MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

September 14, 2009

Via Electronic Mail: secretary@cftc.gov

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

Re: Proposed Rulemaking (RIN 3038-AC82) to Create a Separate Account Class for Customer Positions in Cleared OTC Derivatives

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the U.S. Commodity Futures Trading Commission's (the "Commission" or "CFTC") proposed rulemaking issued on August 13, 2009 (RIN 3038-AC82) (the "Proposal")[2] to amend Part 190 of its regulations to: (1) create a sixth and separate "account class" for cleared over-the-counter ("OTC") derivatives, applicable in the case of a bankruptcy of a commodity broker that is a futures commission merchant ("FCM"); and (2) codify the appropriate allocation of OTC derivatives positions and collateral during bankruptcy when positions and collateral of different account classes are pooled together pursuant to a Commission order. MFA applauds the Commission's efforts to provide necessary protection to customers of FCMs regarding the treatment of cleared OTC derivatives positions and collateral in the event of an FCM bankruptcy. MFA members are active participants in the OTC derivatives markets and are generally customers of commodity brokers that are FCMs.

MFA strongly supports both parts of the Proposal. In particular, we believe the implementation of each part of the Proposal: (1) will significantly mitigate counterparty risks as between market participants and systemic risk to U.S. financial markets by providing clear bankruptcy protection when an FCM customer clears its OTC derivatives positions; (2) is necessary to ensure broad market support of customer clearing initiatives in light of alleged uncertainty; and (3) is consistent with current policy objectives and some legislative proposals that include measures to protect customer positions and collateral in the context of central clearing. In addition, we also ask the Commission to consider additional measures that are not contemplated by the Proposal, which will further mitigate counterparty and systemic risks. We elaborate on each of these points in Section II of this letter.

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[1] MFA is the voice of the global alternative investment industry. Our members include professionals in hedge funds, fund of funds and managed futures funds. 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 represent the vast majority of the largest hedge fund groups in the world that 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, NY.

[2] 74 FR 40794 (August 13, 2009) (the "Proposal").

I. Background

The Proposal seeks to amend Part 190 of the CFTC Regulations in two important respects in the case of a bankruptcy of a commodity broker that is an FCM.[3] Immediately below, we describe the concept of an account class, followed by a summary of each part of the Proposal.

1. Account Class Designation Provides Bankruptcy Protection.

Under Section 20 of the Commodity Exchange Act (the "CEA")[4], the Commission has the power to define the amount of a customer's claim (also referred to as "net equity" under the CEA and the Bankruptcy Code) against a commodity broker in bankruptcy and to prescribe by regulation the procedures for determining such amount. Section 761(17) of the Bankruptcy Code[5] also provides the Commission with the power to prescribe those procedures. In furtherance of these powers, the Commission has established: the concept of an account class; procedures outlining the types of commodity contracts that fall within a certain account class; and how FCMs and Derivatives Clearing Organizations ("DCOs") should manage accounts.

CFTC Regulation 190.01(a) currently sets forth five separate account classes—(1) domestic futures accounts; (2) foreign futures accounts; (3) leverage accounts; (4) commodity option accounts; and (5) delivery accounts—to ensure that, in the bankruptcy of a commodity broker that is an FCM, customers who hold positions in different types of commodity contracts are afforded certain protections based on the underlying characteristics of those contracts. The concept of an account class is included in the definition of net equity under section 20 of the CEA and section 761(17) of the Bankruptcy Code. In the event of an FCM bankruptcy, a bankruptcy trustee calculates and generates the total amount that each FCM customer is entitled to recover based on the account class or classes in which all money, securities and/or other property are held on behalf of such customer (*i.e.*, an FCM customer's net equity). If an FCM customer's positions and collateral are not held in such an account—which is current industry practice with respect to OTC derivatives—the FCM customer would become an unsecured creditor of a bankrupt FCM.

Depending on the account class, an FCM or DCO will have to comply with differing levels of segregation requirements with respect to a customer's positions and any related collateral. CFTC Regulations 1.20 through 1.30 provide the strongest protections to positions (and any related collateral) that are held in a domestic futures account. An FCM or DCO must segregate customer

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[3] *Id.* at 40796.

[4] 7 U.S.C. 24.

[5] 11 U.S.C. 761(17). Section 761(17) of the Bankruptcy Code specifically defines "net equity" as, "*subject to such rules and regulations as the Commission promulgates under the [CEA]*, with respect to the aggregate of all of a customer's accounts that such customer has in the same capacity - (A) the balance remaining in such customer's accounts immediately after - (i) all commodity contracts of such customer have been transferred, liquidated, or become identified for delivery; and (ii) all obligations of such customer in such capacity to the debtor have been offset; plus (B) the value, as of the date of return under section 766 of [the Bankruptcy Code], of any specifically identifiable customer property actually returned to such customer before the date specified in subparagraph (A) of this paragraph; plus (C) the value, as of the date of transfer, of - (i) *any commodity contract* to which such customer is entitled that is transferred to another person under section 766 of [the Bankruptcy Code]; and (ii) any cash, security, or other property of such customer transferred to such other person under section 766 of this title to margin or secure such *transferred commodity contract*." (Emphasis added.)

positions and collateral into separate accounts under these regulations, unless the Commission issues an order pursuant to Section 4d of the CEA, permitting the FCM or DCO to commingle those accounts.[6]

2. First Part of the Proposal: Proposed Amendments to Include "Cleared OTC Derivatives" as a Separate Account Class.

The first part of the Proposal seeks to make three amendments to Part 190 of the CFTC Regulations in the case where positions and collateral in different account classes are not commingled. The first amendment would create a sixth and separate account class for "cleared OTC derivatives" positions and collateral under CFTC Regulation 190.01(a).

The second amendment would define "cleared OTC derivatives" in CFTC Regulation 190.01 by incorporating the term "cleared-only contracts" from the Commission's "Interpretative Statement Regarding Funds Related to Cleared-Only Contracts Determined to Be Included in a Customer's Net Equity," dated September 28, 2008 (the "Statement on Cleared OTC Derivatives").[7] By incorporating this term, the Commission is seeking to limit the term cleared OTC derivatives to only those positions and collateral that "are required to have been (i) segregated in accordance with a rule, regulation, or order issued by the Commission, or (ii) held in a separate account for 'cleared-only contracts' in accordance with the rules or bylaws of a DCO."[8]

The third amendment to Part 190 of the CFTC Regulations would make certain conforming changes. In particular, this amendment would: (a) incorporate the new cleared OTC derivatives account class into the procedures for calculating a customer's net equity in the bankruptcy of an FCM under CFTC Regulation 190.07(b)(2)(viii); and (b) add the new account class to certain bankruptcy claim forms.

Prior to the release of the Proposal, some market professionals questioned whether, in the absence of a Commission order or rule, OTC derivatives positions and collateral would fall within the domestic futures account class or any of the other account classes (*i.e.*, would constitute a "commodity contract"), thereby providing those positions and collateral with certain protections in the bankruptcy of an FCM.[9] The Commission states that the first part of the Proposal would make it clear that those positions and collateral (held separate from other positions) are afforded bankruptcy protection.

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[6] 7 U.S.C. 6d.

[7] *See* 73 FR 65514, 65515 (November 4, 2008).

[8] *See* 74 FR at 40796.

[9] *See* pages 34-5 of the "Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customers CDS Positions and Related Margin" dated June 30, 2009 (the "Customer Access Report"), which provides there is uncertainty as to the proposition that cleared OTC derivatives contracts constitute "commodity contracts", thereby receiving account class protections under the CEA and the Bankruptcy Code. The Customer Access Report is publicly available at: http://www.newyorkfed.org/newsevents/news/markets/2009/an090713.html.

3. Second Part of the Proposal: Proposed Amendment to Codify Appropriate Allocation of Collateral to Certain Account Classes When Positions Are Commingled.

The second part of the Proposal intends to codify the appropriate allocation of positions and related collateral during the bankruptcy of an FCM when those positions and collateral are commingled or otherwise pooled together pursuant to a Commission order under Section 4d of the CEA.[10] A Section 4d order permits an FCM or DCO to commingle positions and collateral of one account class with positions and collateral of the domestic futures account class.[11] If the Commission issues a Section 4d order, CFTC Regulation 190.01(a) provides that those commingled positions are treated as being held in the domestic futures account class. As a result, FCMs or DCOs who commingle commodity options positions with domestic futures positions in one account are required to implement the most stringent protections under CFTC Regulation section 1.20 through 1.30 for all customer positions and related collateral.

In the Proposal, the Commission also notes that some have questioned the certainty regarding whether cleared OTC derivatives positions that are commingled with domestic futures positions would be afforded the same bankruptcy protections of the latter. The Proposal cites to two of its previous interpretations in support of this treatment. The Commission issued its first interpretation on October 21, 2004 regarding the commingling of positions in the foreign futures accounts class with positions in the domestic futures account class ("Statement on Commingling Foreign Futures Positions").[12] In the Statement on Commingling Foreign Futures Positions, the Commission stated that "collateral supporting foreign futures placed in [an account with] domestic [futures] segregation pursuant to a Commission Order should be treated as in a futures account, not a foreign futures account, for purposes of Part 190."[13] The Commission subsequently issued the Statement on Cleared OTC Derivatives, which extended the conclusion reached in the Statement on Commingling Foreign Futures Positions to cover cleared OTC derivatives that are commingled with positions relating to commodity contracts of the domestic futures account class. Notwithstanding the release of the Statement on Cleared OTC Derivatives, some argue that ambiguity continues to exist as to the legal effect of these interpretations on cleared OTC derivative positions.

Through the release of the Proposal, the Commission now seeks to "codify explicitly, in Regulation 190.01(a), a generalized version of the Statement on Commingling Foreign Futures Positions and the Statement on Cleared OTC Derivatives."[14] The Commission intends for the second part of the Proposal to remove doubts as to whether cleared OTC derivatives positions can be afforded the highest bankruptcy protections (*i.e.*, the protections under CFTC Regulation 1.20 through 1.30) when those positions are commingled with domestic futures account positions pursuant to a Section 4d order.

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[10] *See* 74 FR at 40797.

[11] 7 U.S.C. 6d.

[12] *See* 69 FR 69510 (November 30, 2004).

[13] *Id.* at 69511. The Commission also noted in the Statement on Commingling Foreign Futures Positions that it would accord similar treatment to other positions that were commingled with domestic futures accounts.

[14] *Id.*

II. Discussion

As mentioned above, MFA strongly supports both parts of the Proposal. Specifically, we believe the implementation of each part of the Proposal: (1) will significantly mitigate counterparty risks as between market participants and systemic risk to U.S. financial markets; (2) is necessary to ensure broad market support of customer clearing initiatives; and (3) is consistent with current policy objectives and some legislative proposals. Lastly, in Sub-section 4 below, we raise an important issue, which is not addressed in the Proposal, but that we believe the Commission should consider with respect to non-cleared OTC derivatives.

1. The Proposal Would Significantly Mitigate Counterparty Risk and Systemic Risk.

We believe that both parts of the Proposal would significantly mitigate counterparty risk and systemic risk in the context of the OTC derivatives market. As noted above, some market professionals have questioned whether cleared OTC derivatives positions and collateral would be considered a commodity contract that falls within any of the five account classes under the CEA and Bankruptcy Code in the absence of a Commission order or rule. The first part of the proposal would enact such a rule pursuant to the Commission's authority under the CEA and Bankruptcy Code. As a result, cleared OTC derivatives (which are required to be segregated) would be included within the definition of net equity and FCM customers would thereby receive the minimum protections afforded to commodity contracts in other account classes.

