad Definition of "Standardized"

Consistent with our view that mandatory central clearing is necessary to protect against systemic risk, we support a broad definition of the term "standardization" that will serve to prevent technical avoidance of a mandatory clearing requirement. Speaking very generally, we believe that the Agencies would in most cases find that a swap is "standardized" where it has been accepted for clearing by a registered clearing organization following a review by the appropriate committees of the registered clearing organization, including the clearing organization's risk management and operations committees.

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[9] We believe that there is in excess of $8,900,000,000 in customer assets still being held in Lehman Brothers International (Europe) ("LBIE"), which belongs to pension funds, endowments, hedge funds, and other large U.S. institutions whose beneficiaries are U.S. citizens.

[10] We do not believe that it is sufficient merely to mandate that the custodian of the initial margin be a separate legal entity from the registered swap dealer. As we have seen when Lehman Brothers failed, entities that are under a common holding company are near to inextricably related. If one entity under the holding company fails, that failure is very likely to spread to the other members of the group. If a swap dealer fails, it is likely that so will its affiliated custodian. Nonetheless, we did not want to eliminate wholly the possibility that an affiliated custodian might hold initial margin pledged to a swap dealer. For example, where the custodian is an entity that is engaged solely in a trust or custody business, and so does not require any material amount of financing to operate from day to day, it may be able to continue operations at least long enough to return collateral it holds to the appropriate owners.

More specifically, we believe that the Agencies should determine a swap to be "standardized" when it has: (1) common product terms/definitions (*e.g.*, ISDA product definitions); (2) common trade term and economic specifications (*e.g.*, in the case of a credit default swap, effective date, coupon, reference entity/reference obligations, established prices sources); and (3) common trading/market conventions. In addition, we believe that in order to be eligible for clearing on a registered derivatives clearing organization[11], a swap should be susceptible to clearing, valuation and margining within a registered clearing organization's established and approved risk management, pricing and collateral management practices.

VI. Transparency and Trade Reporting

MFA believes that price transparency, accomplished by trade reporting and by the reports of derivatives clearing organizations or repositories, is an essential feature of developed markets. Such transparency both protects end-users who may have more limited access to trading and price information than dealers and, it serves as a means to ensure that parties mark their positions accurately and do not transfer, or demand the transfer, of either too much or too little margin.

Insofar as the mechanics of trade reporting are concerned, we believe that the operations of the swaps markets should be consistent with the operations of the securities markets. In a trade that is accepted by a derivatives clearing organization, the derivatives clearing organization would report the trade and any related information to the regulators as required by them. For a non-cleared trade between a dealer and a non-dealer, only the dealer should be required to report both sides of the trade and any related information. Swaps dealers will necessarily have systems and operational procedures in place that will allow them to report promptly on all swaps to the relevant trade repository, and to provide such information as the Agencies may require, including, if required, the identity of the non-dealer party on a non-public confidential basis. Requiring the non-dealer party to trade report, in addition to the dealer, would not provide the Agencies with any additional information as to a swap. If it seems necessary to accomplish the purposes of the DMA, the Agencies should be given the authority to require that non-dealers report non-cleared swap transactions in those rare instances where non-dealers trade with each other and not with or through a dealer.

VII. Exchange Trading

MFA supports the goals of market transparency and enhanced liquidity. In this regard, we support the ongoing development of trading markets that respond to the needs of both swaps dealers and end-users, whether this is exchange trading, OTC trading, or, as we think will eventually likely be the case, a hybrid market that accommodates both exchange and OTC trading. Further in this regard, MFA supports the development of exchange-traded products as a complement to OTC products and we believe, that given the recent and significant efforts regarding product standardization and clearing, such products will steadily emerge in the marketplace. To the extent such products or exchange markets do not emerge over a reasonable

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[11] A "registered derivatives clearing organization" should be one that is registered with the relevant Agency or with a federal banking regulator pursuant to the DMA, as it may be ultimately revised and adopted. In addition, where a non-U.S. clearing organization will accept a standardized swap, market participants should also be able to clear through that non-U.S. clearing organization.

time period, the Agencies should undertake a study to determine whether there are artificial barriers standing in the way of the development of such products or markets.[12]

VIII. Position Limits with Respect to Commodities

As a general matter, we believe that there may be a public policy justification for position limits only in those circumstances when there is a limited supply of a commodity that is the subject of the contract, and because of that limited supply, there is a strong possibility of market manipulation. Accordingly, MFA believes that regulators should impose position limits only for physically-delivered commodities and only where the deliverable supply of the commodity is limited and, thus, subject to control and manipulation. On the other hand, where there is a nearly inexhaustible supply of the underlying commodity, concerns related to control and manipulation are largely irrelevant, making position limits an unnecessary and costly interference in markets.

