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

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***Via* Electronic Mail:** whitewayr@parliament.uk

Mr. Robert Whiteway
Clerk of EU Sub-Committee A
Committee Office, House Of Lords,
London, SW1A 0PW

Re: Managed Funds Association Response to Call for Evidence on Ensuring Safe and Sound Derivatives Markets

Dear Mr. Whiteway:

Managed Funds Association ("MFA")[1] welcomes the opportunity to provide comments in response to the House Of Lords, EU Sub-Committee A's call for evidence (the "Call for Evidence") regarding the European Commission's communications on ensuring safe and sound derivatives markets (the "Communications"). MFA applauds the House Of Lords' efforts to develop proposals to reform the supervision of the over-the-counter ("OTC") derivatives markets in the European Union through an informed and deliberative consultation process.

These issues are of significant importance to MFA members because hedge funds are active participants in the OTC derivatives markets and have a strong interest in promoting the integrity and proper functioning of these markets. Because OTC derivatives provide significant benefits to various market participants by allowing them to manage risks associated with their business activities or their financial assets, MFA believes that these markets are essential to the restoration of capital flows within the global economy.

For your convenience, we have included the questions from the Call for Evidence in this response letter. The questions are in the order presented in the Call for Evidence and are in italics, with MFA's response included below each question.

1. What economic benefits do derivatives bring?

As mentioned above, MFA believes that OTC derivatives play a critical role in our global capital markets by enabling businesses, financial institutions, governments and institutional investors to effectively manage various risks associated with their business activities or financial assets. For example, market participants use derivatives contracts to hedge against market risks (*e.g.*, events such as bankruptcy, fluctuations in the relative value of foreign currencies, or for companies that issue debt to fund their growth, changing interest rates) and counterparty risks (*i.e.*, default exposure to a trading counterparty). OTC derivatives perform these functions better than other risk management tools because

[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.

they are liquid with low transaction costs, have substantial depth of market, and are more readily accessible as compared with other financial products.

The importance of the OTC derivatives market is further demonstrated by the various types of financial institutions, non-financial institutions and other market participants, which use them. For example, the International Swaps and Derivatives Association ("ISDA") has recently published data showing that OTC derivatives are used by a vast number of the world's largest companies to manage various risks that arise in connection with their businesses.[2] ISDA's survey reveals that these companies have found OTC derivatives to be essential to their day-to-day operations by helping insulate them from various market and counterparty risks.

In addition, OTC derivatives markets also provide significant benefits to the global economy by providing liquidity for capital markets. For instance, banks and other financial institutions have been able to engage in increased lending and corporate finance activities as a result of their ability to trade CDS, which provides them with a mechanism through which they can transfer credit risks to other market participants, which are willing to accept that risk. Ultimately, increased lending and credit flows result in: (i) lowered costs of borrowing for many big and small businesses all around the world; and (ii) greater access for consumers to credit to purchase necessary goods and services.

2. What risks are associated with derivatives and derivatives markets?

There are three primary types of risk associated with, but that are not unique to, OTC derivatives and OTC derivatives markets: (1) operational risk; (2) counterparty default risk; (3) and systemic risk. Operational risk is the potential for losses that could occur from human errors or failures of systems or controls. Over the last five years, market participants and financial regulators have taken steps to help mitigate operational risks and challenges related to OTC derivatives trading activities, with a particular focus on the market's infrastructure. Market participants and financial regulators have collaborated to eliminate large backlogs of unconfirmed derivatives, to publish standardized contract terms for OTC derivatives, and to develop improved processes and procedures for the physical settlement of underlying assets, novation of derivatives positions from one counterparty to another, and procedures for addressing valuation disputes.

Counterparty default risk is the risk that a derivatives counterparty will be unable to meet its contractual obligations under a derivatives contract. In addition to potentially not receiving contractual payments, a derivatives counterparty whose counterparty defaults could suddenly be left without protection of the derivatives contract and could either have to replace the contract at current, higher market values or go without protection. Dealers, large buy-side firms and some other market participants that have large derivatives exposures currently use a variety of techniques to limit, forecast, and manage their counterparty risk, including the posting of mark-to-market margin (commonly known as variation margin) and upfront margin (commonly known as initial margin). For example, hedge funds generally post both initial margin and variation margin to their dealer counterparties in connection with their derivatives positions. As a general matter, this practice makes hedge funds less risky in

[2] ISDA published results of a survey it conducted on derivatives usage by the world's 500 largest companies (April 23, 2009). A press statement regarding the survey is available at: www.isda.org.
See our response to question 7 below, which further discusses our position with respect to collateral management practices and AIG's role in the financial crisis of 2008.

comparison with derivatives counterparties that do not post margin or provide other protections (*e.g.*, AIG).[3]

Systemic risk is the aggregation or interconnectedness of counterparty default risks faced by individual firms, which may ultimately effect the entire financial system. It is our view that the possibility of widespread default throughout the financial system caused by derivatives alone is exaggerated, principally due to the low default risk associated with individual derivative contracts. Recognizing the threat that OTC derivatives could pose to the financial system, regulators and market participants have initiated several efforts to address certain risks posed by these financial products, including the standardization of many OTC derivative products, the establishment and implementation of industry-wide protocols, and the multilateral netting of large derivatives portfolios, which reduces the number of trades outstanding between market participants without affecting each participant's risk profile.[4]

In addition to the above-described primary risks, regulators and some observers have cited the lack of transparency or disclosure in the OTC derivatives market as a major concern. While MFA strongly supports increasing market transparency, we believe that the lack of transparency or disclosure may have compounded systemic risk concerns and overall market uncertainty regarding market concentration of exposures and the worldwide gross notional and total net exposure of OTC derivatives contracts.

There are several market initiatives underway to increase transparency and disclosure of OTC derivatives contracts. Pricing, trading volumes and aggregate open interests are currently available on most credit derivatives contracts through databases operated by privately-owned service providers. For instance, Markit®, an industry pricing service, currently provides end-of-day pricing on over 3,000 issuers through daily polling of approximately 100 contributing parties.[5] In addition, as is discussed in our response to question 6 below, market participants have increased the use of trade repositories as a means to disclose their positions.

Notwithstanding these market initiatives, MFA is fully supportive of the regulatory reform efforts in the United States to oversee the derivatives markets and derivatives dealers. The legislative

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[4] Examples of these efforts include, without limitation: (1) dealer clearing started in Europe in July 2009; (2) the reduction by 92% of backlogs of outstanding CDS confirmations since 2005; (3) the establishment of electronic processes to approve and confirm CDS novations; (4) the establishment of an auction hardwiring completed April 8, 2009, to allow for auction-based settlement of CDS (called the "Big Bang Protocol"); (5) the roll out of a restructuring credit event protocol (also known as the "Small Bang Protocol") to further standardize CDS contracts for centralized clearing; and (6) several non-dealer firms began clearing their CDS transactions on certain CCPs on December 15, 2009.

Many of these initiatives have taken place under the auspices of the Senior Supervisors Group, which is comprised of senior financial supervisors from seven countries including regulators in Europe and the United States. More information on their efforts can be found on the U.K. Financial Services Authority Web site at: http://www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/index.shtml

[5] More information on Markit's pricing data is available at: http://www.markit.com/en/products/data/cdspricing/cds-pricing.page.

proposals that are now before U.S. Congress seek to: (1) reduce risk through the use of CCPs, while respecting the importance of customized derivatives contracts; (2) require segregation of customer collateral at the request of a customer; (3) increase regulatory transparency through trade reporting; and (4) provide the government with additional authority to avert and respond to economic or financial turmoil without disrupting the ordinary operation of the markets). We believe the passage of the derivatives legislation ultimately will improve market efficiency, reduce counterparty risk and systemic risk, and help regulators identify cases of market manipulation, insider trading or other abuses.

3. What role did derivatives play in the recent financial crisis?

In the wake of the most recent financial crisis, some market observers have cited OTC derivatives as one of the primary causes of the crisis. Many regulatory bodies and industry observers have stated, however, that derivatives were not a central cause of the crisis.[6] We agree with these regulatory bodies and observers and believe that that excessive risk-taking in the housing industry, excessive use of leverage, and over-reliance on credit ratings were integral parts of the financial crisis of 2008 and 2009.

In contrast, OTC derivatives helped market participants to hedge their risk exposures during the worst months of the financial crisis. It is arguable that OTC derivatives helped market participants to prevent further losses during that time. For example, the CDS market was essential for managing risk in connection with more than 53 global corporate defaults (including Lehman Brothers) in 2008 and 2009.[7]

4. What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?

MFA has a strong interest in ensuring that any regulatory reform in the European Union addresses counterparty risk and systemic risk. We strongly support the clearing of "clearable" or "standardised" derivatives on CCPs based in Europe and the United States. We also support competition among CCPs and believe that derivatives regulation should not force segmentation of the market based on jurisdiction.[8] We believe, however, that EU regulation should impose three rules on central counterparties ("CCPs") to reduce these risks: (1) protection of customer positions and collateral (specifically, initial margin); (2) open access and membership for end users, including hedge funds; and (3) appropriate resources and infrastructure to prevent CCP failure.

MFA believes that the protection of customer positions and collateral in a central clearing regime is absolutely critical to the success of central clearing initiatives and the reduction of counterparty risk and systemic risk. MFA urges the European Commission to impose rules that would require: swap dealers and CCPs to segregate initial margin in accounts that are separate and apart from

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[6] As referenced above in footnote 4, the Senior Supervisors Group noted that "the industry's substantial efforts to standardize practices and reduce backlogs of unconfirmed over-the-counter derivatives positions appear to have significantly mitigated a substantial systemic risk." *See* "*Risk Management Lessons from the Global Banking Crisis of 2008*" (October 21, 2009), which is available at: www.sec.gov/news/press/2009/report102109.pdf.

[7] For more information regarding the number of credit events and auctions, please visit www.isda.org.

[8] We do not believe it is appropriate to place jurisdictional-based requirements on central clearing. See our response to question 9 below, which sets out our position regarding the European Commission's proposal requiring market participants to use a European-based CCP to clear CDS on European-reference entities and indices.

the assets of the swap dealer; and CCPs to move customer positions in the event of the insolvency of a clearing member. In our view, these rules would greatly reduce counterparty and systemic risk associated with the trading of OTC derivatives in the event of clearing member insolvency.

Lehman Brothers' failure demonstrates the reasons why a rule requiring segregation of customer collateral would reduce these risks. In our view, a requirement to segregate customer collateral would have helped to lessen the rippling effects of the Lehman Brothers' bankruptcy. As a regular practice, Lehman Brothers and other swap dealers did not segregate customer collateral. Instead, they used it as an inexpensive source of financing. After Lehman Brothers' bankruptcy, their failure to segregate customer collateral raised concerns regarding the viability of those other dealers. These concerns eventually weakened market stability as market participants acted quickly to protect their assets from further counterparty exposure. Ultimately, this practice exacerbated systemic risk to global capital markets by increasing counterparty risk.

In addition, MFA believes that the European Commission should impose rules that broadly encourage central clearing by allowing end-users (including hedge funds) to have fair and open access to central clearing either through direct participation in a CCP as a clearing member, or through a clearing member. In addition, we believe that CCP governance arrangements should be transparent and take into account the views of all market participants. In our view, these measures will encourage end users to centrally clear their derivatives contracts, which will in turn reduce the interconnectedness that results from too much credit exposure flowing through a limited number of dealers.

Finally, we believe the European Commission should impose rules requiring CCPs to have appropriate financial resources and risk management practices to minimize risk of CCP failure. By definition, CCPs are systemically significant entities, and therefore, it is essential that the European Commission impose rules to ensure the viability and proper functioning of CCPs that operate in Europe.

5. Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

We believe that it is appropriate for regulators to impose higher capital charges on trades that are eligible for central clearing, but that are not centrally cleared. Imposing higher capital charges in this instance would create a strong incentive for market participants to centrally clear OTC derivatives where it is possible for those derivatives to be cleared through a CCP.

In contrast, MFA believes that it is critical to provide market participants with the ability to engage in non-standardised or customized derivatives without imposing overly burdensome capital charges. Non-standardised derivatives allow market participants to custom manage their firm or company's specific risks in a way unmatched by standardized derivatives. Instead, MFA believes that the European Commission should work with market participants to increase the number of standardised derivatives eligible for central clearing and require the imposition of appropriate levels of margin in connection with the trading of non-standardised derivatives.

6. What benefits [do] the use of trade repositories bring both in terms of transparency and improved risk management?

As mentioned above, MFA strongly supports the use of trade repositories to record non-cleared OTC derivatives contracts. We believe that trade repositories will enhance market transparency for regulators and will reduce systemic risk by ensuring that regulators have a comprehensive picture of market concentrations and exposures within a given asset class. In addition, a trade repository may also provide operational benefits for market participants by helping to facilitate central clearing and by reducing the notional amount of trades through trade portfolio compression.

7. The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?

We believe that the European Commission's approach to monitor and, when appropriate, to impose minimum collateral levels with respect to non-cleared derivatives transactions is the correct approach. It is our view that industry-wide collateral practices were inadequate prior to the near-failure of AIG. As referenced above in our response to question 2, AIG was able to take very concentrated derivatives positions without having to post any collateral in connection with those positions. The financial crisis arguably would not have been as acute, if all or a majority of derivatives market participants were required to post appropriate levels of collateral. We believe ultimately that increased oversight of market participants with highly concentrated positions will help increase market stability.

8. The [European] Commission intends to review the Market Abuse Directive and may extend its scope to capture more OTC derivatives and give regulators the power to set position limits. Will this improve the integrity of derivatives markets as intended?

MFA does not believe that providing regulators with the authority to set position limits will improve the integrity of derivatives markets. Position limits do not address market integrity or systemic risk concerns, which can be addressed through appropriate capital and margin charges, disclosure requirements, and other regulatory measures. As a general matter, MFA believes that position limits should be imposed only for physically-delivered commodities and where the deliverable supply of the commodity is limited and, thus, susceptible to control and manipulation.[9]

9. Are current EU regulatory plans regarding derivatives markets sufficiently harmonized with U.S. and global regulatory plans to avoid regulatory arbitrage or business migration?

Although many of the details of the regulatory proposals in the European Union, the United States and other countries remain uncertain, we believe that these proposals share the same policy objectives: mandatory central clearing, increased reporting to trade repositories, greater transparency, etc. In light of the global nature of the OTC derivatives markets, MFA believes that coordinated international regulation will permit greater market efficiencies and prevent market segmentation. MFA strongly encourages the European Commission to coordinate its regulation and oversight of the OTC derivatives markets with other regulators around the world.

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[9] MFA does not take a position with respect to whether broadening the scope of the Market Abuse Directive to include OTC derivatives will improve market integrity.

On September 4, 2009, MFA submitted comments to the Committee of European Securities Regulators ("CESR") on, among other things, the issue of regulatory harmonization of the derivatives market in response to CESR's call for evidence on mutual recognition with non-EU jurisdictions.[10] In our letter, we expressed our concerns with the European Commission's requirement that market participants must use a European-based CCP to clear CDS on European-reference entities and indices. In our view, this requirement would frustrate the establishment of a globally harmonized regulatory framework for derivatives and lead to an unfair playing field for European-based CCPs.

In contrast, and as noted above, we support the legislative proposals under consideration in the U.S. Congress to regulate the derivatives markets and derivatives dealers, although many of the details of these proposals remain uncertain. In particular, we believe that the provisions in these proposals that encourage international coordination, permit non-U.S. market participants to register with U.S. regulators, and reduce risks to the global financial system, are consistent with the global harmonization of regulation over the OTC derivatives markets.

10. Are there further areas for regulation that the communications do not cover?

For all of the same reasons cited in response to question 4 above with respect to collateral segregation for *cleared derivatives*, MFA believes that regulation that would require dealers to offer their customers the availability of collateral segregation in *bilateral, non-cleared derivatives transactions* is necessary. We believe that the benefit that the financial system will derive from the mandatory clearing of standardised derivatives will be substantially multiplied if consistent protections are at least made available with respect to non-cleared derivatives.

Conclusion

Again, MFA appreciates the opportunity to provide comments in response to the Call for Evidence regarding the Communications. MFA supports efforts to create more efficient OTC derivatives markets, reduce risks, promote investor protection, and protect the stability of the global financial system. We are committed to being constructive participants in the regulatory reform discussions in the European Union and to working with the European Commission to reestablish a sound financial system and restore stable and orderly markets.

Respectfully submitted,

/s/ John G. Gaine

President Emeritus and
Special Counsel, International Affairs

Cc: Miss Hadia Choudhury,
Committee Assistant to EU Sub-Committee A,
U.K. House of Lords

[10] A copy of MFA's letter is available at:
http://www.managedfunds.org/downloads/MFA%20comments%20on%20CESR%20Letter%20Mutual%20Recognition.pdf