The second part of the Proposal would provide even greater protections to those FCM customers. Specifically, FCM customers' cleared OTC derivatives positions and collateral would benefit from the strongest protections under CFTC Regulations 1.20 through 1.30 following the Commission's issuance of a Section 4d order. Thus, a customer's cleared OTC derivatives would be treated like domestic futures positions once both positions are commingled pursuant to such an order.

By issuing both parts of the Proposal pursuant to its authority under the CEA and Bankruptcy Code, the Commission would mitigate counterparty and systemic risks that were seen during the most recent financial crisis. In a letter to the Commission, the Federal Reserve Bank of New York and the U.S. Securities and Exchange Commission dated December 23, 2008, MFA explained how these risks arise in the context of OTC derivatives trading between the major OTC derivatives dealers (the "Major Dealers") and their non-dealer counterparties, which include MFA's members.[15]

As is described more fully in MFA's letter, when entering into an OTC derivatives contract with non-dealers, the Major Dealers require their counterparties to post upfront collateral (also known as "initial margin") to cushion against default risk. The Major Dealers do not typically segregate initial margin posted by their counterparties from other unsecured assets. When a Major Dealer becomes insolvent, initial margin posted by a counterparty is treated in bankruptcy as a general unsecured claim of that counterparty. As a result, counterparties to the Major Dealers stand to incur significant losses, regardless of the current value of their OTC derivatives contracts. When the creditworthiness of a Major Dealer appears to be diminishing, certain counterparties will seek to protect the assets of their investors and minimize their losses by purchasing credit default swap ("CDS") protection, shorting

[15] *See* Letter from Richard H. Baker (President and C.E.O., Managed Funds Association) dated December 23, 2008 to Timothy F. Geithner (President) the Federal Reserve Bank of New York; The Honorable Christopher Cox (Chairman) U.S. Securities and Exchange Commission; and The Honorable Walter Lukken (Acting Chairman) U.S. Commodity Futures Trading Commission. A copy of this letter is attached.

equity, and, if the Major Dealer is their prime broker, transferring assets held at that Major Dealer to another prime broker. Each of these factors may contribute to market instability and uncertainty at the point when the markets are most volatile.

Additionally, if a Major Dealer files for bankruptcy, its counterparties must cover their losses arising from the loss of initial margin held at the Major Dealer. These counterparties may be forced to sell unrelated assets, which may further contribute to market instability.

A good example of this uncertainty and its affects on the global economy was seen in the bankruptcy of Lehman Brothers Holdings, Inc. ("LBHI"). LBHI traded OTC derivatives through one of its affiliates. LBHI's failure triggered the unwinding of a significant percentage of the CDS and other OTC derivatives positions held by LBHI's derivatives affiliate. The majority of the affiliate's customer assets were not segregated. Once LBHI was placed into bankruptcy, its customers became general unsecured creditors, freezing up several billions of dollars of its customers' investment capital. Since LBHI and the Major Dealers were highly interconnected to each other through their exposures to one another, LBHI's failure resulted in market concerns about the viability of other Major Dealers. These concerns ultimately caused significant volatility in global capital markets when many market participants simultaneously begun selling assets to cover their losses.

Ultimately, we support both parts of the Proposal because we believe they would help reduce counterparty risks associated with cleared OTC derivatives positions and all related collateral (not for just initial margin, and regardless of whether those positions and collateral are segregated or commingled) in the event of the bankruptcy of an FCM. In addition, by providing protections to customers in the event of an FCM failure, the Proposal would help promote broader market stability by allowing capital to continue to flow freely regardless of such a failure.

