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

February 12, 2010

The Honorable Neal S. Wolin
Deputy Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Treatment of Derivatives Contracts in a Liquidation Event

Dear Deputy Secretary Wolin:

Managed Funds Association ("MFA") appreciates the opportunity to set out certain issues regarding the treatment of over-the-counter ("OTC") derivatives contracts, whether centrally cleared or not, in bankruptcy and under a resolution authority framework. As you know, MFA's members are active participants in the OTC derivatives markets. As active participants in OTC markets, we believe it is important for policy makers, regulators and market participants to clearly understand the rules regarding the treatment of OTC derivatives contracts in a liquidation event, whether the liquidation occurs in a bankruptcy framework or in a resolution authority framework. We also believe that it is important that collateral posted with a clearing member of a central counterparty provider ("CCP") in connection with a centrally cleared OTC derivatives transaction be fully protected in a liquidation event.

MFA and its members have worked with outside counsel and identified several potential issues with respect to the treatment of OTC derivatives in the event a hedge fund's counterparty is liquidated. The first issue relates to the protection of collateral posted with a clearing member of a CCP in connection with an OTC derivatives transaction. The second issue relates to differences in the treatment of OTC derivatives under title 11 of the United States Code (the "Bankruptcy Code"), compared to the Resolution Authority title in H.R. 4173, the "*Wall Street Reform and Consumer Protection Act of 2009*" (the "Bill").

Protection of Collateral Posted with CCP Clearing Members

MFA members believe that it is critical for policy makers to address two key concerns with respect to any central clearing framework: the segregation of initial margin in an account separate from the assets of the dealer; and the ability to move customer positions from one dealer to another in the event of a dealer's insolvency. MFA has advocated changes to the

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Bankruptcy Code and U.S. banking laws to provide protections to customer initial margin[1] and ensure adequate portability of contracts. This letter focuses on these proposed changes in connection with the proposed CCP frameworks; however, it is our view that these changes should apply to all OTC derivatives contracts, including those that are not centrally cleared.

During 2009, several CCPs emerged with frameworks to clear credit default swaps ("CDS") contracts. The private sector formed a special working group comprised of eight dealers, four MFA members and four other buy-side market participants in May 2009 at the request of the Federal Reserve Bank of New York to conduct a cross-jurisdictional analysis of six U.S. and European CCPs regarding the issues of: (1) initial margin segregation for customers; and (2) portability of cleared customer CDS positions. The working group engaged the law firm of Cleary Gottlieb Steen & Hamilton to assist in conducting the analysis and preparing a report titled, "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" (the "Cleary Report"), which the group submitted to several U.S and European regulators on July 13, 2009.

The Cleary Report analyzes the current legal framework for protection of customer initial margin and portability of CDS positions in the event of a default by a clearing member of a CCP.[2] A copy of the Cleary Report can be accessed on the website of the Federal Reserve Bank of New York.[3]

The Cleary Report ultimately concludes that customer rights in a clearing member insolvency under each CCP framework largely depends upon the law applicable to the defaulting clearing member, which in turn varies by the entity type and jurisdiction of the clearing member. In connection with the Cleary Report, the two U.S.-based CCPs, *i.e.,* CME and ICE Trust, proposed amendments to U.S. law that would provide greater certainty regarding the protection of customer positions and related collateral in the event of a clearing member's insolvency. These amendments can be found on pages 141 and 142 of the Cleary Report and are discussed below. Based on the analysis in the Cleary Report, MFA and its members are concerned that the U.S. CCPs, CME Clearing and ICE Trust U.S., do not fully address the issues of segregation of initial margin and portability of customer positions absent these recommended legislative amendments.

Each CCP took a different approach in addressing the protection of customer positions and segregation of initial margin because each CCP's framework is based on a different legal regime: the CME follows U.S. commodity laws; and ICE Trust has a more flexible

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[1] In contrast with our position on the segregation of initial margin, we do not support the segregation of mark-to-market or variation margin and believe that it is appropriate to allow market participants to pass such margin back-and-forth.

[2] As noted above, the Cleary Report also analyzes four European CCPs, however, this letter focuses on the two U.S. CCPs.

[3] http://www.ny.frb.org/newsevents/news/markets/2009/an090713.html.

framework that requires an analysis of multiple statutes. To address the concerns identified in the Cleary Report, CME proposed an amendment to the Bankruptcy Code, while ICE Trust proposed amendments under the U.S. banking laws, specifically the Federal Deposit Insurance Corporation Improvement Act of 1991 (the "FDICIA") and the Federal Deposit Insurance Act (the "FDIA"). MFA believes that both approaches are necessary since market participants will likely clear their CDS contracts on both U.S.-based CCPs. We discuss these recommendations in more detail below.

CME. The CME's clearing framework requires that customer CDS positions be cleared through futures clearing merchants ("FCMs"), which are members of CME.[4] Based on the analysis in the Cleary Report, we believe that CME's proposed segregation and portability provisions generally address segregation and portability in an appropriate manner, provided that OTC contracts cleared through a CCP registered under the U.S. Commodity Exchange Act (the "CEA"), constitute "commodity contracts" within the meaning of the Bankruptcy Code.

While the CME believes that under current law (both the CEA and the Bankruptcy Code) the Commodity Futures Trading Commission (the "CFTC") can determine that OTC contracts are "commodity contracts", the Cleary Report concluded that uncertainty exists under the Bankruptcy Code as to whether the CFTC has the authority to redefine "commodity contract" to include a cleared OTC contract. To address this uncertainty, CME offered its legislative proposal, which would amend section 761(4)(F) of the Bankruptcy Code to define the term "commodity contract" to include any OTC derivatives contract cleared through a registered CCP.

It is critical that centrally cleared OTC derivatives contracts be included within the definition of "commodity contract" under the Bankruptcy Code. Commodity contracts under the Bankruptcy Code are subject to the rules for determination and resolution of customer claims set out under the CEA, including the priority of claims in the event of an FCM insolvency. That is, the CEA currently establishes the amount of a customer's claim against an FCM in bankruptcy. The Bankruptcy Code provides the CFTC with the power to prescribe the procedures for determining such amount; and the CFTC has promulgated regulations that set out these procedures and provide other protections for cleared OTC contracts. Without the proposed amendment, there would be significant uncertainty regarding the treatment under the Bankruptcy Code of collateral posted by customer in connection with a centrally cleared OTC contract.

ICE Trust. Unlike the CME's framework, ICE Trust's clearing framework allows dealers to clear CDS through the entities in which they currently conduct their CDS business. The flexibility that ICE Trust has afforded to its clearing members has presented it with the challenge of accommodating clearing members of differing organizational types (*e.g.*, U.S.

[4] The Cleary Report notes that, currently, dealers generally do not conduct their CDS business through FCMs.

banks, U.S. federal and New York branches of non-U.S. banks) and clearing members across multiple jurisdictions.

ICE Trust offered legislative amendments to the FDICIA and the FDIA to address the issues of segregation and portability with respect to those CDS contracts that are cleared through a U.S. clearing member. As noted above, swap dealers generally conduct their CDS business through an affiliated entity that is not registered as a broker-dealer or an FCM. In the Cleary Report, ICE Trust limited their recommendations to address the issues of segregation and portability with respect to CDS contracts cleared through U.S. banks and bank affiliates; their recommendations do not provide legislative proposals that would apply to CDS cleared by non-U.S. banking clearing members, U.S. FCM clearing members or non-U.S.-based clearing members.

Specifically, ICE Trust's legislative proposal would amend two laws: (1) Section 404 of the FDICIA; and (2) Section 11(e) of the FDIA. ICE Trust did not propose changes to the Bankruptcy Code.

ICE Trust proposed amending section 404 of the FDICIA by adding two new subsections. The first amendment would clarify that a CCP has the authority to transfer positions (including related positions) and margin, in addition to its authority to net and terminate positions. The second amendment would give the appropriate federal regulator authority to establish rules as to the manner in which segregated property is to be held by a clearing member and in which it may be invested. It would also allow the regulator to establish rules as to the segregated status of property pledged by customers of a failed clearing member and as to the customer's right to the return of any excess amounts posted, free of claims of unsecured creditors.

ICE Trust also proposed amending Section 11(e) of the FDIA to help facilitate the moving of cleared contracts carried with a failed clearing member to a new clearing member, by permitting the FDIC to transfer cleared positions separately from non-cleared positions.

MFA's Perspective Regarding CCP Proposals. MFA strongly supports the legislative proposals offered by each CCP, which would provide greater certainty that customer CDS contracts cleared through a CCP would be protected in the event of a clearing member insolvency. As mentioned above, we believe that all of these legislative amendments are necessary since market participants will likely clear their CDS contracts on both CCPs.

Differences in Treatment of Derivatives under the Bankruptcy Code versus the Resolution Authority Bill

In addition to the work regarding centrally cleared derivatives, we have worked with the law firm of Willkie Farr & Gallagher to analyze the treatment of derivatives contracts under the Bill as compared to the Bankruptcy Code. MFA has not taken a policy position regarding the differences in treatment of derivatives in the respective statutes; however, we believe it is important that policy makers and market participants understand those

differences. Set out below is our analysis of the respective treatment of derivatives contracts, with a focus on: (1) the exception to the automatic stay provided for in section 362(b)(17) of the Bankruptcy Code, as defined in sections 560 and 101(53B) of the Bankruptcy Code; and (2) the trustee's authority under section 544 of the Bankruptcy Code and his/her concomitant avoidance powers under sections 547 and 548 of the Bankruptcy Code (Preferences and Fraudulent Transfers, respectively).

With respect to the automatic stay provisions in the relevant statutes, the Bill and the Bankruptcy Code grant substantially similar rights to swap participants, with two notable exceptions. Like the Bankruptcy Code, the Bill provides that a counterparty shall not be prohibited from exercising a right such counterparty has under a "Qualified Financial Contract". The Bill defines a Qualified Financial Contract as including, among other types of contracts, a swap agreement. Further, the Bill's definition of swap agreement is identical to the definition of "Swap Agreement" under section 101(53B) of the Bankruptcy Code. In this respect, the Bill allows a counterparty to a swap transaction the same rights of "setoff or net out [of] any termination value, payment amount, or other transfer obligation" arising under a Qualified Financial Contract as is allowed by the Bankruptcy Code under section 362(b)(17). However, the Bill affirmatively limits the rights and remedies of counterparties to a Qualified Financial Contract in two ways that differ from the Bankruptcy Code: First, the Bill states that "Walkaway Clauses"[5], which suspend or terminate the obligation of a party to make a payment under a contract solely because a receiver has been appointed with respect to the counterparty to the contract, are not enforceable. Second, the Bill suspends payment obligations due under the Qualified Financial Contract until the earlier of: (a) "the time such party receives notice that such contract has been transferred"; or (b) "5:00 p.m. on the business date following the date of the appointment of [the FDIC] as receiver."

With respect to the avoidance powers of the bankruptcy trustee and resolution authority receiver, the Bill generally provides the FDIC with avoidance powers similar to those available under sections 547 and 548 of the Bankruptcy Code; however, as to payments made under Qualified Financial Contracts, the general avoidance powers do not apply, and the FDIC (as receiver) is prohibited from recovering such payments unless they were made with "actual intent to hinder, delay, or defraud the company, the creditors of such company, or any receiver appointed for such company." The primary difference between this portion of the Bill and the Bankruptcy Code is the absence of a limitation period, *e.g.,* section 548 of the Bankruptcy Code provides for a two-year look-back period for fraudulent transfers. While not certain, it could be argued that this provision of the Bill permits a perpetual look-back period because, in section 1609(a)12(A) of the Bill, Congress did provide for a five-year limitation period for fraudulent transfers. Thus, with respect to a Qualified Financial Contract, the FDIC does not have general authority to avoid preferential transfers, but the

[5] The Bill defines a "Walkaway Clause" as any provision in a qualified financial contract that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of such party's status as a nondefaulting party in connection with the insolvency of a covered financial company that is a party to the contract or the appointment of or the exercise of rights or powers by a receiver of such covered financial company, and not as a result of a party's exercise of any right to offset, setoff, or net obligations that exist under the contract, any other contract between those parties, or applicable law.

FDIC is empowered to avoid transfers made with the actual intent to defraud -- perhaps without a limitation period.

There is one large caveat to the similarities described between the Bankruptcy Code and the Bill. The Bill grants the FDIC the authority to stay any proceedings regarding creditor's claims, including any case filed under the Bankruptcy Code. Therefore, even though the Bill grants parties to Qualified Financial Contracts substantially similar rights to those of a swap participant under the Bankruptcy Code, the Bill affords the FDIC broad authority to determine (and promulgate additional rules to aid in determining) the value, allowance, and/or disallowance of claims. Similarly, the Bill caps the FDIC's liability at that which would have been allowed if the company had been liquidated under the Bankruptcy Code. Finally, the Bill does provide for judicial review of the FDIC's claim determinations, but such review is by federal district court and could lead to unpredictable results because bankruptcy court jurisprudence will not be dispositive. Likewise, judicial review of the FDIC's claims determinations may be subject to the broad deference provided to administrative agencies under Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), and National Cable & Telecommunications Association v. Brand X Internet Services, Inc., 545 U.S. 967 (2005), and/or under the "substantial evidence" standard of review.

In conclusion, the protections afforded swap participants under the Bill are substantially similar to those provided under the Bankruptcy Code, with a few exceptions. However, given the FDIC's broad authority under the Bill to make business decisions on behalf of the troubled business, as well as judicial and rulemaking determinations that affect creditors' claims, this lack of certainty is a concern.

MFA appreciates the opportunity to share its views regarding the treatment of OTC derivatives contracts in the event of a liquidation of a hedge fund's counterparty. As active market participants in OTC markets, it is important to our members that their collateral be protected by strong segregation and portability protections in connection with centrally cleared OTC contracts and that there clarity with respect to the treatment of derivatives under bankruptcy and resolution authority statutes, respectively. If you have any questions on this letter, or if you would like to discuss our comments in more detail, please contact Benjamin Allensworth or me at (202) 367-1140.

Sincerely,
/s/ Stuart J. Kaswell

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

Cc: The Hon. Darcy Bradbury, Chairman
The Hon. Richard H. Baker, President and CEO