



December 19, 2011

Via Electronic Filing:

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

Re: MFA Comments on Proposed Rules and Related Guidance on the Criteria for Designating Systemically Significant Nonbank Financial Institutions

Dear Secretary Geithner:

Managed Funds Association (“MFA”)¹ appreciates the opportunity to comment on the Financial Stability Oversight Council’s (the “Council”) notice of proposed rulemaking, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (the “Proposed Rules”) and related interpretive guidance (the “Guidance”). As we have stated in previous letters to the Council, we strongly support the goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act (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.² 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.

As discussed in our prior letters, MFA believes that the Council should analyze financial institutions based on objective, quantitative data to determine which nonbank financial companies should be deemed systemically significant and, therefore, subject to supervision by the Board of Governors of the Federal Reserve System (the “Fed”). It is

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 \$2.0 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

² MFA’s previous letters available at: http://www.managedfunds.org/wp-content/uploads/2011/06/2.25.11-MFA.letter.on_.systemically.significant.institutions.pdf; and <https://www.managedfunds.org/wp-content/uploads/2010/11/MFA-letter-on-systemically-important-institutions-2.pdf>.

also critical that the process for determining whether certain nonbank financial companies should be deemed systemically important be transparent and based on objective criteria. In that regard, we applaud the effort of the Council in providing additional detail on the criteria it will consider in the Guidance.

We note that the Proposed Rule acknowledges that the Council may need to revisit the thresholds and may need to issue additional guidance with respect to asset managers and hedge and private equity funds. In considering the appropriate criteria and analysis that should be applied to hedge funds, we encourage the Council to consider the important difference between the fund managers, which often do not hold significant assets, but rather manage assets on behalf of clients, and the investment funds, where the assets are held. To the extent the Council does engage in future rulemaking or guidance with respect to asset managers or hedge and private equity funds, we encourage the Council to propose such rules or guidance for public review and comment.

We further encourage the Council to provide additional clarity regarding the criteria that it will consider when analyzing nonbank financial institutions, particularly the so-called Stage 1 thresholds set out in the Guidance. We believe that additional clarification regarding the metrics will reduce the potential for uncertainty and confusion among market participants and avoid unnecessary burdens on the Council that could result from an overly broad group of financial institutions being subject to additional Council review.

Analysis of Investment Funds and Asset Managers

In considering the analysis of hedge funds, there are important structural factors to consider. The advisers (also frequently referred to as the managers) do not have substantial assets; though the principals of the adviser typically have personal capital invested in the funds they manage. It is the funds that hold the financial assets, that transact with trading counterparties on a collateralized basis, and to which investors commit capital. Accordingly, the risks and rewards of the funds' 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.)³ The adviser typically is not liable for the obligations of the fund, nor does the fund have responsibility for the liabilities of the adviser. This is one reason why, as recognized in the Dodd-Frank Act and the Council's Proposed Rule, 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 significant. We are concerned, however, that the proposed metrics set out the Guidance that establish the

³ The MFA has consistently urged Congress and the SEC to raise investment thresholds to address the effects of inflation and to prevent hedge funds from becoming accessible to retail investors.

Stage 1 thresholds are not well suited to analyzing asset management firms and we encourage the Council to develop a different approach in analyzing such firms.

Another structural aspect of hedge funds is the legal separation of different funds managed by the same adviser. These legally distinct funds, even when managed by the same adviser, often have different investors and can engage in entirely distinct trading activities in different assets and markets. Any losses of one fund are borne exclusively by the investors in and counterparties to 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 prevalent elsewhere in the financial services industry, the different funds managed by a common adviser do not typically have the kind of intercompany loans or transactions that can create intraconnectedness or tie the risks associated with one company to other companies in the same ownership structure.

Because of these important structural features of hedge funds and their advisers, we believe that the appropriate level of analysis typically is at the individual fund level and not the manager level. We do not believe that the Council should use consolidation or other accounting rules to determine which entity or entities should be analyzed together, because accounting rules do not necessarily reflect the reality of where the at-risk assets are located and, therefore, could provide a misleading view of the risks of investment funds and their advisers. We further believe that the analysis of investment funds should be on a fund by fund basis, absent specific circumstances, such as multiple funds having identical investment strategies, assets and liabilities or interfund transactions or obligations that tie the risks of one fund to another fund. We note that footnote 12 in the Guidance says that funds may be considered as a single entity if their investments are identical or highly similar. We encourage the Council to state explicitly that the analysis of investment funds primarily will be on a fund-by-fund basis, absent specific circumstances that tie the risks of funds together in a substantial way that supports analyzing multiple funds as a single entity. The Securities and Exchange Commission's regulations establishing Form PF provide guidance on which funds should be combined for reporting purposes that may be helpful to the Council as a framework for thinking about this related question.

Public Review and Comment of Additional Rules or Guidance

The Proposed Rule states, “[after getting Form PF data] the Council will consider whether to establish an additional set of metrics or thresholds tailored to evaluate hedge funds and private equity firms and their advisers.” We believe that when the Council analyzes the information collected from hedge funds on Form PF in light of the six categories set out in the Proposed Rule, it is unlikely that the Council will determine that the failure of any hedge fund or hedge fund manager would have systemic implications. To the extent that the Council determines that it needs to establish additional or revised metrics to analyze hedge funds, it is important that such additional rulemaking or guidance be subject to public review and comment. Similarly, to the extent the Council

determines it needs to establish additional or revised metrics to analyze asset managers, that rulemaking or guidance should be subject to public review and comment.

We strongly support the collection of information about hedge fund investment activity and the direct regulation of hedge fund advisers, though we remain concerned about existing or potential redundant registration, reporting and regulatory requirements, which we believe impose unnecessary burdens on market participants. We encourage the Council to facilitate a coordinated approach to data collection and information sharing to ensure that member agencies of the Council have access to information they need to conduct appropriate oversight without requiring multiple regulators to impose unnecessarily duplicative or potentially inconsistent requirements on market participants in order to obtain similar information directly.

Calculation of Total Consolidated Assets

We encourage the Council to provide greater clarity regarding the calculation of an institution's total consolidated assets for purposes of the \$50 billion Stage 1 threshold. Specifically, we encourage the Council to provide guidance that the threshold will be calculated on a net asset basis, rather than a gross asset basis, for investment funds and that asset managers will not have to consolidate client assets under management onto the adviser's balance sheet for purposes of the threshold.

With respect to investment funds, we believe that a net asset calculation better reflects investor capital at risk than a gross asset calculation would. Further, net assets, as calculated on an investment fund's balance sheet and audited annually, are easily verifiable. Gross assets may be calculated differently by market participants, leading to confusion and significant uncertainty for regulators in trying to compare funds. We believe that the leverage threshold combined with a net asset calculation ultimately provides the Council with a gross asset metric; therefore, it is unnecessary to use a gross asset calculation with respect to the \$50 billion threshold. Accordingly, we encourage the Council to provide guidance that the \$50 billion threshold for investment funds should be calculated on a net asset basis.

We also are concerned that applying a consolidated balance sheet test to hedge fund advisers could be overly broad with respect to these firms. This is because accounting standards may, under certain circumstances, require the assets of client investment funds managed by an adviser to be consolidated onto the balance sheet of the adviser. However, this accounting treatment does not reflect the reality of where the at-risk assets are located and would provide a misleading view of the size, financial significance, and stability of investment advisory businesses (*i.e.*, accounting rules can misleadingly make the unitary balance sheet of other types of financial institutions seem similar to multiple pools of assets in legally separate hedge fund entities). Accordingly, we encourage the Council to specify that client assets under management will be excluded from an investment adviser's consolidated balance sheet test, regardless of the accounting treatment with respect to such client assets.

Leverage

Similar to the issues discussed above regarding the appropriate level of analysis for investment funds and their advisers, we believe the leverage calculation for investment funds should be made at the fund level and generally on a fund-by-fund basis, absent special circumstances that tie the risks of multiple funds together in a substantial way that supports analyzing multiple funds as a single entity.

Credit Default Swaps (“CDS”) Outstanding

We believe it is important for market participants to understand the source(s) of data that the Council will use to measure the thresholds set out in the Guidance. Knowing the source(s) of information will provide greater certainty to market participants about whether or not they are likely to trigger the Level 1 Thresholds established by the Council. In that regard, we encourage the Council to use the Depository Trust & Clearing Corporation’s Trade Information Warehouse (the “DTCC TIW”) for information about the amount of CDS outstanding on a financial institution. We believe the DTCC TIW currently provides the most comprehensive information about CDS contracts.

Derivatives Liabilities

The Guidance provides that, in calculating whether a financial institution has \$3.5 billion of derivative liabilities, the Council will take into account master netting agreements and cash collateral held with the same counterparty. We believe the Council should expand the types of collateral that will be taking into account for netting purposes to include other types of liquid collateral, in addition to “cash collateral.” We are concerned that limiting eligible collateral to cash is unnecessarily restrictive. As drafted, it appears that highly liquid assets such as U.S. Treasuries, for example, posted as collateral would not be considered when determining an institution’s derivatives liabilities. While we understand that the Council may want to limit the types of collateral that it will consider in reducing an institution’s derivatives liabilities, we encourage the Council to include other types of liquid collateral in addition to cash collateral for netting purposes.

Loans and Bonds Outstanding

The Guidance establishes as one of the Stage 1 thresholds whether a financial institution has \$20 billion in loans and bonds outstanding. Because neither the Proposed Rule nor the Guidance defines the terms “loans” or “bonds,” there is uncertainty as to the scope of the instruments covered under this threshold. We believe the Council should clarify the scope of the definitions “loans” and “bonds,” and provide that other financing arrangements, which present different exposures and risks than traditional loans and bonds, including repos, securities lending arrangements, and collateralized borrowing/lending, are not included.

Short-Term Debt Ratio

The proposed threshold measuring a financial institution's short-term debt ratio does not clearly distinguish being secured and unsecured borrowings. We believe that secured borrowings do not create the same type of exposure as unsecured borrowings and we encourage the Council to clarify that the secured borrowings will not be included in the short-term debt ratio metric. We also believe the fundamental issue the Council is analyzing with this metric is one of asset/liability mismatch, not short-term borrowing *per se*. If an institution holds highly liquid securities that have been purchased, in part with short-term borrowing, there is little or no liquidity risk. Of course, financing a pool of illiquid assets with overnight borrowing clearly entails more risk, as was observed in the failure of Bear Stearns, Lehman, and other financial institutions. We further believe the Council should clarify that other financing arrangements, including repos, and securities lending are not included within the scope of this metric.

Non-Disclosure of Financial Institutions Being Analyzed

The Proposed Rule states that the Council will make public any final determination that it makes with respect to a financial institution. The Proposed Rule does not state whether the Council intends to publish the names of financial institutions that are in the process of being analyzed by the Council. We encourage the Council not to publish the names of financial institutions which have not been designated as systemically significant institutions that will be subject to supervision by the Fed. We believe that market participants may misinterpret the relevance of any disclosure that an institution is being analyzed by the Council, which could lead to unintended consequences if market participants act based on such misinterpretations.

Conclusion

MFA appreciates the opportunity to comment on the Proposed Rule and the Guidance. We appreciate the Council's decision to publish for review and comment additional details regarding the metrics the Council intends to use when analyzing financial institutions. 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 as it continues to evaluate and develop the metrics and processes for analyzing nonbank financial institutions.

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) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

CC: The Honorable Ben 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 Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation
William Haraf, Commissioner, California Department of Financial Institutions
John Huff, Director, Missouri Department of Insurance, Financial Institutions, and Professional Registration
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division
The Honorable Debbie Matz, Chairman, National Credit Union Administration
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The Honorable Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission
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