MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

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EXECUTIVE VICE PRESIDENT AND
MANAGING DIRECTOR, GENERAL COUNSEL

MANAGED FUNDS ASSOCIATION

For the Hearing
To Review the Implementation of title VII of the
Dodd-Frank Wall Street Reform and Consumer Protection Act, Part II

BEFORE THE

SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 15, 2011

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WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION

Reviewing the Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Part II
February 15, 2011

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Agriculture Subcommittee on General Farm Commodities and Risk Management's hearing, "[t]o review implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act [(the "Dodd-Frank Act")], Part II" held on February 15, 2011. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies around the world.

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 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.

In addition, MFA members are active participants in the OTC derivatives markets, where they use swaps to, among other things, hedge risk. For example, an asset manager that has investments denominated in foreign currencies may engage in a currency swap to hedge against the risk of currency fluctuations and protect its portfolio from such related losses. As active participants in the derivatives markets, MFA members also play a critical role in enabling commercial and other institutional market participants to reduce their commercial or balance sheet risk through the use of swaps. For example, corporate end-users may purchase a credit default swap from a dealer to protect themselves from the default of another corporation, or a pension fund may purchase a variance swap from a dealer to protect against stock market volatility and to ensure that it can meet its future obligations to pensioners. In such scenarios, dealers generally look to balance their books by purchasing offsetting protection from market participants who may be better positioned to manage such risk, such as hedge funds. Dealers would be limited in the amount of protection they could offer their customers if

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there were no market participants willing to purchase or sell protection to mitigate a dealer's risk.

MFA members depend on reliable counterparties and market stability. As such, we have a strong interest in promoting the integrity and proper functioning of the OTC derivatives markets, and in ensuring that new regulations appropriately address counterparty and systemic risk, and protect customers' collateral by requiring a clearing organization to hold, and a swap dealer to offer to hold, customer funds in individually segregated accounts, which are protected in the event of bankruptcy. MFA is fully supportive of policymakers' goals to improve the functioning of the markets and protect customers by promoting central clearing of derivatives, increasing transparency and implementing other measures intended to mitigate systemic risk. MFA believes that smart regulation will improve efficiency and competitiveness in the OTC derivatives markets, reduce counterparty and systemic risk, and help regulators identify cases of market manipulation or other abuses.

MFA appreciates the Committee's review of the implementation of Title VII of the Dodd-Frank Act. We provide a number of comments, which we believe are consistent with the Committee's public policy goals and will further enhance the benefits of OTC derivatives regulation. We would like to work with the Subcommittee, the CFTC and any other interested parties in addressing these issues and are committed in working towards regulations that will restore investor confidence, stabilize our financial markets, and strengthen our nation's economy.

PROTECTING THE INTEGRITY OF THE REGULATORY PROCESS

MFA recognizes that the Dodd-Frank Act mandates regulators to promulgate a record number of new regulations within 360 days of its enactment, and commends regulators for their diligence and dedication to implementing a new OTC derivatives regulatory framework. Nevertheless, we offer a few recommendations to further encourage the Committee, in its oversight role, to ensure and protect the integrity of the regulatory process.

The OTC derivatives markets play an important role in our economy because OTC derivatives have become an important tool for market participants to mitigate risk. MFA supports a formal OTC derivatives regulatory framework as we believe smart regulation will reduce systemic and counterparty risk, and enhance market efficiency, competition and investor protection. We are concerned however, that at times the current regulatory process has been overly focused on quantity over quality of regulations.

In order to establish a regulatory framework that achieves the goals of policymakers, it is important to ensure that the implementation of Title VII proceeds in a thoughtful, logical fashion that strengthens the derivatives markets and does not impair market participants' ability to mitigate risk through swaps. In this respect, we note, as an

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example, that it has been a challenge responding to proposals on the regulatory requirements of certain entities prior to understanding how the specific entities are proposed to be, or will be, defined.

MFA also respectfully urges the Committee to encourage regulators to enhance coordination and consistency of their regulations, where applicable, and reduce duplicative regulation. The reality of more and more market participants diversifying their trading strategies and business ventures is that more entities will find that they need to register with both the Commodity Futures Trading Commission ("CFTC') and Securities and Exchange Commission ("SEC"). Inconsistent regulations will be costly, burdensome and, in some cases, impossible for market participants to comply with both regimes. We believe regulators should also work together to reduce duplicative regulation. This would be a more efficient use of government resources, as well as reduce the regulatory costs and burdens on market participants and their customers.

