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

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Ms. Akiko Ohnuma
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Financial Markets & Community Investment Team
441 G Street, NW
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Re: Follow-up to Managed Funds Association Interview on January 15, 2009

Dear Ms. Ohnuma:

Managed Funds Association ("MFA")[1] and its members truly appreciated the opportunity to speak with you and your colleagues at the U.S. Government Accountability Office ("GAO") on January 15, 2009 in connection with the GAO's examination of the risks and challenges presented by the credit default swaps ("CDS") market. We acknowledge and appreciate your efforts in compiling, analyzing and objectively reporting information on these products.

While we eagerly await the GAO's final report, we submit this letter to highlight and summarize several key points that MFA and its members made during the interview, as well as to present our perspective on some of the questions that we were unable to address during our discussion due to time constraints. We believe that it is important that we supplement the responses delivered during our telephone interview to assist the GAO in accurately and thoroughly meeting its task.

Key Points from Interview

During the interview, MFA and its members made the following key points regarding the CDS market, which we wish to highlight.

CDS Contracts Provide Significant Benefits to Market Participants. CDS contracts have improved our capital markets by enhancing risk transparency, price discovery and risk transferal. Market participants use the CDS market as a metric for evaluating real-time, market-based estimates of a company's credit risk and financial health; and it is in this way that the CDS markets provide risk transparency and price discovery. Market participants find that CDS market indicators are a superior alternative to relying on credit rating agency

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[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.

scores. CDS contracts also provide banks, dealers and other market participants with a tool to mitigate or manage risk by dispersing credit risk and reducing systemic risk associated with credit concentrations in major institutions. (We discuss this point in more detail below in response to Question 3.b.)

CDS Contracts Provide Significant Benefits to the Overall Economy. The CDS market has created significant benefits for the broader financial system. Specifically, CDS trading provides a mechanism through which banks and other lenders are able to transfer credit risks to other market participants that are willing to accept that risk. As a result, these banks and other lenders have the ability to engage in greater lending and corporate finance activities.

Risk Concerns Raised by Collateral Segregation. Current mechanisms for collateral management by dealers do not adequately protect their clients who pledge collateral (i.e., hedge funds and other investment managers). Ultimately, this lack of protection for client collateral greatly contributes to systemic risk. As we noted during our interview and in MFA's December 23, 2008 letter to the Federal Reserve Bank of New York ("New York Fed"), the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), protection of client collateral with respect to all bilaterally negotiated OTC derivatives should be incorporated into the existing transaction structure through the use of a segregated account, in the name of, and held for the benefit of, the client. This requirement would promote broader market stability and also mitigate counterparty risk.

The systemic risk implications of inadequate collateral management practices were recently seen in the weeks following the collapse of Lehman Brothers. The majority of Lehman Brothers' client assets were not segregated. Once Lehman Brothers was placed into bankruptcy, their clients became general creditors of the company, freezing up several billions of dollars of investment capital.

MFA Supports the Establishment of CDS Central Clearinghouses. MFA members are supportive of the establishment of one or more clearinghouse platforms for CDS, if they are appropriately structured to include, among other things: (1) open transparency and direct access; robust protection for customer collateral[2]; (2) standard terms with respect to when a CDS contract will terminate; (3) certainty and consistency of margin requirements across all market participants; (4) increased transparency of trade executions (*e.g.*, price), open interest, volumes, etc.; (5) legal certainty of trade confirmations; (6) product breadth for index and index-constituent single name CDS; (7) ability to easily novate or step-out of existing trades; and (8) independence and balanced representation in the governance of each clearinghouse by buy and sell-side market participants. It is noteworthy that many MFA members also would like to trade CDS on exchanges.

[2] After early discussions with certain clearinghouse platform providers, we are especially concerned that their operations will not adequately protect client collateral through segregated accounts.

Standardization versus Non-standardized CDS Contracts. Although the CDS market is relatively young as compared to other OTC derivatives, it has quickly achieved a level of standardization and trading efficiency, which has made it ripe for centralized clearing. We do not believe that statutes or rules should require that all OTC derivatives transactions be cleared through a central clearinghouse. Market participants must have the ability to trade bespoke and structured contracts and transactions outside of a central clearinghouse. Also, until other OTC derivatives products are standardized, it will be difficult to operate a central clearinghouse for those products.

Responses to Specific GAO Questions

For your convenience, we have organized in chronological order our responses to the questions presented by the GAO in advance of our interview.

3. Please describe how the CDS market has evolved in recent years. One of the biggest developments in the CDS market in recent years has been the dramatic growth in the use of credit derivatives, both as a risk transfer and investment tool. The CDS market originally started in 1997 as an inter-dealer market to exchange credit risk without selling the underlying debt obligations, but now involves varying financial institutions, such as hedge funds, traditional asset managers and insurance companies. Industry statistics estimate that the market has grown from $180 billion in notional amount in 1997 to $54.6 trillion in June of 2008.[3] The growth of the CDS market is often attributed to the fact that CDS contracts are highly liquid and are an effective investment tool for any market participant desiring to shift default risk to a third party.

The remarkable growth also put a strain on the industry's operational infrastructure since most CDS trades were documented using paper confirmations. The large volumes of papered transactions resulted in a high level of unconfirmed transactions and novations in 2004 (confirmation backlogs). As a result, in February 2005, the U.K. Financial Services Authority issued a "Dear CEO" letter to the major dealers, alerting them to the regulators' concerns regarding confirmation backlogs. The New York Fed and other regulators then began meeting with the major dealers in an effort to reduce backlogs during the course of 2005, all of which led to an industry-wide effort to improve market practices and the operational infrastructure for processing CDS trades and novations.

Since 2005, the industry has achieved a significant reduction in systemic and operational risks through drastic improvements and innovations to the CDS infrastructure and business and operational practices, including: (1) establishment of the DTCC Trade Information Warehouse for electronic confirmations of CDS trades; (2) creation of a central settlement facility; (3) industry-wide adherence to the ISDA Novation Protocol and the creation of electronic platforms for processing novation consents; (5) promotion of documentation standardization (*i.e.*, widespread use of a "matrix" of standard terms rather than negotiating master confirmations); (6) establishment of a successful auction-based mechanism that has been actively employed in cash settlement of 14 credit events, including

[3] See International Swaps and Derivatives Association's ("ISDA") 2008 Mid-Year Market Survey.

Fannie Mae, Freddie Mac, Washington Mutual and Lehman Brothers; and (7) promotion of several industry-wide commitments to establish central clearinghouses and clearing alternatives.

3.a. What changes have occurred since the recent crisis? There have been several significant and positive changes that have occurred since the recent crisis. In particular, as discussed above, there has been increased industry focus on establishing central clearinghouses to clear all electronically eligible CDS trades, as well as increased attention placed on counterparty credit risk and protection of collateral. In addition, the industry has expedited the development of an industry-wide CDS auction determinations protocol that will create standard procedures for the determinations of credit and succession events. Finally, the industry has worked together with regulators and electronic solution providers (*e.g.*, DTCC, Markitwire, T:Zero, *etc.*) to decrease overall trading volumes through portfolio compression and the elimination of offsetting trades. [4]

3.b. What are the important benefits that CDS provide to your funds or to markets generally? The benefits of CDS to markets and market participants are well-documented.[5] As stated above, hedge funds and other market participants extensively use CDS as a risk management tool. In addition, CDS provide a means of investing in credit markets by allowing investors to replicate bond and loan positions (*e.g.*, in cases where bonds or loans may not be freely available or accessible to hedge funds). Compared to bond market, the CDS market is more liquid and has greater number of pricing sources. CDS also provide real time, market-based information regarding the financial health of a company. As a result, they are often more reliable, timely than credit ratings. Finally, CDS provide a risk transfer tool through which banks and lenders can engage in expanded lending and corporate finance activities.

3.c. In your experience, what share of CDS is used for risk management versus speculative purposes? Hedge funds and other market participants use CDS to reduce the risk of their portfolios and achieve different investment strategies. No industry data currently exist, however, that provide the percentage of CDS used for hedging versus non-hedging or investment purposes. On this point, we believe that it is important to emphasize that without investment capital in the CDS market, market participants wishing to hedge their positions through CDS would find few, if any, market participants to take the other side of CDS contracts. Thus, market participants who purchase CDS for non-hedging or investment purposes provide necessary depth and liquidity to the market.

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[4] According to ISDA's 2008 Mid-Year Market Survey, the notional amount outstanding of CDS dropped by 12 percent to $54.6 trillion in the first half of 2008.

[5] See the President's Working Group on Financial Markets' ("PWG") Statement on Financial Market Developments (March 13, 2008) at www.ustreas.gov/press/releases/hp871.htm; and the PWG's more recent Initiatives to Strengthen OTC Derivatives Oversight and Infrastructure (November 17, 2008) at www.ustreas.gov/press/releases/hp1272.htm. See also the testimony of Patrick M. Parkinson, Deputy Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System before the House Committee on Agriculture regarding credit derivatives on November 20, 2008.

We also believe it is important to note that the media and even some policy makers inappropriately associate the term "speculation" with high-risk investing on the basis of incomplete information. It is our view that this term as used in the context of the CDS market has developed an unfair and negative connotation. Merriam Webster defines "speculation" as the "assumption of unusual business risk in hopes of obtaining commensurate gain." Following a plain language reading of this definition, not all investments can be properly characterized as speculation. It is unlikely that every investment in a stock or bond would be considered "speculating". Indeed, hedge funds and other market participants often invest in CDS in the same way they invest in stocks, bonds, private equity, real estate, *etc*.

15. Is your firm a member of the Operational Management Group ("OMG") or Counterparty Risk Management Policy Group ("CRMPG")? If so, what role has your firm played in those initiatives? MFA fully supports collaborative industry-wide efforts and partnerships with regulators, like the New York Fed, SEC and CFTC to develop solutions to promote sound practices and to strengthen the operational infrastructure and efficiency in OTC derivatives trading. For several years, MFA and some of its members have been active participants in the OMG. Last year, MFA co-signed three OMG letters in March, July and October to U.S. and non-U.S. regulators detailing industry-wide operational targets and commitments. In June, MFA and other members of the OMG met with then New York Fed President Timothy Geithner and other U.S. and international industry regulators to review published commitments and the industry's progress to date, as well as to present a comprehensive buy-side implementation plan, which set forth objectives for the broader buy-side trading community in improving operational efficiency in the CDS market.

To advance the industry-wide commitments established by the OMG, MFA co-sponsored with other industry groups five educational events over the last year, including one seminar event in New York that drew over 250 professionals from asset management and dealer firms plus more than 325 call-in participants and a radio call that drew over 930 industry professionals and regulators. At these events, MFA members, the major dealers and representatives from other trade associations communicated and answered several questions regarding the important goals developed by the OMG to improve the trading and processing of CDS and mitigate operational and systemic risks.

MFA and its members have also participated in a number of industry initiatives organized by ISDA to drive stability in the CDS market. These initiatives have focused on standardizing the transaction documentation and industry practices related to CDS trading (*e.g.*, the development of a CDS auction protocol).

With respect to the CRMPG, some MFA members have participated in each of the three CRMPG projects. Their involvement in, and results of, those projects, however, was less apparent. That is, the dealers controlled the CRMPG discussions and they were not very receptive to input from hedge funds and other investment managers.

15.a. What successes or challenges have you faced in instituting any of these policies or recommendations? Following the OMG and CRMPG's release and publication of their respective commitments, policies and recommendations, dealers and purchasers and sellers of CDS have reduced their confirmation backlogs dramatically on an industry-wide basis (*e.g.*, achievement of 92 percent aged-confirmation backlog reductions for CDS notwithstanding volume increases of over 300 percent since 2005; increased rate of electronic confirmation automation for CDS from 19 percent in 2006 to 95 percent in 2008). In addition, these changes have made novation processing far more efficient. In fact, the industry is now transitioning to the exclusive use of electronic platforms to process CDS novation consent requests.

15.b. How much progress has been made with the electronic processing efforts for CDS and other OTC derivatives? In recent years, the OMG and other industry-led initiatives have made notable progress in the OTC derivatives space. Some of the more recent market improvements and systemic risk mitigants—many of which were referenced above—have included: (1) the reduction by 80 percent of backlogs of outstanding CDS confirmations since 2005; (2) the establishment of electronic processes to approve and confirm CDS novations; (3) as mentioned above, the establishment of DTCC's Trade Information Warehouse to document and record confirmed CDS trades and of a successful auction-based mechanism to allow for cash settlement of credit events; and (4) the reduction of 74 percent of backlogs of outstanding equity derivative confirmations since 2006, and 53 percent of backlogs in interest rate derivative confirmations since 2006.

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MFA welcomes the opportunity further to discuss any of the points made above and would be pleased to respond to any additional inquiries from the GAO. In addition, to the extent that the GAO plans to share a preliminary draft of the report or specific excerpts therefrom, we would be happy to offer our assistance during the editing process. If you have any questions or comments, please do not hesitate to contact me at (202) 367-1140.

Respectfully submitted,

C. E. Kennedy

Carl Kennedy
Legal Counsel