



May 16, 2011

Via Email:

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

Re: Managed Funds Association Response to Shadow Banking: Scoping the Issues

Dear Sir/Madam:

Managed Funds Association (“MFA”)¹ welcomes the opportunity to provide comments to the Financial Stability Board (“FSB”) in response to its Background Note “Shadow Banking: Scoping the Issues” (the “Background Note”). MFA supports the FSB’s initiative to analyze the “shadow banking system” and explore potential approaches and regulatory measures for monitoring the shadow banking system and address systemic risks concerns posed by shadow banking. In doing so, MFA believes that it is important that the FSB should have a clear understanding of the size of the hedge fund industry, the leverage utilized by hedge funds and hedge funds’ role in the broader financial system, before making recommendations on a regulatory approach for the shadow banking system. It is also important that the FSB consider the improvements made by hedge fund counterparties (such as banks and broker-dealers) over the past few years to risk management practices, as well the new regulatory requirements which have been put in place since the advent of the financial crisis.

Overview

As discussed in further detail below, MFA believes that the activities of hedge funds are unlikely to pose the types of systemic risks or regulatory arbitrage concerns raised in the Background Note for the following reasons:

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 \$1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

- *The size of the hedge funds industry*: the hedge fund industry – both in terms of the advisers/fund managers as well as the funds they manage – is relatively small in comparison to other financial market participants, the broader financial industry, and the financial markets in which hedge funds operate. Within the hedge fund industry, there is no significant concentration of assets under the management of any individual adviser/fund manager or a group of advisers/fund managers.
- *Low leverage*: hedge funds generally do not employ a significant amount of leverage and typically post collateral in connection with any leverage employed (whether it be *via* borrowing arrangements or derivatives contracts), thereby substantially reducing the credit risk exposure for their counterparties.
- *Stable capital base*: capital invested in hedge funds is subject to limited redemption rights; this provides a stable equity base and helps prevent runs on the fund’s cash and assets.
- *Liquidity*: hedge funds typically structure their borrowings to avoid a mismatch between their equity capital and investments on the one hand and their secured financing on the other hand. Hedge funds are also not significant market participants in the context of maturity transformation.
- *Regulation*: hedge fund advisers/managers are subject to regulatory supervision in many jurisdictions. Following the banking crisis, the regulation of hedge fund managers and the markets in which they operate has been enhanced.

Definition of “shadow banking system”

MFA generally agrees with the definition of “shadow banking system” proposed in the Background Note; in particular MFA supports a definition which does not make references to specific entities.

Although the proposed definition of “shadow banking system” does not mention specific entities the Background Note does mention examples of entities (ABCP conduits, SIVs, monoline guarantors, *etc.*) which are constituents of the shadow banking system. The Annex to the Background Note identifies various entities in the column “credit intermediation chain;” hedge funds are listed under the category “Distribution/Wholesale Funding” in that column.

In relation to hedge funds being listed as such, we would make the following observations.

- First, we believe that there is no particular reason for mentioning hedge funds specifically. To the extent the category “Distribution/Wholesale funding” is an appropriate category in the credit intermediation chain, we believe that every kind of institutional investor in the financial markets is relevant for that category. In this regard, hedge funds are no different

from other non-bank institutional investors such as long-only mutual funds, insurance companies, pension funds, private equity funds and other large corporate investors.

- Second, we believe that only those entities which are systemically important should be identified as being relevant to the shadow banking system (and thus identified for purposes of the credit intermediation chain). For the reasons set forth further below, we would submit that hedge funds in general are not systemically relevant.

Simply to refer to “hedge funds” as being part of the shadow banking system in the Background Note may therefore be misleading. It would also mean that any regulatory approach which seeks to single out and regulate “hedge funds” directly in the shadow banking context would be inappropriate.

In light of the issues outlined in the Background Note, MFA believes that it is first important to provide the FSB with a detailed description of hedge funds’ current role in the financial system, including an analysis as to why hedge funds are not systemically relevant in the financial system. We then address the key considerations presented in the Background Note as applied to hedge funds, including (i) systemic risk concerns arising from maturity/liquidity transformation and leverage; and (ii) regulatory arbitrage concerns.

The role of hedge funds in the financial system

Size and concentration of the hedge fund industry

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 broader financial markets.² 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 industry managed \$23.7 trillion in assets, as of September 30, 2010.³ The top 50 U.S. bank holding companies alone had \$14.4 trillion in assets, as of September 30, 2010.⁴ By comparison, the global hedge fund industry had an estimated \$1.9 trillion in assets under management, as of September 30, 2010.⁵

² Our comments are intended only to provide a perspective regarding the size and concentration of the hedge fund industry; we are not commenting on the systemic significance of other financial market participants or industries.

³ Source: Investment Company Institute, available at: http://www.ici.org/research/stats/worldwide/ww_06_10.

⁴ Source: Federal Financial Institutions Examination Council, available at: <http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx>.

⁵ 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/>.

In addition to the relatively small size of the hedge fund industry as a whole, hedge fund assets are not heavily concentrated in any individual adviser or group of advisers, as illustrated by the fact that the largest hedge fund adviser manages assets equal to only approximately 3% of the entire hedge fund industry.⁶ Considering the fact that many advisers manage multiple funds, assets are even less concentrated when looking at asset concentration on a fund-level basis. The dispersion of assets among a broad group of advisers and funds significantly reduces the risk that the failure of any one fund or adviser would create systemic risk due to a lack of substitutes. Indeed, each year, many hedge funds dissolve or fail for reasons as diverse as extended poor performance reducing their attractiveness to investors, the retirement or departure of senior personnel, or an investment strategy that no longer excels in a changed market environment. The fund's assets are sold, sometimes gradually over many months by the manager and sometimes suddenly in a "liquidation" mode by the prime brokers and exchanges with which the fund traded and that hold its collateral. This market discipline is a hallmark of the industry as funds and firms fail and other funds (existing or new) emerge.⁷ Moreover, because hedge funds are one of many different types of asset management structures, other investment managers and institutional investors also replace the services of failed hedge funds.

Interconnectedness of hedge funds

Next, in considering the interconnectedness of hedge funds, both with other hedge funds as well as with the wider financial system (and thus the potential systemic impact of hedge funds), there are important structural factors to take into account. Hedge fund advisers 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. 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. The UK Financial Services Authority (the "FSA") observed in March 2011 that "risk-taking by non-banks may be less concerning because non-banks are more likely to be able to fail without damaging the wider financial sector and economy. For example, many hedge funds fail each year without causing any systemic problems."⁸

⁶ Source: <http://www.finalalternatives.com/node/14018>, citing *AR Magazine's Billion Dollar Club*, available at: <http://www.absolutereturn-alpha.com/>.

⁷ According to a recent report from Hedge Fund Research, Inc., 945 hedge funds were formed in the most recent twelve-month period. Source: <http://www.reuters.com/article/2010/12/15/us-hedgefunds-launches-idUSTR6BE48120101215>.

⁸ See Section B4 of *Prudential Risk Outlook 2011*, Financial Services Authority, March 2011, available at <http://www.fsa.gov.uk/pubs/other/pro.pdf>.

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 at one fund are borne exclusively by the investors in, and counterparties to, that fund (though counterparty losses are typically limited for the reasons discussed below) and do not subject other funds managed by the same adviser directly to losses.

Further, unlike related entities in a financial 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 concentration 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 engage in one distinct business – namely, making investments for investors in that specific fund, reducing the risk of contagion substantially.

Hedge funds and maturity/liquidity transformation

Unlike many other financial market participants, hedge funds generally do not rely on unsecured, short term financing to support their investing activities. Instead, hedge funds typically rely on secured borrowings, which are designed to more closely match the term or expected liquidity of the asset and the financing which funds it. Without the benefit of a government safety net, the industry has evolved carefully crafted practices to manage liquidity risk.⁹ The FSA has recently conducted several studies on the hedge fund industry which confirm these practices, finding that the assets of the surveyed hedge funds could be liquidated in a shorter timeframe than the period after which their liabilities (to investors and finance providers) would become due.¹⁰

There are generally two sources of funds for a hedge fund: its investors and its bank/broker counterparties (typically global banks or broker-dealers) Hedge fund borrowings from bank/broker counterparties, which include funding *via* repos, are done almost exclusively on a secured basis (*i.e.*, secured by each fund's overall assets or

⁹ See, MFA's Sound Practices for Hedge Fund Managers, available at: www.managedfunds.org; see, also, the President's Working Group on Financial Markets' Asset Managers' Committee report: Best Practices for Hedge Fund Managers, available at: <http://amaicmte.org/Public/AMC%20Report%20-%20Final.pdf>.

¹⁰ FSA studies, *Assessing possible sources of systemic risk from hedge funds*, February 2011 and July 2010 (the "FSA Hedge Fund Studies"), available at: http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf and http://www.fsa.gov.uk/pubs/other/hf_report.pdf.

specifically posted collateral), which limits the amount of leverage that any fund may obtain.¹¹

With respect to maturity/liquidity transformation, most hedge funds build strong liquidity protections into their contractual relationships with investors who are subject to a variety of restrictions, including:

- (a) limited periods of redemption (sometimes monthly, and often quarterly, annual, or longer);
- (b) significant advance notice requirements (often 30 to 90 days) prior to the requested withdrawal dates;
- (c) the right of advisers to impose gates to manage outflows or even suspend redemptions (at the investor and/or the fund level), if deemed necessary; and
- (d) side pocket vehicles for highly illiquid assets that allow redemptions only when realizations occur.

These provisions help reduce the likelihood that redemptions of investor capital will be disruptive to a fund or to markets over extremely short periods of time, because they allow advisers to better match the assets and liabilities of the funds they manage and to manage orderly outflows of investor funds.

It is true that, like other market participants, hedge funds may obtain financing on the repo market (*i.e.*, short term liability) and use such financing to acquire longer dated assets, and so theoretically engage in “maturity transformation.” However, the significant difference between typical hedge fund repo liabilities and the typical liabilities of other entities such as ABCP conduits, SIVs or mutual funds is that hedge fund liabilities in repo transactions are constantly as part of the collateral and margining process. In addition to the overcollateralization by hedge funds that is built into the repo transaction *via* haircuts or initial margin, daily mark-to-market margining allows repo buyers (that is, the lender) to call for additional cash or securities assets from repo sellers (the hedge fund). Thus, if the value of the repo collateral decreases, the repo buyer can make margin calls and the repo seller is required to deliver additional collateral to the repo buyer. This ensures that the hedge fund must always have sufficient assets to meet such potential margin calls. This in turn means that the asset/liability profile of hedge funds when borrowing *via* repos is very different from the profile of SIVs, for example, where the investors in the paper issued by the SIV had no right to call for additional collateral, even when the value of the SIV’s assets substantially reduced over time. Thus,

¹¹ In the United States, 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, impose margin or collateral requirements, thereby restricting the amount of credit that a financial institution can extend to counterparties, including hedge funds. Similarly, European proposals with respect to regulation of the derivatives markets also contain provisions that will have the effect of restricting the amount of leverage that can be obtained by derivatives users, including hedge funds.

as SIVs' assets declined in value in 2008, SIVs started to breach their capital loss tests. SIV programme documentation typically provided that, when a capital loss test was breached, the SIV had to sell its assets immediately in order to meet maturing debts as quickly as possible; the SIV would also typically be required to be wound up.

