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Response to FSB and IOSCO's Consultation Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systematically Important Financial Institutions

Thank you for the opportunity to comment on this paper. We fully support this important initiative to identify and monitor Non-Bank Non-Insurer Global Systemically Important Financial Institutions (NBNI G-SIFIs) by the world's leading financial authorities.

If such initiatives are appropriately formulated, orchestrated and converge with the industry's own requirements, then there is enormous scope for a very tangible win-win-win for regulators, Investors and NBNI G-SIFIs. Conversely, however, entrenching discrepancies at this stage would be a damaging step back, rather than a step forward.

The authorities have a legitimate interest in understanding the aggregate exposures arising from the NBNI G-SIFIs as they look for sources of systemic risk. They also wish to minimize the risk of fraudulent practices. Investors have the exact same desire to understand aggregate exposures within their portfolios and to avoid fraudulent funds. Harnessing this alignment both **empowers investors** and **minimizes costs** to the NBNI G-SIFIs.

In our Response to **ESMA Consultation Paper** on **"**Guidelines on reporting obligations under Article 3 and Article 24 of the AIFMD". (link: http://www.esma.europa.eu/system/files/albourne_response_to_esma_consultation_paper.pdf) we had support from **242** entities from across the globe, including Investors (69), Alternative Investment Fund Managers (AIFMs) (165) and Service providers (8) in the alternative investment industry globally. They believe that the "**Open Protocol Enabling Risk Aggregation**" (the 'Open Protocol': described in **Section 1**) initiative has a key role to play in aligning the risk-reporting requirements of multiple major jurisdictions.

The Open Protocol is a **non-commercial initiative** and was forged by the **collaborative efforts** of hands-on practitioners drawn from investors, AIFMs, Investment Banks and service providers. The Open Protocol is a fully-worked **technically detailed** blue print for reporting. It is, effectively, an exact response to the challenge set by the IOSCO technical committee on 25th February 2010.

The Open Protocol could be fully and exactly adopted as-is as a reporting format. By way of example, APRA have recommended that this format be used by July 2014. In our submission to the US's SEC consultation over form PF (link: http://www.sec.gov/comments/s7-05-11/s70511-59.pdf), we described such adoption on a broad basis as the ideal "unison" solution. Our submission to the SEC also described an alternative "harmony" solution under which AIFMs could use the exact same methodologies as are prescribed by the Open Protocol to complete Form PF and their investor reports. The SEC adopted the latter approach.

We understand that the current consultation paper is at an initial stage and has not asked for a detailed template; however we feel that there are some key benefits to incorporating Open Protocol in discussions early and these are highlighted in **Section 2**.

Section 3 focuses on the explicit questions asked by the consultation document. We have focused our replies on Investment Funds as that is our area of expertise, but we believe that this solution could also be applied to other entities.

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We see the interests of Regulators and Investors as being closely aligned. The regulators' main objectives are:

- To identify and monitor potential systemic risks arising from private funds
- To detect and verify potential frauds
- To ensure smooth functioning of financial markets

Investors have similar objectives but at a more micro level.

- To identify and monitor the impact of potential systemic risk to their portfolio and individual investments.
- To avoid funds with implausible returns (i.e. marking-to-model or fraud).

  To ensure risk is sufficiently monitored and controlled so as to maximise the probability of achieving the investment objectives.

Furthermore, we see similarities in the challenges faced by regulators and investors. The regulators' challenge is to ensure the most efficient use of limited enforcement resources. The investors' challenge is to ensure the most efficient deployment of their limited investment capital. Both require an alerting mechanism to effectively narrow down the monitoring universe and then focus their limited resources on it. To be effective the alerting mechanism needs to:

- Be based on a unified data structure across all market participants
- Be produced from a unified global database
- Incorporate both quantitative and qualitative data

The Open Protocol already provides a blueprint for the unified data structure. Albourne would be pleased to provide our experience and analytics that regulators could apply to creating a unified global database.

If you prefer, we would welcome the opportunity to discuss our response further in person and to demonstrate how we could use the Open Protocol data to practically answer all the questions raised in this consultative document. If you have any further queries, please feel free to contact us.

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Section 1: The Open Protocol: Summary and Provenance

The Open Protocol, as the name suggests, is **completely open** and has **zero commercial agenda**. It is freely available for download from the website (www.theopenprotocol.org).

The protocol was developed by the working group after several meetings and lengthy discussions. Industry bodies and regulators were invited to observe all the discussions with a view to ensure that the protocol is **unbiased**, **objective** and **independent**. The Working group also held a 6 week **public consultation** exercise which helped to make the protocol inclusive and promote awareness.

The Open Protocol is basically a taxonomy or language; and if consistently applied will lead to **better understanding** of the exposures and help **identify outliers**. It looks to define **consistent practices**, not best practices and where available it incorporates existing standards and protocols. The Open Protocol is based on a **holistic approach to understanding risk**. The greatest risk in "risk" comes from assigning too much significance to any one measure of it.

Working Group

The Open Protocol was developed by an independent working group of 16 members representing different participants in the AI industry. Members included:

Investors:	BT Pension Scheme Management Limited
	Investcorp Investment Advisers Ltd
	Utah Retirement Systems
	Federal Way Asset Management (fka Weyerhaeuser Asset Management).
AIFM:	Brevan Howard
	Lansdowne Partners Limited
	Och-Ziff Capital Management Group LLC
	The D.E. Shaw Group
Investment Banks:	Credit Suisse Group AG
	Goldman Sachs Group Inc.
	Morgan Stanley
	UBS AG
Administrators	CITCO
	International Fund Services - a State Street Company
Consultant	Albourne Partners Ltd (“Albourne”) (Co-Chair)
Media	Thomson Reuters (Co-Chair).

Component Parts: The Open Protocol comprises 3 documents (**Appendix I** contains the complete list of attachments).

1) **Template:** The template provides an exhaustive list of all the information that an AIFM should provide in human eye-friendly format. The level of granularity of the information can be controlled by the managers by using the pre-defined “Grade System”. There are three grade levels. For more information please see Attachment 1 “Open Protocol Template (Excel)”.
2) **Manual:** Defines the methodology for calculating various metrics in the template. It provides the details which are essential to ensure consistent reporting and covers all the grades. The working group has always strived to define the most objective method with a view to creating an unbiased output. For more information please see Attachment 2 Open Protocol Manual (PDF).
3) **XML schema:** Standard electronic template which can be easily read and analysed by a computer. It would help in seamless transmission of information and avoid manual entry errors. For more information please see Attachment 3 Open Protocol Schema (XML).

Section 2: Key benefits of adopting Open Protocol

First key benefit: a unified data structure facilitates aggregation

A simple example of the disutility of a splintered approach to reporting is the regional focus of each regulatory initiative. For example under **question 8 AIFMD Annex IV** is asking for a breakdown of bond exposure by EU bonds and non G10 bonds, while **question 26 of SEC's Form PF** asks for US bonds and non US G10 bonds.

Without an overriding definition of the regions to establish consistency, the proliferation of regional-focused templates fatally compromises data structure. The more practical solution is clearly for all regulators to collect all information on the same basis. Any given regulator would then still have the option to drill down on a specific region.

The authorities need to approach this by working back from how they will end up having to use the data gathered. Be it proactively, or reactively, it is certain that the world's authorities will eventually need to aggregate the data that they receive. Data structure inconsistencies at this stage are bound to create difficulties in the future.

Investors always need to understand and integrate market risks on a global basis, so the Open Protocol is an exact example of the kind of unified data structure that is required. It will make it easier to share information across regions and facilitate comparison by asset classes, regions, instruments and enable effective aggregation.

Second key benefit: greater breadth of data collected

Proposed regulatory reporting formats to date have focused on the "usual suspects" of systemic risk, such as the financial sector. For example under **question 8 AIFMD Annex IV** is asking for "Listed equity" broken down into 2 groups Financial Institutions and Other Sectors. The Open Protocol, on the other hand, asks for "Listed equity" to be broken down into 10 sectors, one of which is Financials.

The Open Protocol collects broader data. This might prove valuable if the next crisis turns out to be materially different from the last crisis (i.e. bond shock) or even one of the earlier crises (e.g. Tech bubble). It would be hard and expensive for the authorities and AIFM to have to continually reconfigure reporting requirements. Changes in data structure also compromise the utility of historic data.

The Open Protocol is a more complete solution.

Third key benefit: harnessing the "group intelligence" of the world's investors

If regulators and investors receive the same well-structured data then the confidence in that data should increase.

Investors should be comforted by the penalties for inaccurate reporting. Regulators should also be comforted by knowing that investors are reviewing the data searching for concentrations of risk and signs of implausibility. In such a scenario, the world's great investors would effectively be amplifying the resources at the disposal of the authorities.

However, narrowly defined “regulatory” data might well ‘crowd out’ broadly defined and well-structured investor-friendly data. If such “regulatory” data proved to be less coherent, less consistent, harder to harness and harder to interpret then there would be less point in investors studying it. Most ironically, an unmonitored submission might even provide an ‘alibi’ for a mis-intentioned AIFM.

When it comes to the monitoring of both market and operational risk, the authorities should look upon investors as assets.

Fourth key benefit: eventual coherence and effectiveness of policy responses

There would not be much point in the authorities collecting such data if there was not the possibility of their one day acting on it. At that time, it will be absolutely essential that the world’s providers of risk capital have faith that the correct information has been collected and interpreted. Anything short of this will lead to an exodus of risk capital that will substantially magnify the kind of crisis that such data collection was intended to help mitigate. This could prove to be a deeply painful example of unintended consequences.

By definition, paying very close attention to the concern of investors now is the only way to prevent those very same concerns coming back to materially jeopardize the effectiveness of future policy responses.

Fifth key benefit: minimizing cost

Proliferating and diverging regulatory reporting requirements can only translate into costs. If they meant safer financial markets and a safer industry then these might be costs worth paying. However, for the reasons outlined above, we consider the exact opposite to be true.

More positively, there is a very real possibility that the authorities can serve as a profoundly effective catalyst for a much needed rationalization of how AIFM communicate their market risk exposure to their investors. In time, this could actually reduce costs for the industry. There is already substantial industry-based momentum behind the Open Protocol initiative. Whether it be the ‘unison’ or ‘harmony’ solutions referred to above, any overlap of methodologies with regulatory initiatives would ensure that the Open Protocol moves to the top of the AIFM to do list.

Section 3: Response to questions

Q1-1. In your view, are the three transmission channels identified above most likely to be the ones transmitting financial distress of an NBNI financial entity to other financial firms and markets? Are there additional channels that need to be considered?

Answer: We agree that the three transmission channels identified are very important. In addition we would also consider relationships within the various market participants like other managers and investors. As the paper rightly points out in footnote 40, even small managers with similar strategies or similar exposures to an asset class could have a disproportionate impact on the market if they behaved similarly under a stress event. Similarly, investors with common objectives and risks, i.e. all funds of hedge funds who have maturity transformation risk, could behave similarly under a liquidity event.

Q2-1. Does the high-level framework for identifying NBNI G-SIFIs (including the five basic impact factors) adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system and economic activity? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed? If so, why?

Answer: We agree with the five basic impact factors. We also believe that the impact factors like Interconnectedness, Complexity, and Global Activities necessitate the need for a comprehensive global unified data structure, such as the Open Protocol, that work across multiple trading strategies and business structures.

An additional impact factor that we would recommend is Concentration. For example, hedge fund managers are the dominant holders of convertible bonds and therefore the convertible bond market is disproportionately exposed to the behaviour of the hedge fund industry. Also, if a manager owns a large proportion of outstanding public market issuance of a security, their risk gets transmitted to the other holders of the same security.

Q2-2. Is the initial focus on (i) finance companies, (ii) market intermediaries, and (iii) investment funds in developing sector-specific methodologies appropriate? Are there other NBNI financial entity types that the FSB should focus on? If so, why?

Answer: We agree with the initial list.

Q3-1. Is the proposed scope of assessment outlined above appropriate for operationalising the high-level framework for identifying NBNI G-SIFIs? Are there any practical difficulties associated with the proposed scope of assessment?

Answer: While we understand the need to look at the highest level, we feel that by starting at the highest level you lose the ability to drill down to the more granular level and the flexibility to look at a different set of issues, if required. It is very difficult to predict the origin or the cause of the next crisis, therefore it is important to collect information at the lowest level. One can always aggregate information to the highest level, however it is difficult to disaggregate information to a lower level. We would recommend that you consider collecting information at the most practical granular level.

Q3-2. In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

Answer: For economic reasons it would make sense to have materiality thresholds for collecting detailed data. However, in practice materiality thresholds are difficult to implement efficiently because they rely on calculating size or total exposure. Some of the Investment funds use complex and non linear instruments which make it very difficult to calculate overall exposure. The proposed “Gross Notional Exposure” may be misleading. For example, under the current proposals all hedge funds with significant exposure to Interest Rate Derivatives (large notional but low risk) will be identified.

Alternate method would be to collect information on everybody, and then systematically look at the impact factors. If the risk of the impact factor is high for an entity then you can look at its size and other factors to access the potential of systemic risk.

Another advantage of looking at all participants irrespective of the size is that the needs of all investors and not just that of the investors of large entities are considered. The paper discusses the role that investors could play based on “full disclosure”. Having a common template will go a long way in empowering investors.

Q3-3. Are there any practical difficulties in applying the materiality thresholds?

Answer: We feel that there are a few practical difficulties in applying the materiality thresholds. We would recommend not having materiality thresholds. Instead all entities should be required to report information that would benefit the regulators and investors. This would mean that the utility of the cost for all managers is maximized. Also, since the interests of the regulators and investors are aligned, both of them would benefit.

Q3-4. In your view, what is the appropriate threshold level, taking into account the range given above (USD 400-600 billion in GNE), for hedge funds? Please also provide reasons with data to back it up.

Answer: Please refer to Question 3-2. In addition, the Open Protocol does not differentiate between small and large funds, it applies to all funds. Open Protocol also proposes that all managers should report market exposure information on a monthly basis. More frequent collection of information leads to more effective monitoring and facilitates timely action.

However, due consideration should be given to the nature of information while determining the frequency of reporting. Some information under current AIFMD template and not contained in the Open Protocol template, such as “Counter Party Risk Profile”, does not change frequently and is expensive to put together and therefore should be collected less frequently.

Q3-5. Do you think that it would be beneficial to set additional materiality thresholds based on “global activity”? If so, please explain the possible indicator and the level on which materiality thresholds should be set (with reasons for selecting such indicator, the level and any practical challenges).

Answer: Global activity is a difficult term to measure. Therefore, we would recommend a unified data structure that covers all regions. This would help in communication across regional regulators; it would also help all investors, irrespective of the region.

A comprehensive unified data structure like the Open Protocol has the potential to be Win-Win-Win solution for regulators, investors and managers.

We do not have any expertise on Finance companies and Securities broker-dealers and therefore have not answered Questions in section 4, 5 and 7.

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

Answer: Yes, the proposed definition provides a strong base onto which other structures like managed accounts could be added at a later date.

Q6-2. Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

Answer: Yes, Exposure and Asset liquidation are potentially more important. Critical function/Substitutability is less important for Investment funds.

Q6-3. Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone entity basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.

Answer: We believe that (i) Individual investment funds would be the most appropriate level to start collecting information. However, we would highlight that information should be collected at Individual "*Master"* Investment Fund level and not at the Individual Feeder Investment Fund level. The rationale for asking for information at the Master level includes:

1) In practice all investment activities are managed at the Master AIF level, feeder AIFs are just legal structures. Therefore it would be better to receive all investor, exposures, and risk information at the level where decisions are made and the majority of the costs are incurred.
2) Examining exposures at Master AIF level will lead to accurate assessment of the true magnitude of the positions and concentrations from an AIF. At the feeder level the exposures would be broken down and would under-represent the true economic exposures.
3) It is easier and cost effective for AIFMs to report at the Master AIF level.

As already mentioned in answer to question 3-1, it is easier to aggregate from bottom up and very difficult to disaggregate from top level.

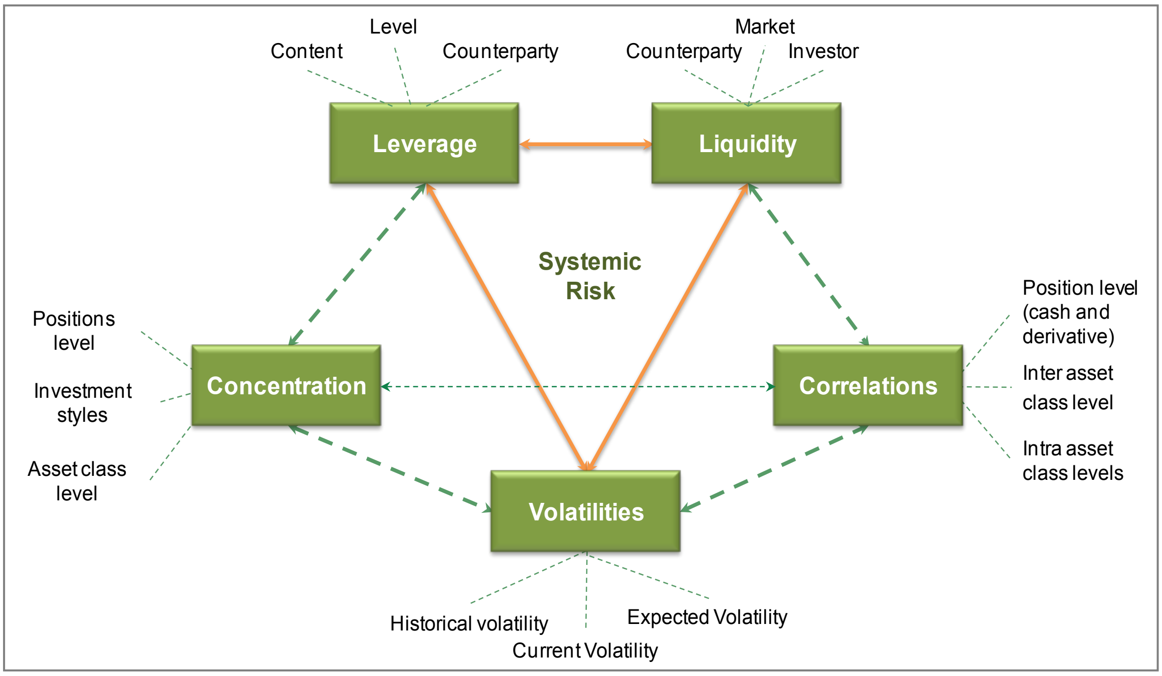
Q6-4. Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

Answer: It is difficult to predict the origin and the impact of the next systemic event. We would therefore argue that a comprehensive data collection exercise would better prepare the regulators for an unexpected systemic event.

Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

Answer: We feel that the following picture and the following explanation captures the risks arising from investment funds.

Search for Global Systemic Risk:



Leverage: Leverage is the emotive word most closely associated with Systemic Risk. Leverage could be thought of from three perspectives:

1) Level: What is the level of leverage? Generally "Long + Short" is a good starting point but the following issues need to be considered:
   - Adjustments for each asset class and instrument, for example Options: Delta adjusted; Sovereign Bonds: 10 year equivalent etc.
   - Netting rules need to be clearly defined, for example different counterparty; hedging etc
2) Content: Where is the leverage deployed?
   - Recent FCA survey suggested that hedge funds are 64x levered, however Interest Rate Derivatives and Currency account for 90% of it.
3) Counterparty: How Stable is the leverage?
   - Number of counterparties along with the credit worthiness of the counterparty.

Liquidity: Liquidity is an elusive concept and one of the more difficult metrics to measure correctly. The following three perspectives help in getting a better handle on Liquidity.

1) Market: How quickly can one exit from an existing market exposure at a reasonable price?
   - Measuring liquidity for OTE products relies on independent, regular, periodic observations.
   - There is no objective method of measuring liquidity for most OTC instruments.
   - Some OTC markets, such as Currency, are expected to be liquid due to large trading volumes from natural (non speculative) traders.
2) Investor: How stable is the investor base?
   - How quickly can the existing investors redeem from the fund?
3) Counter Party: How long can one go without renegotiating the terms of financing?
   - Periodicity of the existing financing terms with counterparties.
   - Access to additional financing if required under existing terms.

Correlation: It is important to not imply an economic relationship based purely on strong statistical correlation. Sometimes even economically sound relationships tend to break down under stress periods due to differing market dynamics. For example, under stress periods the relationship between the synthetic (unrestricted supply) and related cash instrument (restricted supply) can break down.

Volatility: Volatility can be looked at from three perspectives; first, volatility of the markets the fund has exposures to, second, historical volatility of the systematic exposures, and finally, volatility of residuals generated from the differences in actual versus expected performance. Another dimension to consider is time, i.e. Historical, Current and Expected volatility.

Concentration: Similar to liquidity, concentration also needs to be considered from the perspective of market exposure, investor base, and counterparty exposure. Market concentration can be further looked at from the perspective of the number of positions, different trading styles and exposure to different asset classes.

Q6-6. For "cross-jurisdictional activities", should "the fund's use of service providers in other jurisdictions (e.g. custody assets with service providers in jurisdictions other than where its primary regulator is based)" be used?

Answer: Yes, it is important to look at local jurisdiction of the counterparty.

Q6-7. Is the definition of "net AUM" and "GNE" appropriate for assessing the "size" (indicators 1-1 and 1-2)?
Answer: Please refer to leverage section of the answer to question 6-5. In addition, there are two asset classes where this could have misleading results:

1) Sovereign Interest Rate exposure: This is especially true where an AIF has exposure to short and long term sovereign bonds. Short term bonds have substantially lower market risk than the longer term bonds and therefore a large notional exposure to short term bonds could mask the true risk which would be in the longer term bonds. Open Protocol requires and SEC's Form PF gives the AIF the option to report all Sovereign Interest Rate exposure on a 10 year equivalent basis. Converting sovereign interest rate exposure into 10 year swap equivalent allows for better representation of risk.

   Worked example: Long $100,000,000 of 3m US T Bills
   DV01 of 3m US T Bills: 0.25
   DV01 of 10 year US Swap: 9.25
   Calculate the ratio: 0.25/9.25 = 0.027
   Report exposure as 100000000*0.027 = $2,700,000

   The basic idea here is to calculate the interest rate exposure in terms of 10 year swaps by using DV01 as the relationship.

2) Convertible Bond exposure: CESR guidelines (CESR/10-788) state that convertible bond exposure should be calculated using the following formula: Number of referenced shares * market value of underlying reference shares * delta; this methodology focuses on the equity risk of the convertible bonds and would underestimate the credit risk inherent in convertible bonds. Over the last ten years credit risk has become an increasingly larger part of total risk in convertible bonds and therefore should not be ignored. For convertible bonds Open Protocol requires AIF to report notional market value.

Q6-8. Is the definition of “investment strategies” sufficiently clear for assessing the “substitutability” (indicator 3-3)?

Answer: We do not believe that the current turnover-based proposed methodology would help in identifying “substitutability”. We would instead focus on concentration measures like percentage of outstanding market issuance held by an AIF or a group of AIF with similar strategies.

Appendix I: Attachments

1. Open Protocol Template (Excel)
2. Open Protocol Manual (PDF)
3. Open Protocol Schema (XML)