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

April 21, 2010

The Honorable Blanche Lincoln
Chairman
Committee on Agriculture, Nutrition and Forestry
U.S. Senate
355 Dirksen Senate Building
Washington, D.C. 20510-0404

The Honorable Saxby Chambliss
Ranking Member
Committee on Agriculture, Nutrition and Forestry
U.S. Senate
416 Russell Senate Office Building
Washington, D.C. 20510-0404

Managed Funds Association Comments on the "*Wall Street Transparency and Accountability Act of 2010*" (the "Bill")

Dear Chairman Lincoln and Ranking Member Chambliss:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide our perspective on the Bill. MFA supports the broad objectives of the Bill, most significantly: (i) reducing systemic risk through the use of central clearing; (ii) protecting counterparties and the financial system by requiring adequate margin and collateral for all swaps, by protecting customer collateral at central clearing houses through segregation and bankruptcy protection, and by providing customers with the option of having their collateral for customized swaps segregated; and (iii) increasing regulatory transparency through trade and position reporting. MFA has concerns, however, that certain provisions of the Bill will have negative, unintended consequences.

In this regard, we highlight several key concerns with the Bill: (i) the definitions of "swap dealer" and "major swap participant" ("MSP"); (ii) the potential imposition of capital requirements on MSPs; (iii) the requirement that the recipient of any non-dealer swap margin payment be required to register as a futures commission merchant ("FCM"); and (iv) the authority of the Securities and Exchange Commission (the "SEC") to establish position limits with respect to securities and security-based swaps.[2] These key concerns reflect only the most important issues to MFA and its members. MFA would welcome the opportunity to meet with you or your staffs to engage in a discussion regarding our perspective on other measures in the Bill.

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

[2] For purposes of this letter, we use the term "swap" in the first and second sections to refer to both "swaps" and "security-based swaps" as those terms are used in the Bill. The third section of our letter is solely concerned with "swaps" as that term is used in the Bill. The final section of our letter is solely concerned with "security-based swaps" as that term is used in the Bill.

Definitions of Swap Dealer and MSP

MFA is concerned that the Bill's current definitions of swap dealer and MSP are overly broad in that both definitions may capture regulated, non-bank participants that are already federally regulated and that secure their swap transactions with collateral. The attendant requirements are inappropriate, and effectively preclude certain institutions from participating in the swap market altogether. Our concerns and recommendations are detailed below.

Under the Bill's definition of swap dealer, any institution that "regularly engages in the purchase and sale of swaps in the ordinary course of business" or "regularly accepts either side of swaps transactions in the ordinary course of business" would be captured. These standard investor practices, which underlie ordinary hedges and provide liquidity to both sides of the market, would inappropriately render swap end-users as swap dealers.

As a result, we suggest that the definition track the corresponding securities law definition of "dealer" in Section 3(a)(5) of the Securities Exchange Act of 1934 (the "Exchange Act"), which is intended to provide a suitable regulatory regime for those institutions that operate as financial intermediaries for securities customers. That definition has remained unchanged since 1934, and during that time, a significant and well-established body of law has developed around the operative words in the Exchange Act's definition of dealer. That body of law has afforded market participants with legal certainty as to which activities would cause such participants to fall within the scope of the Exchange Act's definition of dealer. Although the Bill's proposed definition of swap dealer includes language that is similar to the dealer definition in the Exchange Act, the proposed language in the Bill is broader and could unintentionally include any customer that engages in more than one swap transaction as part of its business. In our view, the creation of legal uncertainty in this manner would be very disruptive to financial markets. We believe that this uncertainty could be easily avoided while meeting the objectives of reform with respect to institutions that trade over-the-counter ("OTC") derivatives by using the existing statutory definition for dealer under the Exchange Act, while still maintaining the integrity and intent of the reform objectives.

On the definition of MSP, MFA supports the regulation of non-dealer, swap end-users that do not have a federal financial regulator and whose OTC derivatives positions would expose both their counterparties and the broader financial system to substantial risk in the event of default. AIG's near failure and subsequent bailout in 2008 provides an example of type of non-dealer, swap end-user that poses significant counterparty and systemic risks. In AIG's case, its counterparties did not require AIG to post collateral because it was a AAA-rated entity. Thus, when AIG subsequently defaulted on its swap positions, its counterparties lost the value of their previously profitable positions. AIG was able to develop a substantial position in the swap market at little cost because it did not post collateral and it left its creditors unprotected. The cascading effect of AIG default on the broader market was devastating, resulting in widespread investor uncertainty, credit constriction and significant losses of capital. However, when collateral is posted between swap counterparties and complemented by direct federal financial regulation, market discipline is restored and counterparties and the system are protected.

Accordingly, we do not believe that the registration and regulation of non-dealer, swap end-users will provide the SEC or the Commodity Futures Trading Commission (the "CFTC") with effective tools to increase transparency or reduce systemic risk. Rather, we believe that the definition of MSP should focus on market participants that have substantial net positions that expose their counterparties to a full risk of loss. In implementing the definition of MSP, regulators should consider whether a market participant is systemically important, is not otherwise subject to federal financial regulation or could significantly impact the financial system by posing a credit risk to its counterparties.

Further, we believe that defining an MSP to include "highly-leveraged" institutions could potentially lead to two significant, unintended consequences; one with respect to relatively small institutions and one with respect to other market participants. First, we believe that the Bill's definition of MSP could result in the registration of numerous relatively small institutions that have no systemic significance to financial markets. The fact that an institution would not be captured within the MSP definition until it had "substantial positions" in a "major swap category" does not eliminate this concern, particularly given that the Bill neither defines nor explains these quoted terms. In our view, this definition would give rise to significant market uncertainty. Second, with respect to other market participants we are concerned that a regulatory determination that a financial institution would be deemed to be highly leveraged may send a potentially inaccurate and unintended signal to the market that regulators believe, or at least are concerned, that such institution is not creditworthy or is at risk of insolvency. Any such governmental signal of this type may risk precipitating a "run" on that institution, thereby unintentionally hastening its failure. It could also contribute to increasing the costs of obtaining, and decreasing the availability of, capital in our financial system, which would have a significant negative impact on our still fragile economy. We do not believe that Congress intends to create these results.

Accordingly, we recommend that Congress limit the Bill's definition of MSP to those institutions without a primary federal financial regulator: (i) that have substantial net positions, exposing their counterparties to risk of loss; and (ii) whose default on those positions would pose systemic risk to the broader market. This definition would provide a clear benchmark to capture large, systemically risky, non-dealer institutions that do not post collateral to cover their losses (such as AIG), and that create credit exposure to their counterparties and to the broader financial system. Ultimately, we believe that private investment firms, given the new, extensive SEC regulatory authority, should not fall within the definition of MSP as long as they post the collateral required by OTC derivatives regulators on their swap positions.

Capital Requirements for MSPs

We support enhanced regulation of systemically relevant, non-bank market participants and believe that regulators should have both the authority and flexibility to tailor regulations to these participants. Conversely, we believe that mandatory, bank-like regulation of investment funds and advisers, such as capital requirements, is inappropriate, misplaced and could effectively preclude certain institutions from participating in the market. Capital requirements, which are appropriate for banks and other depository institutions that receive federal guarantees on deposits, as well as professional dealers, protect counterparties and the system from risk of loss in the event of a bank or depository institution or dealer's failure. In contrast, non-bank entities such as investment funds currently post collateral and make margin deposits with their counterparties at levels which already reflect the risks of the individual funds' failure. It would be duplicative and punitive for regulators to impose capital in addition to collateral requirements on investment funds. Accordingly, we believe that legislation imposing bank-like capital requirements on these funds (or their advisers) would be inappropriate and misplaced.

Treatment of Margin; FCM Registration Requirement

MFA strongly supports the Bill's provisions that protect the positions and the collateral of swap end-users. Indeed, we believe that certain provisions in the Bill establish sufficient supervisory standards for clearing and afford significant improvements on collateral treatment for cleared and non-cleared transactions. For example, we believe that broadening the definition of "commodity contract" in the Bankruptcy Code to include cleared swaps is an important measure in allowing the expedited recovery of the markets in the event of the failure of a financial institution. We further support the Bill's required segregation of customer initial

margin from the proprietary assets of a swap dealer or clearing organization, as well as from the assets of other customers. In fact, to the extent that the Bill allows more flexible treatment of collateral as to securities-based swaps than it does as to swaps regulated under the Commodity Exchange Act (the "CEA"), we generally support the more protective treatment afforded to CEA-regulated swaps.

In contrast, there is one provision in the Bill with respect to customer collateral that we believe will create significant, unintended and harmful consequences. Specifically, Section 114 of the Bill requires that any swap counterparty that receives margin must register as an FCM. This registration requirement does not distinguish between the receipt of initial margin—which is a one-way payment made by a swap end-user to a swap dealer—and variation margin that both swap counterparties may exchange with each other to reflect a mark-to-market change.

If swap end-users could not collect variation margin without being required to register as FCMs, two significant, negative consequences would result. First, counterparty, systemic and liquidity risks would greatly increase because swap end-users would be incentivized to elect not to secure their exposure through the receipt of variation margin in order to avoid becoming FCMs. Second, swap end-users would likely experience significant liquidity risks to the extent that these end-users would be required to pay out cash for variation margin on unprofitable transactions, but would be unable to collect variation margin on transactions that are in their favor. We believe that both of these problems can be avoided by limiting the FCM registration requirement to institutions that collect initial margin.

Accordingly, we believe that the requirement for swap end-users that receive margin, whether initial or variation, to register as FCMs is unduly burdensome and unnecessary. We, therefore, strongly recommend eliminating this requirement.

Position Limits with Respect to Securities and Securities-based Swaps

We believe the SEC should not be given authority to set position limits on securities positions, either in the cash market or for securities-based swaps. Under the Exchange Act, securities investments and related transactions have historically been regulated through disclosure, not by establishing limits on the size of permitted investments. Under the current regulatory regime, to the extent the size of investments is a concern, it is dealt with through Exchange Act Section 13 reporting requirements and Section 16 short-swing profit regime. In addition, this concern can also be addressed under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, if it raises an anti-trust issue.

Giving the SEC the authority to set position limits on capital market investments would be unprecedented. Such an extraordinary grant of authority should not be made without full consideration of the reasons for granting such authority. It is not clear why, or on what basis, the SEC would impose position limits with respect to securities investments or security-based swaps. We are not aware of any argument that the SEC requires such authority or that it would have been in any way relevant to the past financial crisis. Before Congress grants such novel authority to the SEC, we respectfully believe the effects of granting such authority should be further examined.

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MFA appreciates the opportunity to provide our key concerns regarding the Bill, the overall objectives of which we support. We believe that, in many respects, the Bill provides a thoughtful approach to accomplishing those objectives. As discussed above, we do, however, have some remaining concerns about certain provisions that could impede legitimate market activity. We would be happy to discuss any of

our key concerns and other comments with you or your staffs, or answer any questions that you may have. Please do not hesitate to contact me, Lou Costantino or David Landers at (202) 367-1140, should you wish to discuss any of the matters discussed in this letter.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO