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

November 5, 2010

Via Electronic Filing:

The Honorable Timothy F. Geithner
Chairman
Financial Stability Oversight Council
1500 Pennsylvania, Ave., NW
Washington, DC 20220

Re: MFA Comments on Systemically Important Institutions

Dear Secretary Geithner:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the Financial Stability Oversight Council's (the "Council") advance notice of proposed rulemaking (the "Advance Notice") on the criteria that the Council should consider when determining whether to designate a nonbank financial company as systemically significant pursuant to section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We strongly support the goals of the Dodd-Frank Act in establishing the Council to address potential systemic risks before they arise, and mandating enhanced regulation of systemically important financial companies. MFA also strongly supports efforts by regulators to gather data from different types of market participants, including investment advisers and the funds they manage, which we believe is a critical component of effective systemic risk monitoring and regulation.

Overview

MFA believes that the Council should analyze financial institutions based on quantitative data to determine whether nonbank financial companies should be deemed systemically important in light of the criteria set out in section 113 of the Dodd-Frank Act and, therefore, subject to supervision by the Board of Governors of the Federal Reserve System (the "Fed"). It is also critical that the process by which the Council determines whether nonbank financial companies should be deemed systemically important be transparent and based on objective criteria. Uncertainty with regard to how firms could be subject to designation, or designating an overly broad set of firms, could

[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.

have significant unintended consequences for markets and for the broader economy. Congress recognized the importance of avoiding an overly broad designation of systemically relevant firms. The statutory text and legislative history of the Dodd-Frank Act clearly indicate Congress's intention that the Council designate as systemically important and regulate only those financial institutions that were previously considered "too big to fail," *i.e.*, those companies that, if they failed, would threaten U.S. financial stability.[2]

In considering the potential systemic implications of hedge funds, we believe that it is important for the Council to have a clear picture of the size, concentration, leverage and structure of the hedge fund industry in the context of other financial market participants. It is also important for the Council to consider changes made over the last decade to improve counterparty risk management by banks and broker-dealers, and regulatory requirements that the Dodd-Frank Act mandates.

As discussed in more detail below, the hedge fund industry, as well as individual firms and the funds they manage, are relatively small, both in comparison to the broader financial industry and to the markets in which they operate. Hedge funds also generally do not use a significant amount of leverage and typically post collateral in connection with their borrowing, thereby reducing the risk to their counterparties. Further, the enhanced regulation of hedge fund managers and the markets in which they participate following the passage of the Dodd-Frank Act ensures that regulators will have a timely and complete picture of hedge funds and their activities. We encourage the Council to consider these factors, which we believe are relevant to the criteria set out in section 113 of the Dodd-Frank Act with respect to the hedge fund industry.

Hedge Fund Industry Discussion

Size and Concentration.

Although the hedge fund industry is important to capital markets and the financial system, it is relatively small in size when considered in the context of the wider financial landscape.[3] For example, the hedge fund industry is significantly smaller than both the global mutual fund industry and the U.S. banking industry. The global mutual fund

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[2] In a July 2007 report, the staff of the Federal Reserve Bank of New York offered a similar view of systemic risk, stating that a central element of systemic risk is "when financial shocks have the potential to lead to substantial, adverse effects on the *real* economy." See, Kambhu, John, Schuermann, Til, and Stiroh, Kevin J., *Federal Reserve Bank of New York Staff Reports: Hedge Funds, Financial Intermediation, and Systemic Risk*, July 2007, page 10. Available at: http://www.ny.frb.org/research/staff_reports/sr291.pdf.

[3] Our comments are intended only to provide perspective regarding the size and concentration of the hedge fund industry; we are not commenting on the systemic importance of other financial market participants or industries.

industry managed $21.44 trillion in assets, as of June 30, 2010.[4] The top 50 U.S. bank holding companies alone had $14.4 trillion in assets, as of June 30, 2010.[5] By comparison, the global hedge fund industry had an estimated $1.7 trillion in assets under management, as of July 1, 2010.[6]

Moreover, the hedge fund industry is not concentrated, as illustrated by the fact that the largest hedge fund adviser manages assets equal to only approximately 3%[7] of the entire hedge fund industry. The lack of concentration in the industry reduces the risk of that the failure of any one manager or fund would create systemic risk. It would be unlikely for any one hedge fund to be so interconnected with other financial companies that such fund's failure would result in an overall vulnerability of any such major financial institution.

Leverage

Similarly, though hedge funds are often mischaracterized as being highly leveraged financial institutions, the industry is, and has been, significantly less leveraged than other financial market participants. According to a recent Columbia University study, 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.[8] 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, and a high of 2.6. 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.[9]

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[4] Source: Investment Company Institute, available at: http://www.ici.org/research/stats/worldwide/ww_06_10.

[5] Source: Federal Financial Institutions Examination Council, available at: http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx.

[6] Source: http://www.marketwire.com/press-release/Combined-Assets-Billion-Dollar-Hedge-Funds-Nearly-Flat-First-Half-2010-AR-Magazine-Survey-1327660.htm, citing *AR* Magazine, available at: http://www.absolutereturn-alpha.com/. The article also cites *AR* Magazine as reporting the assets under management for the industry at $1.9 trillion, as of September 30, 2010.

[7] Source: http://www.finalternatives.com/node/14018, citing *AR* Magazine's Billion Dollar Club, available at: http://www.absolutereturn-alpha.com/.

[8] Hedge Fund Leverage, available at: http://www2.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf.

[9] See, BofA 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% [2.72], as of April, 2010), available at: http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf, and The Turner Review, A regulatory response to the global banking crisis, March 2009 (finding that the leverage ratio of the hedge

Such leverage is generally obtained from financial counterparties that conduct substantial due diligence and engage in ongoing risk monitoring. Hedge fund borrowings are done almost exclusively on a secured basis (*i.e.,* secured by each fund's overall assets or specifically posted collateral), which limits the amount of leverage that any fund may obtain.[10] This collateral posting by hedge funds reduces the credit exposure of counterparty financial institutions and makes hedge funds substantially less likely to contribute to systemic risk by causing the failure of a systemically important institution, such as a major bank. Given the limited leverage and the collateral posted by hedge funds, any losses that hedge funds incur are almost exclusively borne by their investors, not the general financial system.

Structure of the Industry.

In analyzing systemic risk in the context of the asset management industry, it is important to consider the distinction between the investment adviser and the investment funds it manages. The advisers (also frequently referred to as the managers) themselves do not have substantial financial assets, but rather manage the assets of the funds in exchange for a fee. It is the funds which hold the financial assets, which transact with trading counterparties on a collateralized basis, and to which investors commit capital. As such, the risks and rewards of the investment portfolios are borne by a diverse group of underlying sophisticated investors, institutions or ultra-high net worth individuals, who typically invest in hedge funds as part of a diversified portfolio. (Hedge funds neither transact with retail investors nor do they take in investments (or deposits) from retail investors.[11]) As recognized in the Dodd-Frank Act, the extent to which a financial institution manages assets owned by others rather than managing assets owned by the institution itself is a key consideration in whether a financial institution should be designated as systemically important.

A second key structural aspect of the hedge fund industry is that hedge fund investors typically are subject to a variety of liquidity restrictions, including: limited periods of redemption (often monthly, quarterly, annual, or longer); significant advance

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fund industry since 2000 has been two- or three-to one), available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

The above studies use different formulas for calculating leverage ratios, which explains the slight differences in leverage ratios determined by each study. Our purpose in this letter is not to endorse any particular formula, but to demonstrate that the leverage ratios for the hedge fund industry are significantly less than the ratios for many other types of financial institutions.

[10] Various rules, for example, Regulations T, U and X with respect to securities, and regulations mandated under Title VII of the Dodd-Frank Act with respect to derivatives (discussed in more detail below), impose margin or collateral requirements, thereby restricting the amount of credit that a financial institution can extend to counterparties, including hedge funds.

[11] MFA consistently has urged Congress and the SEC to raise investment thresholds to address the effects of inflation and to prevent hedge funds from becoming a retail product.

notice requirements (often 30 to 90 days) prior to withdrawals; the ability of managers to impose gates or suspend redemptions (at the investor and/or the fund level), when necessary; and side pocket vehicles for highly illiquid assets. These liquidity provisions help reduce the likelihood that redemptions of investor capital will be disruptive to a fund or to markets over short periods of time, because they allow managers to better match the assets and liabilities of the funds they manage and to manage orderly outflows of investor funds.

The principals of hedge fund advisers also typically invest significant amounts of their own capital in the funds they advise, which promotes an alignment of interests between management and investors. The structure of performance fees earned by hedge fund advisers, which typically includes high-water marks, also serves to align the interests of the adviser and the investors by encouraging the adviser to manage the funds with the objectives of generating attractive risk-adjusted returns and discouraging excessive short-term risk taking.

Another key structural aspect of the hedge fund industry is the legal separation of different funds managed by the same adviser. The legally distinct funds, even when managed by the same adviser, often have different investors and often engage in entirely distinct trading activities in different assets and markets. Any losses at one fund are borne almost exclusively by the investors in that fund and do not subject other funds managed by the same adviser to losses. Further, unlike related entities in a holding company or other similar structures, the different funds managed by a common adviser do not typically have the kind of intercompany loans or transactions that can create interconnectedness and tie the risks associated with one company to other companies in the same ownership structure. Unlike bank holding companies and other nonbank financial institutions such as insurance companies, hedge funds tend to engage in one distinct business – namely, making investments for investors in the fund, so the risk of contagion is less likely.

Changes in the Industry since 1998.

The failure of Long Term Capital Management ("LTCM") in 1998 is often cited as an example of a hedge fund that created a systemic risk to the financial system. First, it is important to note that the failure of LTCM did not result in any use of taxpayer funds. The firm's financial counterparties worked out a private sector resolution of the firm's liabilities under the careful eye of the financial regulators, but at no point was assistance offered or used. Lessons were learned, however, by both market participants and regulators, which have led to sounder practices. The resulting changes may be one of the reasons that hedge funds were not the focus of the recent global financial crisis.

Excessive position size and leverage and inadequate counterparty risk management by LTCM and its counterparties are often cited as the primary risks associated with LTCM. As a reminder, LTCM, as of January 1, 1998, was leveraged

more than 25-to-1,[12] which is approximately 10 times the amount of the highest leverage ratio for the hedge fund industry (2.6-to-1) during the period from December 2004 to October 2009.[13] Perhaps most importantly, LTCM was able to achieve such leverage because its counterparties did not require LTCM to post initial margin on its OTC derivatives trades.

Since the failure of LTCM, however, there have been significant changes in the market with respect to counterparty risk management, particularly with respect to limiting the amount of leverage used by hedge funds through the use of collateral to secure the financing provided to hedge funds. Also, as a result of improvements to counterparty risk management best practices, financial institutions today conduct substantial due diligence on and have a much greater degree of transparency with respect to their hedge fund clients' overall portfolios. Many of these changes have been brought about by the work done by the Counterparty Risk Management Policy Group, which led to strengthening counterparty risk management practices.[14] The improvements in risk management and limitations on leverage are well recognized, as noted by Fed Chairman Bernanke, who said:

> Since the LTCM crisis, ongoing improvements in counterparty risk management and the resultant strengthening of market discipline appear to have limited hedge fund leverage and improved the ability of banks and broker-dealers to monitor risk, despite the rapidly increasing size, diversity, and complexity of the hedge fund industry. Many hedge funds have been liquidated, and investors have suffered losses, but creditors and counterparties have, for the most part, not taken losses.[15]

New Regulatory Requirements for the Industry.

In addition to risk management and market improvements made over the past decade, the Dodd-Frank Act imposes a variety of regulations to ensure appropriate oversight on hedge funds and their advisers. Following passage of the Dodd-Frank Act, all hedge fund advisers with at least $150 million in assets under management will be required to register with the Securities Exchange Commission (the "SEC").[16] These registered advisers will be required to maintain books and records, make reports to the

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[12] Hedge Funds, Leverage and the Lessons of Long-Term Capital Management, Report of The President's Working Group on Financial Markets, April 1999 available at: http://www.ustreas.gov/press/releases/reports/hedgfund.pdf.

[13] See the discussion in the section above regarding the leverage of the industry.

[14] Copies of the reports are available at: http://www.crmpolicygroup.org/index.html.

[15] Speech by Chairman Ben S. Bernanke, *Hedge Funds and Systemic Risk*, May 16, 2006. Available at: http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm.

[16] See sections 403 and 408 of the Dodd-Frank Act.

SEC and be subject to examination by the agency. Congress specifically amended the Investment Advisers Act of 1940 to provide that the recordkeeping and reporting requirements for hedge fund advisers apply to the funds as well as the adviser.[17] As a consequence, the SEC and the Council will have full access to information about hedge fund advisers and the funds they manage. It is also important to note that one of the criteria the Council is to consider under section 113 of the Dodd-Frank Act is whether a financial institution is already regulated by another financial regulatory agency.

The Dodd-Frank Act also creates a comprehensive regulatory regime for over-the-counter derivatives where none existed previously. These new regulations: (1) require certain standardized transactions to be cleared and exchange traded; [18] (2) require "Swap Dealers" and "Major Swap Participants" to register with the SEC/CFTC, and subjects them to significant requirements; (3) impose initial and variation margin requirement on both cleared and uncleared transactions; and (4) provide for significant incremental transparency, including transaction reporting, to market participants and regulators. These rules will significantly reduce the potential for systemic risk involving the derivatives markets and their participants, such as hedge funds. For cleared swaps, central counterparties possess the ability to manage their risks by imposing margin requirements and other risk mechanisms that limit their exposure to potential losses from defaults by members and participants. The margin requirements must be sufficient to cover potential exposures in almost all market conditions. These provisions are well designed to ensure that central counterparties' operations would not be disrupted and non-defaulting members would not be exposed to unexpected losses.

In addition, the Dodd-Frank Act increases supervision of banks and broker-dealers, incorporating enhanced review of counterparty exposure and other risks associated with the prime brokerage and over-the-counter derivatives businesses in their examinations of these institutions, which provides regulators with critical information with respect an institution's aggregate exposure to individual hedge funds as well as the hedge fund industry as a whole.

In summary, MFA believes that the size, concentration, structure, and levels of leverage of the hedge fund industry, financial services industry incentives and practices, and the substantial regulatory framework that the Dodd-Frank Act institutes over hedge fund advisers, banks, and broker-dealers and the OTC derivatives markets, substantially reduce the likelihood that the failure of a hedge fund would have systemic implications.

Criteria for Determination of Systemically Important Financial Companies

Section 113 of the Dodd-Frank Act sets out a list of criteria the Council must consider when it determines whether a financial institution should be deemed systemically significant, many of which are discussed above with respect to the hedge

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[17] See section 404 of the Dodd-Frank Act, amending Section 204 of the Investment Advisers Act.

[18] See *e.g.*, section 723 of the Dodd-Frank Act.

fund industry.[19] As a general proposition, we do not believe systemic importance should be based upon any one criterion set out in the Dodd-Frank Act. To assist the Council in its deliberations, we have highlighted below those criteria listed in section 113 (with their specific reference letter in the Dodd-Frank Act) that we think are most relevant to the determination of whether a hedge fund is systemically significant.

- *(A) The extent of the leverage of the company; (I) the amount and nature of the financial assets of the company; and (J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding.*
    - In considering leverage as a contributor to systemic risk, it is important to consider not only the aggregate amount of such leverage (inclusive of off-balance liabilities), but importantly the sources and terms of such leverage. Debt that is secured, for example, significantly mitigates systemic risk compared to debt that is unsecured. Similarly, short-term leverage (such as overnight borrowing) introduces greater risk than term borrowings, which more closely match the term of the asset and the financing which funds it. Finally, the degree of an investment fund's portfolio leverage must be considered in the context of its asset mix, including the liquidity of those assets, the liquidity rights of fund investors, as well as the size and nature of the capital markets in which those assets are transacted.

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[19] Section 113(a)(2) of the Dodd-Frank Act provides:

> (2) CONSIDERATIONS.—In making a determination under paragraph (1), the Council shall consider—
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> (A) the extent of the leverage of the company;
> (B) the extent and nature of the off-balance-sheet exposures of the company;
> (C) the extent and nature of the transactions and relationships of the company with other significant nonblank financial companies and significant bank holding companies;
> (D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;
> (E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
> (F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
> (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
> (H) the degree to which the company is already regulated by 1 or more primary financial regulatory agencies;
> (I) the amount and nature of the financial assets of the company;
> (J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
> (K) any other risk-related factors that the Council deems appropriate.

- *(B) The extent of the off-balance sheet exposures of the company.*
    - Off-balance sheet exposures should be considered as part of determining overall leverage. However, the market value or risk of loss must be considered from a risk exposure perspective, as opposed to simply looking at notional values. Additionally, the nature of the instruments in question and risk of loss must be considered. For example, a purchased option has substantially less risk than a sold option. Similarly, collateral arrangements, as well as offsetting positions across a portfolio (a hedge), must be taken into account.
- *(C) The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies.*
    - The degree of a firm's interconnectedness to major financial institutions should be measured by such institutions' unsecured credit exposure (including potential exposure) to the firm in question, indicating the overall vulnerability of other major financial institutions if the firm in question were to fail.
    - However, counterparty risk in and of itself is not an indicator of systemic risk. Counterparties need to take risks in order to earn returns; they are responsible for managing such risk during the normal course of their business. Such risk only should rise to potential systemic significance when it could cause harm to the financial stability of the U.S.
    - Systemic risk and counterparty risk should not be conflated. The risk that a financial institution, including a systemically significant financial institution, may suffer losses from its dealings with its counterparties should not be sufficient to warrant a determination that the counterparties themselves are systemically significant.
- *(G) The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company.*
    - The ability of hedge fund advisers to appropriately match the assets and liabilities of a fund (in light of the fund's leverage, sources of leverage, and equity capital stability) should prevent or mitigate the extent to which a fund is likely to become subject to a forced unwind.

- The size of individual investment fund portfolios managed by an investment adviser should not in and of itself be an indicator of systemic riskiness but must be considered in the context of its activities, the amount of leverage, the specific capital market segments in which such funds are active and the capital structure of the fund.

- *(K) Any other risk factors that the Council deems appropriate.*

Other potential considerations include:

- Whether an investment fund or other financial institution has an implicit or explicit government guarantee (*e.g.*, FDIC deposit insurance and debt guarantees; government-issued charter), access to government-funded capital (*e.g.*, TARP) or other access to government assistance (*e.g.*, access to the Federal Reserve's discount window), any of which would pose losses to taxpayers from the firm's failure.

- The extent to which the persons managing investment funds have substantial stakes in such investment funds' equity capital, which incentivizes such persons not to take inappropriate investment or operational risks that could contribute to the failure of those funds.

We are happy to work with the Council to expand upon the thoughts outlined above or to discuss further any of the criteria in the Dodd-Frank Act.

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Conclusion

We believe that, in light of the structure of the hedge fund industry and the market and regulatory changes regarding counterparty risk management, leverage and use of collateral, as described above, applying the criteria in Section 113 to the hedge fund industry should lead to the conclusion that it is highly unlikely that any hedge fund is systemically important at this time. We recognize, however, that circumstances can change and that there is a possibility that a hedge fund may, in the future, become systemically important.

We support robust reporting requirements to regulators (with appropriate confidentiality protections) to ensure that regulators have the information they need to assess all financial market participants, including hedge funds. Such periodic assessments, combined with oversight from the relevant regulators would help the Council assess whether circumstances have changed and that the Council should re-evaluate whether a hedge fund might have become systemically significant.

MFA appreciates the opportunity to comment on the Advance Notice. We recognize that the Council has an ongoing responsibility to monitor and assess the systemic risk of market participants and we look forward to continuing the dialogue on this subject with the Council.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other regulatory issues, please do not hesitate to contact Stuart J. Kaswell or me at (202) 367-1140.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

CC: The Honorable Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation
The HonorableBen S. Bernanke, Chairman, Board of Governors of the Federal Reserve System
Edward J. DeMarco, Acting Director, Federal Housing Finance Agency
The Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission
The Honorable Debbie Matz, Chairman, National Credit Union Administration
The HonorableMary L. Schapiro, Chairman, U.S. Securities and Exchange Commission
John Walsh, Acting Comptroller of the Currency