MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

STUART J. KASWELL
EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL

MANAGED FUNDS ASSOCIATION

For the Hearing on the

"Derivatives Markets Transparency and Accountability Act of 2009"

BEFORE THE

U.S. HOUSE COMMITTEE ON AGRICULTURE

FEBRUARY 2, 2009

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TESTIMONY OF MANAGED FUNDS ASSOCIATION

"Derivatives Markets Transparency and Accountability Act of 2009"
February 2, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Agriculture's hearing on the "Derivatives Markets Transparency and Accountability Act of 2009" (the "Derivatives Act") to be held February 2, 2009. 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, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies around the world.

MFA appreciates the opportunity to express its view on the Derivatives Act and the important issues that it raises. MFA members are active participants in the commodities and over-the-counter ("OTC") derivatives markets and have a strong interest in promoting the integrity of these markets. MFA consistently supports coordination between policy makers and market participants in developing solutions to improve the operational infrastructure and efficiency of the OTC credit derivatives markets. We are supportive of the Committee's goals to: (1) enhance transparency and reduce systemic risk; (2) promote a greater understanding of the OTC markets and their interaction with exchange-traded and cleared markets; (3) ensure equivalent regulatory oversight in the international regulatory regime for energy commodities and derivatives and provide for greater information sharing and cooperation among international regulators; and (4) provide additional resources to the Commodity Futures Trading Commission ("CFTC").

Nevertheless, we have significant concerns with several provisions of the Derivatives Act, including, in chronological order, Section 6 "Trading Limits to Prevent Excessive Speculation", Section 11 "Over-the-Counter Authority", Section 12 "Expedited Process", Section 13 "Clearing of Over-the-Counter Transactions", and Section 16 "Limitation on Eligibility to Purchase a Credit Default Swap". We believe these provisions would have the effect of reducing market participants' hedging and risk management tools, and negatively impact our economy by raising the cost of capital and reducing market transparency and efficiency in capital markets. We would like to work with the Committee in addressing these issues. We respectfully offer our suggestions in that regard.

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TRADING LIMITS TO PREVENT EXCESSIVE SPECULATION

As a general matter, greater market liquidity translates into more effective price discovery and risk mitigation, especially in physically-settled contracts. We are concerned that Section 6 "Trading Limits to Prevent Excessive Speculation" will impose upon the CFTC a new obligation that historically has been left to the exchanges in deference to their greater expertise respecting the various factors that affect liquidity in these markets. We are concerned that Section 6 implements an overly rigid structure for establishing speculative position limits. We urge that the markets are best served by placing the CFTC in an oversight role.

Currently, the exchanges, as part of their self-regulatory obligations, are involved daily in monitoring the activities of market participants. They frequently engage in soliciting the views of speculators and hedgers in their markets. Also, they are more closely engaged in watching deliverable supply. Because position limits may have an impact on price, we believe speculative position limits are best determined by a regulatory authority, rather than market participants through position limit advisory groups. For these reasons, we believe that the exchanges, subject to their regulatory obligations under the Commodity Exchange Act ("CEA"), should propose the size of the speculative position limits following the processes they now employ with their energy and other markets.

Section 6 would require the CFTC to convene a Position Limit Agricultural Advisory Group and a Position Limit Energy Group, consisting of industry representatives, exchanges and electronic trading facilities, to provide the CFTC with position limit recommendations. While, as stated, we believe the exchanges, subject to the CFTC's oversight, should determine and administer speculative position limits, we are concerned that the make-up of these advisory groups is not well-balanced and therefore does not provide a mechanism for obtaining the views of all parties active in these markets. For example, non-commercial participants add vital liquidity to these markets through investment capital and are necessary to the success of a market. Thus, we believe that each advisory committee should have the same number of non-commercial participants as there are short and long hedgers.

We support the setting of speculative limits in spot months for physically-delivered energy and agriculture commodities for two reasons. First, physically-delivered futures contracts are more vulnerable to market manipulation in the spot month, because the deliverable supply of the commodity is limited and, thus, more susceptible to price fluctuations caused by abnormally large positions or disorderly trading practices. Second, the commodity is likely delivered by the contract owner during the spot month and has a closer nexus to the end-price received by consumers.

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On the other hand, we believe that requiring speculative position limits for all months and for aggregate positions in the energy markets, in particular, has the capacity to distort prices. Commercial hedgers often enter into long-dated energy futures (for example, a contract with an expiration date seven years into the future) to hedge specific projects. Speculators typically take the other side of these contracts. The markets for contracts in these distant (or back) months are less liquid as there are fewer buyers and sellers for long-dated contracts.

We are concerned that by setting position limits for all months, including the less liquid, back months, the speculative position limit will reduce liquidity in these distant months and distort the market price for these contracts. We note that the CFTC already has at its disposal several tools, including position reporting and accountability levels, which serve effectively in ensuring market integrity without the inflexibility of speculative position limits.

Cash-settled commodities do not raise the same market manipulation concerns as do physically-delivered commodities in that the ability to impact the futures price by controlling deliverable supply is absent. Cash-settled commodities (particularly financial futures) tend to have deep and liquid markets, are primarily used for hedging and risk mitigation by commercials, do not contribute to price discovery which is usually set in the cash markets and therefore have little or no impact on consumers. The CEA, as amended by the CFTC Reauthorization Act of 2008, provides that any contract that has a significant price discovery function on an exempt commercial market, is subject to greater CFTC regulation and oversight.

We are concerned that imposing speculative position limits on cash-settled commodities will have the effect of depressing liquidity and thereby increase the cost of using these back months. It would appear that Congress has already addressed this issue in Section 4a of the CEA which grants to the CFTC broad authority to impose limits on trading and to curb excessive speculation. In MFA's view it would be advisable for all interested parties to work together to address concerns about excessive speculation, rather than having Congress mandate a process that could result in negative consequences. As market participants, we have a strong interest in promoting fair and orderly markets. To this end, we believe the CFTC should be afforded regulatory flexibility, which the current framework provides, in addressing excessive speculation and policing the markets.

OVER-THE-COUNTER AUTHORITY & CENTRAL CLEARING

MFA supports the requirement in Section 9 "Review of Over-the-Counter Markets" that the CFTC study and analyze the effects of OTC trading and aggregate limits across the OTC markets, designated contract markets and derivative transaction execution facilities. We applaud this effort in conjunction with the additional authority Congress seeks to provide to the CFTC through Section 4 "Detailed Reporting and Disaggregation of Market Data" and Section 5 "Transparency and Recordkeeping

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Authorities". We believe these provisions will provide the CFTC with better information to understand the OTC markets and how best to regulate these markets. However, we believe that the CFTC should be authorized to determine position limits under Section 11 "Over-the-Counter Authority" only after the study has defined the existence of risks that are appropriately controlled by the imposition of such limits. In other words, the results of such study should be the predicate for taking further legislative or regulatory action.

We are concerned that Section 11 creates a test that can only result in the CFTC concluding that all fungible OTC agreements must be subject to position limits. Section 11 requires the CFTC to determine whether fungible OTC agreements have the *potential* to disrupt market liquidity and price discovery functions, cause severe market disturbance, or prevent prices from reflecting supply and demand. It would be extremely difficult for the CFTC to find that OTC agreements have absolutely no potential for disruption under any circumstances, whether currently known or unknown. Thus, Section 11 may be interpreted to automatically provide the CFTC with the authority to impose and enforce position limits for anyone trading in fungible significant price discovery agreements. We recognize that the bill would leave to the CFTC the discretion to use its authority as to the size of the position limits it imposes. Nonetheless, we think the grant of authority is too broad.

With regard to Section 13 "Clearing of Over-the-Counter Transactions", we strongly support the concept of central clearing and believe that it offers many potential market benefits. We greatly appreciate the urgent attention of federal regulators and Congress in addressing this important matter. The private sector, working in conjunction with the Federal Reserve Bank of New York ("NY Fed"), has made strong progress in standardizing credit default swap ("CDS") contracts and establishing a central clearing house for these contracts. There is also a private sector initiative to develop exchange trading for CDS contracts. As investors in the OTC derivatives markets, we would like to see greater contract standardization and a move toward central clearing for other OTC derivatives instruments, including interest rate, foreign exchange, equity and commodity derivatives.

MFA shares Congress' desire to expedite the establishment of central clearing platforms covering a broad range of OTC derivative instruments. We believe a central clearing platform, if properly established, could provide a number of market benefits, including: (1) the mitigation of systemic risk; (2) the mitigation of counterparty risk and protection of customer collateral; (3) market transparency and operational efficiency; (4) greater liquidity; and (5) clear processes for the determination of a credit event (for CDS). In fact, MFA and its members have been actively involved in the establishment of CDS central clearing platforms.

Congress, regulators, and the private sector should promote central clearing of OTC derivative products. However, while we urge Congress and regulators to stay engaged in the process and development of establishing central clearing platforms for OTC derivatives products, we do not believe that Congress should mandate clearing for all OTC derivatives by a certain date. As a step in this direction, Congress should

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simplify regulatory procedures and remove obstacles to prompt approval of central clearing for OTC products. For example, in view of the support shown by many spokespeople for different sectors of the agricultural industry, we believe Congress should allow agricultural swaps to be centrally cleared without the need to first obtain an exemption from the CFTC.

Our concern with Section 13 mandating central clearing of all OTC derivatives transactions is twofold. First, as central clearing platforms for financial derivatives are still in development, there remain many undetermined and unresolved operational factors that could limit the value of central clearing. Among the operational factors are: most importantly, protection of customer collateral; central counterparty governance and dispute resolution; the most appropriate formats for clearing; and the optimum fee structure.

To the point on protection of customer collateral, we are especially concerned that early discussions on central clearing operations will not protect customer assets through segregated accounts. As noted in our December 23, 2008 letter to the NY Fed, the Securities and Exchange Commission ("SEC") and the CFTC (attached hereto), the current collateral management mechanism used by banks do not adequately protect a participant's pledged collateral, and as such, contributes to systemic risk. For example, because pledged collateral at Lehman Brothers was not segregated, once the company was placed in bankruptcy, pledgors became general creditors of the company. With respect to central counterparty governance, we believe a central counterparty should be an established independent body led by a board reflecting balanced representation of all market participants. Similarly, a central counterparty should have an independent, fair and efficient dispute resolution process.

Second, central clearing is not readily attainable for the majority of OTC derivatives because these products are not standardized. We appreciate the Committee's attempt to address the issue of non-standardized, highly unique (individually-negotiated or bespoke) contracts by providing the CFTC with the authority to exempt a transaction from the Section 13 clearing requirement. We note that as part of a regulatory framework that maximizes the ability of market participants to mitigate risk and encourage product innovation, it is important to provide market participants with the ability to engage in non-standardized, highly unique contracts. However, in view of the number of OTC derivative contracts that would have to rely on an exemption and the delays that occur when an agency must staff a new mandate, we are concerned that the implementation of Section 13 would be highly disruptive to the marketplace.

In contrast to other OTC derivatives, the CDS market has quickly become more standardized for various reasons. When the CDS markets began to develop in 1997, only a few of the major derivatives dealers traded these products. Since these dealers were similarly positioned in the market and traded these contracts as both buyers and sellers, they were able to negotiate and develop standardized templates for CDS contracts. These template contracts, with some modifications, have remained relatively unchanged and are

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currently used by all market participants that trade CDS. This standardization is a major reason why CDS contracts are highly liquid and attractive products.

Conversely, derivatives dealers are generally the sellers of other OTC derivatives and will negotiate and structure different terms with each counterparty. As a result, other OTC derivatives are not as fungible or liquid as CDS. The fungibility and liquidity of CDS contracts have caused them to reach a certain level of standardization and efficiency, which have made them ripe for centralized clearing. The same can be said for certain interest rate, energy and agricultural commodity derivatives.

By way of comparison, the majority of OTC derivatives markets, including those trading interest rate, foreign exchange, and equity derivatives, are nowhere near the level of standardization of the CDS markets. The CDS markets account for roughly 8 to 9% of the notional volume of the OTC derivatives market. As stated above, these other OTC derivative instruments are not interchangeable between buyers and sellers, and are generally sold by banks or dealers to market participants other than banks or dealers.

MFA fully supports collaborative industry-wide efforts and partnerships with regulators, like the NY Fed, SEC and CFTC to develop solutions to promote sound practices and to strengthen the operational infrastructure and efficiency in OTC derivatives trading. MFA is an active participant in the Operations Management Group (the "OMG"), an industry group working towards improving the operational infrastructure and efficiency of the OTC derivatives markets. The goals of the OMG are:

- Full global use of central counterparty processing and clearing to significantly reduce counterparty credit risk and outstanding net notional positions;
- Continued elimination of economically redundant trades through trade compression;
- Electronic processing of eligible trades to enhance T+0 confirmation issuance and execution;
- Elimination of material confirmation backlogs;
- Risk mitigation for paper trades;
- Streamlined trade life cycle management to process events (*e.g.*, Credit Events, Succession Events) between upstream trading and confirmation platforms and downstream settlement and clearing systems; and
- Central settlement for eligible transactions to reduce manual payment processing and reconciliation.

In recent years, the OMG and other industry-led initiatives have made notable progress in the OTC derivatives space. Some of the more recent market improvements and systemic risk mitigants have included: (1) the reduction by 80% of backlogs of outstanding CDS confirmations since 2005; (2) the establishment of electronic processes to approve and confirm CDS novations; (3) the establishment of a trade information repository to document and record confirmed CDS trades; (4) the establishment of a successful auction-based mechanism actively employed in 14 credit events including Fannie Mae, Freddie Mac and Lehman Brothers, allowing for cash settlement; and (5) the

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reduction of 74% of backlogs of outstanding equity derivative confirmations since 2006 and 53% of backlogs in interest rate derivative confirmations since 2006.

MFA supports the principles behind Section 13, but, as discussed, has concerns with how these principles will be implemented. Although central clearing is not appropriate for *all* OTC derivative contracts, we firmly believe that greater standardization of OTC derivative contracts and central clearing of these more standardized products would bring significant market benefits. Indeed, we believe that central clearing offers substantially greater opportunity to address concerns about systemic risk, than other alternatives, such as Section 16 of the legislation. To this end, MFA is committed to continuing its collaboration with the major derivatives dealers and service providers to prioritize future standardization efforts across OTC derivatives and other financial products. MFA also understands Congress's desire to have greater oversight of these markets and believes there is an important role for the NY Fed, CFTC and SEC to play in monitoring and guiding industry-led OTC derivatives solutions. We believe it would be more appropriate at this stage to require the applicable regulatory authorities to work with market participants towards the principles espoused in Section 13 and to provide the Committee with frequent progress reports.

EXPEDITED PROCESS

Section 12 "Expedited Process" provides the CFTC with the authority to use emergency and expedited procedures. While we do not object to this authority, we strongly urge Congress and the CFTC to use the notice and comment process whenever possible. We believe the notice and comment process is more likely to protect the public interest, minimize market disruptions and unintended consequences, and result in better regulation.

LIMITATION ON ELIGIBILITY TO PURCHASE A CREDIT DEFAULT SWAP

Credit derivatives are an important risk transfer and management tool. Market participants use credit derivatives for hedging and investment purposes. We believe both are legitimate uses of the instrument and are equally important components of a liquid and well-functioning market.

Section 16 would make it a violation of the CEA for a market participant to enter into a CDS unless it has a direct exposure to financial loss should the referenced credit event occur. We appreciate that it is the goal of the provision to add stability to the CDS market by reducing excess speculation. Nonetheless, this provision would severely cripple the CDS market by making investment capital illegal and removing liquidity providers. Without investment capital in the market, market participants wishing to hedge their position through a CDS would find few, if any, market participants to take the

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other side of the contract. As a result, the CDS market could cease functioning for lack of matching buyers and sellers. Market participants that risk their own capital provide depth and liquidity to any market, and the market for CDS is no exception. Because the provision would eliminate such market participants, the CDS market would have much less price transparency and continuity.

This outcome is particularly troubling given the benefits the CDS markets provide to the capital markets and to the overall economy. CDS contracts have improved our capital markets by enhancing risk transparency, price discovery and risk transferal, with the effect of reducing the cost of borrowing. Market participants use the CDS market as a metric for evaluating real-time, market-based estimates of a company's credit risk and financial health; and it is in this way that the CDS markets provide risk transparency and price discovery. Market participants find that CDS market indicators are a superior alternative to relying on credit rating agency scores.

CDS contracts also provide banks, dealers and other market participants with a tool to mitigate or manage risk by dispersing credit risk and reducing systemic risk associated with credit concentrations in major institutions. Take the following scenario, which Section 16 would prohibit, for example:

Bank A owns a $1 billion loan to Company X. Bank B owns a $1 billion loan to Company Y. Both banks would be better off from a risk management perspective, assuming that Companies X and Y have comparable credit worthiness, if they each had a $500 million Company X loan and a $500 million Company Y loan. The loans, however, are not transferable. Through CDS contracts, Bank A is able to buy Company X protection and sell Company Y protection, and Bank B is able to do the opposite. In this way, market participants use CDS contracts to manage risk. Financial markets benefit overall from the reduction in systemic risk.

Accordingly, these products reduce an issuer's cost of borrowing from banks, dealers and other market participants by enabling these entities to relay existing risk and/or purchase risk insurance against a particular issuer. Simply put, CDS markets facilitate greater lending and support corporate and public finance projects. By reducing the depth and liquidity of the CDS market, the cost of capital would rise. As a consequence, new investment in manufacturing facilities and other private sector projects and public works efforts would be more expensive.

If market participants could not hedge their market risk through CDS contracts, the risk premium on debt would increase significantly. We do not believe this is advisable, especially in light of the troubled state of the U.S. economy and the Congress' current stimulus package deliberations. To our knowledge, Congress has never before imposed a trading restriction such as is proposed in Section 16 on any type of commodity or financial instrument, and for good reason. Congress has previously recognized in Section 3 of the CEA that we have a national public interest in providing a means for managing and assuming price risks, discovering prices or disseminating price information. Shutting out investors from the CDS market would be contrary to the public

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policy interests enumerated in the Act. As noted below, we believe that there are more effective alternatives for addressing concerns about the CDS markets.

ALL COMMODITIES ARE NOT EQUAL

Finally, we are concerned with the expansion of the bill to all commodities. Physically-delivered, cash-settled and OTC commodities each trade in distinct markets and have different characteristics. We believe the rationale behind certain requirements, such as spot month speculative limits and aggregate position limits, are not applicable to financial futures or their OTC derivatives. Legislation that attempts to regulate all commodity and financial markets in an identical manner will fail to take into consideration the different needs of these markets and important functions they serve. Specifically, we refer to Sections 6, 11 and 13, which we believe attempts to uniformly regulate these distinct markets. Moreover, such legislation will risk affecting liquidity and the opportunity for innovation that have made these markets so widely used and integral to the economy.

CONCLUSION

As Congress, including this Committee, considers ways to restore stability and confidence to our markets and to address the recent economic downturn, we believe it is important to recognize the important role the OTC derivatives markets have played. These products allow market participants to contribute vital market liquidity, mitigate risk, support lending and project finance, and facilitate economic growth.

In considering ways to promote enhanced risk management and greater transparency in the marketplace, we urge you to resist any efforts which, while well-intended, could prove harmful to these important markets and our broader economy. These markets have played a pivotal role with respect to the development of our financial markets and the growth of our nation's economy. This success is attributable to the innovation and sophistication of our financial markets and the participants of these markets. It is also a testament to the competency of the underlying regulatory framework.

MFA would like to thank the Committee for allowing us the opportunity to share our views on these important issues. MFA, and our members, are committed to working constructively with this Committee, the Congress, and the Administration over the coming weeks and months as this legislation and the broader dialogue regarding financial regulatory reform progresses.

Thank you.

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