MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry

WASHINGTON, DC | NEW YORK

MFA

March 21, 2011

Via Electronic Submission: http://comments.cftc.gov

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

Re: RIN No. 3038-AC98: Notice of Proposed Rulemaking on Risk Management Requirements for Derivatives Clearing Organizations

Dear Mr. Stawick:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "**Commission**") on its proposed rulemaking on "Risk Management Requirements for Derivatives Clearing Organizations" (the "**Proposed Rules**")[2] related to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[3] MFA supports the Commission's approach to establishing regulatory standards for compliance with derivatives clearing organization ("**DCO**")[4] Core Principles C, D, E, F, G and I (collectively, the "**Core Principles**").[5] We believe that the Proposed Rules are generally consistent with current best practice and provide appropriate guidelines and standards to enhance uniformity, transparency and consistency within the U.S. clearing regime. In that vein, we respectfully submit suggestions on the Proposed Rules, in particular those implementing

[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 $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] 76 Fed. Reg. 3698 (Jan. 20, 2011) (the "**Proposing Release**").

[3] Pub. L. 111-203, 124 Stat. 1376 (2010).

[4] The Commission has not yet promulgated final rules regarding the requirements for registration as a DCO. Thus, for the remainder of this letter, when we refer to DCOs, it shall mean an entity likely to be registered as such an entity based on the Commission's current proposed rules.

[5] We note that the Commission also has released a Notice of Proposed Rulemaking on "Requirements for Processing, Clearing, and Transfer of Customer Positions", 76 Fed. Reg. 13101 (Mar. 10, 2011), which amends and supplements certain provisions within the Proposed Rules, in particular proposed Section 39.12. MFA will comment separately on this notice of proposed rulemaking.

Core Principles C and D, to assist the Commission with adopting final rules that serve the public interest and enhance the clearing regime.

I. Core Principle C: Participant and Product Eligibility

A. Participant Eligibility

Under Core Principle C,[6] each DCO must establish appropriate admission and continuing eligibility standards for members of, and participants in, the DCO, including ''sufficient financial resources and operational capacity to meet obligations arising from participation."[7] In addition, Core Principle C specifies that the requirements must be objective, publicly disclosed and permit fair and open access.[8] The Commission's proposed Section 39.12 would codify the specific requirements that a DCO must meet to comply with Core Principle C.

MFA agrees with the requirements in amended Core Principle C, especially that requirements be objective, risk-based, publicly disclosed and permit fair and open access. In particular, we strongly support proposed Section 39.12's mandate that a DCO not adopt participation requirements that unreasonably restrict any market participant from becoming a clearing member. In our view, the exclusion of certain market participants from clearing membership through imposition of requirements not reasonably related to a clearing member's capacity to discharge its responsibilities[9] has delayed the adoption of clearing and has stifled competition for clearing services. Therefore, we agree with the Commission's decision to promote more inclusive DCO participation requirements,[10] which we believe will benefit DCOs and the markets by: (i) reducing DCO concentration risk; (ii) increasing diversity of market participants involved in DCO governance; (iii) enhancing competition in the provision of clearing services; and (iv) lowering overall costs for non-clearing members. [11]

[6] Core Principle C, as amended by the Dodd-Frank Act, Section 5b(c)(2)(C) of the Commodity Exchange Act ("**CEA**"); 7 U.S.C. 7a–1(c)(2)(C).

[7] Section 725 of the Dodd-Frank Act. In addition, the requirements must include capital requirements that are scalable such that they are proportional to the risks posed by the particular clearing member. Core Principle C also requires that each DCO establish and implement procedures to verify compliance with each participation and membership requirement on an ongoing basis.

[8] *Id*.

[9] Currently, clearinghouses impose conditions on membership not objectively related to an entity's ability to discharge its responsibilities as a clearing member, including: (i) obliging the entity to hold excessive capital; (ii) mandating that the entity be designated as a dealer or other particular type of entity; (iii) requiring the entity be affiliated with an existing clearing member; and (iv) specifying minimum thresholds for the entity's existing swap portfolio size or transaction volume.

[10] Proposing Release at 3700-02.

[11] We note that promoting competition with respect to DCOs is also the subject of Core Principle N (Antitrust Considerations), which states that unless necessary or appropriate to achieve the purposes of the Dodd-Frank Act, DCOs must not ''(i) adopt any rule or take any action that results in any unreasonable restraint of trade; or (ii) impose any material anticompetitive burden". Core Principle N, as amended by the Dodd-Frank Act, Section 5b(c)(2)(N) of the CEA; 7 U.S.C. 7a–1(c)(2)(N).

In addition, we support the Proposed Rules' limiting the maximum capital requirement that a DCO can impose as part of its clearing membership requirements to $50 million.[12] It is crucial that the $50 million upper limit remain[13] and that the Commission require DCOs to set objective capital requirements that the DCO determines are proportionate to the risk of the overall position of the clearing member at the DCO. Historically, DCO minimum capital requirements have had the effect of excluding all but a small number of the largest banks from becoming clearing members. However, as the Proposed Rules make clear, a DCO can foster fair access to direct clearing membership and ensure the safety of the DCO and fellow clearing members by scaling each clearing member's net capital obligation in proportion to that clearing member's risk exposure.[14] We respectfully request that the Proposed Rules further require that such scaling be in turn determined by objective, risk-based methodologies that are based on reasonable stress and default scenarios and consistently applied to all clearing members, without use of "tiers" that could have discriminatory or anti-competitive effects.[15]

Further, under the Proposed Rules, it would be possible for a DCO to comply with the $50 million net capital requirement but impose a non-risk-based and excessive threshold guaranty fund contribution that would have the effect of excluding eligible direct clearing members. Accordingly, we recommend that, similar to the requirements for DCO margin methodologies and net capital requirements, the Commission expressly require DCOs to use guaranty fund[16] scaling methodologies that are objective, risk-based, based on reasonable stress and default scenarios and consistently applied to all clearing members.[17] We believe that mandating application of such principles across each key reserve category – margin, net capital and guarantee fund obligations – will prevent the scaling requirements from having an exclusionary effect, steering trade flow away from clearing or causing cleared trade volumes to settle at one particular DCO versus another.

[12] Proposed Section 39.12(a)(2)(iii).

[13] We agree that the $50 million is reasonable because it signifies a threshold level of financial expertise. Additionally, we support the Commission's inclusion in proposed Section 39.12(a)(2)(i) of a definition for "capital" in this context. Inclusion of this definition will ensure that DCOs use a consistent calculation methodology as to the level of capital required for clearing membership rather than allowing DCOs to choose different and potentially less standard calculations that could have the effect of making it difficult for certain types of otherwise eligible entities to qualify for clearing membership.

[14] Proposing Release at 3701.

[15] We are generally opposed to "tiers" in clearing membership. We believe the scaling requirements, and conversely, a DCO's prerogative to cap the risk of any clearing member proportionate to its financial resources, should be sufficient to appropriately allocate risk sharing among clearing members without the need for tiers, which could competitively disadvantage certain classes of participants.

[16] Over many years, the clearing of futures has demonstrated the importance of the guaranty fund. *See e.g.*, Chicago Board of Trade, Handbook of Futures and Options (2006) at 66. Proposed Section 39.15(b)(2)(i)(H) now provides that in order for a DCO to commingle customer positions in futures, options on futures and swaps, and any money, securities, or property received to margin, guarantee or secure such positions, a DCO must describe to the Commission the composition and availability of a guaranty fund with respect to the commingled instruments.

[17] This approach is consistent with the standards set forth by the Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (the "**CPSS-IOSCO Standards**").

B. Product Eligibility

With respect to product eligibility, Core Principle C requires each DCO to establish appropriate standards for determining the eligibility of agreements, contracts or transactions submitted to the DCO for clearing. Section 723 of the Dodd-Frank Act further requires each DCO to provide for non-discriminatory clearing of a swap executed bilaterally on or subject to the rules of an unaffiliated designated contract market ("**DCM**") or swap execution facility ("**SEF**"). MFA wholly supports non-discriminatory clearing of a swap executed bilaterally or on a DCM or SEF.

However, to ensure that DCOs comply with this principle, and given the interconnectedness among DCOs, DCMs and SEFs, we also believe that the Commission should expressly mandate that DCO requirements with respect to their clearing platforms be flexible, open and unbiased, since any barriers to clearing connectivity could undermine the competitiveness of SEFs or other execution facilities and could result in execution being driven to specific platforms as the market for electronic execution evolves. Specifically, in this context, the Commission should require DCOs to provide highly standardized mechanisms for establishing connectivity with SEFs and any other permitted trading venues, which would provide executing counterparties with fair and open access so long as such trading venues conform their use to objective, commercially reasonable standards that the DCO makes publicly available. For example, the Commission could require DCOs to establish standard two-way protocols for messages indicating that a trade has been executed and accepted for clearing in real time and for post-trade workflow. Imposing such a requirement for open, standard, two-way protocols will promote consistent and efficient clearing as well as increase competition by allowing for equal access based on unbiased standards.

Additionally, we strongly believe that the Proposed Rules should mandate that the DCO keep the clearing acceptance process anonymous (*i.e.*, without the customer's clearing member knowing the identity of the customer's executing counterparty), since the clearing member as guarantor of its customer's position will never have exposure to the executing counterparty, only to the DCO and its customer. Lack of anonymity would give clearing members an advantage over competing executing dealers because the clearing member could utilize that knowledge to restrict a customer's range of execution counterparties, and thus damage open access to available execution and fair competition in the market.

II. Core Principle D: Risk Management

A. Margin Requirements

MFA strongly supports the Proposed Rule's express requirement that each DCO set margin requirements for its clearing members that are risk-based and subject to regular review. While we agree with the Commission that margin should "be sufficient to cover potential exposures in normal market conditions"[18] (*e.g.*, as outlined in the CPSS-IOSCO Standards), we believe that imposing margin requirements that are excessive relative to risk exposure will

[18] Proposed Section 39.13(g).

adversely affect market liquidity and is inconsistent with the Commission's desire to incentivize clearing. Therefore, we urge the Commission to adopt final rules that retain flexibility with regard to the specific margin criteria, so that the criteria can evolve with the markets. For example, initial margin covering a five-day liquidation horizon may be or become excessive for highly liquid instruments, even in times of market volatility or absent a DCM or similar execution market (*e.g.*, "on-the-run" 10-year interest rate swaps). We respectfully submit it would be better to require the DCO to adhere to the CPSS-IOSCO Standards (including the confidence levels expressed in those standards) or other similar guidelines, but allow the DCO to retain flexibility as to liquidation horizon or other margin and guaranty fund calculation parameters in reaching those standards. If the Commission, however, does mandate minimum liquidation times in the final rules, we respectfully recommend that the Commission also allow DCOs to apply for exemptions from these rules for specific groups of swaps as market conditions prove that application of the rules is excessive.

B. Customer Initial Margin Requirements

With respect to setting initial margin requirements, we believe that the Commission's final rules should mirror the long-established practice in other cleared markets whereby each DCO sets its initial margin requirements for all cleared transactions or portfolios and each clearing member determines additional margin ("**excess margin**"), if any, necessary to secure its guarantee obligations for individual customers. The DCO is the appropriate party to establish initial margin requirements since only the DCO has the risk management capability and control of all aspects of its default management framework, of which margin is only one element.[19] In contrast, clearing members are the parties that are in direct contact and contractual privity with individual customers, and thus, clearing members are best situated to assess the risk that each customer poses to them as guarantor, determine if excess margin is necessary, and if so, incorporate it into their clearing documentation.

The inclusion in the Proposed Rules of a requirement that customer initial margin be automatically higher than direct clearing members' initial margin for the same portfolio suggests that the Commission believes that: (i) customers as a group pose greater credit risk; (ii) clearing members are unable to make satisfactory assessments of their customers' credit risk; and (iii) a DCO is able to assess the credit risk of clearing members' customers better than the clearing members themselves. We believe that all of these assumptions are unfounded.

During the 2008 financial crisis, many customers used far less leverage and were more creditworthy than many regulated entities.[20] Given that customers' obligations are guaranteed by

[19] We think that the references in the Proposing Release to situations where clearing members might set foundational margins are unclear (*see* Proposing Release at 3706) and believe that the Commission should make it clear that DCOs are in all cases the appropriate party to set initial margin requirements.

[20] A recent study by academics at Columbia University indicates that 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 investment banks in 2009, and the leverage ratio of the entire financial sector during that period was 9.4. By comparison, this study found that the leverage ratio for the hedge fund industry was 1.5 as of October 2009, with an average ratio of 2.1 from December 2004 to October 2009, with a high of 2.6. See Hedge Fund Leverage, available at: http://www2.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf.

their designated clearing members, it is unnecessary to mandate that DCOs require clearing members to collect customer initial margin for non-hedge positions at a level that is greater than 100% of the DCO's initial margin requirements with respect to each product and swap portfolio. Moreover, we note that the changes contained in proposed Section 39.13(g)(8)(i) (requiring DCOs to collect customer initial margin on a gross basis)[21] would already provide enhanced protection against customer credit risk by requiring DCOs to hold a greater amount of margin and ensuring that each DCO applies its margin methodology neutrally to all clearing members.

Further, we respectfully disagree that DCOs are able to properly assess the excess margin to which any individual customer, or customers as a whole, should be subject. Under the Proposed Rules,[22] the DCO must set excess margin levels for individual customer accounts, even though the DCO has no relationship with any individual customer. Without such a relationship, the DCO lacks the contractual privity with, and sufficient information about, individual customers that are necessary to make an informed creditworthiness determination. Instead, we believe that the Commission should permit clearing members to assess excess margin in accordance with their counterparty credit assessment practices (*i.e.*, DCOs should remain excluded from these determinations).

Moreover, we do not agree that it would be helpful for DCOs to collect excess margin from clearing member customers to eliminate "the need for the clearing members to make frequent margin calls to their customers."[23] MFA's members are prepared to support daily (or more frequent) margin calls to cover both mark-to-market variations and recalibrations of initial margin as needed in light of evolving volatility. This frequent exchange of margin is current market practice for bilateral trades and market participants are able to comply with these margin calls as necessary. However, requiring market participants to comply with DCO excess margin requirements would impair market liquidity by limiting the frequency and amount in which certain market participants are able to trade, resulting in greater market concentration.

In view of the foregoing, we believe that the margin requirement in proposed Section 39.13(g)(8)(ii) is unnecessary, contrary to the goals of systemic risk mitigation and should be removed from the Proposed Rules.

The findings of this study with respect to the leverage ratio of the hedge fund industry are consistent with other studies, which report leverage ratios below 3.0 for an extended period of time. See, Bank of America Merrill Lynch study, which finds the leverage ratio for the industry was 1.16 as of July 2010 http://www.reuters.com/article/idUSTRE67G28220100817. *See also*, FSA study, assessing possible sources of systemic risk from hedge funds, July 2010 (finding a leverage ratio of 272%, as of April 2010), available at: http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf. *See also* The Turner Review, a regulatory response to the global banking crisis, March 2009 (finding that the leverage ratio of the hedge fund industry since 2000 has been two- or three-to one), available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

[21] Proposed Section 39.13(g)(8)(i) would require a DCO to collect initial margin on a gross basis for each clearing member's customer account without offset between different customer accounts, which departs from current practice where clearinghouses are permitted to offset between different customer accounts.

[22] Proposed Section 39.13(g)(8)(ii).

[23] Proposing Release at 3706.

Finally, with respect to DCOs' process for setting initial margin, it is important that the process be transparent in order to give all market participants certainty as to the margin they can expect the DCO to assess. To this end, we would respectfully urge that the final rules require the DCO to make available to all market participants, at no cost, a margin calculation utility, so that market participants can replicate the margin that such DCO will assess.[24]

III. Effective Date

MFA believes that the 180-day effective date that the Commission prescribes in Section III of the Proposing Release[25] is sufficient for implementation of the changes required under the Proposed Rules and we would advise against permitting a longer phase-in period. We concur with the Commission that the costs to market participants will be substantial, if the Commission does not adopt these regulations[26] and we note that, over the past few years, the industry has made significant commitments to prioritize preparation for mandatory central clearing.[27]

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[24] While proposed Section § 39.13(g)(8)(ii) would only apply with respect to customers' non-hedge positions, we believe that it would be highly burdensome to distinguish between hedge and non-hedge positions for purposes of the application of differentiated margining, especially in a portfolio margining context.

As a further matter, we strongly support efforts to streamline approval of cross product margin, including among swaps and futures because of the clear systemic risk reduction benefits as well as the commercial and transactional efficiency benefits of such arrangements.

[25] Proposing Release at 3715, where the Commission proposes that the requirements in the Proposing Release become effective 180 days from the date the final rules are published in the Federal Register, with the exception of certain enumerated requirements.

[26] Proposing Release at 3717.

[27] *See e.g.*, industry commitment letter to the Global Regulators dated March 1, 2010, where industry participants indicated their willingness to greatly expand clearing access and volumes, including to customer participants. A sample of this letter, addressed to the Federal Reserve Bank of New York from ISDA, is available at http://www.newyorkfed.org/newsevents/news/markets/2010/100301_letter.pdf.

MFA thanks the Commission for the opportunity to provide comments regarding the Proposed Rules. Please do not hesitate to call Carlotta King or the undersigned at (202) 730-2600 with any questions the Commission or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

cc: 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
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