



September 1, 2017

Via E-Mail:

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Managed Funds Association Regulatory Priorities

Dear Ladies and Gentlemen:

Managed Funds Association (“MFA”)¹ respectfully encourages the Board of Governors of the Federal Reserve (the “Federal Reserve”) to reconsider the policy and market implications of several proposed and final rules, in light of President Trump’s February 3 Executive Order 13772 on “Core Principles for Regulating the United States Financial System” (the “Core Principles Executive Order”)² and President Trump’s Executive Order 13777, “Enforcing the Regulatory Reform Agenda” (the “Regulatory Reform Executive Order” and, together with the Core Principles Executive Order, the “Executive Orders”).³

¹ The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

² Section 2 of the Core Principles Executive Order provides:

The Secretary of the Treasury shall consult with the heads of the member agencies of the Financial Stability Oversight Council and shall report to the President within 120 days of the date of this order (and periodically thereafter) on the extent to which existing laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other Government policies promote the Core Principles and what actions have been taken, and are currently being taken, to promote and support the Core Principles. That report, and all subsequent reports, shall identify any laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other Government policies that inhibit Federal regulation of the United States financial system in a manner consistent with the Core Principles.

Executive Order 13772, Core Principles for Regulating the United States Financial System (Feb. 3, 2017), available at:

<https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states>.

³ President Trump’s Executive Order 13777 is available at: <https://www.whitehouse.gov/the-press-office/2017/02/24/presidential-executive-order-enforcing-regulatory-reform-agenda>.

Specifically, we encourage the Federal Reserve to reconsider aspects of the final supplementary leverage ratio rules (the “SLR”) and the proposed net stable funding ratio rules (the “NSFR”). We are concerned that these rules are having, and will continue to have, significant and adverse effects on capital markets by distorting investment activity and reducing liquidity in important markets.

We believe that review and reconsideration of these rules is not only consistent with the policies set out in the Executive Orders,⁴ but also is consistent with recent statements by Federal Reserve Chair Janet Yellen and Federal Reserve Governor and Vice Chair for Supervision Jerome Powell regarding the Federal Reserve’s need to review existing regulations. We further note that review of these rules is consistent with the Federal Advisory Council’s conclusions regarding the banking rules most likely to be reviewed as a result of the Core Principles Executive Order.

In discussing the banking regulatory framework that has been enacted following the financial crisis, Chair Yellen, in an August 25 speech, said:

[T]he scope and complexity of financial regulatory reforms demand that policymakers and researchers remain alert to both areas for improvement and unexpected side effects. The Federal Reserve is committed to continuing to evaluate the effects of regulation on financial stability and on the broader economy and to making appropriate adjustments.⁵

Governor Powell expressed similar thoughts in a June 26 speech, stating:

As we consider the progress that has been achieved in improving the resiliency and resolvability of our banking industry, it is important for us to look for ways to reduce unnecessary burden. We must also be vigilant against new risks that may develop. In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. We look forward to working with our fellow regulatory agencies and with Congress to achieve these important goals.⁶

⁴ See also, U.S. Department of the Treasury Report to President Donald J. Trump in response to the Core Principles Executive Order, “A Financial System That Creates Economic Opportunities, Banks and Credit Unions”, June 2017 (“First Treasury Report”), available at: <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.

⁵ Chair Yellen speech, *Financial Stability a Decade after the Onset of the Crisis*, at “Fostering a Dynamic Global Recovery,” a symposium sponsored by the Federal Reserve Bank of Kansas City (August 25, 2017), available at: <https://www.federalreserve.gov/newsevents/speech/yellen20170825a.htm>.

⁶ Governor Powell speech, *Remarks*, at the Salzburg Global Seminar (June 26, 2017), available at: <https://www.federalreserve.gov/newsevents/speech/powell20170626a.htm>.

Finally, the Federal Advisory Council discussed regulatory reform at its February 10, 2017 meeting and concluded that, as a result of the Core Principles Executive Order, several aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and its associated regulations are likely to be reviewed and potentially amended. The Advisory Council specifically noted in that regard:

Opportunities for making regulations more risk focused include adjustments to the requirements and timing of resolution-plan submissions; exemptions from Volcker Rule restrictions; relief from [Comprehensive Capital Analysis and Review (CCAR)]supervisory-run stress tests, including the allowance of capital planning independent of the annual CCAR exercise; and modification of liquidity coverage ratio and net stable funding ratio requirements.⁷

Accordingly, we encourage the Federal Reserve to work with other banking regulators to revise the SLR and NSFR rules to achieve the underlying policy objectives while minimizing adverse consequences on capital markets activities.

Recalibrate Bank Capital and Margin Requirements that Create Unintended Harms

SLR Discourages Central Clearing of Derivatives

MFA opposes the current formulation of the SLR because it undermines derivatives clearing. The SLR does not consider initial margin (“IM”) that our members post with their respective clearing firms as a risk mitigant. Accordingly, the capital rules force the clearing firm to hold capital against such margin as if it were a conventional liability. The effect of this rule is to raise the cost of clearing with resulting unintended adverse consequences that undermine systemic risk reduction.

MFA has been a strong supporter of Title VII of the Dodd-Frank Act and believes that clearing (as well as trading mandates) improve pricing and reduce systemic risk. Customers are a vital part of the derivatives markets and have been critical to the success of central clearing in the U.S. While some clearing of swaps between dealers existed prior to enactment of the Dodd-Frank Act, artificial barriers to entry prevented customers from similarly participating in the cleared swaps market. Implementation of the central clearing requirement eliminated many of those artificial barriers and resulted in substantial customer clearing.

However, at present, swaps customers exclusively access central counterparties (“CCPs”) indirectly through clearing members, rather than becoming direct members of CCPs, for a variety of reasons, both financial and operational. MFA expects the demand for clearing services to increase as regulators in different jurisdictions fully implement their

⁷ See, Record of Meeting of the Federal Advisory Council and the Board of Governors, available at: <https://www.federalreserve.gov/aboutthefed/fac-20170210.pdf>.

respective mandatory clearing initiatives.⁸ As a result, it is critical that customer clearing services remain available at an affordable price to ensure that customers have fair and equal access to CCPs.

MFA along with other industry participants have expressed strong concerns about the Basel Committee on Banking Supervision's (the "Basel Committee") treatment of segregated IM for centrally cleared derivatives exposure under the Basel III leverage ratio. This proposal threatens the ability of customers to use centrally cleared derivatives and could limit their ability to hedge their risks.⁹ Our concerns also apply to the SLR, including the enhanced SLR ("eSLR") for global systemically important banks, as currently formulated in the U.S. MFA echoes the call in the First Treasury Report for recommended adjustments to the SLR and eSLR to address such unfavorable impacts caused by high leverage ratio capital charges.¹⁰

MFA's request for recalibration of the SLR is premised on the fact that CCPs' risk management methodologies are predicated on the collection of IM and variation margin from clearing members and customers to collateralize potential exposure. In addition, direct clearing members guarantee payment of their customers' obligations to the CCP. Because the IM is the customer's money,¹¹ rules adopted by the Commodity Futures Trading Commission (the "CFTC") require clearing members to segregate customer funds from the clearing member's own assets.

While the leverage ratio framework captures a clearing member's guarantee to the CCP as an off-balance sheet exposure, leverage ratio rules fail to provide an offset that recognizes the exposure-reducing effect of customers' segregated IM. In the U.S., segregation rules severely restrict the ability of IM to be held in anything other than extremely low-risk and extremely liquid assets, assuring that it is always available to absorb

⁸ For example, mandatory central clearing of certain OTC derivatives began in the EU in mid-2016. In addition, central clearing has already begun in Australia and Mexico, and is expected to begin soon in other countries, including Canada, Hong Kong, Singapore, and Switzerland. Notably, in light of these global developments, the CFTC has finalized rules that will expand the central clearing requirement in the U.S. to harmonize with these foreign jurisdictions. See CFTC final rule on "Clearing Requirement Determination under Section 2(h) of the CEA for Interest Rate Swaps", available at: <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-23983a.pdf>.

⁹ Available at: <https://www.managedfunds.org/wp-content/uploads/2016/11/Letter-to-BCBS-GHOS-FSB-from-Participants-in-Cleared-Derivatives-Markets-Final.pdf>.

¹⁰ See *supra* note 4, First Treasury Report at p.126.

¹¹ Under CFTC rules, a clearing member must separately account for, and segregate as belonging to the customer, all money, securities and property it receives from a customer as margin. See 17 C.F.R. §§ 1.20-1.30; 17 C.F.R. §§ 22.2-22.7.

losses ahead of the bank.¹² Moreover, the substantial majority of segregated IM is posted to the CCP, and therefore, is entirely outside the control of the clearing member.¹³

The SLR's current failure to recognize the purpose of segregated IM is a threat to the use of cleared derivatives by customers. Because of the lack of offset for segregated IM, clearing members will incur large leverage ratio exposures, which will likely raise prices for customer clearing significantly. This substantial cost increase may cause customers to reduce their hedging activities to levels that are inadequate to manage their risk, which could result in price increases and volatility for food, gasoline, and other consumer goods.

MFA notes that, on November 23, 2016, the European Commission proposed changes to the EU capital requirement regulation and directive that would, among other things, allow clearing firms to reduce the leverage ratio exposure measure by the IM received from clients for cleared derivatives.¹⁴ MFA applauds this European Commission proposal.

To ensure the continued affordability and robustness of customer clearing in the U.S., MFA encourages the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of Comptroller of the Currency to consider the EC's proposal and industry-wide concerns in their rulemaking processes, and provide an offset for clearing members to the extent that customer IM is posted to the CCP, or is segregated under the U.S. regulatory regime. MFA emphasizes that our recalibration request is consistent with the recommendation of the Treasury Department in the First Treasury Report¹⁵ and with remarks by Federal Reserve Governor Powell at its Global Finance Forum in Washington, D.C. on April 20, 2017, who called for recalibration of the SLR in the U.S. due to its damaging impact on client clearing.

Initial Margin Requirements Should be Tailored to the Risk of Certain Non-Clearable Derivatives

MFA believes that the Federal Reserve should work with other U.S. prudential regulators and the CFTC to recalibrate and appropriately tailor their IM requirements for

¹² In the United States, segregated margin cannot be reinvested except for investments in low-risk and highly liquid assets, such as U.S. government securities, managed "with the objectives of preserving principal and maintaining liquidity". See 17 C.F.R. § 1.25(b).

¹³ Applicable U.S. margin and CCP regulations result in a significant majority of margin being passed onto the CCP. Although margin rules vary across jurisdictions outside of the U.S., non-U.S. margin frameworks for centrally cleared derivatives generally result in a substantial portion of margin held at the CCP rather than the clearing member.

¹⁴ Available at: <https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF>. Paragraph (11) at p. 26 states: "A leverage ratio should also not undermine the provision of central clearing services by institutions to clients. Therefore, the initial margins on centrally cleared derivative transactions received by institutions in cash from their clients and that they pass on to central counterparties (CCP), should be excluded from the leverage ratio exposure measure".

¹⁵ See *supra* note 4, First Treasury Report at p. 126 (recommending "significant adjustments" to the supplementary leverage ratio and a deduction from the leverage exposure denominator for IM for centrally cleared derivatives).

uncleared swaps to reflect the actual risk posed by certain non-clearable swap products, such as total return swaps (“TRS”) for complex equity trades. Under the forthcoming rules, swap dealers must charge higher margin for non-cleared swaps than for cleared swaps. One reason for this distinction is to encourage all market participants to clear as many derivatives trades as possible. As noted, MFA supports derivatives clearing.

Unfortunately, market conditions make it unlikely that market participants will clear certain categories of derivatives, such as TRS. Many hedge funds trade such TRS to achieve exposure to equities. Therefore, the margin rules that will be coming into effect for our members’ uncleared trades on September 1, 2019 or 2020 will penalize hedge funds that use non-clearable TRS by having to over-collateralize them based on the higher IM requirements. One of the underlying policy objectives for the higher uncleared margin requirements is to encourage clearing swaps that are suitable for clearing. That policy objective has a punitive and disproportionate effect on buy-side market participants who trade non-clearable TRS and collateralize them based on the actual risk posed by such products. Moreover, we note that, as banks do not trade such TRS among themselves, our requested tailored revision to IM requirements for such products would present relatively little systemic risk. Given that banks’ risk-based initial margin models would remain subject to regulatory approval, there would still be ample regulatory oversight and validation of the margin methodologies and calculations for such products. Based on the foregoing, we urge the prudential regulators to reconsider IM requirements for certain non-cleared swaps, such as TRS, when market conditions make it unlikely that market participants will clear such swaps for the foreseeable future.

Reconsider Proposed NSFR Rules to Address Impact on Liquidity, Derivatives Clearing, and Interdependent Assets and Liabilities

We respectfully urge the Federal Reserve and other banking agencies to recalibrate the NSFR requirements in light of the numerous other changes to bank capital and other requirements. A host of capital and liquidity regulations that the Federal Reserve and other banking agencies have introduced in the last several years, including Basel III risk-based capital requirements, the eSLR, and the Liquidity Coverage Ratio (the “LCR”), have resulted in banks having to comply with significant capital and liquidity requirements to support the capital markets activities of those banks. Other requirements, including the eSLR, the surcharge for Global-Systemically Important Banks, Total Loss Absorbing Capacity requirement, Long-Term Debt requirement, Single Counterparty Credit Limits, and capital and liquidity stress testing, are based on many of the same concepts as risk-based capital requirements, and impose even more requirements on banks engaged in capital markets activities. Finally, mandatory clearing requirements and margin requirements have fundamentally transformed the derivatives markets and the requirements to access them for banks’ clients such as our members.

In combination, these regulations have addressed a broad spectrum of risks to banks arising out of securities and derivatives activities that have made these organizations, and the markets they operate in, safer. But the regulations also have made it more difficult and costly for banks to offer these products and services to their clients, resulting in higher costs, decreased liquidity, and reduced access for financial products’ end users like our members

and their clients. We are particularly concerned about the possible reductions in market liquidity and distortionary effects that could result from cost increases that make it uneconomical for covered institutions to offer certain low-risk, low-margin products and services to clients. These securities and derivatives products and services offered by banks are central to our members' investment and risk-management strategies.

In this context, we have serious concerns that the proposed rules to implement the NSFR (the "Proposed NSFR Rules") would yield very little incremental benefit from a policy perspective, while at the same time adversely affecting important market activities by increasing execution costs and compliance burdens, to the detriment of pensioners, investors, corporations and consumers. The purpose of the Proposed NSFR rules is to reduce systemic risk by preventing banks from engaging in excessive maturity transformation by funding long-term liabilities and assets with short-term financing. The Proposed NSFR Rules seek to achieve this objective by assigning weightings to bank sources of financing, bank liabilities, and bank assets, based on liquidity and other characteristics of those items and requiring a bank's available stable funding ("ASF") to be at least 100 percent of its required stable funding ("RSF"). Unfortunately, the Proposed NSFR Rules, particularly when viewed in combination with other banking regulations that impose substantial capital requirements on banks, would further increase costs on banks, and indirectly on their customers, while potentially distorting capital markets by making low-risk, low-cost transactions uneconomical. We therefore urge the Federal Reserve and other banking agencies responsible for implementing the NSFR to take into account the cumulative impact of their rules, in addition to their benefits, before adding NSFR requirements that could result in higher costs, distortions in market activity away from low-risk, low-margin transactions, and reduced market liquidity while offering little additional prudential benefit.

For the reasons described above, we encourage the Federal Reserve to work with other banking agencies to make the following changes to improve the Proposed NSFR Rules:

- *Tailor the Criteria for Recognition of Variation Margin to the NSFR Context.* The Proposed NSFR Rules would provide that all variation margin provided by a bank to its counterparty would reduce the bank's derivatives liability amounts, implicitly recognizing that all variation margin reduces the bank's obligation to its counterparty. However, the Proposed NSFR Rules would not allow variation margin received by a bank to reduce the bank's derivative asset amounts unless the margin satisfies criteria for recognition in the SLR. These criteria include that variation margin: (1) is in the form of cash, (2) is in the same currency as the settlement currency, and (3) is the full amount necessary to fully extinguish the net current credit exposure to the counterparty of the derivative.

We encourage the Federal Reserve to work with other banking agencies to amend the Proposed NSFR Rules to address this asymmetrical treatment of variation margin received by and variation margin provided by banks. Specifically we encourage banking agencies to modify the Proposed NSFR Rules by: (1) permitting variation margin in the form of securities that are high quality liquid assets to reduce a bank's derivative asset amounts, (2) permitting variation margin denominated in

any currency of a jurisdiction in which the bank operates to reduce derivative asset amounts, (3) permitting variation margin to reduce derivative asset amounts even if it is not the full amount necessary to extinguish the bank's current exposure, and (4) permitting variation margin that is exchanged less frequently than daily to reduce derivative asset amounts.

- *Provide a Downward Adjustment to the RSF Factors of Derivatives With a Short Remaining Maturity.* The Proposed NSFR Rules generally require less stable funding for shorter-term assets compared to longer-term assets. With respect to derivatives, however, under the Proposed NSFR Rules all derivative assets would require the same amount of funding whether a bank would have access to the inflows under those assets soon or over a longer period of time.

We encourage the Federal Reserve to work with other banking agencies to modify the Proposed NSFR Rules to recognize that short-dated derivative assets require less stable funding by including downward adjustments for derivatives with a remaining maturity of one year or less and six months or less, consistent with other parts of the Proposed NSFR Rules.

- *Release More Information Relating to the Add-On for Potential Portfolio Valuation Changes and Re-propose the Add-On.* The Proposed NSFR Rules impose an RSF add-on equaling 20 percent of a bank's gross derivative liabilities, which was intended to capture the liquidity risk associated with potential changes in the value of a bank's derivative transactions that would require a bank to post more variation margin to its counterparties. It is not clear from the proposing release how the add-on, which is not risk adjusted for differences in volatility or remaining maturity, for example, addresses the intended policy objective.

We encourage the Federal Reserve to work with other banking agencies to release data supporting the proposed add-on, explain how the add-on relates to the risk it seeks to capture, and only after taking those steps, re-propose the add-on for more meaningful public comment. At the very least, the final U.S. NSFR rules should not gold-plate the Basel NSFR standard by grossing up settlement payments that extinguish a bank's obligation to its counterparty for purpose of calculating the add-on.

- *Treat Repo and Reverse Repo Symmetrically.* As it would with variation margin, the Proposed NSFR Rules would treat repos and reverse repos with financial sector entities asymmetrically. Under the Proposed NSFR Rules, short-term borrowing by a bank from a financial sector entity would be assigned a 0 percent ASF factor, whereas short-term lending by a bank to a financial sector entity would be assigned a 10 percent or 15 percent RSF factor, depending on the quality of the collateral received and whether the bank has the right to re-hypothecate the collateral.

We encourage the Federal Reserve to work other banking agencies to modify the Proposed NSFR Rules to assign the same percentage factors to the ASF of repos

and the RSF for reverse repos for financial sector entity counterparties so as not to disincentivize low-credit risk funding and potentially harm capital market liquidity.

- *Recognize Assets and Liabilities Associated With Client Shorts as Interdependent Assets and Liabilities Requiring 0 Percent RSF or ASF.* Notwithstanding the intent of the Basel Committee for member jurisdictions to recognize certain transactions as creating interdependent assets and liabilities, the Proposed NSFR Rules would not recognize any such transactions in the United States. However, we firmly believe banks' assets and liabilities arising out of client short transactions that our members and their clients enter into as part of their investment strategies can fit squarely within the criteria set out by the Basel Committee.

We encourage the Federal Reserve to work with other banking agencies to amend the Proposed NSFR Rules and use the discretion permitted to them under Paragraph 45 of the Basel standard to assign a 0 percent RSF to assets arising out of client short transactions when the bank's role in the securities borrowing transaction is subject to Regulation T.

- *Assign a 0 Percent RSF Factor to Segregated Client Assets.* For a client asset held in a segregated account, the Proposed NSFR Rules would assign the asset the RSF factor that would be assigned to the asset if it were not held in a segregated account. Segregated client assets can arise on a bank's balance sheet in connection with a variety of custodial, investment, and hedging transactions, and it is important to our members that banks are not penalized or disincentivized from maintaining client property pursuant to applicable segregation regimes.

Accordingly, we encourage the Federal Reserve to work with other banking agencies to amend the Proposed NSFR Rules and treat assets subject to applicable Securities and Exchange Commission or CFTC segregation requirements as client property, requiring no stable funding.

Conclusion

MFA appreciates the opportunity to provide these comments to the Federal Reserve. We encourage the Federal Reserve, working together with other regulators, to reconsider aspects of the above rulemakings and to amend the above rules to minimize the distortionary and adverse effects on capital markets described above. We look forward to continuing to work with the Federal Reserve to develop alternative proposals that seek to achieve the underlying policy objectives in ways that do not unnecessarily affect valuable investment activity that is critical to strong and vibrant capital markets.

If you have any questions regarding any of the information provided above, or if we can provide further information with respect to the issues discussed in this letter, please do not hesitate to contact Benjamin Allensworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice-President and Managing
Director, General Counsel