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

November 28, 2013

**By email to fsb@bis.org**

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

**Re: FSB Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (29 August 2013) (the "Policy Framework")**[1]

Dear Sir or Madam:

Managed Funds Association ("**MFA**")[2] welcomes the opportunity to provide comments on the Policy Framework; MFA's comments on the Policy Framework and responses to the FSB's policy recommendations and questions in Annex 1 and Annex 2 of the Policy Framework (*Proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions*) (the "**securities financing proposals**") are set out in the Appendix to this letter.

MFA supports the FSB's goal of identifying gaps in regulation and ensuring appropriate regulatory oversight of activities that create systemic risk. In that regard, we welcome the FSB's continued work in identifying shadow banking activities that could create systemic risks and proposing rules to address those risks, including its work in developing the Policy Framework.

In considering the specific recommendations to address systemic risk concerns related to repo and securities lending markets; however, it is important that the Policy Framework be implemented in a manner that is appropriately tailored to address identified risks and not in a manner that would be disproportionately onerous for market participants. Overly burdensome rules could have the unintended consequence of stemming forms of securities lending and repo

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[1] http://www.financialstabilityboard.org/publications/r_130829b.pdf

[2] Managed Funds Association 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, the Americas, Australia and other regions where MFA members are market participants.

transactions that play a valuable role in the proper and efficient functioning of securities markets and do not pose systemic risks to any national, or the global, economy.

As a general point in assessing the appropriateness and proportionality of any proposed regulation in this area, we ask the FSB to take into consideration the specific characteristics of hedge funds that have already proven effective in mitigating the kind of systemic risks that the FSB aims to address through the securities financing proposals. MFA outlined a number of these characteristics in our response letter dated May 16, 2011[3] to the FSB Background Note "Shadow Banking: Scoping the Issues".[4] In particular, we note the following points regarding risk mitigation in the hedge fund industry:

i. 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 fund them.[5]

ii. Unlike other entities such as asset-backed commercial paper (ABCP) conduits, structured investment vehicles (SIVs) or mutual funds, 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. Liabilities in repo transactions are continually marked-to-market as part of collateral and margining processes. 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. The same points apply in respect of securities lending.

iii. 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.[6]

We believe that national policy makers and regulators should consider these points in implementing the securities financing proposals to ensure that the proposals are implemented in a

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[3] http://www.financialstabilityboard.org/press/c_110901m.pdf
[4] http://www.financialstabilityboard.org/publications/r_110412a.pdf
[5] This is supported, for example, by the former UK Financial Services Authority's (FSA) studies on the hedge fund industry which found 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 (FSA studies, Assessing possible sources of systemic risk from hedge funds, February 2011 and July 2010 available at: http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf and http://www.fsa.gov.uk/pubs/other/hf_report.pdf).
[6] According to a Columbia University study published in 2011 (Hedge Fund Leverage, available at: http://www2.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf), 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. 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.

manner that targets systemic risk specifically and effectively, without undermining liquidity levels and market functionality.

While we note that the FSB has requested public comment on the policy recommendations and questions contained in Annex 2 of the Policy Framework, we believe that further consideration should be given to the policy recommendations contained in Annex 1 of the Policy Framework as well. As such, we have provided comments in the Appendix with respect to policy recommendations set out in both Annexes.

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

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice President & Managing Director, General Counsel

# APPENDIX

**MFA comments on FSB Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (29 August 2013) and responses to specific questions in Annex 1 and Annex 2 of the Policy Framework**

## A. Responses to Policy Recommendations in Annex 1

*Reporting requirements – Recommendations 1 - 5*

In respect of Recommendations 1 and 2 and sections 2.1 and 2.2 of the Policy Framework, we agree that it is appropriate to align reporting requirements to risks and that it is important that regulators have appropriate levels of visibility and transparency into financial institutions' activities in securities lending and repo markets. However, to the extent that market participants are already required under existing or pending regulatory regimes to report on the categories of information listed at section 2.2 of the Policy Framework, they should be deemed to be in compliance with any new requirements developed under the Policy Framework.

Private funds are already subject to a number of reporting requirements, such as under the US Commodity Futures Trading Commission and the Securities and Exchange Commission joint rules on "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF" under the US Dodd-Frank Act and under the EU AIFMD. Therefore, to the extent that there is any intention to consider imposing new reporting requirements on market participants of this nature, careful consideration should be given to avoid imposing duplicate reporting requirements or requirements that are similar in substance to existing requirements. Additional requirements covering the same category of information already being reported are unlikely to be of significant value to regulators but are likely to be onerous for market participants to comply with.

In this regard, we believe it is important that the FSB considers carefully the types of information that are likely to be of most value to regulators before designing a new reporting framework. As part of this scoping exercise we recommend that the FSB conducts a review of the tri-party custody books at major custodians. This should provide a better understanding of the type of information required to uncover the potential build-up of systemic risk. In the US, for example, examining the tri-party custody books of such custodians, sell-side positions (which are already required to be disclosed), and a time series analysis of securities lending transactions cleared through the Depository Trust Company would provide a more comprehensive view of the size of the US repo and securities lending markets. Other markets may benefit from a similar analysis.

In respect of Recommendation 3 and section 2.3 (*A regime for data collection and aggregation at the global level*), we understand and support the FSB's recommendation that regulators share aggregate data with the FSB that can be further aggregated at the global level. We also support the FSB's goal of harmonized data collection by regulators to ensure consistent data for regulators to compare. With respect to any data collection by regulators, it is important that regulators ensure that sensitive or proprietary information is treated confidentially and that any information that is disclosed only be on an aggregate basis. Disclosure of a financial institution's confidential information could greatly jeopardize its business and the risk of disclosure could have unintended adverse effects on markets and market participants generally.

In respect of Recommendation 4, and section 2.4 (*Improvement in corporate disclosures*) of the Policy Framework, we agree that it is appropriate to align disclosure requirements to risks and that it is important that investors and regulators have appropriate levels of visibility and transparency into financial institutions' activities in securities lending and repo markets. The proposed corporate

disclosures appear to be applicable to publicly traded financial institutions, such as banks and other sell side firms. We do not believe that such disclosures should be required of other types of market participants that do not present the same types of risks as publicly traded, large financial institutions.

In respect of Recommendation 5, and section 2.5 (*Improvement in reporting by fund managers to end-investors*), MFA is supportive of providing appropriate transparency to investors. However, we believe the indicative list of information that should be reported at section 2.5 of the Policy Framework is overly detailed and prescriptive and that much of the information is unlikely to be of value to many investors. For example, information regarding the number of custodians and the amount of assets held by each would be a level of granularity in the requirements that is likely to be disproportionate to any potential benefit in terms of risk mitigation. We also believe that the level of detail recommended by the FSB is likely to be overly extensive compared to the relative risk profile of many funds and, as such, may be misleading to investors when compared to other disclosures they receive. Further, some of the information is likely to be commercially sensitive and proprietary information of the fund manager, for example concentration data (which could reveal a particular investment strategy). To the extent the FSB nonetheless recommends disclosure of such information, we believe that it should be disclosed to regulators and that those regulators should be subject to confidentiality obligations in respect of any commercially sensitive elements of the disclosures.

Generally, in respect of fund managers reporting information to investors, a distinction should be drawn between the situation where a fund manager lends assets held in the name of an investor and where a fund manager lends assets held in the name of a fund managed by it in which there are various different investors. In the latter case, the types of reporting information envisaged in the Policy Framework are less likely to be of value to, or expected to be received by, investors (*i.e.,* various investors in the fund) as the risk to any single investor in respect of an individual securities lending transaction of assets in which its investment is pooled is likely to be marginal. By way of general comment, it is important that any additional reporting requirements imposed upon fund managers are proportionate to the risks they are intended to mitigate and consistent with the expectations of investors.

*Policy Recommendations on Cash Collateral Reinvestment, Re-hypothecation of Client Assets, and Collateral Valuation and Management -- Recommendations 7-9*

MFA understands that cash collateral reinvestment, re-hypothecations of client assets, and collateral valuation and management are relevant areas for regulators to consider, as each in an important aspect of repo and securities lending markets. We believe; however, that further evaluation and analysis of the market impact of the FSB's recommendations should be undertaken before policy makers propose substantive reforms to these important markets. In particular, we believe policy makers should clearly identify the specific problems that need to be addressed, and how those problems can create systemic risk, before proposing shadow banking rules that could significantly affect the repo and securities lending markets. We further believe that policy makers should conduct a rigorous market impact analysis to determine the costs associated with any policy proposal and whether there are any less costly alternative methods of addressing identified concerns. MFA and its members welcome the opportunity to engage constructively with policy makers as part of that process.

*Recommendations regarding Central Clearing and Bankruptcy Reform – Recommendations 10, 11*

MFA agrees with the FSB that both of these areas would require further study and consideration before specific policy proposals could effectively be created. We also agree with the FSB that, given the complexity of issues associated with bankruptcy reform, those issues should not be a priority for policy makers at this time.

**B. Responses to Questions and Policy Recommendations in Annex 2**

**Q1. Do the proposed policy recommendations in Annex 2 adequately limit the build-up of excessive leverage and reduce procyclicality? Are there alternative approaches to risk mitigation that the FSB should consider to address such risks in the securities financing markets? If so, please describe such approaches and explain how they address the risks. Are they likely to be adequate under situations of extreme financial stress?**

**Q2. What issues do you see affecting the effective implementation of the policy recommendations?**

**Q3. Please address any costs and benefits, as well as potential material unintended consequences arising from implementation of the policy recommendations? Please provide quantitative answers, to the extent possible that would assist the FSB in carrying out a quantitative impact assessment.**

*Numerical haircut floors*

As a threshold matter, any regulation in this area should be targeted to the systemic risks that the FSB aims to mitigate and proportionate to the levels of risk that actually exist in the relevant markets. In particular, it is important that market participants are afforded the flexibility to negotiate haircuts on a bilateral basis. This will reduce the risk of creating unintended consequences (examples of which are given below) and allow market participants to tailor haircuts to address the particular risks of a transaction. MFA believes that it is at best unnecessary, and at worse counterproductive, to risk mitigation to prescribe numerical floors in regulation. Such an approach is a blunt instrument that ignores and discourages a market participant's own diligence of the risks of a securities lending or repo transaction in respect of a particular security with a particular counterparty. Despite the FSB's intention that there should be careful monitoring of the relevant prescribed floor becoming a standard across the market, MFA is concerned that such floors will quickly be adopted generally and discourage careful and considered analysis of the correct haircut for a particular transaction. Our responses to the questions set out in this letter are therefore applicable only to the extent that such requirements are imposed and are without prejudice to this objection.

*Global and national regulatory co-ordination to avoid duplicative and conflicting rules*

Many of the issues identified by the FSB in respect of the shadow banking system will necessarily require a regulatory approach that achieves consistency across various regulatory regimes around the globe as well as within national regimes. As such, it is important that every effort is taken to avoid creating regulatory requirements that may be inconsistent with those under other national and global regulatory frameworks and regimes (whether existing or proposed). This is likely to require the development of specific measures to address the risk of inadvertent duplication of requirements on both a global and national level. The FSB should foster and encourage global co-ordination among national regulators so as to address the risk of conflicting, inconsistent, or duplicative rules.

*Scope for regulatory arbitrage*

MFA supports the FSB's efforts to minimise the risk of regulatory arbitrage that may arise from regulation in this area. In particular, we support the FSB's plans to coordinate closely with the BCBS-IOSCO monitoring group on margin requirements for non-centrally cleared derivatives so as to minimise incentives to arbitrage any differences between the two regimes.

*Call for further diligence in future quantitative impact assessments*

It is important that the design of any regulation arising as a consequence of the securities financing proposals takes the results of impact and cost-benefit assessments into full and careful consideration and does not pre-empt these analyses.

We therefore welcome the FSB's current and proposed impact assessment surveys in respect of the securities financing proposals. However, it is necessary that future impact assessments, and detailed cost-benefit analyses, are conducted in a manner that is broad and robust enough to ensure that the proposals target the risks they are intended to address and do not result in unnecessary or disproportionate requirements or restrictions being placed on market participants. MFA believes that the scope of the FSB's future analyses, as well as any analysis by policy makers considering whether to adopt the FSB's proposals, should therefore include a more detailed discussion of the particular risks that the proposals are intended to address, as well as the market impact and potential unintended consequences of the proposals.

In particular, we recommend that the FSB and policy makers include the following items in their analyses:

i. the percentage of securities lending and repo transactions across the market that would be affected by the securities financing proposals;

ii. the categories of counterparties likely to be affected directly or indirectly by the securities financing proposals (*e.g.*, pension funds); and

iii. the volume of G8 and non-G8 government securities that are subject to securities lending and repo transactions and, within each of these groups, the percentage of those securities that are rated below "AA" by Standard & Poor's[7] (or an equivalent measure of creditworthiness by another rating agency).

**Q4. What is the appropriate phase-in period to implement the policy recommendations? Please explain for (i) minimum standards for methodologies and (ii) the proposed framework for numerical haircut floors separately.**

Given the connection between the type of collateral used for uncleared derivatives and the securities subject to securities lending and repo transactions, we would support a broadly concurrent

[7] Standard & Poor's Ratings Definitions can be found at the following webpage: https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1019442&SctArtId=147045&from=CM&nsl_code=LIME

timeframe for implementation of the securities financing proposals and the BCBS-IOSCO margining requirements for non-centrally cleared derivatives.

**Q5. Are the minimum standards described in Section 2 appropriate to capture all important factors that should be taken into account in setting risk-based haircuts? Are there any other important considerations that should be included? How are the above considerations aligned with current market practices?**

**Q6. Would the additional considerations described in Section 3 appropriately capture all important factors that should be taken into account in setting risk-based haircuts on a portfolio basis? Are there any other important considerations that should be included? How are the above considerations aligned with current market practices?**

We note the FSB's broad approach to the consideration of relevant factors in sections 2 and 3 of Annex 2 of the Policy Framework. However, we also note the absence of any reference to counterparty credit risk. If this is not included within the criteria, and given the dangers of imposing numerical haircut floors discussed above, there may be a risk of the unintended consequence that market participants are incentivised to enter into securities lending and repo transactions on securities issued by issuers of a poor credit. This may create more risk in the global financial markets.

**Q7. In your view, is there a practical need for further clarification with regard to the definition of proposed scope of application for numerical haircut floors?**

**Q8. Would the proposed scope of application for numerical haircut floors be effective in limiting the build-up of excessive leverage outside the banking system and reducing procyclicality of that leverage, while preserving liquid and well-functioning markets? Should the scope of application be expanded (for example, to include securities financing transactions backed by government securities), and if so why?**

**Q9. In your view, what would be the impact of introducing the numerical haircut floors only on securities financing transaction where regulated intermediaries extend credit to other entities? Does this create regulatory arbitrage opportunities? If so, please explain the possible regulatory arbitrage that may be created and their impact on market practices and activity.**

*Types of entity to which numerical haircut floors should apply (if they are required)*

MFA believes that the proposed scope of application for numerical haircut floors to certain market participants requires further consideration. We support the FSB's efforts to reduce procyclicality outside the banking system and understand that one of the FSB's principal concerns is to reduce systemic risk caused by interconnectedness between banks and non-bank financial entities (as set out in the FSB's Global Shadow Banking Monitoring Report 2013).[8] However, we are unclear as to why the proposed framework of numerical haircut floors applies only in respect of transactions in which entities not subject to regulation of capital and liquidity/maturity

[8] Published 14 November 2013: http://www.financialstabilityboard.org/publications/r_131114.pdf. (See part 6, pp. 21-24.)

transformation *receive* financing from regulated financial intermediaries against collateral and not the other way around (*i.e.*, where an entity subject to such regulation receives financing from an entity that is not). We believe that, were such requirements to be imposed, they should apply to any transactions identified as potentially creating systemic risk or procyclicality, regardless of counterparty type.

We are concerned that, by excluding certain types of transactions where a regulated financial intermediary receives financing, the proposed rules may create an unlevel playing field that could distort competition in the securities lending and repo market. Further, this could lead to regulatory arbitrage and unfairly benefit particular types of market participants. As such, we encourage the FSB to recommend any rules in this regard to apply generally across market participants and types of financing transactions.

*Inclusion of transactions backed by government securities*

Given the systemic risks the FSB is attempting to address, we do not think the exclusion of transactions backed by government securities is appropriate. We believe further analysis of the potential for procyclicality in markets in such securities, and the effects this could have on haircuts, would be helpful. Whilst it is true that imposing numerical haircut floors on these transactions could have an impact on the liquidity and functioning of funding markets, this is equally true of imposing such floors on other transactions that are currently within the proposed scope. Sovereign bonds are subject to default risk, even in domestic currency, and, therefore, are subject to procyclical price movements. Furthermore, as the price of some countries' government debt is more volatile than others, and as price volatility varies between different debt instruments (based on differences in maturity for example), a blanket exclusion of all transactions linked to any government debt is unlikely to adequately encompass the systemic risks that the proposed reforms aim to address.

Moreover, excluding transactions backed by government securities from the scope of the proposed requirements may have the unintended consequence of shifting the relevant risks into markets for sovereign debt and connected instruments which could cause increased volatility in those markets. Were this to occur, the systemic consequences of such inadvertent risk spillover could be far greater than the original risks the proposed reforms are intended to address.

Lastly, were transactions backed by government securities to remain excluded, there would need to be a clear definition of the types of securities that this would include. Achieving a clear and appropriate definition is likely to be challenging and may create a risk of arbitrage and market distortion.

**Q10. In your view, would the proposed levels of numerical haircut floors as set out in table 1 be effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets? If not, please explain the levels of numerical haircut floors that you think are more appropriate and the underlying reasons.**

MFA supports the FSB's qualification that the proposed numerical haircut floors should be risk-based, but not too granular, and that they should ideally not be based on credit ratings determined by credit rating agencies, in order to avoid mechanistic reliance on external ratings. This

is especially important given that, if haircuts are tied to such credit ratings, sudden and unexpected changes in such ratings are likely to trigger large-scale negative contagion effects on other markets.

**Q15. What are your views on the proposed treatment of collateral upgrade transactions described above? Please explain an alternative approach you think is more effective if any.**

**Q16. What are your views on exempting collateral upgrade transactions from the proposed framework of numerical haircut floors if securities lenders are unable to re-use collateral securities received against securities lending and therefore do not obtain financing against that collateral?**

MFA supports the FSB's proposal that securities lenders should be exempt from the proposed numerical haircut floors on "collateral upgrade" transactions – or securities borrowing/lending transactions against the pledging of other securities as collateral, rather than cash – if they are unable to re-use collateral securities received against securities lending and therefore do not obtain financing against that collateral. We suggest that it be made clear though that a securities lender's inability to re-use collateral securities in this manner could (amongst other methods) be evidenced by a contractual restriction on such reuse in an agreement between the securities lender and its counterparty.

**Q17. What do you view as the main potential benefits, the likely impact on market activities, and possible material unintended consequences on the liquidity and functioning of markets of introducing the proposed framework of numerical haircut floors on securities financing transactions as described above?**

Please see our responses to questions 7 to 9 above.

**Q18. Would implementing the proposed numerical haircut floors through regulatory capital or minimum margin regimes for regulated intermediaries be effective in reducing procyclicality and in limiting the build-up of excessive leverage by entities not subject to capital or liquidity regulation?**

In respect of the FSB's suggestion that "the ability to raise the numerical haircut floors beyond the initial levels could in theory be used as a macro-prudential tool by the relevant authorities", MFA believes that it remains an open question whether numerical haircut floors represent the most appropriate mechanism for implementing macro-prudential regulation. The conditions/triggers for considering whether overheating or excessive leverage is occurring would need to be very clearly defined to avoid uncertainty regarding the potential for macro-prudential measures being used at any given time.

**Q19. Are there specific transactions or instruments for which the application of the proposed framework of numerical haircut floors may cause practical difficulties? If so, please explain such transactions and suggest possible ways to overcome such difficulties.**

In respect of derivatives used to achieve similar economic objectives to repo and securities lending transactions (*e.g.*, total return swaps), MFA supports the FSB's proposed coordination with the BCBS-IOSCO monitoring group on this issue. However, we would caution against imposing

requirements regarding the derivatives market under the proposed framework on shadow banking. Were any additional requirements in respect of derivatives to be proposed, and it is not at all clear that this is indeed necessary, such requirements should be separate from those applying to repos and should be tailored specifically to the relevant type of derivatives in question.

**Q20. What would be an appropriate phase-in period for implementing the proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions? Please explain for (i) minimum qualitative standards for methodologies and for (ii) numerical haircut floors separately.**

Please see our response to question 4 above.