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Via Electronic Submission: www.esma.europa.eu

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AIMA/MFA Response - The Clearing Obligation Under EMIR

Dear Sirs,

The Alternative Investment Management Association (AIMA) and Managed Funds Association (MFA, and together with AIMA, we) welcome the opportunity to provide comments to the European Securities and Markets Authority (ESMA) on its Discussion Paper regarding "The Clearing Obligation Under EMIR"¹ (DP).

In responding to the DP, we highlight our agreement with ESMA's comment that "[g]iven the global nature of the OTC derivatives markets, the international dimension of the clearing obligation is important for market participants".² Many of our members operate in multiple jurisdictions and, therefore, support efforts to ensure consistency in terms of which classes of contracts with particular characteristics are subject to the clearing obligation in different jurisdictions, notably the US and EU. In a number of our responses to ESMA's questions, we refer to those contracts already subject to mandatory clearing in the US,³ and believe that these contracts are most suited to being subject to the clearing obligation in the EU. In this regard, we support ESMA's acknowledgement of the agreement of the OTC Derivatives Regulators Group in respect of the clearing determination. Mutual consultation by regulators is vital to achieving international consistency and smooth implementation of the clearing obligation.

More broadly, regulators must couple consistency in terms of which contracts are subject to the clearing obligation with a globally coherent approach to cross-border business that properly addresses overlaps or conflicts between different jurisdictions' rules. Achieving such alignment requires individual authorities to work together to develop comprehensive substituted compliance or equivalence frameworks, based on broad comparability of regulatory outcomes, rather than the similarity of the language in detailed rules. As we recently made clear, we believe that authorities in the US and EU must continue to engage in ongoing dialogue with the goal of promoting a workable outcome for market participants that operate in multiple jurisdictions.⁴

As regards phase-in of the EMIR clearing obligation, we believe that ESMA should provide at least a 3-month phase-in period for all market participants from the date that ESMA determines that a specific class of contracts is subject to the clearing obligation before requiring market participants to clear that class of contracts. We support the same phase-in period for all market participants because we believe that a phase-in solution that provides different timescales for different categories of participants could give rise to competitive distortions,

¹ ESMA/2013/925. Available online at http://www.esma.europa.eu/system/files/2013-925_discussion_paper_-_the_clearing_obligation_under_emir_0.pdf.

² See DP at 38, paragraph 105.

³ See Commodity Futures trading Commission (CFTC) Final Rule on the "Clearing Requirement Determination Under Section 2(h) of the Commodity and Exchanges Act", 77 Fed. Reg. 74284 (13 December 2012) (CFTC Clearing Requirement). Available online at <http://www.cftc.gov/ucm/groups/public/@rfederalregister/documents/file/2012-29211a.pdf>.

⁴ See AIMA MFA Joint Response on CFTC Further Proposed Guidance Regarding Compliance with Certain Swap Regulations (February 2013). Available at www.aima.org.

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particularly if ESMA defines those categories in a way that results in market competitors becoming subject to the clearing obligation at different times. We would also urge ESMA not to phase in the clearing obligation in a manner that requires clearing members to clear ahead of clients. Such a phase-in could cause central counterparties (CCPs) to finalize their clearing offerings based on the initial preferences of clearing members, rather than the views of the full universe of entities that will ultimately be required to clear under EMIR.

As regards ESMA's approach to defining the characteristics that it should use to group contracts into asset classes, we believe that it is difficult to offer a firm view on those characteristics at this stage, particularly for asset classes for which clearing is less well established. It is possible that as clearing in these classes becomes more established, it will become apparent which are the key characteristics for purposes of determining CCPs' clearing offerings and applying the clearing obligation. Therefore, we encourage ESMA to review frequently its framework for grouping contracts in light of the ongoing evolution of the OTC derivatives market. Although we expect ESMA to address this matter in future consultation papers with respect to specific regulatory technical standards (RTS), we wish to stress the importance of ensuring that this review is a feature of such consultations.⁵

Finally, our response underlines our significant concerns in respect of the retroactive application of the clearing obligation, referred to as "frontloading". Parties price cleared and non-cleared trades according to different assumptions, reflecting their different credit risk profiles and the requirements of the CCP that clears the product. Retroactive application of the clearing requirement would fundamentally change the pricing assumptions used in respect of bilateral transactions, such that ESMA would in effect confer an unfair financial advantage on one of the parties to the original trade. For this reason, we strongly urge ESMA not to use its power to require frontloading.

We would be happy to discuss with you any of the points raised in this submission.

Yours truly,

/s/

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/s/

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⁵ See DP at 6, paragraph 3.



Annex 1

Question 1 (Series for Index CDS): Please indicate your preference between the options presented. Do you believe that the possibility for a new series to exhibit low liquidity is a risk worth being considered when defining the classes of Index CDS? Under Option C, which criteria do you believe are relevant and how should they be calibrated?

We believe that Option B is the best of the options presented (*i.e.*, where an index is subject to the clearing obligation, any future series of that index should also be subject to the clearing obligation on an automatic basis, without ESMA having to determine specifically that the new series is subject to the obligation).

An approach based on positive assessment by ESMA (*i.e.*, Option C) is unworkable because new series of an index can be created relatively frequently as constituents fall out of the index. For example, in addition to regular updates of index series (as mentioned in paragraph 35 of the DP), if there is a credit event with respect to one of the single-name constituents of an existing series, the index provider must establish a new index series and participants must migrate to using it quickly. In such a situation, within a matter of days, the index provider would create a new index version number and existing cleared trades using the old series would be automatically re-booked under CCP rules to constitute trades in the new series. The new series would be identical to the old series, except for exclusion of the defaulted constituent. Market participants need certainty that they will not be breaching the clearing obligation when an index is “reversioned” in this way. Requiring participants to continue trades using the old index pending positive ESMA assessment (which could take 6 months), could prevent market participants from settling following a credit event.

In terms of choosing between Option A and Option B, we believe that it is sensible for ESMA to reserve the power to remove a particular series from the clearing obligation if it becomes necessary to do so, but would note the importance of proceeding with care before using this power.

We also note that in the DP ESMA suggests that National Competent Authorities (NCAs) should be able to initiate the process of removing a particular series from the clearing obligation.⁶ Generally, in respect of any possible removal of an OTC derivative contract from the clearing obligation, we are of the view that ESMA or the NCA responsible for the supervision of the relevant CCP clearing the contract should be able to initiate this process. It should not be that NCAs in any other EU member state are able to initiate a process of withdrawal.

Question 3 (Index CDS): Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

We believe that the index CDS contracts that the CFTC has made subject to mandatory clearing in the US (see below) are also best suited to the clearing obligation in the EU. Global consistency in this regard will support smooth implementation of the clearing obligation, whilst reducing the operational burden on market participants that operate on a cross-border basis.⁷

⁶ See DP at 7, paragraph 5.

⁷ See CFTC Clearing Requirement at 74291.



Specification	North American Untranchéd CDS Indices Class
1. Reference Entities	Corporate.
2. Region	North America.
3. Indices	CDX.NA.IG. CDX.NA.HY.
4. Tenor	CDX.NA.IG: 3Y, 5Y, 7Y, 10Y. CDX.NA.HY: 5Y.
5. Applicable Series	CDX.NA.IG 3Y: Series 15 and all subsequent Series, up to and including the current Series. CDX.NA.IG 5Y: Series 11 and all subsequent Series, up to and including the current Series. CDX.NA.IG 7Y: Series 8 and all subsequent Series, up to and including the current Series. CDX.NA.IG 10Y: Series 8 and all subsequent Series, up to and including the current Series. CDX.NA.HY 5Y: Series 11 and all subsequent Series, up to and including the current Series.
6. Tranchéd	No.
Specification	European Untranchéd CDS Indices Class
1. Reference Entities	Corporate.
2. Region	Europe.
3. Indices	iTraxx Europe. iTraxx Europe Crossover. iTraxx Europe HiVol.
4. Tenor	iTraxx Europe: 5Y, 10Y. iTraxx Europe Crossover: 5Y. iTraxx Europe HiVol: 5Y.
5. Applicable Series	iTraxx Europe 5Y: Series 10 and all subsequent Series, up to and including the current Series. iTraxx Europe 10Y: Series 7 and all subsequent Series, up to and including the current Series. iTraxx Europe Crossover 5Y: Series 10 and all subsequent Series, up to and including the current Series. iTraxx Europe HiVol 5Y: Series 10 and all subsequent Series, up to and including the current Series.
6. Tranchéd	No.

Question 5 (Single name CDS): Please indicate your preference between the options presented. Under Option C, which criteria do you believe are relevant and how should they be calibrated?

We believe that Option C is the most appropriate of the options presented. We agree that liquidity will tend to be greater in contracts that reference index constituents. Nevertheless, both individual constituents of a reference index and non-index constituent single-name contracts might be sufficiently liquid to support the clearing obligation. Therefore, ESMA should seek to develop a criteria-based approach to determine which single-name CDS contracts are ultimately made subject to the clearing obligation.

We do not believe that Option B (*i.e.*, applying the clearing obligation to single-name constituents of an index) is appropriate or workable. CCPs with existing single-name CDS contracts do not currently clear all contracts that reference a single-name constituent of an index that the CCP clears, especially if the single-name constituents are clearing members of the CCP or nationalised companies.

Question 6 (Single name CDS): Do you consider that the main characteristics of Single Name CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

The proposed framework set out in the DP appears unduly simplistic, as different contracts within the proposed subdivisions will not necessarily be fungible, despite the fact that economic fungibility should be a central consideration in ESMA's determination as to whether to group particular contracts together. Specifically, we encourage ESMA to consider the various characteristics relied on in the ISDA Physical Settlement Matrix.⁸ The fields set out in the ISDA Physical Settlement Matrix provide a more granular structure according to which contracts can be grouped, thereby ensuring that the contract groupings reflect economic fungibility.

Question 7 (Single name CDS): Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

We believe that it makes sense to first apply the clearing obligation to CDS indices, before addressing the application of the obligation to single-name contracts. Once ESMA subjects a given index to the clearing obligation, it will create an incentive for market participants to clear voluntarily the single-name contracts that

⁸ Available online at http://www.isda.org/c_and_a/docs/Credit-Derivatives-Physical-Settlement-Matrix-20120529.xls.



are constituents of the index, thereby increasing the liquidity in those contracts, and ultimately increasing the likelihood that those single-name contracts will also be suited to the clearing obligation at a later point in time.

Question 9 (Interest rate derivatives): Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

We believe that the interest rate derivatives contracts that the CFTC has made subject to mandatory clearing in the US (see below) are best suited to the clearing obligation in the EU. Global consistency in this regard will support smooth implementation of the clearing obligation, whilst reducing the operational burden on firms who operate on a cross-border basis.⁹

TABLE 5—INTEREST RATE SWAP DETERMINATION

Specification	Fixed-to-floating swap class			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)	Yen (JPY). LIBOR.
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR.
3. Stated Termination Date Range	28 days to 50 years ...	28 days to 50 years ...	28 days to 50 years ...	28 days to 30 years.
4. Optionality	No	No	No	No.
5. Dual Currencies	No	No	No	No.

TABLE 5—INTEREST RATE SWAP DETERMINATION—Continued

6. Conditional Notional Amounts	No	No	No	No.
Specification	Basis Swap Class			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)	Yen (JPY). LIBOR.
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR.
3. Stated Termination Date Range	28 days to 50 years ...	28 days to 50 years ...	28 days to 50 years ...	28 days to 30 years.
4. Optionality	No	No	No	No.
5. Dual Currencies	No	No	No	No.
6. Conditional Notional Amounts	No	No	No	No.
Specification	Forward Rate Agreement Class			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)	Yen (JPY). LIBOR.
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR.
3. Stated Termination Date Range	3 days to 3 years	3 days to 3 years	3 days to 3 years	3 days to 3 years.
4. Optionality	No	No	No	No.
5. Dual Currencies	No	No	No	No.
6. Conditional Notional Amounts	No	No	No	No.
Specification	Overnight Index Swap Class			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP). SONIA.	
2. Floating Rate Indexes	FedFunds	EONIA	SONIA.	
3. Stated Termination Date Range	7 days to 2 years	7 days to 2 years	7 days to 2 years.	
4. Optionality	No	No	No.	
5. Dual Currencies	No	No	No.	
6. Conditional Notional Amounts	No	No	No.	

Question 10 (Equity derivatives): Please indicate your preference between the options presented. Under Option D, which criteria do you believe are relevant and how should they be calibrated?

At this stage, we do not have a strong preference for any of the options under consideration. Rather, given that clearing in OTC equity derivatives is not well established, we believe that it makes sense to reserve judgement on how ESMA might categorise and apply the clearing obligation to equity derivatives.

⁹ See CFTC Clearing Requirement at 74311.



Question 13 (Equity derivatives): Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

At this stage, we do not believe any OTC equity derivatives are suitable for the clearing obligation, given that clearing of OTC equity derivatives is not well established.

Question 15 (FX derivatives): Do you have preliminary views on the specific items of the presented class which would be the best candidates for the clearing obligation, in view of the criteria to be assessed by ESMA, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

FX swaps and forwards are qualitatively different from other product classes, for a number of reasons, as set forth below and as the US Department of Treasury explores in further detail in its final “Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act”¹⁰:

- FX swaps and forwards involve the exchange of principal amounts that the parties know at the inception of the contract, meaning that the primary risk for this asset class is settlement risk (as opposed to credit or market risk).
- FX swaps and forwards typically have a much shorter maturity than contracts in other asset classes, with over 98% of FX swaps and forwards maturing in less than one year, and 68% in less than one week, meaning that credit risk is less pronounced than in other derivative classes with typically longer maturities.¹¹
- FX swaps and forwards trade in a highly transparent trading environment, with significant use of electronic trading platforms.
- The extensive role of CLS¹² mitigates a significant portion of settlement risk in the FX market. It is estimated that 75% of FX transactions are settled without settlement risk to either party to the transaction.¹³

Recital 19 of EMIR also alludes to these distinctions by noting that the “predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as foreign exchange) from other classes. CCP clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk.”

For these reasons, we believe that it makes sense for ESMA to eliminate explicitly the possibility of subjecting FX swaps and forwards to the clearing obligation for the foreseeable future, aligning itself with the US Treasury’s approach.

Question 19 (readiness of the classes): Do you agree with this analysis?

We agree with ESMA’s analysis that certain contracts within the interest rate and CDS asset classes are the best candidates for the clearing obligation, which parallels the approach that the CFTC has adopted.¹⁴ Indeed, we strongly support on-going dialogue between regulators in different jurisdictions to ensure that there is consistency when it comes to the contracts that are subject to the clearing obligation under different regulatory regimes.

We would, however, caution ESMA against focusing exclusively on the availability of electronic confirmation processing as a proxy for the standardisation of contracts. A high degree of operational standardisation of a contract does not necessarily mean that the contract exhibits the level of standardisation that is required for ESMA to determine that it should subject the contract to the clearing obligation under EMIR.

¹⁰ 77 Fed. Reg. 69694 (20 November 2012) (Treasury FX Determination). Available online at www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf.

¹¹ See Treasury FX Determination at 69697, citing statistics from the Foreign Exchange Committee.

¹² CLS is a multicurrency cash settlement system that mitigates settlement risk for the FX transactions of its members and their customers. See <http://www.cls-group.com/Pages/default.aspx> for further information.

¹³ See Treasury FX Determination at 69697, citing statistics from the Foreign Exchange Committee.

¹⁴ See CFTC Clearing Requirement at 74291, 74310 and 74311.



Question 20 (dates, phase in): What would you consider to be the shortest delay to impose a clearing obligation to a class of OTC derivatives when there are several CCPs available? And when there is only one CCP available? Please specify in your answer whether the cause of delay is due to operational issues (e.g. time for CCP/counterparties to be ready for the CO) and/or to market issues (e.g. time for a CCP to add a new product to its offering).

We would suggest that there be a phase-in period of at least 3 months for all market participants prior to imposing the clearing obligation on a class of derivatives, with a longer phase-in period provided where there are few CCPs clearing the product in question. We elaborate in our response to question 25.

Question 22 (dates, phase in): What should be the assumption regarding market share which the CCP would have to be able to assume? Should it be requested that each CCP be able to handle the whole volume to tackle the worst case scenario?

Ultimately, we believe that ESMA will best accomplish the goals of central clearing if more than one CCP clears a particular contract because it would maximize competition and systemic resilience if a CCP fails. However, we also believe that it makes sense to pursue an approach to clearing that ensures that a single CCP is able to manage the whole volume of trading activity of all contracts subject to the clearing obligation, if this becomes necessary. We acknowledge that such capacity would be necessary only in a worst case scenario, and would be of greater relevance where there are a limited number of CCPs clearing a particular product.

Question 25 (categories of counterparties): Please indicate your preference between the options presented. Would you rather use an option that is not detailed here? Under Options B and C, do you agree to base the clearing access approach on the asset class to which the counterparties have access? What should be the date on which clearing access/threshold calculation should be assessed?

We would support an alternative approach, whereby all market participants would benefit from a period of at least 3 months before having to clear a contract that ESMA has made subject to the clearing obligation. This 3-month time period is the minimum required to complete the significant volume of work associated with onboarding for clearing, which includes conclusion of legal agreements, systems development and testing. In situations where the number of CCPs clearing the contract, or the number of clearing members offering client clearing services, is limited, a period of 6 months would be more appropriate to ensure that the CCP and its clearing members are able to onboard the necessary numbers of clients. See also our response to question 27.

A phase-in solution that provides different timescales for different categories of participant, as provided in the three options outlined in the DP, could give rise to competitive distortions, particularly if ESMA defines those categories in a way that results in market competitors becoming subject to the clearing obligation at different times. We would also urge ESMA not to phase-in the clearing obligation in a manner that requires clearing members to clear ahead of clients, which could cause CCPs to finalize their clearing offerings based on the initial preferences of clearing members, rather than the views of the full universe of entities that will ultimately be required to clear under EMIR.

Question 26 (categories of counterparties): What would in your view be the appropriate timeframe for counterparties with / without access to clearing in the relevant asset class?

As explained in our response to question 25, we would recommend a phase-in of the clearing obligation for all categories of counterparties at the same time. ESMA should determine the appropriate timeframe for this phase-in by looking at the extent to which market participants currently have access to clearing (*i.e.*, where any category of market participant has limited access, ESMA would provide a longer phase-in period that would apply to all market participants).



Question 27 (categories of counterparties): Do you agree that a key factor to take into account when defining the phase in for the counterparties to comply with the clearing obligation will be the number of clearing members offering client clearing services? Is the client clearing capacity of the CCP also a relevant factor? What could be the other criteria?

We agree with ESMA's assessment that it should take into account the number of clearing members offering client clearing services when defining the phase-in period. Where clearing members provide client clearing on a limited basis, ESMA would provide a longer phase-in period that would apply to all market participants. This approach would also provide time for the CCP and clearing members to expand their offering, and for other CCPs to begin providing clearing of the contract in question.

Question 28 (remaining maturity): What are your views regarding the calibration of the remaining maturity of the contracts to be subject to the CO? What criteria should ESMA take into account when defining it?

Frontloading is the retroactive application of the clearing obligation to derivatives contracts of a given maturity entered into after a competent authority has authorised a CCP to clear that class of contracts, but before ESMA has decided whether to apply the clearing obligation to that class of contracts. We expect that there will be a period of trading of at least 6 months between a competent authority's clearing authorisation and the effective date of ESMA's decision to apply the clearing obligation to a class of contracts.

We have the following significant concerns regarding the notion of frontloading:

- Cleared and non-cleared transactions are priced according to inherently different assumptions (reflecting the different credit risk profile associated with each and the requirements set by the CCP). For ESMA to determine that an existing bilateral transaction is subject to the clearing obligation would change the assumptions on which the parties concluded the contract, such that ESMA would in effect be conferring unfair financial advantage on one party to the original bilateral trade.
- In the case of particular contracts, it might not be possible to clear the transaction through a CCP. For example, in the case of an index CDS contract, a roll date might fall in the period during which frontloading might be required; at the roll date, a new series of that index is created and the level of trading activity in the earlier series of the index declines markedly as it goes "off-the-run". It might well be impossible to find a CCP that will be able to clear the off-the-run position on a retroactive basis.
- Frontloading is problematic because it would require counterparties to renegotiate contract terms, which increases the potential for party disputes and thus would detract from the goal of an orderly implementation of the clearing obligation.
- While some participants will start clearing on a voluntary basis after a competent authority's authorisation decision (in order to avoid the potential disputes and operational challenges associated with frontloading), voluntary clearing will not be possible for some clients that do not have access to clearing. Those clients without access to clearing might instead cease trading a class of contracts following a competent authority's authorisation decision to ensure that they do not become subject to frontloading obligations with which they are unable to comply. Such a change in trading behaviour could potentially lead to some clients having large, unhedged exposures.

For this reason, we do not believe that there are any contracts for which frontloading is an appropriate approach, and we strongly urge ESMA not to use its power to require frontloading at this stage.



Question 35 (Modification of a Class+): For which reason (other than the fact that a CCP does not clear it any longer) do you believe that the clearing obligation of a class - or subset of it - would need to be removed? Please focus on the risks which could stem from a clearing obligation on contracts which would no longer be appropriate for mandatory clearing and provide concrete examples.

It is difficult to anticipate the precise circumstances under which ESMA would need to remove a contract from the clearing obligation. However, we reiterate that ESMA should use its power to remove a contract from the clearing obligation with caution, but when ESMA determines to remove a contract, it should also be able to do so expeditiously. Please also refer to our answer to question 36.

Question 36 (Modification of a Class+): In case a clearing obligation would need to be reviewed, how crucial would be the time needed to dis-apply the clearing obligation?

If a situation arises in which it is necessary to dis-apply the clearing obligation, then it is highly probable that ESMA will need to act as a matter of urgency. Therefore, we encourage ESMA to ensure that its approach to the disapplication of the clearing obligation does not entail undue procedural delay, which would certainly be the case if ESMA were compelled to prepare new RTS in order to dis-apply the obligation.



About the associations

AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector - including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,200 corporate bodies in over 40 countries.

Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.