CENTRAL CLEARING AND ACCESS TO CLEARING SIGNIFICANT ENTITIES

MFA supports policymakers' efforts to reduce systemic risk through proliferating central clearing and enhancing transparency. We believe that central clearing will play an essential role in reducing systemic, operational and counterparty risk. While we expect a bilateral market to remain for market participants to customize their business and risk management needs, we believe that mandatory clearing and gathering of data by swap data repositories ("SDRs"), to the extent practicable, are key first steps that will offer increased regulatory and market efficiencies, greater market transparency and competition. Therefore, it is important to move with alacrity towards central clearing.

As customers, we recognize that the success of central clearing and the gathering of data will depend on the structure, governance and financial soundness of derivatives clearing organizations ("DCOs"), SDRs, swap execution facilities ("SEFs") and designated contract markets ("DCMs"). Accordingly, we emphasize the need for DCOs, wherever applicable, to have transparent and replicable risk models and to enable fair and open access in a manner that incentivizes competition and reduces barriers to entry. Thus, from a customer protection perspective, we believe it is important to have customer representation on the governance and risk committees of DCOs because given the critical decisions such committees will make (*e.g.*, decisions about which classes of swaps the DCO is permitted to clear), they will benefit from the perspective of such significant and longstanding market participants. We also believe that to completely effectuate fair representation and balanced governance, it is critical that the CFTC adopt regulations that prohibit any group from constituting a controlling majority of DCO boards or risk committees.

With respect to DCOs, DCMs and SEFs, MFA appreciates that the CFTC has proposed rules intended to ensure that these crucial entities are governed in a manner that prevents conflicts of interest from undermining the CFTC's mission to reduce risk,

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increase transparency and promote market integrity within the financial system. We very much appreciate that the proposed rules reflect the CFTC's detailed appraisal of market concerns, and we believe the rules are a critical step towards mitigating conflicts of interest at DCOs, DCMs and SEFs while preserving their competitiveness and ability to provide the best possible services to the markets.

With respect to SDRs, we emphasize that their role as data collectors is critical to providing transparency and greater information about the financial markets. We believe that the data received by SDRs and shared with regulators will form an essential component of the regulatory process by providing regulators with the information necessary to refine their regulations and to effectively oversee the markets and market participants.

SEGREGATION OF CUSTOMER COLLATERAL

MFA supports measures aimed at increasing protections for customer assets posted as collateral for swaps. Therefore, with respect to uncleared swaps, we support the legislation's requirement that swap dealers ("SDs") offer their customers the option to segregate initial margin in a custodial account, separate from the assets and other property of the SD. Similarly, we support indications from the CFTC that they intend to require segregation of customer collateral for uncleared swaps be pursuant to custodial agreements where the SD or MSP, custodian and customer are all parties (*i.e.*, tri-party agreements). It is essential that counterparties have the right to elect individual segregation of initial margin for uncleared swaps on commercially reasonable terms because it not only protects customer property in the event of an SD or MSP default, but also ensures the stability and integrity of the OTC derivatives markets.

While the CFTC's proposed rule for uncleared swaps seems to imply that an SD or MSP is required to offer segregation of initial margin to its counterparty in the form of a tri-party agreement, policymakers should recommend that the CFTC explicitly clarify that use of a tri-party agreement is required. Many of our largest members have already negotiated tri-party agreements with respect to their initial margin for uncleared swaps, but we believe all counterparties should have the right to these protections, which will help to prevent harm to counterparties and the markets.

However, we recognize that tri-party agreements are only one of several arrangements through which counterparties might protect their collateral delivered as margin for uncleared swaps. As a result, we appreciate that the CFTC has retained the flexibility for counterparties to accept a less secure form of segregation. We agree that market participants' should have the freedom to use any form of negotiated collateral arrangement they so choose.

For cleared swaps, MFA applauds policymakers' decision in the legislation to prohibit futures commission merchants ("FCMs") from treating a customer's margin as

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its own and from commingling their proprietary assets with those of their customers. We agree that segregation of assets is a critical component to the effective functioning of the mandatory clearing regime and necessary to ensure that customer assets are protected in the event of the FCM's insolvency. Because we support the protection of customers, we are concerned that the CFTC appears to be moving away from requiring the use of individual customer segregated accounts for cleared swaps.

The comment period recently closed on a CFTC advanced notice of proposed rulemaking, where the CFTC solicited comment on four potential segregation models for collateral posted on cleared swaps. Out of the CFTC's four proposed models, we believe that only the full segregation model offers strong protections for customer collateral in the event of an FCM default and allows for efficient transfer of customer positions and collateral in the event of an FCM default.

MFA recognizes that other market participants have provided the CFTC with conflicting views on the expense of the proposed segregation models. We believe current cost estimates associated with the use of the full physical segregation model may be overstated. To determine which proposed model best accomplishes the goals of the legislation and the CFTC, we strongly urge policymakers to recommend that the CFTC conduct or sponsor an independent, comparative cost study of each segregation option before adopting any particular model, and require the CFTC to provide market participants sufficient time to evaluate the study results and respond. If the study concludes that adopting full physical segregation for cleared swaps would not impose inordinate costs on customers, we strongly urge adoption of this model in order to best protect customer assets and allow for the transfer of customer accounts and related assets.

DEFINITION OF MAJOR SWAP PARTICIPANT

The legislation provides a definition for a new category of market participant called "major swap participants" ("MSPs"). Because entities that become MSPs will be subject to significant regulatory obligations, including new capital requirements as well as a number of business conduct and other requirements, the way in which this important term is defined will significantly affect the evolving markets for swaps and the conduct of participants in these markets. MFA believes that the MSP designation should capture systemically important, non-dealer market participants whose swap positions may adversely affect market stability. In addition, we strongly support the need for enhanced market standards and consistency to prevent anomalous and dangerous practices, such as AIG's, and which mitigate the excessive build-up of counterparty and systemic risk.

The legislation gives the CFTC, jointly with the SEC, (together with the CFTC, the "Commissions"), the authority to define certain important terms that form part of the MSP definition, such as "substantial position", "substantial counterparty exposure" and "highly leveraged". Recently, the CFTC and SEC jointly issued a proposed rule

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providing different tests and threshold levels for these terms in order to clarify which entities are MSPs.

MFA supports the Commissions' general approach to the MSP definition and the tests for the different terms. However, we think it would be useful for the Commissions first to conduct an informal survey to determine which types of market participants will likely meet the definition and whether the proposed definitional thresholds are appropriate as proposed. We think such a survey can be conducted without incurring significant costs or delaying the progression of the regulations. In addition, we would appreciate more clarity around the tests, such as the effects of over-collateralization or cleared swap positions on the calculations, to ensure that there is a bright line where market participants have certainty as to whether they need to register as an MSP. Lastly, to be effective going forward, the Commissions need to ensure that their proposed rules take into account reasonable projections about market activity and growth, so that the rules capture the intended market participants.

CAPITAL AND MARGIN REQUIREMENTS

For market participants that must register as MSPs, the legislation requires that the CFTC impose capital and margin requirements on entities that are subject to regulation as non-bank SDs or MSPs. We are concerned, however, about what capital requirements the CFTC may impose.

Unlike banks, our members do not hold capital, but instead manage assets on behalf of their investors, who have the right to redeem them subject to the terms of their contractual agreements. Accordingly, instead of holding capital, our members post margin to secure their obligations to their counterparties and our members are generally comfortable with margin requirements consistent with current market levels. Moreover, our members posting of margin serves a risk mitigation purpose functionally equivalent to the role that capital serves for banks (*i.e.*, protecting our counterparties and the financial system against our default).

As a result, requiring our members to hold capital would be inconsistent with their business structures and would materially increase the cost for them to enter into OTC derivatives contracts. Furthermore, imposing capital requirements over and above the margin that our members post could have significant, unintended consequences, including potentially precluding them from participating in the market altogether. Accordingly, given our members' business model, we believe that in setting capital requirements for non-bank MSPs, the CFTC should count margin posted by such non-bank MSPs towards any capital requirements to which they may be subject.

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POSITION LIMITS

MFA recognizes that the Dodd-Frank Act expanded the CFTC's authority to set position limits, as appropriate, to deter and prevent excessive speculation, market manipulation, squeezes and corners. Academic and governmental studies and real world examples show that policies restricting investor access to derivatives markets impair commercial participants' ability to hedge and restrict the use of risk management tools. We do not believe position limits have proven to be effective at reducing volatility or market manipulation.

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.

Nevertheless, if the CFTC is determined to impose position limits, we believe it is critical for the CFTC to conduct a study on commodities markets for purposes of assessing the appropriateness of setting position limits, and, if appropriate, the level at which limits should be set. Regulation should be based on appropriate findings, and the CFTC should have data on the size of the markets before considering imposing position limits. We also believe it is critical for any position limits regulation to provide market participants with a bona fide hedging exemption, consistent with CFTC Regulation 1.3(z), and independent account controller exemptions. In this way, position limits regulation is less likely to unintentionally reduce market liquidity and the ability of market participants to appropriately diversify and hedge risk. Accordingly, we recommend that the Subcommittee encourage the CFTC to conduct a study of the commodities markets, including the size and number of market participants in related or equivalent OTC derivatives markets, prior to imposing position limits.

SWAP EXECUTION FACILITIES

The legislation defines a "swap execution facility" (a "SEF") as "a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that—(A) facilitates the execution of swaps between persons; and (B) is not a designated contract market." However, we are concerned that the CFTC is interpreting the definition too narrowly

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because its proposed rule requires that to qualify as a SEF a company must offer a "many-to-many" quote platform (*i.e.*, a trading platform where a market participant must transmit a request for a buy or sell quote to no less than five market participants).

MFA believes that each SEF trading platform needs to be appropriate for the product type it will execute, as the characteristics and corresponding trading needs vary. In addition, we believe that permitting the broadest range of swap trading platforms (subject to the requirements under the legislation) would benefit investors, promote market-based competition among providers, and enable greater transparency over time and across a variety of products. Therefore, we would appreciate it if policymakers could provide guidance to the CFTC on Congress's intended interpretation of the definition, so that the CFTC's final rules will preserve flexibility and opportunity for variety and organic development among SEF trading platforms to the benefit of all market participants and consistent with the approach in other markets.

MFA is still reviewing and analyzing the CFTC's proposal and we would appreciate the opportunity to provide our written comment letter to the Committee as an addendum to our testimony once it is complete.

CONCLUSION

MFA appreciates the Subcommittee's review of the implementation of Title VII of the Dodd-Frank Act. As discussed, MFA believes that OTC derivatives regulation has the potential benefits of reducing systemic and counterparty risk, and enhancing market efficiency, competition and investor protection. We recommend that the Subcommittee encourage the CFTC in implementing the Dodd-Frank Act to work with market participants to consider and adopt meaningful and cost-effective regulations in a logical, thoughtful and timely manner. 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, as well as the likelihood that an entity will need to register with both agencies. 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 Subcommittee and regulators to restore investor confidence, enhance our regulatory system, stabilize our financial markets, and strengthen our nation's economy. Thank you for the opportunity to appear before you today. I would be happy to answer any questions that you may have.

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Stuart Kaswell
Executive Vice President and Managing Director, General Counsel

Stuart J. Kaswell is Executive Vice President and Managing Director, General Counsel at Managed Funds Association (MFA). In his role as chief legal officer, Stuart represents the hedge fund industry on domestic and international legislative and regulatory policy issues. Stuart works directly with MFA's President and CEO to oversee all legal aspects of the Association's legislative and regulatory policy initiatives in Washington and around the world.

Prior to joining MFA, Stuart was Partner in Bryan Cave's White Collar Defense & Investigations, Securities Litigations & Enforcement practice groups and focused on issues including financial services regulation and short sale regulation. Previously, Stuart was Partner in the financial services group at Dechert, LLP. Stuart was Senior Vice President and General Counsel, Securities Industry Association for nearly a decade (1994-2003) serving as chief legal officer and responsible for all legal and regulatory matters. Prior to that, he was Republican (Minority) Counsel, Committee on Energy and Commerce, U.S. House of Representatives. Earlier in his career, (1979-1986) he held several positions at the Securities and Exchange Commission, including as branch chief, OTC regulation, during which time he was responsible for oversight of the NASD. Stuart received his A.B. in political science from Vassar College with General and Departmental Honors, and his J.D., from Washington College of Law, The American University. His bar admissions include Virginia, District of Columbia, Maryland, U.S. Supreme Court and various Federal Courts.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2008.

Name: Stuart J. Kaswell

Organization you represent (if any): Managed Funds Association

1. Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:

Source: NONE Amount: _____

Source: _____ Amount: _____

2. If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2008, as well as the source and the amount of each grant or contract:

Source: NONE Amount: _____

Source: _____ Amount: _____

Please check here if this form is NOT applicable to you: _____

Signature: [signature] 2/14/11

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

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