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

December 23, 2008

President Timothy F. Geithner
President
Federal Reserve Bank of New York
33 Liberty Street, 10F
New York, NY 10045

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable Walter Lukken
Acting Chairman
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington D.C. 20581

Dear President Geithner, Chairman Cox and Chairman Lukken:

Recently, Managed Funds Association ("MFA")[1] and its members met with the Federal Reserve Bank of New York (the "NYFRB") to discuss and provide comments regarding the state of the credit default swap ("CDS") market, including our feedback on current proposals to establish a central clearing counterparty for the CDS market. As part of our ongoing commitment to proactively work with regulators on topics that pose significant market or systemic risk concerns, we wish to direct your attention to the protection and safeguarding of customers' initial margin that they deposit with dealer financial institutions in connection with the trading of all over-the-counter ("OTC") derivatives.

Effects of Current Collateral Management Practices

By way of background, the default of Lehman Brothers, a major OTC derivatives counterparty, and the resulting market concerns about the viability of other major dealers, has caused significant volatility in the capital markets. These concerns demonstrate that current mechanisms for collateral management, outside of the context of broker-dealer accounts covered by Exchange Act Rule 15c3-3, do not adequately protect the pledgors of collateral and can contribute to systemic risk in several important respects:

- The purpose of initial margin is to provide dealers with a cushion against the potential counterparty risk they assume when entering into an OTC derivatives contract with a customer. However, since such margin is not typically segregated from the dealers' other unsecured assets, what is supposed to be a credit mitigant for the dealer instead subjects the customer to actual credit risk on the posted amounts.
- If a dealer becomes insolvent, initial margin posted by customers that is not so segregated is treated in bankruptcy as a general unsecured claim of the customer. As a result, customers who are counterparties to that dealer stand to incur significant losses, regardless of the current value of their derivatives contracts.

[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.

- Investment managers have fiduciary duties to their investors. When a dealer experiences difficulties, the risk to initial margin may cause managers to seek to hedge counterparty exposure to such dealer (either through the CDS market or by trying to close-out or assign derivatives trades away from such dealer). These hedging actions can have a further destabilizing impact on such dealer and the market generally, thereby increasing systemic risk.
- In addition, given that dealers are able to freely use posted collateral, they have come to rely on initial margin, a fluctuating source of cash, to fund their business activities. As trades are closed-out or assigned, dealers are required to return initial margin to their customers. The return of margin constricts dealers' liquidity and, as recent events demonstrate, the inability of the dealers to access cash has potentially severe market consequences.

We highlight that the aforementioned counterparty risks related to customer initial margin have been greatly exacerbated over the last few months as dealers as a whole have significantly increased their demands for initial margin. These risks are in turn further compounded by the general weakening of the financial sector as a whole.

Enhanced Customer Segregated Accounts

As you are aware, the segregation of initial margin is a key component of the central clearing party initiatives for the CDS market, and we understand that the NYFRB, SEC and CFTC have stipulated this condition to be a prerequisite for regulatory approval. We agree that segregation of initial margin is crucial to the success of these clearing initiatives, but also believe that the protection of customer initial margin should be implemented more broadly for all OTC derivatives, irrespective of the launch of any CDS central counterparty because it is critical in order to promote broader market stability and to mitigate counterparty risk. Protection of customer initial margin with respect to all bilaterally negotiated OTC derivatives could be incorporated into the existing transaction structure through dealer use of a segregated account, in the name of, and held for the benefit of, the customer (e.g., at a U.S. depository institution or a regulated U.S. broker-dealer), whereby the dealer would not be permitted to rehypothecate the initial margin held in such an account. This would promote broader market stability and mitigate counterparty risk.

Given that dealers will be required to provide initial margin segregation as part of the clearing initiatives, they should be capable of offering this to customers on a broader basis. However, to date the dealer community, as a whole, has been resistant to such efforts by MFA's members and other investment managers.

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We recognize the efforts of regulators to collaborate on mitigating risk and promoting market stability. We appreciate the constructive working relationship fostered by each of you as well as the opportunity to share the views of our members on this important topic. We welcome the opportunity to discuss this issue further with each of your staffs. If we can provide further information on this topic, or be of further assistance, please do not hesitate to contact us at (202) 367-1140.

Yours Sincerely,

Richard H. Baker
President and Chief Executive Officer

cc: The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System
Patrick M. Parkinson, Deputy Director, Division of Research and Statistics, Board of the Federal Reserve System
Ananda Radhakrishnan, Director, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission
Theodore Lubke, Senior Vice President, Bank Supervision Group, Federal Reserve Bank of New York
Erik R. Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission