From: King, Carlotta <cking@managedfunds.org>
Sent: Thursday, September 23, 2010 3:19 PM
To: rule-comments@sec.gov; dfadefinitions <dfadefinitions@CFTC.gov>
Cc: Kaswell, Stuart <stuart@managedfunds.org>
Subject: File Number S7-16-10
Attach: SEC-CFTC Title VII Key Definitions - MFA Final Letter.pdf

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Dear Ms. Murphy and Mr. Stawick:

Please find attached Managed Funds Association's comment letter on the CFTC and SEC Advance Joint Notice on Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act. I apologize for the tardiness of this submission, but we hope you and your colleagues will consider our comments.

Thank you for your consideration and feel free to contact me if you have any questions.

Kind regards,
Carlotta King

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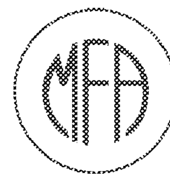

September 23, 2010

Via Electronic Mail: rule-comments@sec.gov dfadefinitions@cftc.gov

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington DC 20581

Re: File Number S7-16-10 – CFTC and SEC Advance Joint Notice on Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Ms. Murphy and Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC", and together with the SEC, the "Commissions") on the Advance Joint Notice (the "Advance Notice") on Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").[2] We applaud the Commissions for offering interested parties an important opportunity to provide input on these key definitions before they publish specific rule proposals for comment.

MFA strongly supports the goals of over-the-counter ("OTC") derivatives regulation to enhance transparency and reduce systemic risk and we intend to be an active and constructive participant throughout each Commission's rulemaking process. As a result, in addition to providing our initial thoughts on the definitions set forth in the Advance Notice, we also fully

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies.

MFA is headquartered in Washington, D.C., with an office in New York.

[2] CFTC and SEC, Exchange Act Release 62717; (August 13, 2010); 75 FR 51429 (August 20, 2010).

intend to comment on the specific rule proposals related to Title VII generally as the Commissions issue them.[3]

I. Definition of "Swap"

Section 721(a)(47) of the Dodd-Frank Act defines "swap" under clause (B)(ii) to exclude "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is *intended to be physically settled*" (emphasis added). The CFTC has an analogous long-standing body of law around the meaning of "future delivery", which has been integrated into market practice for the physical trading of commodities.[4] We believe the CFTC should clarify in final guidance that "intended to be physically settled" will be determined at the time a transaction is entered into between parties. We believe such guidance will provide regulatory certainty and delineate between swaps regulation and regulation of physically-settled commodities.

II. Definitions of "Swap Dealer" and "Security-Based Swap Dealer"

A. General

Sections 721(a)(21) and 761(a)(6) of the Act define "swap dealer" and "security-based swap dealer" (together, "Swap Dealers"), respectively and in relevant part, as a person who: (i) holds themself [*sic*] out as a dealer in "swaps" or "security-based swaps" (together, "Swaps"); (ii) makes a market in Swaps; (iii) regularly enters into Swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in Swaps.[5] MFA is concerned that because of the breadth of this definition, it may inadvertently capture non-bank customers entering into Swaps for their own accounts that do not act as dealers and that Congress did not intend to regulate as dealers or banks. Specifically, the third category of the definition, which relates to "regularly entering into swaps", could inappropriately be read to capture parties that would traditionally be thought of as investors or hedgers, as opposed to true dealers or market-makers. As a result, certain customers would inappropriately become Swap Dealers, which will create excessive regulatory burdens and impede market depth and liquidity.

B. Security-Based Swap Dealer Registration Requirements

With respect to cleared security-based swaps, Section 763(d) of the Act makes it unlawful for a person to accept any money, securities, or property as margin from a swaps customer, unless the person has registered as a security-based swap dealer. MFA is concerned that this registration

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3 *See* MFA letter to Elizabeth M. Murphy, Secretary, SEC, and MFA letter to David A. Stawick, Secretary, CFTC, from Richard H. Baker, President & CEO, Managed Funds Association, each on September 22, 2010, *respectively available at:* http://www.managedfunds.org/downloads/MFA SEC Letter.9.22.10.pdf and http://www.managedfunds.org/downloads/MFA CFTC Letter.9.22.10.pdf.

MFA submitted comments to the SEC in response to its Comment Page for SEC Initiatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act and we submitted comments to the CFTC in response to its Comment Page for CFTC Rulemakings related to the Act. In each letter, we provided some general comments on the provisions of the Act across all titles that would most directly affect our members.

4 Section 1(a)(27) of the CEA (as renumbered by the Act).

5 Section 761 amends Section 3(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), to add new subsection (71).

requirement does not distinguish between the receipt of initial margin—which is a one-way payment made by a swap customer to a dealer at the outset of a trade—and variation margin that both swap counterparties may exchange with each other to reflect a mark-to-market change throughout the life of a trade. If swap customers could not collect variation margin for cleared security-based swaps without being required to register as a security-based swap dealer, two significant, negative consequences would result. First, counterparty, systemic and liquidity risks would greatly increase because customers would have a perverse incentive not to secure their exposure through the receipt of variation margin in order to avoid becoming security-based swap dealers. Second, customers would likely experience significant liquidity risks to the extent that they would be required to pay out cash for variation margin on unprofitable transactions, but would be unable to collect variation margin on transactions that are in their favor.

We believe that Congress did not intend to subject swap customers to security-based swap dealer registration and regulation with respect to their cleared security-based swaps. Moreover, we believe that Congress did not intend to define security-based swap dealer to include a person who accepts variation margin. Accordingly, we believe it would be prudent for the SEC to employ its authority under Section 761 of the Act by further defining the term "margin" for this purpose as initial margin only.

C. Longstanding Dealer Definition

We note that the federal securities laws already provide a definition of "dealer", which has a longstanding role in market parlance and practice, and which distinguishes between a dealer performing market making functions and an institutional investor that regularly buys and sells substantial numbers of securities for its own account or for its advisory clients, such as a pension fund, college endowment, or private investment fund.[6] This distinction is based on the parts of the Exchange Act that require a dealer to be "engaged in the business of buying and selling securities for such person's own account" and that exclude a person buying for its own account "but not as a part of a regular business."

These same phrases appear in the relevant provisions of the Act, which define a Swap Dealer as a person who regularly enters into Swaps "as an ordinary course of business for its own account", holds itself out as a dealer in Swaps, or makes a market in Swaps.[7] In addition, the Act excludes a person entering into Swaps for its own account but not as a part of regular business.

Based on the provisions in the federal securities laws, the SEC has historically excluded from dealer regulation investors who do not engage in the following activities:

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[6] Section 3(a)(5) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") provides the following "dealer" definition: "[t]he term 'dealer' means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise" and excludes "a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business."

[7] In a now withdrawn proposed rule, the CFTC also employed these types of phrases and concepts when it was considering a definition for a swap dealer. *See* Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (Jan. 26, 2010) (subsequently withdrawn; 75 Fed. Reg. 50950 (Aug. 18, 2010)).

- Buying and selling securities as inventory – Investors trade to take positions, hedge, or manage cash based on investment decisions, rather than to hold inventory to respond to other investors' needs. In contrast, a dealer holds inventory for resale or facilitation;

- Holding oneself out to the public as a dealer – This concept is part of the test in the Act and has been interpreted as a person who solicits clientele for the purchases and sales of securities[8];

- Market making – This concept is also part of the test in the Act; a dealer is continuously available to the public to buy and sell at quoted prices. In contrast, an institutional trader is not continuously in the market on the same security and does not publish quotations;

- Regularly effecting transactions directly with market participants as their customers (including investors) rather than through a registered broker or dealer; and

- Underwriting or originating securities.[9]

Institutional investors generally do not engage in these activities, and therefore, have traditionally been viewed as traders rather than dealers.

D. MFA Recommendations

Given the above, MFA believes that the definitions of "swap dealer" and "security-based swap dealer" under sections 721(a)(21) and 761(a)(6) of the Act should follow the SEC's traditional definition of "dealer", which excludes institutional traders, such as private investment funds and their advisers, who are not regularly entering into swaps as a part of regular business. Moreover, the concept of a dealer should: (i) be consistent under both the securities and

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8 *See* Ezra Weiss, Registration and Regulation of Brokers and Dealers, 9 (1965) ("the solicitation of prospective customers by a person intending to engage in business as a…dealer would be regarded as an activity which is tantamount to engaging in the business of a…dealer.").