2. The Proposal Is Necessary to Ensure Broad Market Support of Customer Clearing Initiatives.

MFA also strongly supports both parts of the Proposal because each would provide necessary protections to FCM customers, which to date, have been discouraged from centrally clearing their OTC derivatives positions as a result of the uncertainty surrounding the protection that would be afforded to those positions. MFA members and other FCM customers are supportive of, and extremely interested in, centrally clearing their OTC derivatives positions because of the benefits central clearing would provide to them in terms of reducing counterparty exposure. To date, however, some market professionals have expressed concern regarding whether central clearing through use of an FCM would actually reduce counterparty exposure in the absence of a Commission order or rule providing bankruptcy protection to FCM customer positions and collateral. In addition, some central counterparty offerings, which operate outside of the commodity futures regulatory framework, do not provide any bankruptcy protection to customers of clearing members with respect to their positions and collateral.[16] Many market observers have asserted that, without certainty regarding such protection when centrally clearing under any regulatory framework, counterparty exposure would continue to present a problem for customers.[17]

[16] *See* pages 1-31 of the Customer Access Report.

[17] *See id.*

Again, we believe that the two parts of the Proposal would provide certainty to MFA members and other FCM customers with respect to the protection afforded to their cleared OTC derivatives positions under the CEA and the Bankruptcy Code regardless of whether an FCM segregates those positions or commingles them with positions in other accounts classes. While we completely agree with the Commission that its prior interpretations were clear on this issue[18], we believe that the two parts of the Proposal will make certain that a bankruptcy trustee includes such positions and collateral in its calculation of net equity, regardless of whether those positions are segregated or commingled.

We recognize that policy makers and regulators are proposing a regulatory regime under which large volumes of OTC derivatives are centrally cleared.[19] In addition, a number of central clearing offerings have begun to central clear inter-dealer OTC contracts, with a 2009 year-end goal to expand those offerings to customers.[20] In MFA's view, the Commission's issuance of the Proposal is an important and necessary first step in encouraging all market participants to centrally clear their positions, which ultimately will result in the central clearing of a significant number of OTC derivatives positions.

3. The Proposal Is Consistent with Current Policy Objectives and Legislative Proposals.

MFA believes that the Commission's actions are consistent, in part, with sweeping legislative reform proposals that are currently under review by Congress with respect to the OTC derivatives market. All of these proposals seek to promote stability in the OTC derivatives market through the enhancement of market transparency and strengthening of market infrastructure. Some proposals even include measures to provide protections to customer OTC derivatives positions and related collateral. For example, on August 11, the Obama Administration released a comprehensive legislative proposal to regulate the OTC derivatives market.[21] The Administration's proposal includes a measure requiring central counterparties to develop risk control mechanisms that protect customer positions and related collateral in the event a clearing member default.

In addition to the introduction of several legislative proposals, Congress has held several hearings on OTC derivatives regulatory reform, during which protection of customer positions and related collateral were discussed. At one such hearing before the House Financial Services Committee on July 22, Commission Chairman Gary Gensler asserted that a comprehensive regulatory framework governing OTC derivatives dealers and the OTC derivatives market should include safeguards for customer positions and collateral.[22] In particular, Chairman Gensler stated that "Congress should also

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[18] *See* 73 FR at 65514; *see also* 69 FR at 69510.

[19] *See* the Obama Administration's legislative proposal, which is available at: www.financialstability.gov/docs/regulatoryreform/titleVII.pdf . *See also* House Chairmen Barney Frank and Collin Peterson's outline, which is available at: www.house.gov/apps/list/press/financialsvcs_dem/otc_principles_final_7-30.pdf.

[20] *See* Letter from market participants to William Dudley, President of the Federal Reserve Bank of New York, June 2, 2009. A copy of this letter is available at: www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html.

[21] *See* the Obama Administration's legislative proposal.

[22] CFTC Chairman Gensler's written statement is available at: www.house.gov/apps/list/hearing/financialsvcs_dem/gensler_-_testimony_before_house_financial_services_7-22-09_final.pdf

consider explicitly authorizing regulators to require derivatives dealers and counterparties to segregate, or set aside, from their own funds, the margin required."

Lastly, MFA acknowledges and applauds Chairman Gensler's Letter to Congressional leaders dated August 17, 2009, in which he comments on the Administration's legislative proposal.[23] In Chairman Gensler's letter, he requests, among other things, the imposition of a mandatory set-aside requirement with respect to collateral received by OTC derivatives dealers on all OTC derivatives, including those transactions that are not centrally cleared. MFA firmly supports Chairman Gensler's statements before Congress and in his letter on this specific issue, as well as any measures in legislative proposals that provide protections to customer positions and related collateral across all OTC derivatives transactions, irrespective of whether those transactions are centrally cleared.

4. Important Consideration: Protections for Non-Cleared OTC Derivatives.

In addition to the Commission's issuance of the Proposal, we believe that the Commission should consider additional measures to promote broader market stability and to mitigate counterparty risk associated with OTC derivatives trading. That is, while MFA believes that protection of customer positions and collateral held by an FCM is absolutely crucial to the success of central clearing initiatives, we also believe that these protections should be implemented more broadly for all OTC derivatives, irrespective of the launch of any central counterparty. In particular, we ask that the Commission and other regulators work with Congress to provide bankruptcy protection to customer positions and collateral with respect to ***both cleared and non-cleared OTC derivatives***.

As noted above in the discussion on cleared positions, in his testimony before Congress on July 22 and in his letter to Congressional leaders, Chairman Gensler expressed his agreement with applying bankruptcy protection to non-cleared positions. In particular, at the hearing, Chairman Gensler stated,

> *Congress should consider amending the Bankruptcy Code to ensure that, if a derivatives dealer or counterparty of a customized OTC transaction that is not cleared becomes insolvent, either party can make themselves whole by accessing margin, and can continue economic activity without major disruption by moving positions to another derivatives dealer.*

We applaud Chairman Gensler's recommendation to Congressional leaders and the proposed statutory language that he included in his letter, which would in effect legislate a set aside requirement for all customer OTC derivatives positions and collateral.[24]

MFA has consistently advocated for the protection of customer collateral in all OTC derivatives trading. As mentioned above, MFA submitted a letter on December 23, 2008 to the Commission and other regulators, emphasizing the importance of providing adequate bankruptcy protection and safeguards to customer OTC derivatives collateral within a central clearing regime and in bilaterally negotiated OTC derivatives contracts.

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[23] *See* page 3 of the Letter from CFTC Chairman Gary Gensler dated August 17, 2009 to the Honorable Tom Harkin (Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate) and the Honorable Saxby Chambliss (Ranking Member, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate).

[24] *See* Attachment B to Chairman Gensler's letter.

III. Conclusion

MFA appreciates the opportunity to provide its views on the Proposal. MFA believes that the proposed changes to Part 190 of the CFTC Regulations would promote broader market stability and mitigate counterparty risk, as well as help ensure the success of OTC derivatives clearing initiatives. We would be pleased to meet with CFTC staff to further discuss our comments in greater detail. If the staff has comments or questions, please do not hesitate to contact Jennifer Han, Carl Kennedy or me at (202) 367-1140.

Respectfully submitted,

\s\ Stuart J. Kaswell

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

CC: The Hon. Gary Gensler, Chairman
The Hon. Michael Dunn, Commissioner
The Hon. Walter Lukken, Commissioner
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner

Attachment

MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

December 23, 2008

President Timothy F. Geithner
President
Federal Reserve Bank of New York
33 Liberty Street, 10F
New York, NY 10045

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable Walter Lukken
Acting Chairman
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington D.C. 20581

Dear President Geithner, Chairman Cox and Chairman Lukken:

Recently, Managed Funds Association ("MFA")[1] and its members met with the Federal Reserve Bank of New York (the "NYFRB") to discuss and provide comments regarding the state of the credit default swap ("CDS") market, including our feedback on current proposals to establish a central clearing counterparty for the CDS market. As part of our ongoing commitment to proactively work with regulators on topics that pose significant market or systemic risk concerns, we wish to direct your attention to the protection and safeguarding of customers' initial margin that they deposit with dealer financial institutions in connection with the trading of all over-the-counter ("OTC") derivatives.

Effects of Current Collateral Management Practices

By way of background, the default of Lehman Brothers, a major OTC derivatives counterparty, and the resulting market concerns about the viability of other major dealers, has caused significant volatility in the capital markets. These concerns demonstrate that current mechanisms for collateral management, outside of the context of broker-dealer accounts covered by Exchange Act Rule 15c3-3, do not adequately protect the pledgors of collateral and can contribute to systemic risk in several important respects:

- The purpose of initial margin is to provide dealers with a cushion against the potential counterparty risk they assume when entering into an OTC derivatives contract with a customer. However, since such margin is not typically segregated from the dealers' other unsecured assets, what is supposed to be a credit mitigant for the dealer instead subjects the customer to actual credit risk on the posted amounts.
- If a dealer becomes insolvent, initial margin posted by customers that is not so segregated is treated in bankruptcy as a general unsecured claim of the customer. As a result, customers who are counterparties to that dealer stand to incur significant losses, regardless of the current value of their derivatives contracts.

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- Investment managers have fiduciary duties to their investors. When a dealer experiences difficulties, the risk to initial margin may cause managers to seek to hedge counterparty exposure to such dealer (either through the CDS market or by trying to close-out or assign derivatives trades away from such dealer). These hedging actions can have a further destabilizing impact on such dealer and the market generally, thereby increasing systemic risk.
- In addition, given that dealers are able to freely use posted collateral, they have come to rely on initial margin, a fluctuating source of cash, to fund their business activities. As trades are closed-out or assigned, dealers are required to return initial margin to their customers. The return of margin constricts dealers' liquidity and, as recent events demonstrate, the inability of the dealers to access cash has potentially severe market consequences.

We highlight that the aforementioned counterparty risks related to customer initial margin have been greatly exacerbated over the last few months as dealers as a whole have significantly increased their demands for initial margin. These risks are in turn further compounded by the general weakening of the financial sector as a whole.

Enhanced Customer Segregated Accounts

As you are aware, the segregation of initial margin is a key component of the central clearing party initiatives for the CDS market, and we understand that the NYFRB, SEC and CFTC have stipulated this condition to be a prerequisite for regulatory approval. We agree that segregation of initial margin is crucial to the success of these clearing initiatives, but also believe that the protection of customer initial margin should be implemented more broadly for all OTC derivatives, irrespective of the launch of any CDS central counterparty because it is critical in order to promote broader market stability and to mitigate counterparty risk. Protection of customer initial margin with respect to all bilaterally negotiated OTC derivatives could be incorporated into the existing transaction structure through dealer use of a segregated account, in the name of, and held for the benefit of, the customer (e.g., at a U.S. depository institution or a regulated U.S. broker-dealer), whereby the dealer would not be permitted to rehypothecate the initial margin held in such an account. This would promote broader market stability and mitigate counterparty risk.

Given that dealers will be required to provide initial margin segregation as part of the clearing initiatives, they should be capable of offering this to customers on a broader basis. However, to date the dealer community, as a whole, has been resistant to such efforts by MFA's members and other investment managers.

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We recognize the efforts of regulators to collaborate on mitigating risk and promoting market stability. We appreciate the constructive working relationship fostered by each of you as well as the opportunity to share the views of our members on this important topic. We welcome the opportunity to discuss this issue further with each of your staffs. If we can provide further information on this topic, or be of further assistance, please do not hesitate to contact us at (202) 367-1140.

Yours Sincerely,

Richard H. Baker
President and Chief Executive Officer

cc: The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System
Patrick M. Parkinson, Deputy Director, Division of Research and Statistics, Board of the Federal Reserve System
Ananda Radhakrishnan, Director, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission
Theodore Lubke, Senior Vice President, Bank Supervision Group, Federal Reserve Bank of New York
Erik R. Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission