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

February 22, 2011

Via Electronic Submission: http://comments.cftc.gov
http://www.sec.gov/rules/proposed.shtml

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

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

Re: RIN No. 3038-AD06; RIN No. 3235-AK65: Further Definitions **of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major** Security-**Based Swap Participant" and "Eligible Contract Participant"**

Dear Mr. Stawick and Ms. Murphy:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments on the rules proposed jointly by the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") (together, the "Commissions") regarding their proposed rule on the further definitions of "swap dealer", "security-based swap dealer", (separately or collectively, "SDs") "major swap participant", "major security-based swap participant" (separately or collectively, "MSPs") and "eligible contract participant" ("ECP")[2]

[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 $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Joint Proposed Rule; Proposed Interpretations "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participant'", Fed. Reg. 80174, December 21, 2010 (the "**Proposing Release")**, available at http://www.sec.gov/rules/proposed/2010/34-63452.pdf).

(the "Proposed Rule") under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3]

I. General and Summary

As the Commissions recognized in the Proposing Release[4], the way in which these important terms under the Dodd-Frank Act are defined will significantly affect the evolving markets for swaps and security-based swaps (together, "Swaps") and the conduct of participants in these markets. MFA supports the Commissions' general approach to the definitions as set forth in the Proposed Rule. We are submitting this comment letter to request further guidance on, and recommend changes to, certain aspects of the Proposed Rule. Our intention is to assist the Commissions in adopting a final rule that, taking into account reasonable projections in market activity and growth, captures the intended market participants, consistent with the goal of monitoring and overseeing entities that could pose systemic risk to the United States financial markets.

In particular, in our effort to assist the Commissions, we make specific suggestions relating to the "potential future exposure" test that forms part of both the determination of what constitutes a "substantial position" in a major category of Swaps and what constitutes "substantial counterparty exposure".[5] The Dodd-Frank Act directs the Commissions to define "substantial position" and "substantial counterparty exposure" at the threshold that they determine to be prudent for the effective oversight of entities that are systemically important.[6] Based on the definitions as proposed, many market participants will need to perform the calculations with some regularity to evaluate whether their Swap exposure has exceeded the MSP thresholds, which creates an additional cost and time burden that seems unwarranted for entities that do not pose a systemic risk. Accordingly, we believe that the Commissions should study the scope of the definitions to ensure that these definitions do not encompass such entities.

Finally, although the substantive requirements applicable to an MSP or SD are not the subject of the Proposing Release, we respectfully urge the Commissions not to impose the same obligations on MSPs and SDs under the final rules. The characteristics of, and systemic risk posed by, SDs and MSPs diverge significantly. Generally, SDs are dealers that make markets and have customers, whereas MSPs are, by definition, not dealers but market participants who have substantial positions in Swaps, such that the entity could significantly impact the financial system of the United States. We agree with the Commissions that SDs' distinct role in the Swap markets and the fact that they are entities that regularly hold themselves out as dealers may warrant imposing a broad range of requirements on them. Imposing broad dealer-like requirements on end users who qualify as MSPs will significantly and unintentionally limit end-users' business activities, and perhaps the markets more generally. We believe regulation of

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3 Pub. L. 111-203, 124 Stat. 1376 (2010).

4 Proposing Release at 80175.

5 *Id.* at 80188 and 80197.

6 *Id.* at 80186 and 80198.

MSPs should focus on mitigating default risk. As a result, as the Commissions adopt final rules related to MSPs, we urge them to tailor the requirements appropriately to reflect MSPs' role in the markets.

II. Definitions of "Major Swap Participant" and "Major Security-Based Swap Participant"

With respect to application of the MSP definitions, the Proposed Rule: (i) provides two tests[7] that determine whether an entity maintains a "substantial position" in any "major" category of Swaps; and (ii) sets forth different thresholds for each test that provide certain discounts based on the Commissions' standards for the relative riskiness of the entity's positions. MFA welcomes the use of objective standards. We also believe that the application of thresholds should complement, not serve as a substitute for, the consideration of certain risk-mitigating tools that hedge fund managers routinely use. Therefore, as we will discuss more specifically below, we recommend that the Commissions modify the proposed tests to use a potential future exposure calculation that is consistent with standard industry practices for measuring risk, such that the tests will more accurately capture the scope of participants that could pose systemic risk. Regardless of the final rules that the Commissions adopt, we believe that the inclusion by the Commissions of example "potential future exposure" calculations in the adopting release would greatly assist any market participants that may need to perform this calculation as part of their compliance efforts.

A. Credit for Over-Collateralization to Offset Potential Future Exposure

The Proposing Release requests public comment on whether the Commissions should allow over-collateralized current positions to offset potential future exposure.[8] We understand that, as proposed, the "current uncollateralized outward exposure" test fully takes into account an entity's over-collateralization of its positions. However, MFA strongly believes that the amount by which an entity over-collateralizes its current positions should also offset its potential future exposure. It is important that the Commissions' final rules fully reflect and encourage the routine practice of over-collateralization.

It is common practice for a hedge fund's counterparties to require the fund to post an "independent amount" of collateral (*e.g.*, initial margin in the context of ISDA Master Agreements) in an amount that exceeds the current mark-to-market exposure of the fund's portfolio. As a general matter, these amounts protect the counterparty against any potential future losses. On any given day, a hedge fund's over-collateralization of current exposures is approximately equivalent to posted independent amounts, as daily mark-to-market changes and the exposures that the fund creates result in daily variation margin calls. Thus, since the purpose of independent amount is to protect a fund's counterparty from potential future exposures and

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[7] The first test measures a person's current uncollateralized outward exposure, while the second test measures a person's combined current uncollateralized outward exposure and potential future outward exposure. *See id.* at 80188-99.

[8] *Id.* at 80193.

over-collateralized amounts further mitigate losses resulting from default, MFA strongly believes that the Commissions should permit market participants to receive full credit in calculations of potential future exposure for their over-collateralized positions.

We also agree with the Commissions that the final adopted rules should not prescribe any particular methodology for the valuation of collateral[9] because the value of collateral and credit for over-collateralization should be calculated in accordance with standard industry practice. Mandating a particular methodology that does not evolve over time would likely cause such methodology to deviate from evolving market practice and would likely impose significant additional costs on market participants.

B. Potential Future Exposure Discount for Centrally Cleared Positions

The Proposed Rule prescribes an 80% discount factor for centrally cleared positions for purposes of the potential future exposure calculation. MFA strongly believes that the Commission should exclude centrally cleared Swaps from the calculation of potential future exposure because such positions should pose little or no systemic risk to the financial system.

In the Proposing Release, the Commissions state that they considered but rejected a full exclusion for positions subject to central clearing "because clearing may not entirely eliminate the risks posed by an entity's potential default."[10] We respectfully request that the Commissions reconsider their position on cleared Swaps. Clearinghouses employ many safeguards with respect to cleared Swaps in order to protect themselves and the market against the risk of clearing member defaults, including:

- requiring clearing members to provide the clearinghouse with margin sufficient to fully collateralize the clearing member's cleared Swaps positions;
- adjusting initial margin daily and variation margin at least daily in order to account for daily volatility and other risk factors;
- a robust, transparent daily mark-to-market process;
- using their discretion to make more frequent adjustments in times of stress; and
- employing supervised risk systems supported by risk mutualization.

Indeed, the Proposing Release acknowledges that mark-to-market margining helps to control risk and the Dodd-Frank Act promotes the central clearing of Swaps to an extraordinary degree because clearing effectively eliminates the default risk posed by dealers.

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[9] *Id.* at 80189.

[10] *Id.* at 80192.

In our view, the Commissions should incentivize central clearing by providing for a full exclusion of centrally cleared Swap positions from the calculation of potential future exposure. In the alternative, and regardless of how the 80% discount factor would operate in combination with any risk factor multipliers, MFA submits that the Commissions should set the discount factor as an independent variable at a level significantly higher than 80%. Specifically, we recommend setting the discount factor in the range of 95% - 99% in recognition of the very limited risk discussed above.

C. Tools of Credit Protection and Other Considerations

We appreciate the Commissions' efforts under the Proposed Rule to establish a "reproducible test" by building upon bank capital standards. We have seven specific recommendations that we believe are consistent with the Commissions' intent to focus on entities that pose systemic risk. We believe these changes reflect market practices and the way in which market participants manage risk.

First, we note that the Proposed Rule does not seem to allow Swaps other than credit default Swaps ("CDS") or index CDS (for which the Proposed Rule caps the exposure at the net present value of unpaid premiums) to reduce potential future exposure.[11] This outcome is cause for concern because many hedge funds mitigate their portfolio risk by entering into Swaps in a wide array of forms (not just CDS). Thus, MFA believes that the proposed discount for credit protection is too limited, and that the potential future exposure for any position with a fixed downside risk (such as the fixed portion of an interest rate Swap) should not exceed the net present value of the remaining unpaid premiums due under the position.

Second, MFA supports allowing holders of credit protection to apply a discount rate to the value of the unpaid premiums for CDS for purposes of the potential future exposure calculation.[12] One possible discount rate is a LIBOR/Swap rate for the applicable currency for the maturity of the Swap, which is the market-standard discount rate used to calculate the net present value of cash flows on Swaps. Additionally, we recommend a further discount (*e.g.*, 50%) to the net present value of unpaid premiums. We would not expect credit spreads to tighten significantly during times of heightened systemic risk. Therefore, if a market participant were to experience significant losses on bought CDS protection due to credit spreads tightening and simultaneously were unable to post collateral, the market should be able to absorb the losses because a tightening of credit spreads implies a healthy credit environment.

Third, the Commissions should treat CDS linked to a single-name reference entity differently from those linked to an index reference entity because the volatility and jump-to-

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[11] *Id.* at 80192. Although the Proposing Release states that, "the proposed measures . . . contain adjustments for certain types of positions that pose relatively lower potential risks", it omits reference to any type of credit protection that poses risks as low as CDS and index CDS. *See* proposed rule 1.3(sss)(3)(ii)(A)(4) under the Commodity Exchange Act ("CEA"); proposed rule 3a67-3(c)(2)(i)(D) under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

[12] Proposing Release at 80192.

default risk associated with an index CDS is much lower than that of a single-name CDS. For example, the final rule could permit buyers or sellers of CDS linked to an index reference entity to apply a risk factor multiplier lower than 10%.

Fourth, hedge fund managers routinely evaluate the risk exposure of the funds they manage by taking into account the riskiness of any underlying reference entity on the fund's Swap positions. Under the Proposed Rule's potential future exposure calculation, the risk factor multiplier for credit Swaps is 10%, without regard to the riskiness of the underlying reference entity. We believe that consistent with market practice, the risk factor multiplier for credit Swaps should vary based on the riskiness of the underlying reference entity. For example, high yield credit Swaps could have a risk factor multiplier of 10%, whereas investment-grade credit Swaps could have a risk factor multiplier of 5%. We believe that the Commission should allow the risk factor multiplier to vary in this manner because it is necessary for the calculations to take into account different risk exposures for debt securities.

Similarly, the Proposing Release provides that any risk adjustment for credit Swaps based on the riskiness of the underlying reference entity cannot rely on credit ratings to measure such riskiness.[13] We suggest that the Commissions consider and adopt a metric that they view as the best measure of risk. One suggestion would be to use credit spreads rather than credit ratings as a proxy for riskiness. For example, the Commissions could consider five year spreads of less than or equal to 500 basis points as "investment grade", and five year spreads of greater than 500 basis points as "high yield" for purposes of applying different risk factors. This approach would parallel the current distinction in bank capital standards based on whether the underlying reference entity of a credit derivative is "investment grade" or "non-investment grade". It would also parallel the approach taken in certain approved margin methodologies.[14] Alternatively, since the SEC is in the process of identifying alternatives to credit ratings for use in a variety of contexts pursuant to a rulemaking under Title IX of the Dodd-Frank Act, the Commissions could use the alternative measure identified in that rulemaking to distinguish between high yield and investment-grade credit Swaps for purposes of the risk adjustment factor.

Fifth, we note that the risk factor multipliers in the Proposing Release are different for each category of Swaps of different maturities, other than credit Swaps. Since Swaps – even those based on instruments of indebtedness – are less risky if they mature sooner rather than later, it is unclear why the Proposed Rule would exclude the holders of credit Swaps from the benefit of a further downward adjustment if such instruments mature in less than five years. Notwithstanding that bank capital standards may not have drawn this particular distinction, it seems only appropriate in light of the goals of the Dodd-Frank Act that the final rules incorporate this point.[15] Thus, MFA requests that the Commissions establish different risk factor multipliers

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[13] *Id.* at 80193.

[14] For example, the Chicago Mercantile Exchange Inc.'s ("CME") portfolio margin methodology for CDS calibrates certain risk factors based on basis point spread, as do margin requirements prescribed by the Financial Industry Regulatory Authority, Inc. ("FINRA") for broker-dealers that do not rely on the CME methodology. *See* FINRA Rule 4240: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118837.pdf

[15] *See* discussion in Proposing Release at 80191-94.

for credit Swaps of different maturities. For example, the risk factor multipliers for credit Swaps could mirror those for equity Swaps, such that the multiplier for credit Swaps that mature in one to five years could be 8% and the multiplier for credit Swaps that mature in one year or less could be 6%. We note that this risk factor multiplier for Swap maturity should be applied separately from the multiplier for rating or spread band designation of the Swap underlier.

Sixth, the Proposing Release states that the duration used for purposes of applying the risk factor multipliers in the potential future exposure calculation would, for options on a Swap ("swaptions"), be equal to the sum of the duration of the option and the duration of the underlying Swap.[16] We recommend that, consistent with industry practice, the Commissions differentiate between physically-settled swaptions and cash-settled swaptions for purposes of determining the duration of the swaption when applying the risk factor multipliers. In particular, we believe that the calculation of the swaptions duration should not include the duration of the underlying Swap for cash-settled swaptions because counterparty exposure only exists until the option expiration date.