In addition, the nature of hedge funds – including their relatively low leverage as discussed below – means that such “maturity transformation” is not on the kind of scale which is systemically relevant, unlike that engaged by banks, SIVs and mutual funds. The influential Turner Review on the global banking crisis, published by the FSA, noted that:

“[Hedge funds] typically have not promised to their investors that funds are available on demand, and are able to apply redemption gates in the event of significant investor withdrawals. They are not therefore at present performing a maturity transformation function fully equivalent to that performed by banks, investment banks, SIVs and mutual funds, in the run-up to the crisis.”¹²

Leverage

Hedge funds are not highly leveraged

Although hedge funds are often characterized 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 9.4.¹³ 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 the Columbia University 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. The FSA in its Hedge Fund Studies found a leverage ratio of 272% [2.72], as of April, 2010 and a leverage ratio of 244% [2.44], as of October, 2009.¹⁴ The Turner Review found that the leverage ratio of the hedge fund industry since 2000 has been two or three to one.¹⁵ A Bank of America Merrill Lynch study found the leverage ratio for the industry was 1.16 as of July, 2010.¹⁶ Each of these

¹² See page 72 of The Turner Review – A Regulatory Response to the Global Banking Crisis, March 2009 (the “Turner Review”); available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

¹³ Hedge Fund Leverage, available at: <http://www2.gsb.columbia.edu/faculty/aang/papers/HFLeverage.pdf>.

¹⁴ See FSA Hedge Fund Studies above.

¹⁵ See Turner Review above.

¹⁶ Available at: <http://www.reuters.com/article/idUSTRE67G28220100817>.

studies demonstrates that the hedge fund industry has consistently employed relatively low levels of leverage.

As noted above, hedge fund borrowings are done almost exclusively on a secured basis. The posting of collateral by hedge funds reduces the credit exposure of counterparty financial institutions to those funds. Consequently, hedge funds are substantially less likely to contribute to systemic risk by causing the failure of a systemically significant counterparty, 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 their creditors, counterparties, the general financial system, or taxpayers. Moreover, it is important to note that hedge funds often diversify their exposures across many counterparties, mitigating the risk that a fund poses to any one counterparty. For example, following the collapse of Lehman Brothers, many large hedge funds increased the number of prime brokers they use, thus reducing their exposure to any individual prime broker.

Changes in the hedge fund industry since Long Term Capital Management

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. Regulators helped coordinate LTCM’s financial counterparties, who worked out a private sector resolution of the firm’s liabilities. But at no point were government funds 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 substantial contributors to the recent global financial crisis.

LTCM’s excessive position size and leverage, along with its counterparties’ inadequate risk management were the primary underlying causes of LTCM’s failure. The seminal analysis of the matter, conducted by the U.S. President’s Working Group on Financial Markets, found that LTCM, as of January 1, 1998, was leveraged more than 25-to-1,¹⁷ as compared to the 2.6-1 peak leverage ratio for the hedge fund industry during the period from December 2004 to October 2009.¹⁸ Perhaps most importantly, the President’s Working Group found that LTCM was able to get such leverage because its counterparties did not require LTCM to post initial margin on its OTC derivatives trades.

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.

¹⁷ 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>.

¹⁸ See sources above.

Since the failure of LTCM, however, there have been significant changes in the market with respect to counterparty risk management. Counterparties now consistently limit the amount of leverage used by hedge funds by requiring the use of collateral to secure financing to hedge funds. Also, as a result of improvements to counterparty risk management best practices, financial institutions today conduct more in-depth 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.¹⁹ In 2006, U.S. Federal Reserve Chairman Bernanke noted the improvements in the market place:

“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.”²⁰

Concluding thoughts on leverage

In conclusion, hedge fund leverage should not be of systemic concern. To the extent that the FSB is concerned that leverage in hedge funds may, notwithstanding the discussion above, increase in the future, mandatory reporting of leverage imposed on the hedge fund industry *via*, for example, the EU Directive on Alternative Investment Fund Managers (“AIFM Directive”), means that regulators will have the ability to monitor the leverage profile of hedge funds on an ongoing basis.

In addition, other regulatory initiatives being considered will reduce the likelihood that hedge funds become significantly leveraged. For example, increased capital and liquidity requirements under Basel III appear likely to have the effect of reducing the amounts that banking groups (containing prime brokers) may wish to make available by way to loans to hedge funds. Alternatively, such loans may be available but at increased costs to hedge funds.

Regulatory arbitrage

In relation to regulatory arbitrage concerns, the FSB points to activities of banks which may use shadow banking entities to increase leverage or find ways to circumvent capital or liquidity requirements. The Turner Review in the UK, for example, identified off-balance sheet vehicles such as SIVs as “a clear case of regulatory arbitrage.”

¹⁹ Copies of the reports are available at: <http://www.crmpolicygroup.org/index.html>.

²⁰ Speech by Chairman Ben S. Bernanke, *Hedge Funds and Systemic Risk*, May 16, 2006. Available at: <http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm>.

This concern about regulatory arbitrage does not apply to hedge funds which, as described above, operate on a much simpler model and generally are independent from banks (and thus are not used by banks to circumvent capital or liquidity requirements).

Potential regulatory measures for shadow banking system

We note that the FSB proposes four potential approaches for monitoring the shadow banking system:

- (a) indirect regulation by regulating banks' interactions with shadow banking entities;
- (b) direct regulation of shadow banking entities;
- (c) regulation of particular instruments, markets or activities; or
- (d) macro-prudential measures (*e.g.*, policies to strengthen market infrastructure).

MFA supports a careful and well thought out approach to monitoring the shadow banking system. As a general matter, however, MFA is of the view that the direct regulation of entities (option (b) above) would not be appropriate. As a starting point, the direct regulation of entities (which presumably would be "shadow banks") would appear to be inconsistent with the FSB's proposed definition of "shadow banking system," which does not identify specific entities but rather points to a collective system. In addition, in respect of the hedge fund industry, hedge fund managers and the markets in which they operate are already subject to extensive regulation. Following the recent enactment of several legislative initiatives, the regulatory supervision of the hedge fund industry has been enhanced in many respects. For example, under the Dodd-Frank Act in the U.S., hedge fund advisers are required to register with the U.S. Securities and Exchange Commission and are subject to increased regulatory reporting and transparency requirements. In the European Union, hedge fund managers are subject to the AIFM Directive, which requires compulsory authorisation and imposes capital, disclosure and reporting obligations. Hong Kong and Singapore (the main locations for hedge fund managers in Asia) have similarly enhanced their regulatory requirements of fund managers.

In respect of the regulation of particular instruments, markets or activities (option (c) above), MFA is of the view that such regulation (if any) should be commensurate with the perceived risk. Given the breadth of the definition of "shadow banking system," MFA is concerned that regulation of instruments, markets or activities over and beyond what is already required (for example pursuant to the Dodd Frank Act or the EU Markets in Financial Instruments Directive ("MiFID") Review) would result in many types of entities being caught in the regulatory net, when those entities have nothing to do with the credit intermediation chain. This would result in an excessive regulatory burden placed on the market in a manner which is not proportionate with the perceived risks.

MFA believes that, of the four options presented, the macro-prudential measures approach would be the most proportionate and efficient response to the perceived risks of the shadow banking system. This approach would allow the regulators to monitor the financial system as a whole and manage the systemic risks appropriately. Steps can then be taken at the appropriate time, when regulators determine that there may be excessive risk to the system as a whole. This will allow markets to function efficiently, without unnecessary layers of regulation which may be impossible to apply evenly. In this regard, hedge fund managers are happy to provide regulators with relevant information on the funds they manage, in order to allow for efficient monitoring, provided that regulators establish appropriate confidentiality protections for sensitive information. Indeed, the Dodd-Frank Act and the AIFM Directive, along with the review in the MiFID already mandate or will mandate such heightened transparency to regulators.

Conclusion

In conclusion, MFA believes that, in considering hedge funds in light of the concerns set out in the Background Note, it is unlikely that the failure of any hedge fund or hedge fund manager would have systemic implications. Moreover, hedge funds generally do not play an important role in the credit intermediation chain. Consequently, MFA believes that hedge funds do not have a significant role in the shadow banking sector. To the extent regulators feel that positive steps need to be taken to regulate the shadow banking system, the most appropriate option would be to take macro-prudential measures rather than direct regulation of entities or activities on a micro basis.

We would be very happy to discuss our comments or any of the issues raised in the Background Note with the FSB. If the FSB has any questions or comments, please do not hesitate to contact Stuart Kaswell or the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO