FSB FINANCIAL STABILITY BOARD

Liquidity Preparedness for Margin and Collateral Calls: Consultation report

Response to Consultation

MFA

1. **Does the outlined approach identify all key causes of some non-bank market participant's inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress? Are there any sector specific causes that should be considered?**

   The FSB's outlined approach draws from a case-study analysis of four recent episodes of liquidity stress, namely the: i) March 2020 market turmoil; ii) the Archegos failure in March 2021; iii) the 2022 turmoil in certain commodities markets; and iv) the September 2022 issues experienced by many pooled liability-driven investment ("LDI") funds. These case studies were complemented by a survey of financial authorities, and industry outreach events. Overall, the FSB identified weaknesses in liquidity risk management and governance for margin and collateral calls as key causes of market participants' inadequate liquidity preparedness.

   These weaknesses identified by the FSB are broad, non-specific high-level issues, and therefore at a surface level likely to encompass the key causes of inadequate liquidity preparedness. However, it is important to note that whilst MFA does not disagree with the aims and objectives of the Report, it appears that the FSB is attempting to apply a broad brush to all NBFI sector market participants and set out a universal set of recommendations for regulators and SSBs to consider when implementing detailed rules. The broad category of "NBFI" is not particularly useful in presenting recommendations as there are so many distinct business types under that construct, each with substantially different liquidity risk profiles. Accordingly, it is not appropriate to expect that the same set of standards of liquidity risk management will be appropriate for general application for entities in the NBFI universe.

   Furthermore, we are of the view that one of the episodes which the FSB used to inform its approach, the Archegos failure, is not an appropriate prism through which to assess the risks posed by investment funds, or NBFI sector market participants more broadly. The Archegos incident arose from the deliberate fraudulent behaviour of Archegos, amassing significant positions in certain listed securities (using total return swaps) without triggering securities ownership public disclosure requirements, which then allowed it to manipulate the price of those securities and mislead banks into providing Archegos with a continuous credit line. Subsequently, when the value of the securities underlying the total return swaps held by Archegos fell sharply, it failed to meet margin calls from its dealer banks, which prompted a fire sale as each bank rushed to sell off its positions to satisfy Archegos' defaulting swaps. This episode was further exacerbated by counterparty banks failing to enforce margin calls and waiving their own internal risk management controls. MFA also notes that, importantly, Archegos was not a regulated investment fund: rather, it was a family office managed by a single individual who is currently standing criminal trial for fraud in the US.

Whilst Archegos undoubtedly played a pivotal role in this episode, it was the failures and inadequacies in the banks' risk management frameworks permitting such a concentrated exposure to Archegos, which led to the significant losses suffered by the banks and exacerbated the systemic impact of Archegos' failure. As such, as mentioned above, in excluding the role of banks from the scope of the Report, respectfully, the FSB has not adequately considered the critical role which banks play in interfacing with the NBFI sector. However, in any event, the policing of bad actors in the industry is a separate issue to whether the system itself is inadequate. It would not be reasonable for regulators to use an extraordinary instance of unprecedented fraudulent behaviour as a baseline for calibrating the appropriate standard of liquidity risk management measures for the NBFI sector at large.

2. **Is the scope of the proposed policy recommendations appropriate?**

Although MFA supports the overall objectives of liquidity risk management and preparedness, we would point out, in particular in relation to recommendation 7, that sell-side entities, such as banks, are currently responsible for margin and collateral under the existing regulatory framework. Accordingly, if the intention of the recommendations is to set a baseline liquidity risk and collateral management standard, the scope of the proposed policy recommendations is too narrow, as it fails to capture the crucial part that these sell-side entities play. Whilst we understand that the FSB and BCBS-CPMI-IOSCO intend to address the role those entities play separately, we do not think it is appropriate to disregard the contractual and business relationship between these sell-side entities and the NBFI sector when considering liquidity risk management in the NBFI sector.

Private funds manage collateral and understand fully that they may be called upon to post additional collateral. With the exception of the uncleared margin requirements imposed on all counterparties under the European Market Infrastructure Regulation ("EMIR") and Title VII of the Dodd-Frank Act Dodd-Frank and EMIR, MFA's view is that, as they always have, collateral and margin requirements should be directly imposed on the sell-side counterparties.

If the FSB's reasoning for excluding banks from the recommendations is that they are subject to their own rules on liquidity risk management, we would note that, as the FSB has itself identified in Annex 1 to the Report, there are also a range of existing regulatory regimes that already apply liquidity risk management requirements on various NBFI sectors, including in the investment fund, insurance and pensions sectors. Each such sector has specific regulations tailored to their business types and key policy goals, such as the protection of investors, pensioners, or life insurance beneficiaries. All are subject to the market regulations that govern most entities that participate in the financial markets, such as margin regimes for derivative contracts. Exceptions are available for smaller participants because they are deemed to not have systemic implications.

The investment risks of private funds are shouldered by the sophisticated institutional investors of the funds. In the context of private credit funds for example, the US Federal Reserve recently stated that "financial stability vulnerabilities posed by private credit funds appear to be limited." The activities of private funds are best suited to market and investor protection regulation by functional regulators, rather than bank-like supervision and regulation. Private funds historically have provided resilience to financial markets in the UK, EU, and US, often during stressed market conditions. MFA therefore considers that macroprudential regulation, attempting to manage or mitigate risks for private funds, is misplaced.

Private funds also differ from other financial market participants because, critically, they are ultimately vehicles for the management of others' assets. Private funds therefore do not maintain a large balance sheet of their own assets. Private funds facilitate access to financial instruments or strategies on behalf of sophisticated investors that understand the liquidity limitations of the fund and are capable of assessing and bearing investment risks.

Private funds, regardless of strategy, are also fundamentally different from banks. Private funds are not funded by short term liabilities like deposits; instead, private fund investors commit long-term capital, are seeking superior risk-adjusted returns, without requiring frequent liquidity, and accordingly agree to redemption limits established and enforced by contractual terms established by fund managers to manage liquidity. Private fund investors are typically large, sophisticated institutional investors such as regulated financial institutions, foundations, endowments, and pension funds. Such investors understand the redemption limitations on the fund and often have multi-generational investment horizons. The liquidity risk of a given private fund is correlated to the liquidity of the underlying assets. A typical hedge fund, which is invested in a portfolio of liquid securities and other investments, may offer redemptions quarterly or longer, up to a stated percentage of the fund's assets. Once that stated percentage is met, no additional redemptions are permitted for that period. Similarly, many private credit funds are closed-ended, with redemption in the five years or more time horizon. Managing redemption amounts by contract has proven an effective means for private funds to manage liquidity risk.

The current regulatory framework already addresses any potential systemic risks post by investment fund activities. In the UK / EU, leverage limitations for investment funds are addressed both by the UCITS Directive and the Alternative Investment Managers Directive ("AIFMD") (and the recently-adopted AIFMD2 in the EU). The AIFMD also provides for extensive reporting to national regulators. On liquidity risk, the AIFMD also sets out specific rules on liquidity management limits and stress tests, including that AIFMs must carry out stress tests for each fund under both normal and exceptional liquidity conditions which cover a range of risks, such as margin calls, collateral requirements, or credit lines.

AIFMD2 has further increased such liquidity risk management requirements – EU fund managers that manage open-ended funds will have to select at least two liquidity management tools ("LMTs") from a prescribed list, including redemption gates; extension of notice periods; redemption fees; swing pricing; dual pricing; anti-dilution levies; and redemptions in kind.

In the US, the SEC has collected extensive systemic risk data from private funds for over a decade and recently enacted rules to capture even more information. In addition, there is comprehensive data collected on both swaps and futures markets activities that enable regulators to monitor activities. The regulatory regime already in place provides all the tools needed for the regulators to monitor for systemic risk events.

The data collected by the SEC quarterly on Form PF (which requires SEC registered private fund advisers to report asset, leverage, and other metrics to the SEC and the Financial Stability Oversight Council ("FSOC")) demonstrates that hedge funds do not have the same kind of liquidity mismatch that banks and some other market participants have. In a staff paper published by the SEC in March 2021 , it was noted that most hedge funds have a "negative liquidity mismatch", meaning that those funds hold relatively liquid assets compared to the combined liquidity of their liabilities plus equity. The average mismatch in the SEC's sample is -85.5 days, meaning that on average, it takes a shorter time for the typical fund to liquidate its assets than it takes for its stakeholders to reclaim their financing and redeem equity shares.

On February 8, 2024, the SEC adopted amendments to Form PF. The amendments, which the CFTC concurrently adopted, are designed to enhance the ability of the FSOC to monitor and assess any potential systemic risk and to bolster the SEC's oversight of private fund advisers and the agency's investor protection efforts. Among other things, the amendments to Form PF will require large hedge fund advisers to report investment exposures, borrowing and counterparty exposure, market factor effects, currency exposure, turnover, country and industry exposure, central clearing counterparty reporting, risk metrics, investment performance by strategy, portfolio liquidity, and financing and investor liquidity. The intent is to provide better insight into advisers and their fund operations and strategies, and improve data quality and comparability.

The above serves as an example of the variance in liquidity risk profiles of different NBFI sector market participants. Generally, liquidity mismatch risk is not likely to be a key concern for hedge funds, given relatively long redemption periods. However, for certain other funds, especially retail investment funds, where investors expect to be able to withdraw their capital on short notice, the risk posed by liquidity mismatch is higher, and likely to be an issue that is central to the liquidity risk management strategy of those entities. The assessment of what is an appropriate liquidity risk management measure for a private fund is necessarily a case-by-case analysis, and MFA respectfully notes that a 'one-size-fits-all' approach to liquidity risk management is not likely to be an appropriate solution.

3. **Is the focus of the FSB's policy recommendations on liquidity risk management and governance, stress testing and scenario design and collateral management practices appropriate? Are there any other areas the FSB should consider?**

Broadly speaking, MFA considers that the focus of the FSB's policy recommendations is appropriate, and the general aim of recommendations is sensible. We expect that, in practice, most well-run hedge funds are likely to already have liquidity risk management systems and controls that broadly align with the principles set out in the Report.

However, whilst on one hand the substance of the recommendations sound like ‘good hygiene’ as far as liquidity risk and collateral management go, there is a risk that the recommendations will encourage regulators to be overly prescriptive in their consequent rule proposals.

For example, the standard of “extreme but plausible stressed market conditions” in the context of liquidity stress testing is, in our view, not well-defined, overly broad, and subject to frequent change. Five years ago the global pandemic would have been implausible but today arguably is reasonably foreseeable. In any event, firms can and do already carry out stress tests. For example, in the US, the SEC’s Form PF requires funds to calculate 10 stress tests each quarter, and liquidity management metrics also are reported on Form PF. Contractual terms in financing agreements and derivatives contracts also provide for appropriate counterparty monitoring, which includes metrics such as NAV triggers, and concentration limits.

The Report identifies concentration risk as a relevant factor to consider for NBFI sector market participants risk profiles. As the Archegos episode illustrates, a significant cause for the failings (albeit on the banks’ parts), was due to the concentrated exposure that Archegos’ dealers had to it. However, Archegos itself was also over-exposed to specific securities, such as ViaComCBS Inc., whose share price fall triggered the fire sale and margin call defaults. While there should have been alert systems prohibiting such concentration in the first place, our view is that those systems should have been in place at the infrastructure level, i.e., through the regulatory reporting framework. At the time of the Archegos episode, the US SEC’s regulatory framework for security-based swaps was not yet in place. Archegos as a result did not have to either report or post margin on its securities-based swaps transactions. Securities-based swap reporting rules have since been implemented, and as such were a similar situation to occur in future, the SEC at least would have visibility over such large positions being built up using total return swaps and able to take action.

Similarly, in the EU, derivatives reporting requirements under EMIR gave regulators visibility over Archegos’ positions. ESMA published a risk analysis report on the Archegos episode in May 2022 stating that regulatory reporting data it received under EMIR from Archegos’ EU counterparties made it “possible to track the steep increase in concentrated exposures that [Archegos] undertook in February and March 2021” and that such data can “be used to monitor leverage and concentration risk in derivatives markets” .

Accordingly, MFA considers that regulators already have ample tools to monitor the positions of market participants (whether banks / sell-side entities, or in the NBFI sector) and can take steps to intervene where necessary. Furthermore, the Archegos example is not representative of the concentration risk profile of a ‘typical’ private fund. Generally, the private funds industry is in fact highly diverse at the investor level (as opposed to Archegos, as a family office which only invested the funds of one individual), which therefore dilutes the impact in the event of a potential failure of the fund. We would also note that principals of Archegos are currently standing criminal trial in the US for fraudulent misrepresentations made to counterparties or others.

As previously mentioned, both sell-side entities and CCPs are integral to effective collateral management. In reality, dealers and CCPs are the drivers behind margin calls, as opposed to NBFI sector market participants, which play a passive role as margin call takers. The Dodd-Frank and EMIR rules relating to clearing mandates and additional, two-way margin for uncleared swaps also are important systemic and counterparty risk mitigants. Whilst there are certain publicly available portfolio margin models used by CCPs and dealers, dealers also employ proprietary portfolio margin protocols to determine when to issue margin calls or adjust margin rates. These protocols are important for the dealers to accurately predict liquidity constraints, but are typically opaque to the NBFI counterparty, and certain of the inputs may be subjective. As such, there is a predictability issue for NBFI sector market participants, who may not be able to accurately account for potential margin calls when they are not aware of when such calls may be issued and of any unexpected changes in margin amounts or collateral.

NBFI sector market participants are therefore effectively at the whims of the dealer – they can work to ensure that their liquidity is managed vis-à-vis their investors, but in a stress event participants do not have visibility over when the dealer makes a margin call, which can materially affect the participant's liquidity and collateral management strategy. MFA is of the view that one area which the Report should consider in relation to the roles of sell-side entities, is whether recommendations should be made for dealers to provide greater transparency over their margin models, such that NBFI sector market participants which are on the receiving end of the margin calls are able to predict, and replicate, the outcomes of the banks' margin models and tailor their collateral management system appropriately.

As for specific comments in relation to the recommendations, the MFA invites the FSB to consider the following:

- Data sharing. Certain elements of the recommendations appear to set unrealistic expectations of data sharing between counterparties. For example, recommendation 3 includes a requirement for market participants to close data gaps to improve their liquidity risk management (e.g., data on volumes of OTC derivative transactions reported to trade repositories). If interpreted strictly, this could be leveraged by market participants to request information that is commercially sensitive. For example, liquidity analyses may contain highly sensitive intellectual property, which would not be appropriate to share with counterparties.

- Aggregated Stress Testing. The Report's approach of using stress testing also does not take proper account of the way in which investment funds are structured, and as previously highlighted, is an indication of the FSB painting the NBFI industry with a broad brush. The aggregate approach set out in recommendation 4 assumes that an investment fund complex is one body, and as such the stress testing can be carried out across based on collective exposure. However, the assets and liabilities of each investment fund are usually distinct, non-fungible pools of capital. The balance sheets of investment funds are not homogeneous, in the way that bank balance sheets are. Therefore, it would not be appropriate to treat assets held in multiple investment funds run by a single asset manager as if they can be aggregated and moved in a single homogeneous way.

- Eligible collateral. In addition to requirements on market participants, MFA also notes that a potential contributing factor to financial instability during stress events arises from the restrictive, and at times inconsistent rules on eligible collateral across jurisdictions.

When collateral is overly restrictive, stress events will force market participants to convert securities to cash to meet margin calls. This heightens the risk of fire sales, which therefore runs counter to the policy objective of the margin regime and in fact exacerbates, rather than reduces, risk in times of volatility. As such, whilst we agree with the general principle set out in recommendation 7 for market participants to maintain sufficient levels of assets to meet margin calls, we encourage the FSB, SSBs, and regulators to explore ways to extend, and harmonise the range of collateral that can be used to meet margin requirements.

4. **Is the approach to proportionality and materiality clear for all non-bank market participants?**

   MFA agrees broadly with the approach to proportionality and materiality set out in the Report. The factors which may be relevant when assessing the extent to which the recommendations should be applied include size, international footprint, organisational structure, business model, risk profile, degree of interconnectedness with other market participants, and role in the global financial system, as well as the potential impact of idiosyncratic and system-wide risk events. The assessment of materiality should consider the impact on the liquidity needs of NBFI sector market participants.

   These factors, in theory, provide a wide scope for interpretation. Given the diverse liquidity risk profiles between participants, as highlighted in our response to questions 1 and 2 above, a broad reading of these factors may give regulators scope to determine that, in certain cases, the recommendations may simply not be appropriate for certain classes of participants. For example, as previously highlighted, the risk posed by liquidity mismatch to hedge funds, generally speaking, is minimal, so this should reduce the applicability of those liquidity management rules so as not to impose a regulatory burden that is disproportionate to the actual risk.

   However, the Report does not specify how this sliding scale of the application of the recommendations would look in practice. The Report also leaves open the possibility that SSBs and national regulators may further specify proportionality and materiality requirements. This further reduces the practical relevance of the outlined approach, as the eventual implementation of the recommendations will likely end up bring fragmented as different regulators take divergent approaches on how to implement the proportionality and materiality assessment.

   As such, whilst the Report provides an indication as to the direction in which the FSB hopes future regulatory action will advance, in practice it provides little clarity as to what stakeholders can expect on the horizon.

5. **Section 3.1 sets out key elements of a liquidity risk management framework to identify, monitor and manage liquidity risk exposures arising from margin and collateral calls. Are these sufficiently clear for all non-bank market participants?**

   (See response to question 3)

6. **Are the recommendations on liquidity stress testing and scenario design with respect to margin and collateral calls clear and sufficiently specified?**

(See response to question 3)

7. **Are there any jurisdictional or sector-specific differences that are not accounted for in the recommendations?**

As highlighted in the questions above, MFA's key observation is that the recommendations attempt to paint the NBFI sector with a broad brush, which does not sufficiently consider the myriad differences between sectors, and potentially even within sectors.

For example, private funds which have lock-up periods of multiple years may not benefit significantly from annual re-evaluations of the materiality of liquidity risks, which may place an undue burden on the fund and result in increased costs for the investors. Furthermore, within the investment fund sector, depending on the different strategies a manager employs, funds may have dramatically different risk profiles.

The FSB at times also appears to overlook the existing rules which apply to certain NBFI sectors, and under certain jurisdictional regimes, as exemplified in its assertion on page 6 of the Report that "leveraged hedge funds face minimal directly applicable liquidity risk rules, if any". We refer to our response to question 2 noting the that the existing liquidity risk rules under the AIFMD on this point make the Consultation recommendations unnecessary. Both the Dodd-Frank Act and EMIR, to which private funds are subject, have implemented a detailed margin regime for cleared and uncleared swaps and, importantly, all CCP and firm-developed models are subject to regulatory approval. If regulators are dissatisfied with the margin models of CCPs and dealers, they can insist upon changes to them. The Report would therefore benefit from a more comprehensive understanding of the existing rules that already apply to market participants grouped under the NBFI definition.

8. **Collateral readiness at the right time, quality and location is a critical aspect of effective liquidity preparedness for spikes in margin and collateral calls to mitigate the risk of having to liquidate collateral under stressed market conditions. Do the FSB's recommendations in Section 3.3 address all key elements required to be effective in mitigating liquidity risk arising from margin and collateral calls?**

(See response to question 3)

9. **Are there any material challenges to collateral management practices that some non-bank market participants may face that should be considered?**

As highlighted in the discussion to the questions above, the role of banks should not be excluded from discussions of collateral management practices for NBFI sector market participants, given the central role they play. Accordingly, publishing recommendations without due consideration of the contractual and business relationship between such participants and their sell-side counterparties is likely to result in substantial gaps, or unintended consequences which will run counter to the intended purpose of the final recommendations.

If you have any additional comments, please provide them below.

June 18, 2024

By online submission

Financial Stability Board
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Liquidity Preparedness for Margin and Collateral Calls: Consultation report

Dear Sir/Madam,

MFA[1] appreciates the opportunity to represent the views of the global alternative investment industry in this written response to the Financial Stability Board's ("**FSB**") consultation report on liquidity preparedness for margin and collateral calls (the "**Report**"). We have set out our responses to the relevant questions of the Report in the online form to which this letter is enclosed.

In summary, MFA considers that, whilst the recommendations provided by the FSB are, broadly speaking, examples of sound collateral management practice, they present a risk of encouraging Standard Setting Bodies ("**SSBs**") and national regulators to enact overly prescriptive rules in relation to liquidity risk management for participants in the non-bank financial intermediation ("**NBFI**") sector. The assessment of what is an appropriate liquidity risk management measure for a private fund is necessarily a case-by-case analysis, so MFA respectfully notes that a 'one-size-fits-all' approach to liquidity risk management is not likely to be an appropriate solution.

Furthermore, under the existing regulatory frameworks which impose margin / collateral requirements on dealers, as well as specific regulatory regimes which impose margin / collateral requirements on derivative counterparties, policymakers already have ample authority to address potential systemic risk issues. We

[1] Managed Funds Association ("**MFA**"), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member fund managers, including traditional hedge funds, credit funds, and crossover funds, that collectively manage over $3.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

highlight these matters in our responses. We further note the importance of the FSB's work with this Consultation as it was a subject of the FSB's Plenary last week in Toronto.[2]

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MFA appreciates the opportunity to provide these comments to the FSB in response to the Report. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Jeff Himstreet (jhimstreet@mfaalts.org) or the undersigned (jflores@mfaalts.org).

Respectfully submitted,

/s/ Jillien Flores

Jillien Flores
Executive Vice President
Head of Global Government Affairs
Managed Funds Association

[2] *See* FSB Plenary meets in Toronto (14 Jun. 2024) avail. at https://www.fsb.org/2024/06/fsb-plenary-meets-in-toronto/.

ANNEX

CHAPTER 2. CONSULTATION QUESTIONS

Section 1

1. **Does the outlined approach identify all key causes of some non-bank market participant's inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress? Are there any sector specific causes that should be considered?**

   MFA Response

   The FSB's outlined approach draws from a case-study analysis of four recent episodes of liquidity stress, namely the: i) March 2020 market turmoil; ii) the Archegos failure in March 2021; iii) the 2022 turmoil in certain commodities markets; and iv) the September 2022 issues experienced by many pooled liability-driven investment ("**LDI**") funds. These case studies were complemented by a survey of financial authorities, and industry outreach events. Overall, the FSB identified weaknesses in liquidity risk management and governance for margin and collateral calls as key causes of market participants' inadequate liquidity preparedness.

   These weaknesses identified by the FSB are broad, non-specific high-level issues, and therefore at a surface level likely to encompass the key causes of inadequate liquidity preparedness. However, it is important to note that whilst MFA does not disagree with the aims and objectives of the Report, it appears that the FSB is attempting to apply a broad brush to all NBFI sector market participants and set out a universal set of recommendations for regulators and SSBs to consider when implementing detailed rules. The broad category of "NBFI" is not particularly useful in presenting recommendations as there are so many distinct business types under that construct, each with substantially different liquidity risk profiles. Accordingly, it is not appropriate to expect that the same set of standards of liquidity risk management will be appropriate for general application for entities in the NBFI universe.

   Furthermore, we are of the view that one of the episodes which the FSB used to inform its approach, the Archegos failure, is not an appropriate prism through which to assess the risks posed by investment funds, or NBFI sector market participants more broadly. The Archegos incident arose from the deliberate fraudulent behaviour of Archegos, amassing significant positions in certain listed securities (using total return swaps) without triggering securities ownership public disclosure requirements, which then allowed it to manipulate the price of those securities and mislead banks into providing Archegos with a continuous credit line. Subsequently, when the value of the securities underlying the total return swaps held by Archegos fell sharply, it failed to meet margin calls from its dealer banks, which prompted a fire sale as each bank rushed to sell off its positions to satisfy

Archegos' defaulting swaps. This episode was further exacerbated by counterparty banks failing to enforce margin calls and waiving their own internal risk management controls. MFA also notes that, importantly, Archegos was not a regulated investment fund: rather, it was a family office managed by a single individual who is currently standing criminal trial for fraud in the US.

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Section 2

2. **Is the scope of the proposed policy recommendations appropriate?**

<u>MFA Response</u>

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[3] We note that in the US, banking regulators have begun to address the role of banks in contributing to the Archegos default. *See* SR 21-19, The Federal Reserve Reminds Firms of Safe and Sound Practices for Counterparty Credit Risk Management in Light of the Archegos Capital Management Default (10 Dec. 2021), avail. at https://www.federalreserve.gov/supervisionreg/srletters/SR2119.htm.

appropriate to disregard the contractual and business relationship between these sell-side entities and the NBFI sector when considering liquidity risk management in the NBFI sector.

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Private funds, regardless of strategy, are also fundamentally different from banks. Private funds are not funded by short term liabilities like deposits; instead, private fund investors commit long-term

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4 Throughout this comment letter, we use the term "private funds" to include both US-based private funds in addition to alternative investment funds ("**AIFs**") domiciled in the EU and/or UK.

5 https://www.federalreserve.gov/publications/2023-may-financial-stability-report-leverage.htm

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The data collected by the SEC quarterly on Form PF (which requires SEC registered private fund advisers to report asset, leverage, and other metrics to the SEC and the Financial Stability Oversight Council ("**FSOC**")) demonstrates that hedge funds do not have the same kind of liquidity mismatch that banks and some other market participants have. In a staff paper published by the SEC in March

2021[6], it was noted that most hedge funds have a “negative liquidity mismatch”, meaning that those funds hold relatively liquid assets compared to the combined liquidity of their liabilities plus equity. The average mismatch in the SEC’s sample is -85.5 days, meaning that on average, it takes a shorter time for the typical fund to liquidate its assets than it takes for its stakeholders to reclaim their financing and redeem equity shares.

On February 8, 2024, the SEC adopted amendments to Form PF. The amendments, which the CFTC concurrently adopted, are designed to enhance the ability of the FSOC to monitor and assess any potential systemic risk and to bolster the SEC’s oversight of private fund advisers and the agency’s investor protection efforts. Among other things, the amendments to Form PF will require large hedge fund advisers to report investment exposures, borrowing and counterparty exposure, market factor effects, currency exposure, turnover, country and industry exposure, central clearing counterparty reporting, risk metrics, investment performance by strategy, portfolio liquidity, and financing and investor liquidity. The intent is to provide better insight into advisers and their fund operations and strategies, and improve data quality and comparability.

The above serves as an example of the variance in liquidity risk profiles of different NBFI sector market participants. Generally, liquidity mismatch risk is not likely to be a key concern for hedge funds, given relatively long redemption periods. However, for certain other funds, especially retail investment funds, where investors expect to be able to withdraw their capital on short notice, the risk posed by liquidity mismatch is higher, and likely to be an issue that is central to the liquidity risk management strategy of those entities. The assessment of what is an appropriate liquidity risk management measure for a private fund is necessarily a case-by-case analysis, and MFA respectfully notes that a ‘one-size-fits-all’ approach to liquidity risk management is not likely to be an appropriate solution.

3. **Is the focus of the FSB’s policy recommendations on liquidity risk management and governance, stress testing and scenario design and collateral management practices appropriate? Are there any other areas the FSB should consider?**

Broadly speaking, MFA considers that the focus of the FSB’s policy recommendations is appropriate, and the general aim of recommendations is sensible. We expect that, in practice, most well-run

6 https://jai.pmresearch.com/content/iijaltinv/24/1/26.full.pdf

hedge funds are likely to already have liquidity risk management systems and controls that broadly align with the principles set out in the Report.

However, whilst on one hand the substance of the recommendations sound like ‘good hygiene’ as far as liquidity risk and collateral management go, there is a risk that the recommendations will encourage regulators to be overly prescriptive in their consequent rule proposals.

For example, the standard of “extreme but plausible stressed market conditions” in the context of liquidity stress testing is, in our view, not well-defined, overly broad, and subject to frequent change. Five years ago the global pandemic would have been implausible but today arguably is reasonably foreseeable. In any event, firms can and do already carry out stress tests. For example, in the US, the SEC’s Form PF requires funds to calculate 10 stress tests each quarter, and liquidity management metrics also are reported on Form PF. Contractual terms in financing agreements and derivatives contracts also provide for appropriate counterparty monitoring, which includes metrics such as NAV triggers, and concentration limits.

The Report identifies concentration risk as a relevant factor to consider for NBFI sector market participants risk profiles. As the Archegos episode illustrates, a significant cause for the failings (albeit on the banks’ parts), was due to the concentrated exposure that Archegos’ dealers had to it. However, Archegos itself was also over-exposed to specific securities, such as ViaComCBS Inc., whose share price fall triggered the fire sale and margin call defaults. While there should have been alert systems prohibiting such concentration in the first place, our view is that those systems should have been in place at the infrastructure level, i.e., through the regulatory reporting framework. At the time of the Archegos episode, the US SEC’s regulatory framework for security-based swaps was not yet in place. Archegos as a result did not have to either report or post margin on its securities-based swaps transactions. Securities-based swap reporting rules have since been implemented, and as such were a similar situation to occur in future, the SEC at least would have visibility over such large positions being built up using total return swaps and able to take action.

Similarly, in the EU, derivatives reporting requirements under EMIR gave regulators visibility over Archegos’ positions. ESMA published a risk analysis report on the Archegos episode in May 2022 stating that regulatory reporting data it received under EMIR from Archegos’ EU counterparties made it “possible to track the steep increase in concentrated exposures that [Archegos] undertook in February and March 2021” and that such data can “be used to monitor leverage and concentration risk in derivatives markets”[7].

[7] https://www.esma.europa.eu/sites/default/files/library/esma50-165-2096_leverage_and_derivatives_the_case_of_archegos.pdf

Accordingly, MFA considers that regulators already have ample tools to monitor the positions of market participants (whether banks / sell-side entities, or in the NBFI sector) and can take steps to intervene where necessary. Furthermore, the Archegos example is not representative of the concentration risk profile of a 'typical' private fund. Generally, the private funds industry is in fact highly diverse at the investor level (as opposed to Archegos, as a family office which only invested the funds of one individual), which therefore dilutes the impact in the event of a potential failure of the fund. We would also note that principals of Archegos are currently standing criminal trial in the US for fraudulent misrepresentations made to counterparties or others.

As previously mentioned, both sell-side entities and CCPs are integral to effective collateral management. In reality, dealers and CCPs are the drivers behind margin calls, as opposed to NBFI sector market participants, which play a passive role as margin call takers. The Dodd-Frank and EMIR rules relating to clearing mandates and additional, two-way margin for uncleared swaps also are important systemic and counterparty risk mitigants. Whilst there are certain publicly available portfolio margin models used by CCPs and dealers, dealers also employ proprietary portfolio margin protocols to determine when to issue margin calls or adjust margin rates. These protocols are important for the dealers to accurately predict liquidity constraints, but are typically opaque to the NBFI counterparty, and certain of the inputs may be subjective. As such, there is a predictability issue for NBFI sector market participants, who may not be able to accurately account for potential margin calls when they are not aware of when such calls may be issued and of any unexpected changes in margin amounts or collateral.

NBFI sector market participants are therefore effectively at the whims of the dealer – they can work to ensure that their liquidity is managed vis-à-vis their investors, but in a stress event participants do not have visibility over when the dealer makes a margin call, which can materially affect the participant's liquidity and collateral management strategy. MFA is of the view that one area which the Report should consider in relation to the roles of sell-side entities, is whether recommendations should be made for dealers to provide greater transparency over their margin models, such that NBFI sector market participants which are on the receiving end of the margin calls are able to predict, and replicate, the outcomes of the banks' margin models and tailor their collateral management system appropriately.

As for specific comments in relation to the recommendations, the MFA invites the FSB to consider the following:

- **Data sharing**. Certain elements of the recommendations appear to set unrealistic expectations of data sharing between counterparties. For example, recommendation 3 includes a requirement for market participants to close data gaps to improve their liquidity risk management (e.g., data on volumes of OTC derivative transactions reported to trade repositories). If interpreted strictly, this could be leveraged by market participants to request information that is commercially sensitive. For example, liquidity analyses may contain highly sensitive intellectual property, which would not be appropriate to share with counterparties.
- **Aggregated Stress Testing**. The Report's approach of using stress testing also does not take proper account of the way in which investment funds are structured, and as previously highlighted, is an indication of the FSB painting the NBFI industry with a broad brush. The aggregate approach set out in recommendation 4 assumes that an investment fund complex is one body, and as such the stress testing can be carried out across based on collective exposure. However, the assets and liabilities of each investment fund are usually distinct, non-fungible pools of capital. The balance sheets of investment funds are not homogeneous, in the way that bank balance sheets are. Therefore, it would not be appropriate to treat assets held in multiple investment funds run by a single asset manager as if they can be aggregated and moved in a single homogeneous way.
- **Eligible collateral**. In addition to requirements on market participants, MFA also notes that a potential contributing factor to financial instability during stress events arises from the restrictive, and at times inconsistent rules on eligible collateral across jurisdictions. When collateral is overly restrictive, stress events will force market participants to convert securities to cash to meet margin calls. This heightens the risk of fire sales, which therefore runs counter to the policy objective of the margin regime and in fact exacerbates, rather than reduces, risk in times of volatility. As such, whilst we agree with the general principle set out in recommendation 7 for market participants to maintain sufficient levels of assets to meet margin calls, we encourage the FSB, SSBs, and regulators to explore ways to extend, and harmonise the range of collateral that can be used to meet margin requirements.

4. **Is the approach to proportionality and materiality clear for all non-bank market participants?**

   <u>**MFA Response**</u>

   MFA agrees broadly with the approach to proportionality and materiality set out in the Report. The factors which may be relevant when assessing the extent to which the recommendations should be applied include size, international footprint, organisational structure, business model, risk profile, degree of interconnectedness with other market participants, and role in the global financial system, as well as the potential impact of idiosyncratic and system-wide risk events. The assessment of materiality should consider the impact on the liquidity needs of NBFI sector market participants.

   These factors, in theory, provide a wide scope for interpretation. Given the diverse liquidity risk profiles between participants, as highlighted in our response to questions 1 and 2 above, a broad reading of these factors may give regulators scope to determine that, in certain cases, the recommendations may simply not be appropriate for certain classes of participants. For example, as previously highlighted, the risk posed by liquidity mismatch to hedge funds, generally speaking, is minimal, so this should reduce the applicability of those liquidity management rules so as not to impose a regulatory burden that is disproportionate to the actual risk.

   However, the Report does not specify how this sliding scale of the application of the recommendations would look in practice. The Report also leaves open the possibility that SSBs and national regulators may further specify proportionality and materiality requirements. This further reduces the practical relevance of the outlined approach, as the eventual implementation of the recommendations will likely end up bring fragmented as different regulators take divergent approaches on how to implement the proportionality and materiality assessment.

   As such, whilst the Report provides an indication as to the direction in which the FSB hopes future regulatory action will advance, in practice it provides little clarity as to what stakeholders can expect on the horizon.

Section 3.1

5. **Section 3.1 sets out key elements of a liquidity risk management framework to identify, monitor and manage liquidity risk exposures arising from margin and collateral calls. Are these sufficiently clear for all non-bank market participants?**

   (See response to question 3)

Section 3.2

6. **Are the recommendations on liquidity stress testing and scenario design with respect to margin and collateral calls clear and sufficiently specified?**

   (See response to question 3)

7. **Are there any jurisdictional or sector-specific differences that are not accounted for in the recommendations?**

   MFA Response

   As highlighted in the questions above, MFA's key observation is that the recommendations attempt to paint the NBFI sector with a broad brush, which does not sufficiently consider the myriad differences between sectors, and potentially even within sectors.

   For example, private funds which have lock-up periods of multiple years may not benefit significantly from annual re-evaluations of the materiality of liquidity risks, which may place an undue burden on the fund and result in increased costs for the investors. Furthermore, within the investment fund sector, depending on the different strategies a manager employs, funds may have dramatically different risk profiles.

   The FSB at times also appears to overlook the existing rules which apply to certain NBFI sectors, and under certain jurisdictional regimes, as exemplified in its assertion on page 6 of the Report that "leveraged hedge funds face minimal directly applicable liquidity risk rules, if any". We refer to our response to question 2 noting the that the existing liquidity risk rules under the AIFMD on this point make the Consultation recommendations unnecessary. Both the Dodd-Frank Act and EMIR, to which private funds are subject, have implemented a detailed margin regime for cleared and uncleared swaps and, importantly, all CCP and firm-developed models are subject to regulatory approval. If regulators are dissatisfied with the margin models of CCPs and dealers, they can insist upon changes to them. The Report would therefore benefit from a more comprehensive understanding of the existing rules that already apply to market participants grouped under the NBFI definition.

Section 3.3

8. **Collateral readiness at the right time, quality and location is a critical aspect of effective liquidity preparedness for spikes in margin and collateral calls to mitigate the risk of having to liquidate collateral under stressed market conditions. Do the FSB's recommendations in Section 3.3 address all key elements required to be effective in mitigating liquidity risk arising from margin and collateral calls?**

   (See response to question 3)

9. **Are there any material challenges to collateral management practices that some non-bank market participants may face that should be considered?**

   As highlighted in the discussion to the questions above, the role of banks should not be excluded from discussions of collateral management practices for NBFI sector market participants, given the central role they play. Accordingly, publishing recommendations without due consideration of the contractual and business relationship between such participants and their sell-side counterparties is likely to result in substantial gaps, or unintended consequences which will run counter to the intended purpose of the final recommendations.