Seventh, MFA believes that, for the proposed potential future exposure calculation, notional amounts should be adjusted to reflect delta weighting. The Commissions' recent joint proposal to introduce Form PF[17] reflects that delta weighting is important to accurate assessments of systemic risk. The Commission designed proposed Form PF "to assist the Financial Stability Oversight Council in its assessment of systemic risk in the U.S. financial system" and to allow it to "identify potential threats to the financial stability of the United States".[18] The Commissions expect that hundreds of registered large private fund advisers advisers will file this form quarterly and that thousands more registered smaller private fund advisers will file it on an annual basis.[19] We respectfully request that, for purposes of calculating aggregate potential outward exposure under Proposed Rule 1.3(sss)(3), market participants be permitted to use the same methodology for delta weighting their non-linear positions that they are permitted to use for options positions in completing Form PF and/or Form PQR.[20]

In general, MFA believes that incorporating the above changes will improve the accuracy of the proposed calculations and will significantly reduce the chances that the MSP definitions will capture or impose costs on entities that the Dodd-Frank Act was not intended to affect.

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[16] *Id.* at 80193-95. We interpret the Proposing Release to apply only to Swap options and to exclude equity options.

[17] Commissions' Notice of Proposed Rulemaking on "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF" (February 11, 2011), 76 Fed. Reg. 8068.

[18] *Id.* at 8068 and 8072.

[19] *See id* at 8085-86, which includes a discussion of burden estimates.

[20] Proposed Form PF generally indicates that the notional amounts of options positions are to be delta-weighted. Proposed Form PF, Section 1b, Question 11; Section 2(a), Questions 23 and 25; Section 2(b), Questions 27 and 38; Section 3, Question 47; and Section 4, Question 68. *See also*, Proposed Form PQR, Schedule B, Question 5.

D. Definition of "Substantial Counterparty Exposure"

Under the Proposed Rule, market participants would calculate "substantial counterparty exposure" using the same calculation method as the first MSP test for "substantial position". MFA agrees that such a measurement could serve as an indicator of the systemic risk posed by an entity, but we believe that the second MSP test was intended to capture entities that create systemic risk through the size of their exposure to particular counterparties. For example, an undiversified market participant (*i.e.*, an entity with highly concentrated exposure to only one or two dealers) might well pose a significantly greater risk to the financial system than a larger market participant that has a well-balanced portfolio and whose exposure is diversified among a range of dealer or other counterparties. In such case, an entity's counterparty exposure would result in systemic risk only if the default of that entity could threaten a counterparty that is itself systemically important. Accordingly, the Commissions should refine the "substantial counterparty exposure" test to measure the exposure that an entity has to each individual counterparty that is a systemically important financial institution, excluding, for the avoidance of doubt, clearinghouses used by the entity to clear its transactions.

We also note that the first MSP test already takes the aggregate positions of an entity across many or most of its counterparties into account. Accordingly, we believe that modifying the measurement of substantial counterparty exposure in the manner we suggest would more accurately measure the effect that a Swap market participant's default would have on the stability of the financial system and the ability of the financial system to absorb the failure of a well-diversified Swap market participant.

E. Commercial Hedging Exemption

In the Proposing Release, the Commissions state that financial entities may avail themselves of the commercial hedging exemption for purposes of the first prong of the MSP test.[21] MFA would appreciate it if the Commissions would clarify the parameters for this exemption's application and specifically address those circumstances under which the commercial hedging exception of the first prong of the MSP definition is available to financial participants, such as hedge funds.[22] For example, a hedge fund may use index derivatives to hedge an overall portfolio or use derivatives to mitigate exposure to commercial loans it makes, and MFA believes these, and other instances, may be appropriate circumstances for a hedge fund to avail itself of this exemption. We also request that the Commissions clarify the scope of the exemption to allow all entities to avail themselves of the exemption consistently and to prohibit commercial participants from availing themselves of the exemption for purposes of engaging in trading or investing activities (*i.e.*, activities other than commercial hedging activities).

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[21] Proposing Release at 80194-95.

[22] The definition encompasses persons that maintain a "substantial position" in any of the "major" categories of Swaps, as determined by the Commissions, and excludes from the test "positions held for hedging or mitigating commercial risk". *See id.* at 80185-86.

F. Threshold Levels

MFA recognizes that it makes sense to impose relatively stringent requirements on those entities that hold themselves out to the financial markets as dealers.[23] However, while we appreciate the Commissions' efforts to propose sufficiently low and prudential thresholds to meet their need for early detection and appropriate oversight and regulation,[24] we are concerned that the proposed thresholds for MSPs may be too low.

In practice, the thresholds could capture (or require detailed calculations on a regular basis from) certain entities with limited impact on systemic risk, although it is clear Congress did not intend the MSP designation to capture these entities (*i.e.*, entities whose default would not lead to the collapse of a major financial institution or cause a similar systemic event). The definition, therefore, should seek to identify the entities whose uncollateralized exposure or potential future exposure to any single counterparty is of a size and concentration that could cause such a collapse.

As a result, MFA respectfully requests that, when the Commissions initially adopt the Proposed Rule, they raise the thresholds for measuring "substantial position" and "substantial counterparty exposure" to a sufficiently high level such that only a few entities will qualify as MSPs. We recommend that the Commissions retain these higher thresholds until they can conduct a market survey to determine how many entities would need to perform the calculations regularly and whether those entities have characteristics capable of causing systemic risk. Once the Commissions gather this information, they could adjust the thresholds appropriately based upon their consideration of how many entities, if any, they believe should qualify under the MSP definition (based on their potential systemic risk impact) as well as the cost to such entities of performing regular MSP calculations. We believe this incremental and measured approach would allow the Commissions to regulate entities that pose systemic risk, while not subjecting less risky entities to unintended and undue regulation or burden.

As a related matter, MFA suggests that the Commissions build into the final rules automatic, annual, upward adjustments of the MSP threshold amounts to account for inflation and potentially other market-changing events. Without such adjustments, the effects of inflation or other changes to the markets could result in certain entities that do not pose systemic risk as contemplated by the Dodd-Frank Act becoming MSPs in the future. Therefore, we recommend that the upward adjustment should at a minimum reflect inflation, but could also reflect, on a discretionary basis, other relevant measures, such as the amount of equity in the U.S. banking system or other measures the Commissions view as relevant that reflect the financial system's ability to absorb losses generally.

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[23] *See* Section 721 of the Dodd-Frank Act (defining "swap dealer" in new Section 1a(49) of the Commodities Exchange Act, 7 U.S.C. 1a(49)) and Section 761 (defining "security-based swap dealer" in new Section 3(a)(71) of the Exchange Act, 15 U.S.C. 78c(a)(71)).

[24] Proposing Release at 80190, n. 105.

III. Definition of "Highly Leveraged"

In general, MFA agrees with the approach taken by the Commissions to define "highly leveraged" based on a ratio of total liabilities to equity.[25] However, in the case of investment funds, it is important that the Commissions consider not only the aggregate amount of such leverage, but also:

- the fund's asset mix (including the liquidity of those assets);
- the liquidity rights of the fund's investors;
- the size and nature of the capital markets in which the fund transacts; and
- the sources and terms of the fund's leverage.

For example, secured debt significantly mitigates systemic risk compared to unsecured debt. Similarly, certain types of short-term leverage (such as overnight borrowing) introduce greater risk than short-term financing linked to highly liquid assets (such as U.S. Treasuries) or longer-term leverage (such as term borrowings) that more closely matches the term or liquidity of the asset and the financing that funds it.

In response to the Commissions' inquiry in the Proposing Release,[26] we believe that between the proposed options, a ratio of 15 to 1 would initially be more appropriate. The Commissions could subsequently adjust the ratio as they receive empirical data regarding the use of leverage by market participants. Regardless of whether the Commissions adopt the higher of the two proposed "highly leveraged" ratios, we urge the Commissions to define leverage consistently with other definitions of, and concepts relating to, leverage in the Dodd-Frank Act.[27] In particular, we strongly believe that the Commissions should consider applying a calculation that introduces differentiating factors based on asset class, such as, among other things, risk factor multipliers. The use of risk factor multipliers would create discounts for certain types of lower risk holdings, such as high-grade corporate securities, and exclude other holdings, such as U.S. Treasuries, which pose little or no systemic risk to the financial system.

IV. Definitions of "Swap Dealer" and "Security-Based Swap Dealer"

MFA acknowledges the Commissions' functional approach to the definitions of "swap dealer" and "security-based swap dealer" set forth in the Proposing Release.[28] We request,

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[25] *Id.* at 80199.

[26] *Id.* at 80199-200.

[27] *See e.g.,* Section 113 of the Dodd-Frank Act, which requires the Financial Stability Oversight Council ("FSOC") to take "the extent of the leverage of the company" into account for determinations of whether the company is systemically important. *See also* Section 165(j)(1) of the Dodd-Frank Act, which allows the FSOC to limit a company's leverage based on FSOC's determinations in accordance with Section 113 of the Dodd-Frank Act.

[28] Proposing Release at 80175-80179.

however, that the Commissions codify and clarify certain aspects of the SD definitions to avoid inadvertently treating entities as SDs that should be designated, if anything, as MSPs. Such a result would be contrary to the accepted interpretation of the term "dealer" in the context of the securities laws and the approach intended by the Commissions in the Proposed Rule.[29]

Specifically, the third prong of the statutory SD definitions includes any person that "regularly enters into swaps [or security-based swaps, as applicable,] with counterparties as an ordinary course of business for its own account." The Proposing Release clarifies that the Commissions do not interpret this clause literally, but rather read it "in combination with the express exception . . . which excludes 'a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.'"[30] This clarification is essential because for many market participants because of the uncertainty surrounding the meaning of this clause among Swap market participants. As a result, we urge the Commissions to codify their interpretation of the third prong of the Dodd-Frank Act's SD definitions in the text of the adopted rule, rather than providing it only as part of the adopting release text.

In addition, MFA would appreciate it if the CFTC could further clarify in the adopting release how it intends to interpret the definition of "swap dealer", and how that interpretation will differ from that adopted by the SEC with respect to the definition of "security-based swap dealer". We recognize that the Commissions generally plan to treat entities that will fall within the definitions of "swap dealer" and "security-based swap dealer" in a similar manner. However, the Proposing Release includes important differences between how the Commissions plan to interpret those definitions,[31] leaving considerable uncertainty regarding the effect of those differences on Swap market participants. In particular, we would like to gain an understanding of the reasons why the CFTC focuses on "those persons whose function is to serve as the points of connection in [the Swap] markets",[32] instead of taking the SEC's approach, which relies heavily on the SEC's longstanding distinction between "dealers" and "traders" under the Exchange Act.

We also request that the Commissions make it clear that the SD definitions do not encompass entities that operate essentially as investors or customers, such as hedge funds. In the Proposing Release, the Commissions describe entities that are SDs due to the third prong of the SD definitions as entities that accommodate demand and are available to enter into Swaps to facilitate other parties' interest in Swaps (although SDs may also advance their own investment and liquidity objectives by entering into such Swaps). In addition, the Proposing Release notes that an SD's relationships with counterparties is another indicator, in that an SD tends to enter

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29 *Id.* at 80177, citing Securities Exchange Act Release No. 47364 (Feb. 13, 2003).

30 *Id.* at 80177.

31 *Id.* at 80178.

32 *Id.* at 80177.

into Swaps with more counterparties than non-SDs do, and in some markets, non-SDs tend to constitute a large portion of an SD's counterparties.[33]

In addition, the Commissions should confirm that while continuous two-sided quotations and a willingness to stand ready to buy and sell a security are important indicators of market making in the equities markets, these indicia might not be appropriate in the Swap markets. Merely having two-sided quotations does not always indicate that a participant is holding itself out as an SD.[34]

V. Definition of "Eligible Contract Participant"

The scope of the ECP definition is critically important because the Dodd-Frank Act makes it unlawful for a non-ECP to enter into a Swap other than on, or subject to the rules of, a regulated exchange,[35] and because many financial counterparties have arrangements in place with hedge funds and traditional commodity pools that are dependent upon their status as ECPs.

Based on discussions with the Commissions' staff,[36] MFA understands that the Commissions' did not intend for the Proposed Rule to prevent a large number of hedge funds or traditional commodity pools from qualifying as ECPs; provided that, the funds and pools were not formed for the purpose of evading the ECP definition. Therefore, we respectfully request that the final ECP definition clarify that, in general, a hedge fund or traditional commodity pool will continue to qualify as an ECP by relying on Section 1a(18)(A)(v)(I) of the CEA.[37]

We also respectfully request clarification of the scope of Proposed Rule 1.3(m)(5), which states that a commodity pool is not an ECP for purposes of Sections 2(c)(2)(B)(vi) and 2(c)(2)(C)(vii) of the CEA, if one or more of the pool's direct or indirect participants is not an ECP. The Proposing Release explains that this proposed rule is intended to preclude a commodity pool that engages in retail foreign currency transactions (a "Retail Forex Pool") from qualifying an as ECP for purposes of amended Section 1a(18)(A)(iv) of the CEA if any participant in the pool is not independently an ECP.[38] Moreover, a Retail Forex Pool with one or

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[33] *Id.* at 80177.

[34] *See id.* at 80176. MFA does not believe that an investor demonstrating its willingness to buy or sell a Swap at a particular time should be deemed to be engaged in market making. A hedge fund is an investor and customer, and provided it does not engage in market making or other "dealer" activities, should not be treated as subject to SD obligations.

[35] *See* Section 723(a)(2) of the Dodd-Frank Act, which makes it unlawful for a non-ECP to enter into a Swap other than on, or subject to the rules of, a designated contract market; *see also* Section 763(e) of the Dodd-Frank Act also renders it unlawful for a non-ECP to enter into a security-based Swap unless such transaction is effected on a national securities exchange registered pursuant to Section 6(b) of the Exchange Act.

[36] MFA call of February 14, 2011 with the Commissions' staffs on the Proposed Rule.

[37] As amended by Section 721(a)(9) of the Dodd-Frank Act, this clause generally permits a hedge fund having assets exceeding $10,000,000 to qualify as an ECP.

[38] Proposing Release at 80185.

more non-ECP participants that would not be able to qualify as an ECP for purposes of clause (A)(iv) would also be precluded from qualifying as an ECP by virtue of clause (A)(v).

We respectfully submit that hedge funds and traditional commodity pools are functionally different from Retail Forex Pools, in that the former typically do not pool retail cash for the purpose of gaining exposure through currency-based instruments. In so far as a hedge fund or traditional commodity pool engages in retail foreign currency transactions, that activity is, at most, incidental to the fund or pool's normal investment activity and should not disqualify the fund or pool as an ECP. Therefore, we request that the final ECP definition clarify that, unlike Retail Forex Pools, hedge funds or traditional commodity pools will be able to rely on clause (A)(v)(I) for purposes of qualifying as an ECP, without the need to "look through" to determine whether there are one or more direct or indirect participants that are not ECPs. [39]

VI. Application of Definitions to Hedge Funds

As discussed below, MFA would appreciate it if the Commissions could clarify certain aspects of the Proposed Rule to provide greater certainty as to their application to hedge funds. In addition, there are portions of the Proposed Rule that we would recommend that the Commissions modify to avoid imposing undue costs on market participants.

A. Limited Purpose Designations

Under the Proposed Rule, an entity that meets the SD or MSP definitions would be subject to regulation as an SD or MSP, as applicable, across all major categories of Swaps.[40] Moreover, if an entity engages in significant activity with respect to only certain types, classes or categories of Swaps, that entity would then need to apply for a limited purpose designation. MFA believes that prohibiting entities from applying initially for a limited purpose designation imposes an unnecessary and substantial cost upon entities that engage in significant activity with respect to only certain types, classes or categories of Swaps. As a result, we ask that the final rule adopted provide that entities could receive their limited purpose designation upon their initial registration as SDs or MSPs only with respect to the major category or categories of Swap(s) in which they engage in significant activity.

B. Minimum Duration of Status as an MSP

Under the Proposed Rule, once an entity qualifies as an MSP, that entity may only deregister once that entity no longer exceeds any of the applicable thresholds for four consecutive quarters.[41] We respectfully request that the "deregistration period" for MSPs

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[39] For example, the Commissions could consider complementing Proposed Rule 1.3(m) by introducing a clause (7) that reads as follows: "Notwithstanding sub-paragraphs (5) and (6) of this section, a commodity pool is an eligible contract participant provided that the commodity pool (i) has total assets exceeding $10,000,000, or (ii) is operated by a registered commodity pool operator and advised by a registered commodity trading advisor."

[40] Proposing Release at 80200-01.

[41] *Id.* at 80200.

parallel the "reevaluation period",[42] so that an entity that falls below all applicable MSPs thresholds by more than 20% for two consecutive quarters would then be able to deregister as an MSP. We believe that the foregoing alternative would properly ensure that an entity's positions are no longer "substantial" for purposes of the statute before they are permitted to deregister, but would not make the deregistration requirement so short as to cause entities to frequently register and deregister. As a related point, in the event that an abnormal price movement or other similar market event occurs towards the end of the reevaluation period, which causes an entity to temporarily fall below the applicable MSP thresholds by less than 20%, we believe that the Commissions should not deem an entity to have failed the reevaluation period or evaluate the entity for a further consecutive quarter such that the entity would be prevented from deregistering as an MSP.

C. Master-Feeder Fund Structures

We recognize that the clear intent of Congress[43] and the Proposed Rule is that accounts managed by an asset manager should not be aggregated for purposes of determining whether the asset manager is an MSP. However, it is unclear how this principle applies to master-feeder fund structures, in which the feeder fund is the entity to which investors subscribe ("Feeder Fund") and the Feeder's Fund's assets flow down to the master fund for actual investing/trading ("Trading Entity").

Consistent with the proposed approach for managed accounts, MFA requests that in the final rule the Commissions confirm that they intend the MSP definitions to apply to each Trading Entity as a separate legal entity, rather than require asset managers to aggregate entities within the master-feeder structure for purposes of making the MSP determination. For the reasons described below, this approach is consistent with the Commissions' desire to apply the MSP definitions to the entities that actually "maintain" the positions[44] as well as the policy goals presented in the proposing release and the colloquy between Senators Hagan and Lincoln on the issue.[45]

Feeder Funds and Trading Entities are separate legal entities. More importantly, in a master-feeder structure, the Trading Entity is the entity that: (i) is party to the master trading

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[42] *Id.* Reevaluation is a process whereby entities that meet one or more of the applicable major participant thresholds, but only by a modest amount, as a result of its Swap activities in a fiscal quarter, but without exceeding any applicable threshold by more than 20%, would not immediately be subject to the timing requirements discussed above, but only if the entity exceeded any of the applicable daily average thresholds in the next fiscal quarter.

[43] As noted by the Commissions in the Proposing Release, a colloquy on the Senate floor addressed the status of managed accounts for purposes of the MSP definitions, particularly focusing on whether the analysis should "look at the aggregate positions of funds managed by asset managers or at the individual fund level?" In response, it was stated that, "[a]s a general rule, the CFTC and the SEC should look at each entity on an individual basis when determining its status as a major swap participant." *See* 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (colloquy between Senators Hagan and Lincoln).

[44] Proposing Release at 80201.

[45] *See* 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (colloquy between Senators Hagan and Lincoln).

agreements; (ii) negotiates the individual transactions; (iii) holds the assets; (iv) receives the margin calls; and (v) is ultimately responsible for posting collateral. The Trading Entity is also the only entity in the master-feeder structure that can appropriately apply the terms of master netting agreements, as addressed by the Commissions. Feeder Funds, on the other hand, do not select investments or maintain positions.

Furthermore, given the Commissions' focus on reducing significant counterparty risk and systemic risk to the U.S. financial markets, the MSP definition should apply to the fund ultimately responsible for the uncollateralized exposure (*i.e.*, the entity whose creditworthiness counterparties assess prior to entering into a trading relationship). In a typical master-feeder structure, recourse is limited to the Trading Entity and looking through to the Feeder Fund is not possible. Finally, the duties that the Commissions are proposing to impose on an MSP are not duties that the Commissions can logically require at the Feeder Fund level (*e.g.*, "know your counterparty" requirements, daily mark requirements and trade verification and acknowledgment requirements) because Feeder Funds are not party to the transactions.

Whatever the final position of the Commissions on this point, MFA would recommend that the Commissions codify the interpretation in the text of the final rule, rather than in the text of the adopting release, in order to reduce or eliminate the significant uncertainty on this point.

VII. Extraterritorial Application of the Proposed Rule

Considerable uncertainty exists with regard to the extraterritorial application of the Proposed Rule. We believe that the Commissions should provide clear guidance to ensure that any extraterritorial application of the definitions reflects consideration of the potential global impact of imposing onerous obligations on a large number of market participants worldwide. Thus, we request that the Commissions consider and provide guidance on each of the following permutations – fund domicile, manager domicile, reference entity domicile, market location, underlying instrument and counterparty domicile –in order to establish clear definitional boundaries for Title VII of the Dodd-Frank Act.[46]

We think that it is reasonably clear that the Dodd-Frank Act's limitations on regulating any "person [that] transacts a business in security-based swaps without the jurisdiction of the United States"[47] would not capture trading outside of the U.S. between non-U.S. entities or non-U.S. affiliates of U.S. entities. However, MFA believes that the Commissions should also limit the definitions so that they do not capture a non-U.S. domiciled fund that has a U.S. investment manager but trades in Swaps referencing non-U.S. securities or on a non-U.S. market. For these purposes, a "non-U.S. market" should include entities domiciled outside the U.S. and whose performance is not guaranteed by U.S. entities. Similarly, the definitions should not capture a non-U.S. affiliate of a U.S. investment manager that advises an offshore fund. By its very nature, the trading of Swaps between non-U.S. entities does not "have a direct and significant

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[46] Entitled the "Wall Street Transparency and Accountability Act of 2010".

[47] Section 772(c) of the Dodd-Frank Act.

connection with activities in, or effect on, commerce of the United States".[48] Thus, we believe it is important for the Commissions to provide clear guidance on the foregoing and different permutations thereof to bring certainty to the markets and its participants.

We also note that non-U.S. regulators will have jurisdiction over and will regulate non-U.S. activities of U.S. entities. As a result, imposing duplicative regulation on these regulated entities would unnecessarily increase their regulatory burden while requiring U.S. and non-U.S. regulators to expend valuable resources.

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MFA thanks the Commissions for the opportunity to provide comments regarding the Proposed Rule. Please do not hesitate to contact Carlotta King or the undersigned at (202) 730-2600 with any questions the Commissions or their staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director, General Counsel

cc: The Hon. Mary Schapiro, SEC Chairman
The Hon. Kathleen L. Casey, SEC Commissioner
The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner

The Hon. Gary Gensler, CFTC Chairman
The Hon. Michael Dunn, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner

[48] Section 722(d)(i)(1) of the Dodd-Frank Act.