MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

STUART J. KASWELL
EXECUTIVE VICE PRESIDENT AND
MANAGING DIRECTOR, GENERAL COUNSEL

MANAGED FUNDS ASSOCIATION

For the Hearing on
Reform of the Over-the-Counter Derivative Market:
Limiting Risk and Ensuring Fairness

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

OCTOBER 7, 2009

WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION

Reform of the Over-the-Counter Derivative Market:
Limiting Risk and Ensuring Fairness
October 7, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Financial Services' hearing, ""Reform of the Over-the-Counter Derivative Markets: Limiting Risk and Ensuring Fairness" held on October 7, 2009. 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's members are among the most sophisticated institutional investors and play an important role in our financial system. They are active participants in the commodity, securities and over-the-counter ("OTC") derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. The growth and diversification of investment funds have strengthened U.S. capital markets and provided their investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

MFA is fully supportive of the goals embodied in the Over-the-Counter Derivatives Markets Act of 2009 ("DMA"): (1) reducing systemic risk through the use of central clearing houses, the segregation of customer collateral by central clearing houses and by providing customers with the option of having their collateral for customized swaps segregated; (2) increasing regulatory transparency through trade and position reporting; and (3) providing the government with additional authority to avert and respond to economic or financial turmoil without disrupting the ordinary operation of the markets. MFA believes that smart regulation will improve efficiency and competitiveness in the OTC derivative markets, reduce counterparty and systemic risk, and help regulators identify cases of market manipulation, insider trading or other abuses. We believe the DMA takes a huge step in the right direction and largely addresses the outstanding concerns with respect to the swap markets.

As active participants in the OTC derivative markets, MFA members have a strong interest in promoting the integrity and proper functioning of these markets, and ensuring that there is no repetition of the AIG debacle that required Congress to use taxpayer funds to shore up the stability of that market. Similarly, MFA members are concerned with the possibility of another Lehman Brothers-like failure. As is discussed further in my testimony, a large share of the money that was lost in the failure of Lehman Brothers belong to their customers, including swaps customers, who had posted collateral on their OTC swap transactions with Lehman Brothers that was not segregated. As the Committee may be aware, these assets will likely be tied up in bankruptcy proceedings for many years. Both AIG's near default and the actual Lehman Brothers failure raise significant counterparty and systemic risk concerns for our members. MFA members depend on reliable counterparties and market stability. As such, we have a strong interest in ensuring that new legislation addresses counterparty and systemic risk, and protects customers' collateral by requiring a clearing organization to hold, and a swap dealer to offer to hold, customer funds in segregated accounts, which are protected in the event of bankruptcy. In this regard, we appreciate and support the provisions in the Committee's discussion draft that address segregation of collateral. We provide additional comments further below.

MFA appreciates and commends the Committee on its thoughtful discussion draft. We provide a number of comments, which we believe are consistent with the public policy goals of the DMA and will further enhance the benefits of OTC derivatives regulation. We would like to work with the Committee in addressing these issues and are committed to working with Congress and the Administration with respect to efforts that will restore investor confidence, stabilize our financial markets, and strengthen our nation's economy.

I. THE REGISTRATION OF SWAP DEALERS AND "MAJOR SWAP PARTICIPANTS"[1]

MFA favors the registration and regulation of swap dealers along the lines provided by the DMA, with governmental oversight of swap dealers in a manner consistent with its oversight of securities dealers. We believe that such registration and regulation, such as trade and position reporting, will largely close the regulatory gaps that exist in the OTC derivative markets since most swaps transactions are effected with a swap dealer. In particular, the reporting requirements imposed on swap dealers will do much to assure that all material information is available to the responsible regulators.

With respect to registration of "Major Swap Participants", we recognize that the DMA has a more precise definition of major swap participant than the Obama Administration's proposed OTC derivatives legislation, which we believe will better serve the Committee's objectives of reducing risk to the economy while preserving the availability of OTC derivatives as appropriate risk-management tools. Nevertheless,

[1] Unless the context otherwise requires, we use the term "swaps" to refer both to commodity "swaps" that would be regulated by the Commodity Futures Trading Commission under the DMA and to "security-based swaps" that would be regulated by the Securities and Exchange Commission.

regulated users could potentially include insurance, energy and airline companies, utilities, private funds, pension plans and local governmental entities. Developing and imposing regulations, including capital regulations, on entities engaged in such diverse tasks, and doing so without impairing the new registrants' ability to operate, would be difficult, if not impossible, to implement. Accordingly, we do not believe that the regulators should undertake to require the registration of non-dealer entities as a routine matter. Should there be a situation where the regulators believe it prudent and materially beneficial to require the registration of a non-dealer entity as a major swap participant we believe that the regulators should not be required by the DMA to impose capital restrictions on such major swap participant. We believe that collateral and margin requirements, instead, would achieve the same objective.

In defining a major swap participant, we believe it is important that the DMA direct the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC", together the "Agencies") to publish objective standards for purposes of defining a "substantial net position" in order to provide market participants with a clear understanding of the regulatory boundaries for becoming a major swap participant. For non-dealer participants, the standards demanded of a major swap participant could be highly disruptive and impede a participant's primary business. To lessen the potential disruption and impediment, regulation should alert participants as to the major swap participant registration threshold and allow those participants that cross the threshold to take action, whether it be reducing OTC derivative positions or otherwise, to deregister.

We believe the term "substantial net position" is overly broad and subjective. We recommend the DMA direct the Agencies in defining the term to consider certain factors, such as:

(i) The relative net position of swap dealers (*i.e.,* substantial net position should be measured with respect to the net position of swap dealers);

(ii) The participant's average net position over a relative period of time, such as a year;

(iii) Whether the participant's counterparties have a substantial unsecured credit exposure to such participant from outstanding swaps;

(iv) Whether the participant holds assets belonging to retail customers; and

(v) Whether the participant is an existing registrant with either the CFTC or SEC.

II. TRANSPARENCY AND TRADE REPORTING

MFA believes that price transparency, accomplished by trade reporting through the reports of central clearing organizations or swap repositories, is an essential feature of developed markets. Such transparency both protects end-users who may have more limited access to trading and price information than dealers, and it serves as a means to ensure that parties mark their positions accurately and do not transfer, or demand the transfer, of either too much or too little margin. As such, MFA supports the establishment of a regulatory reporting regime for swap participants in which both cleared and uncleared swap contracts are recorded and reported to regulators on a confidential basis.

In addition, we believe that trade reporting to regulators will provide regulators with greater information and transparency for purposes of understanding and regulating the markets as a whole, and for compliance and enforcement purposes. We believe such transparency and efforts by regulators will enhance the integrity and competitiveness of our markets. We strongly believe that swap repositories, central clearing organizations and regulators should maintain information on individual OTC derivative contract information on a confidential basis to protect the proprietary trading information or intellectual property of individual market participants. Further, we believe that disclosure of trading information of individual market participants could lead to unintended consequences, and may be misleading to the public and harmful to reference entities. To enhance general transparency of the OTC derivative markets, we support the broad publication of aggregated market information that does not disclose individual proprietary trading information.

Insofar as the mechanics of trade reporting are concerned, we believe that the operations of the swaps markets should be consistent with the operations of the securities markets. We support the DMA's reporting framework, which requires a derivatives clearing organization to report cleared swaps, a swap dealer to report trades with a non-dealer, and for swap participants to contractually agree as to which party shall report when a dealer is not a counterparty.

III. Clearing, Segregation and Portability Requirements

MFA believes that a regulatory framework for OTC derivatives should maximize the ability of market participants to mitigate risk and encourage product innovation. As such, it is critical to provide market participants with the ability to engage in non-standardized or customized products. These products allow market participants to custom manage their firm or company's specific risks in a way unmatched by standardized products. Further, we must recognize that today's standardized products were, at their inception, highly customized innovations.

That said, however, we believe that cleared OTC derivatives play an essential role in reducing the interconnectedness that results from too much credit exposure flowing through a limited number of dealers and as a result significantly reduce systemic risk. Central clearing will also allow participants to net trades and more efficiently reduce their OTC derivative exposures across positions, rather than engage in off-setting contracts with multiple dealers to economically neutralize a position where counterparty risks are still present. In addition, central clearing reduces operational and counterparty risk, as it does in the equity and futures markets, and offers increased regulatory and market efficiencies with respect to cleared OTC derivative products. Thus, we believe that legislation should strongly promote central clearing of standardized OTC derivative products.

In this respect, we believe the DMA does not go far enough in promoting the use of clearing organizations to clear standardized OTC derivative products. The DMA would only make central clearing mandatory after the appropriate Agency had determined such clearing was appropriate for a particular swap, and even then only as to swaps involving a limited group of participants. We recommend that the DMA broadly encourage central clearing by:

(i) Allowing end-users that post cash collateral to have access to central clearing either through direct participation in a clearing organization or through a swap dealer where there is a clearing house that will take the swap;

(ii) Providing, where it is possible for a swap to be cleared through a clearing house, that the appropriate regulator impose capital requirements on a dealer that would motivate the dealer to trade through the clearing house and not on an uncleared basis; and

(iii) Requiring the Federal Reserve Bank of New York ("NY Fed"), with appropriate standards, to continue its efforts to increase the volume of transactions that are centrally cleared and to report to the Committee on at least an annual basis as to progress in this direction and any impediments to progress.

With regard to clearing organizations, we support the provisions in the DMA that: (i) governance arrangements should be transparent and take account of the views of all market participants; and (ii) membership standards should be fair and open, including with respect to access by non-dealers. In sum, we believe an OTC derivatives regulatory framework should make available to end-users the opportunity to engage in standardized trades eligible for clearing either as direct clearing organization members or through a swap dealer.

At the same time, while we hope that most pre-adoption date or "legacy" standardized swaps would be moved to central clearing organizations, we raise the concern that these trades may have been entered into on the basis of understandings and economic arrangements that reflected then current law. We believe that if Agencies, under the DMA, mandate central clearing for products before addressing these concerns, such a requirement may be very disruptive to the market. For example, the initial margin requirements for a standardized, cleared trade may be linked (or "hedged") to the initial margin requirements for a non-standardized, non-clearable trade. In this instance, if this hedged trade was disrupted by a *post facto* change in law, we think there is the potential for market disruption that would outweigh the advantages of mandatory clearing for this existing business. For these reasons, we suggest that the DMA do the following: (i) exempt from the Agencies' clearing requirement any new swap contracts that hedge legacy swap contracts, but would otherwise be clearable, until the legacy contracts mature or are unwound; and (ii) expedite the transition of legacy trades into centralized clearing by creating inducements (*e.g.*, substantially better capital treatment for cleared trades), but any such provision should not penalize end-users relative to dealers.

With respect to reducing systemic risk, we believe the most important requirement that must be imposed on a registered clearing organization is the prohibition against a clearing organization or its members having access to the collateral of their customers or commingling their proprietary assets with those of their customers, based upon a legal framework that protects those assets from the insolvency of a clearing member. In this regard, we believe the DMA takes a number of important steps by expressly requiring the segregation of collateral on cleared trades and further by requiring that dealers make segregation optional with respect to trades that are not cleared. As positive as these steps are, MFA is concerned that Congress's intent in protecting end-users from dealer failure will not be realized unless corresponding changes are made to the bankruptcy laws, including those applicable to banks that act as swap dealers, which recognize that the margin segregated for customers is meant to be returned to customers and not appropriated for the general expenses of the swap dealer. These changes to the bankruptcy laws, which protect customer assets, will also make it possible to transfer swaps out of a failing dealer and into a stable dealer, which will hopefully do much to diminish financial contagion caused by rippling failures.

Finally, over the past several years, MFA and its members have worked with swap dealers and regulators, including the NY Fed, to build-out the infrastructure of the OTC derivative markets. We believe the NY Fed's involvement has been instrumental in encouraging the industry to agree on key documentation terms that constitute standardization and developing central clearing. This process has benefited buy-side investors by expediting the process of reducing systemic and counterparty risks, and developing and making available efficient, standardized products. We would like to see regulators build on existing public-private efforts to further promote the development of these markets. We recommend that the DMA formalize the public-private working group as an "OTC Derivative Markets Advisory Committee" to further promote the development of central clearing and the OTC derivative markets infrastructure.

IV. SEGREGATION OF CUSTOMER ASSETS ON NON-CLEARED TRANSACTIONS

MFA supports the DMA provision that requires swap dealers to offer customers the availability of collateral segregation. We believe that the benefit that the financial system will derive from the mandatory clearing of standardized products will be substantially multiplied if consistent protections are at least made available with respect to non-cleared products.

The case in point is the failure of Lehman Brothers. The losses resulting from the failure of Lehman Brothers are astronomic. Even as to the money that may eventually be recovered, the delays will be substantial, into the many years. Further, the process of recovery will undoubtedly generate numerous disputes over valuation and conflicting rights that seem likely to deplete a good portion of what otherwise might have been available for distribution to the directly injured parties.

A large share of the money that was lost by the failure of Lehman Brothers was not that of Lehman Brothers' shareholders or even of its ordinary creditors who had made an investment decision to lend money to that firm. Rather, the money lost was that of Lehman Brothers customers, including its swaps customers, who had posted collateral with Lehman Brothers that was not segregated.[2] Ironically, such collateral is often posted as a credit mitigant against a customer failure—yet dealer counterparties are currently free to use such collateral as their own property—exposing customers to the risk of loss. MFA believes that the financial markets cannot perform their purpose of capital formation if customers that are seeking safe custodial treatment of their assets are subject to the same risks, or even disproportionate risks, to the shareholders and creditors of a company. Custodial customers ought to be protected from the imposition of investment risk. In this regard, MFA believes that initial margin posted by end-users on swaps is intended as a safeguard against failure; it ought not to be transformed by a swaps dealer into a disguised and forced investment by a customer into the assets of the swaps dealer. The DMA takes an important step in this direction. But again we emphasize the importance of changing the bankruptcy laws to effectuate these changes.

V. EXCHANGE TRADING

MFA supports the goals of market transparency and enhanced liquidity. In this regard, we support the ongoing development of trading markets that respond to the needs of both swaps dealers and end-users, whether this is exchange trading, OTC trading, or, as we think will eventually likely be the case, a hybrid market that accommodates both exchange and OTC trading. Further in this regard, MFA supports the development of exchange-traded products as a complement to OTC products and we believe, that given the recent and significant efforts regarding product standardization and clearing, such products will steadily emerge in the marketplace. We support the DMA's approach to exchange trading in that it requires the Agencies to endeavor to eliminate unnecessary impediments to exchange trading. However, we believe that exchange trading should not be viewed solely as a vehicle for swap dealers and major swap participants. We believe that end-users may also benefit from exchange or electronic market trading. We recommend that to the extent such products or exchange markets do not emerge over a reasonable time period, the Agencies should undertake a study to determine whether there are artificial barriers standing in the way of the development of such products or markets.

[2] We believe that there is in excess of $50,000,000,000 in customer assets still being held in Lehman Brothers International (Europe) ("LBIE"), which belongs to pension funds, endowments, hedge funds, and other large U.S. institutions whose beneficiaries are U.S. citizens. There is no timetable for when the assets will be returned. Congressman Gregory Meeks (D-NY) has offered a Concurrent Resolution seeking action to free the assets trapped at LBIE (See H. Con. Res. 184).

VI. POSITION LIMITS AND REPORTING

We have strong concerns with the DMA provisions providing the Agencies with the authority to impose position limits in the swap and security-based swap markets. We believe the statutory purpose or public policy objective behind position limits is unclear and that the DMA does not provide the Agencies with adequate guidance as to the policy objectives behind position limits. Position limits do not address systemic risk concerns, which as discussed, can be addressed through appropriate capital and margin charges, among other solutions.

As a general matter, MFA believes that position limits should only be imposed for physically-delivered commodities and only where the deliverable supply of the commodity is limited and, thus, subject to control and manipulation. Even then, regulators need to consider the right size for such limits to accommodate a market's unique depth and liquidity needs. On the other hand, where there is a nearly inexhaustible supply of the underlying commodity, concerns related to control and manipulation are largely irrelevant, making position limits an unnecessary and costly interference in markets.

We observe that it has long been recognized that cash-settled commodities do not raise the same market manipulation concerns as do physically-delivered commodities. Cash-settled commodities have deep and liquid markets, are primarily used for hedging and risk mitigation, and have little or no impact on consumers. We believe that the mechanical imposition of limits for cash-settled commodities will have the effect of reducing liquidity and the ability of commercial participants to hedge against future changes in price by limiting the ability of market participants to appropriately diversify and reduce risk. We are also concerned that position limits would distort markets, especially given the global nature of the OTC derivative markets. We respectfully urge the Committee to take into consideration the impact that such regulation would have on U.S. markets when international markets do not impose position limits. To the extent the Committee determines it necessary that the DMA provide the CFTC with authority to impose position limits, we believe the authority to apply position limits should be subject to the international harmonization provision of the DMA.

With respect to securities, we strongly disagree to the DMA providing the SEC with the authority to set position limits on securities, either in the cash market or on securities-based swaps. Under the Securities Exchange Act of 1934 ("Exchange Act"), securities investments and related transactions are regulated through disclosure, not by establishing limits on the size of permitted investments. That is, 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, as an anti-trust issue, under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR"). Under the HSR, procedures are in place to monitor positions that may be anti-competitive.[3]

---

[3] We also note that many specific industries have ownership restrictions in cases where it is viewed as beneficial to restrict ownership in these industries (*e.g.*, banks, airlines, and casinos).

Giving the SEC the authority to set position limits on capital markets investments would be unprecedented. Any such extraordinary action should not be shoehorned into swaps legislation but should only be considered following an open discussion on the merits. Furthermore, it is not clear why, or on what basis, the SEC would impose position limits on investments in corporate issuers or economic exposure to corporate issuers. We are concerned that imposing position limits on corporate ownership or exposure could have very substantial negative impacts on capital formation, the ability of banks and other credit institutions to transfer risk, the ability for corporations to obtain credit, and on corporate control.

We believe that the emphasis on position limits in the draft legislation is unrelated to the stated goals of addressing systemic risk and should not be used as an inadvertent vehicle to open up issues relating to corporate control. In addition, we believe that in this environment where the SEC is focused on improving shareholder rights and boosting investor confidence, providing the SEC authority to limit investors' investments in corporations may be an unwise expansion of government intervention into corporate governance. We believe these issues should be given further consideration in a separate hearing with representatives from the broader investor community.

MFA stands ready to work constructively with Congress and the SEC in providing an investor perspective as to the appropriate degree of public and regulatory position reporting transparency. As with position limits, however, we do not think it is good policy to revise Section 13(d) and related reporting requirements without giving much greater consideration as to how these statutory changes would impact the capital markets. Accordingly, we respectfully request that the Committee consider a separate hearing to address these important investor issues. Moreover, with respect to position reporting, we believe that the swap repositories will provide the SEC with access to all the data it needs to track swap positions and make factual determinations to see if changes in disclosure policy are warranted.

VI. ABUSIVE SWAPS

The DMA provides the Agencies with the authority to ban abusive swaps. We are concerned that such provision is overly broad and vague, and lacks clear statutory and public policy goals. If the Committee is concerned about the use of a swap to manipulate the market of a reference entity, we believe such scenarios may be more appropriately addressed through the current antifraud and anti-manipulation authority of the SEC and CFTC. To the extent the Committee is concerned that a swap provides a negative signal to the market as to the financial health of a reference entity, we are concerned that by banning the swap, the Agencies would not reduce or eliminate the risk of default by the reference entity, but instead would prevent parties from mitigating their exposure to the reference entity. Moreover, the act of banning such a swap is likely to signal to the market the negative financial condition of the reference entity and could exacerbate the decline of the reference entity's stock price and counterparty relationships. Accordingly, we recommend the Committee replace the DMA's abusive swap provision with an antifraud and anti-manipulation provision to protect the integrity of the swap markets and the markets of their underlying reference entities.

VII. CONCLUSION

MFA appreciates the Committee's thoughtful discussion draft on the Over-the-Counter Derivative Markets Act of 2009. MFA believes that regulation of OTC derivatives products should be implemented in a manner that respects the similarities and important differences among asset classes. To the extent practicable, regulation of OTC derivatives by the CFTC and SEC should be streamlined, consistent, and take into consideration the economic fundamentals of the product. We support the DMA's requirement that the Agencies engage in joint rulemaking, adopt uniform rules, where applicable, and share interpretative guidance. In this way, we believe that the Agencies will minimize the likelihood to create regulatory loopholes and arbitrage opportunities. Further, regulation that were to treat products within an asset class differently, such as single security CDS and CDS indices, would add no benefits in protecting against systemic risk, but would greatly increase the complexity and cost of regulation for market participants and limit their ability to use such products to manage credit risk. We believe that smart regulations that parallel market practice will enhance oversight and compliance, support the risk management needs of market participants and further promote innovation and competition.

MFA is committed to working with Members and staff of the Committee and regulators to enhance our regulatory system, to reestablish a sound financial system and restore stable and orderly markets. Thank you for the opportunity to appear before you today. I would be happy to answer any questions that you may have.