It has long been recognized that cash-settled commodities markets do not raise the same market manipulation concerns as do physically-delivered commodities. Cash-settled commodities have deep and liquid markets, are primarily used for hedging and risk mitigation, and have little or no impact on consumers. We believe that the mechanical imposition of limits for cash-settled commodities will have the effect of reducing liquidity and the ability of commercial participants to hedge against future changes in price by limiting the ability of market participants to appropriately diversify and reduce risk.

IX. Position Limits with Respect to Securities

We strongly believe that Congress should not amend the Exchange Act to grant the SEC authority to set position limits on securities, either in the cash market or on securities-based swaps. Under the Exchange Act, securities investments and related transactions are regulated through disclosure, not by establishing limits on the size of permitted investments. That is, under the current regulatory regime, to the extent the size of investments is a concern, Section 13 of the Exchange Act imposes reporting requirements. To the extent that a purchaser's acquisition of securities presents anti-trust concerns, the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR") imposes restrictions and a pre-merger notification regime. Under the HSR, procedures are in place to monitor positions that may be anti-competitive.[13]

Giving the SEC the authority to set position limits on capital markets investments would be unprecedented. Any such extraordinary action should not be shoehorned into swaps legislation. Furthermore, it is not clear why, or on what basis, the SEC would impose position limits on investments in corporate issuers. In like regard, we do not think it good policy to revise Section 13(d) and related reporting requirements in legislation that is focused on derivatives without giving a much greater degree of consideration to how these statutory changes would impact the capital markets. For example, state anti-takeover laws, state and federal banking laws,

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[12] It should be noted that the determination as to whether a derivative is appropriate for central clearing and whether it is appropriate for exchange trading are two distinct questions. Central clearing — which provides significant pricing transparency and risk mitigation benefits — is appropriate for standardized OTC derivatives contracts, regardless of the liquidity associated with the trading of those contracts. In contrast, exchange trading is only appropriate for standardized OTC derivatives contracts that are also highly liquid.

[13] We also note that many specific industries have ownership restrictions in cases where it is viewed as beneficial to restrict ownership in these industries (*e.g.*, banks, airlines, and casinos).

executive compensation golden parachute arrangements and anti-takeover protections, such as "poison pills", all rely on Section 13(d)'s crucial distinction between true beneficial ownership and pure economic ownership. Before granting further authority to the SEC to discourage or prohibit transactions that may affect corporate issuers, we believe that policy makers should give more detailed consideration to how position limits and position reporting: (1) would affect capital formation, the ability of banks and other credit institutions to transfer risk; and (2) would make it more difficult for corporations to obtain credit; and (3) the effect that such requirements would have on the market for corporate control.

X. Operation of the DMA and the Authority of the Agencies

The proposed DMA gives the Agencies virtually no exemptive authority, on the one hand, while, on the other hand, the DMA prescribes a variety of specific detailed requirements such as the timing of the effective date when trade reporting is mandated. We are concerned that this combination will create problems that are likely to make compliance with the DMA within the specified timetables impossible, and, given, the absence of Agency exemptive authority, could require emergency legislation. We believe that the DMA should provide the Agencies with the general authority that they now exercise to grant such exemptions as are in the public interest and consistent with the purposes of the relevant statute. Further, there are likely to be many instances in which transactions that are within the literal scope of the DMA are not within the intended scope of the DMA, and thus the regulators should have authority to grant exemptions from any aspect of the DMA, and certainly as to the particulars such as trade reporting, whether an individual trade must be cleared, and the like. Further in this regard, we would suggest that the various details of the DMA are better left to the determination of the relevant regulators.

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XI. Conclusion

MFA and its members recognize the importance of reform of the regulatory framework that governs the derivatives market. We are committed to working with the Administration and Congress with respect to efforts that will restore investor confidence, stabilize our financial markets, and strengthen our nation's economy. We appreciate the Administration's efforts in working to address these complex issues, as we believe that it is critical for these issues to be addressed at the federal level, and for there to be appropriately harmonized regulation, both at the federal level and globally.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these, or other regulatory reform or market issues, please do not hesitate to contact Stuart J. Kaswell or me at (202) 367-1140.

Sincerely,

/s/ Richard H. Baker

Richard H. Baker
President and C.E.O.