9 *See, e.g.*, Exchange Act Rel. No. 46745 (Oct. 30, 2002); 67 FR 67496 (November 5, 2002). ("As developed over the years, the dealer/trader distinction recognizes that dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of business (or participate in the distribution of new issues), and generally transact a substantial portion of their business with investors (or, in the case of dealers who are market makers, principally trade with other professionals)."); Exchange Act Rel. No. 40594 (Oct. 23, 1998) (listing the following as activities that might cause one to be a "dealer" as defined in the Exchange Act: "(1) purchasing or selling securities as principal from or to customers; (2) carrying a dealer inventory in securities (or any portion of an affiliated broker-dealer's inventory); (3) quoting a market in or publishing quotes for securities (other than quotes on one side of the market on a quotations system generally available to non-broker-dealers, such as a retail screen broker for government securities) in connection with the purchase or sale of securities permitted under Rule 15a-1; (4) holding itself out as a dealer or market-maker or as being otherwise willing to buy or sell one or more securities on a continuous basis; (5) engaging in trading in securities for the benefit of others (including any affiliate), rather than solely for the purpose of the OTC derivatives dealer's investment, liquidity, or other permissible trading objective; (6) providing incidental investment advice with respect to securities; (7) participating in a selling group or underwriting with respect to securities; or (8) engaging in purchases or sales of securities from or to an affiliated broker-dealer except at prevailing market prices.").

commodities laws, as required by Section 712(d)(2)(D) of the Act,[10] thereby preventing alternative market rules or conventions and continuing the historical understanding of participants as provided by the SEC's time-tested interpretation; (ii) be applied consistently across different types of trading; and (iii) incorporate the concepts that have long existed in the definition of dealer in the federal securities laws and in the SEC's interpretations of that definition. Having different definitions for different markets would lead to confusion and potential abuse.

III. Definitions of "Major Swap Participant" and "Major Security-Based Swap Participant"

A. General

Sections 721(a)(16) and 761(a)(6) of the Act define "major swap participant" and "major security-based swap participant" (major swap participants and major security-based swap participants, together "MSPs"), respectively and in large part, as a non-Swap Dealer: (1) who maintains a substantial position in Swaps; (2) whose outstanding Swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (3) is a financial entity that is highly leveraged relative to the amount of capital that it holds and maintains a substantial position in outstanding Swaps.[11] MFA believes Congress's intent in creating an MSP designation was to focus regulation on systemically important, non-dealer market participants whose Swap positions may pose systemic risk.

Given the overlap in the statutory language, MFA would like to propose the following construct for how each of the three categories of the MSP definition should apply to different categories of derivatives market participants. We believe the first category should apply only to non-financial entities that maintain Swaps positions that create systemic risk. The second category should apply to market participants, including both financial entities and non-financial entities, that maintain Swaps positions that could cause serious adverse effects to the U.S. banking system or financial markets due to their exposure to systemically important counterparties. The third category should apply to non-bank financial entities that are highly leveraged and that also maintain Swaps positions that result in systemic risk. We believe that this construct is consistent with the statutory framework and would provide useful guidance to the Commissions in interpreting these provisions. We would be pleased to elaborate on this construct and our underlying rationale.

B. Defining "Substantial Position"

The terms "substantial position", "substantial counterparty exposure" and "highly leveraged" are key to the MSP definition. Below we offer some comments regarding these critical terms.

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[10] Section 712(d)(2)(D) provides that "[r]ules and regulations prescribed jointly under this title by the Commodity Futures Trading Commission and the Securities and Exchange Commission shall be comparable to the maximum extent possible, taking into consideration differences in instruments and in the applicable statutory requirements."

[11] Section 721 amends Section 1a of the Commodity Exchange Act, while Section 761 amends Section 3(a) of the Exchange Act to add new subsection (67).

1. General

In determining whether a market participant has a "substantial position" in Swaps, we believe that the Commissions should consider such market participant's overall position in Swaps, accounting for offsetting positions, including cleared contracts and securities, that mitigate the risk exposure of the Swaps holdings. We also appreciate Congress's direction to the Commissions that in defining "substantial position" they must take into account "the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures."[12] Such guidance will further help identify the actual risk to counterparties and the broader system if the market participant failed, and would recognize the market-disciplining activities of central clearing and increased bilateral reserves as contemplated by the Act. As a consequence, we believe that the Commissions would be able to tailor the definitions of MSP more narrowly, consistent with Congress's concerns.

2. Cleared vs. Uncleared Swaps

MFA believes that cleared Swaps should not count towards determinations of a market participant's substantial position (except to the degree that they have a risk reducing effect on uncleared Swaps). MFA believes that this approach is consistent with the goals of the Act. The purpose of moving towards greater clearing of Swaps is to increase systemic stability by instituting minimum risk-based margin requirements, enhancing transparency to the regulators and mitigating and mutualizing loss to counterparties and the financial system in the event of a market participant's default.[13]

Moreover, it is evident from elsewhere in the Act as well that Congress intended to treat cleared and uncleared Swaps differently, recognizing that cleared Swaps present substantially lower systemic risks than uncleared Swaps that are insufficiently collateralized.[14]

However, if the Commissions, nonetheless, take the view that it would be appropriate to count cleared Swaps towards "substantial position", it should take into account that the clearing of Swaps significantly mitigates the risk of adverse systemic consequences in the event of a default, and should, at a minimum, assign a materially lower risk factor to cleared Swaps as compared to uncleared Swaps that are insufficiently collateralized.

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[12] *See* Section 761, which amends Section 3(a)(67)(B) of the Exchange Act, in part, by adding a definition of "substantial position", which is relevant to determining who is an MSP.

[13] It should also be noted that even though futures and listed options contracts may have risk characteristics that are similar to cleared Swaps, market participants with positions in futures and listed options would not be categorized as MSPs under the Act, presumably because the risk posed by futures and listed options are already well managed by the relevant regulators through central clearing.

[14] For example, Section 716, the so-called "swaps push-out rule", allows covered bank holding company entities to engage in transactions in cleared credit default swaps ("CDS") but requires uncleared CDS to be "pushed-out" if such entities are to receive federal assistance.

3. Principles for "Substantial Position" and "Substantial Counterparty Exposure"

With respect to defining what a substantial position is and what constitutes substantial counterparty exposure, MFA believes the following principles would be helpful. We believe that the Commissions:

- Should not rely primarily on data about trade counts and gross notional exposure because such data are in and of themselves not an accurate measure of risk, and instead, within each Swap category, the Commissions should apply a risk of loss calculation as the test for whether a portfolio is substantial.
- Should use well-devised risk-based margin models to examine the risk of a Swaps portfolio. A well-devised risk-based margin model requires market participants to post initial margin in amounts greater than potential portfolio losses in extremely stressed market conditions.[15]
- Should make the threshold at which positions becomes a substantial position specific to each Swap category (and not a one-size-fits-all), since market sizes and risk profiles for Swaps categories vary, and should take into account any margin posted.
- Should base each Swap category on the primary underlying product type that is generally referenced in the market (*i.e.*, interest rates, equities, credit, foreign exchange and commodities).
- Should take into account offsetting positions in their risk-based calculations, as appropriate, including long and short positions and other established portfolio hedges that mitigate risk (*e.g.*, CDS and cash bond) and also including offsets between cleared and uncleared positions.
- In connection with their risk-based calculations, should aggregate each Swap category after taking variation and initial margin posted against those positions into consideration.
- In making risk-based calculations should take into account the value and quality of collateral held against counterparty exposures, as provided in the Act. For example, collateral such as cash or short term U.S. Treasury securities offer substantially greater protection against default than other types of collateral.
- Should engage in a formal process if a market participant exceeds the relevant risk-based thresholds established by the Commissions before applying the MSP requirements to the fund.

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[15] *See* FINRA Rule 4240 in support of the proposition that the use of risk monitoring and stress tests to determine the risk of any customer is a well-established concept. FINRA Rule 4240 provides that for CDS cleared on a central counterparty other than on the Chicago Mercantile Exchange or that settle over-the-counter, the clearing member must monitor the risk of any customer of broker dealer accounts by using, among other things, "stress testing of accounts containing CDS contracts in order to monitor market risk exposure from individual accounts in aggregate".

We believe that if the Commissions implement the foregoing principles to the MSP definition, the Commissions will be able to effectively delineate between (a)(i) those Swaps market participants that have a "substantial position", or (ii) whose outstanding Swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets"[16] (because their Swaps portfolios do not conform to these principles); and (b) those Swaps market participants that do not have a substantial position and do not create such counterparty exposure. We would be happy to discuss the above points in greater detail with the Commissions in their effort to develop specific regulatory language.

4. Application of MSP Category to Private Investment Funds

The Act does not indicate for complex business models which entity is the relevant entity for purposes of the MSP determination. In the case of private investment funds, the Commissions should clarify that to the extent that the MSP definition applies, it applies to the relevant private investment fund and not to the adviser who manages it. Application of the MSP definition in this manner is consistent with the Act because it is the private investment fund which is the counterparty to, and maintains the position in, the Swaps transactions.

We also believe that the Commissions should not apply a finding of substantial position to, or aggregate with, other private investment funds managed by the same adviser. The Swaps portfolios and the risk and investment profiles of one private investment fund often differs from that of other funds, even when managed by the same adviser, and the MSP determination should take into account that risk distinction as well as the separate legal existence of each private investment fund.

C. Defining "Highly Leveraged"

Another significant component of the third category of the MSP definition is the term "highly leveraged". Unlike "substantial position", the Act does not provide the CFTC or SEC with any guidance on what this term means or what factors the Commissions should consider in creating this definition. MFA believes that in determining who is "highly leveraged" the Commissions should apply a leverage ratio (*i.e.*, debt-to-equity), which is based on GAAP balance sheet leverage as an appropriate measure. Moreover, other regulators already have established or proposed rules that apply leverage ratios to measure leverage for regulatory purposes,[17] and information from those regulators as well as other sources about use of leverage is at times publicly available.[18] Therefore, in defining "highly leveraged", we respectfully suggest that the Commissions analyze existing data (to the extent publicly available) about different markets participants' use of leverage and look to existing models for guidance on how to apply leverage ratio principles.

[16] *See* Sections 721(a)(16) and 761(a)(6) of the Act.

[17] Bank capital regimes typically use these types of measures.

[18] For example, according to a recent study by academics at Columbia University, the leverage ratio of investment banks during the period from December 2004 to October 2009 was 14.2, with a peak of 40.7 for in 2009, and the leverage ratio of the entire financial sector during that period was 9.4. Hedge Fund Leverage, available at: http://www2.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf.

D. Predictability of MSP Rule

In promulgating rules around the MSP definition, MFA believes that it is of the utmost importance that the Commissions provide a clear, objective and replicable formula to ensure that market participants have certainty as to when they fall within this category and become subject to the additional requirements for MSPs set forth in the Act. In particular, Sections 731 and 764 of the Act provide the registration requirements for MSPs. Whether private investment funds fall within the MSP definition will depend in large part on the definition of "substantial position". Given that the activities of private investment funds are dynamic, the value and volume of the positions in our Swaps portfolios may turnover, increase or decrease on a frequent basis. Accordingly, unlike other market participants, our members have the potential to routinely fall in and out of the MSP category. To that end, we request that in developing the MSP definition that the Commissions tailor the definition to take into account an average basis over time. Moreover, we request that the Commissions have regard for dynamic business models and ensure that the definition adopted will not result in certain market participants having regularly to deregister and re-register.

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MFA appreciates the opportunity to comment on the CFTC's and SEC's Advance Joint Notice on Definitions Contained in Title VII of the Act. We would be pleased to meet with the members of the CFTC or SEC or either of their respective staffs to discuss our comments in greater detail. MFA also plans separately to comment on individual rule proposals from the CFTC and/or SEC as they arise. If the members or staffs of the CFTC or SEC have questions, please do not hesitate to call Carlotta King or the undersigned at (202) 367-1140.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director &
General Counsel

CC: The Hon. Mary Schapiro, SEC Chairman
The Hon. Kathleen L. Casey, SEC Commissioner
The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner

The Hon. Gary Gensler, CFTC Chairman
The Hon. Michael Dunn, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner