May 13, 2019

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Financial Stability Oversight Council
1500 Pennsylvania Ave, NW
Room 2208B
Washington, D.C. 20220

Re: **MFA, AIMA, and ACC Comments on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies**

Dear Sir or Madam:

Managed Funds Association[1] ("MFA"), the Alternative Investment Management Association[2] ("AIMA") and the Alternative Credit Council[3] ("ACC") (collectively, the "Associations") appreciate the opportunity to respond jointly to the Financial Stability Oversight Council's (the "Council") proposed interpretive guidance, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (the "Proposed Guidance"). The Associations support a number of the changes the Proposed Guidance would make in withdrawing and replacing

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

2 AIMA is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

3 The ACC is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 170 members that manage $400bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy, providing finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well as the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts, and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

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The Alternative Investment Management Association Ltd

prior interpretive guidance from the Council regarding the designation process. In particular, we believe that the proposals to (1) focus on activities-based regulation, instead of entity designations, to address identified financial stability risk concerns, (2) increase coordination with primary financial regulators, and (3) provide an "off-ramp" for nonbank firms both pre- and post-designation are significant improvements compared to prior guidance.

In addition to the proposed changes to the designation process, as part of the activities-based approach, the Proposed Guidance asks several questions regarding leverage and how the Council and its member agencies should assess leverage in connection with the potential for risks that pose a threat to financial stability. As discussed in more detail below, the Associations believe it is important for regulators to assess leverage in a manner consistent with the following principles. First, it is important to acknowledge that leverage by itself does not equal risk. Second, because leverage can decrease risk, it is important for regulators to develop an analytical approach that distinguishes between leverage that increases risk and leverage that decreases risk. Finally, it also is important for regulators, as they assess leverage and risks arising from leverage, to distinguish "investment risk" or "counterparty risk" from any risk that poses a "threat to financial stability."

As noted in the Proposed Guidance, Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") established the Council to, among other things, "identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace" and provided the Council with authority to address identified risks that pose a threat to financial stability in multiple ways. In deciding whether to exercise the Council's authority under Section 120, Section 113, or other provisions of Title I of the Dodd-Frank Act, it is important for the Council to clearly identify what constitutes a risk that poses a threat to financial stability. In that regard, we support the Council's decision to define "threat to financial stability" and we believe that focusing on risks "of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict severe damage on the broader economy"[4] is an appropriate interpretation of the types of threats to financial stability Congress enacted Title I of the Dodd-Frank Act to address.

Given the size, structure, and risk management practices of the hedge fund industry as well as the comprehensive regulatory framework to which they are subject, we believe it is unlikely that there are risks to financial stability arising from hedge fund activities or from a hedge fund winding down, even as a result of financial distress. One such feature of the industry is the diversity of investment strategies used by funds (*e.g.,* long/short equity, macro, relative value, and credit strategies). Accordingly, we do not believe that there are regulatory gaps with respect to financial stability risk such that additional financial stability risk rules are likely to be necessary for hedge funds or hedge fund managers. We believe the lack of financial stability risk associated with the hedge fund industry is demonstrated by the fact that hedge funds wind down without causing market impact or financial stability risk. No hedge fund closure created "substitutability" concerns or otherwise threatened the broader financial system during the 2008 crisis or since then. In addition, regulations implemented and market practices adopted since the financial crisis have further reduced the likelihood that counterparty exposures to hedge funds or the liquidation of assets held by one or more hedge funds, even in periods of market stress, could have widespread impact on the financial system or cause any significant harm to a hedge fund's counterparties.

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4 84 Federal Register at 9041 (May 13, 2019).

We recognize, of course, that the Council and its member agencies must work through their own processes to determine whether any regulatory gaps exist, and we look forward to continuing to engage constructively with the Council and its member agencies as part of their processes. In considering whether any regulatory or information gaps remain, we believe it is important for the Council and its member agencies to consider whether existing rules, individually or collectively, already address the identified risk. We also encourage the Council and its member agencies to consider the cumulative impact on firms from the many regulatory actions that have been taken since the financial crisis to mitigate risks, particularly with respect to hedge funds, their activities, and their counterparty relationships. It also is important that the Council and its member agencies ensure that any consideration of new rules takes into account the existing regulatory framework and that any consideration of new rules is based on analysis of a comprehensive risk framework, supported by adequate data collection and assessment, and not make decisions before such analysis is complete.

Financial Stability Risk Regulation – Activities Versus Entity Designation

The Associations support the Council's proposal to emphasize an activities-based approach to addressing identified financial stability risks instead of emphasizing the designation of entities for enhanced supervision and oversight under section 113 of the Dodd-Frank Act. We believe that any regulations intended to address identified financial stability risks should be applied to all market participants. We believe that regulation of activities is the most appropriate regulatory framework because that framework has the benefit of addressing fundamental market behaviors and investment activities that represent sources of risk comprehensively and in a manner that is even-handed and limits opportunities for regulatory arbitrage. With a comprehensive focus on markets and investing activities, regulators can strengthen the system as a whole, rather than merely changing characteristics of certain isolated individual market participants.

Role of Primary Financial Regulators

We also believe that regulation of capital markets activities is best accomplished by primary financial regulators, such as the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") for the capital markets activities of investment funds, rather than bank regulators. Examples of an activities-based approach include:

(1) Regulations implemented under Title VII of the Dodd-Frank Act, such as central clearing and margin requirements, which apply to markets holistically and approach sources of potential risk on a market structure-basis.

(2) Market-wide circuit breaker rules under the Plan to Address Extraordinary Market Volatility Pursuant to Rule 608 of Regulation NMS (*i.e.*, the Limit Up Limit Down Plan).

(3) Hedge fund managers provide detailed information directly to the SEC and the CFTC and those reports also are available to the Council and the Office of Financial Research.

We of course believe that capital markets regulation must still be reasonably tailored to address the identified policy concerns and that any rules should be enacted in a way to accomplish the intended regulatory purpose while minimizing burdens on industry.

We continue to have concerns with the potential application of rules designed for banks to non-banks and non-bank activities such as capital markets activities. Because Council designation of a non-bank financial firm would lead to enhanced prudential regulation by the Board of Governors of the Federal Reserve, and that regulatory framework would use bank regulations as the basis for regulating designated firms, we believe that the designation approach for non-bank firms is fundamentally the wrong approach to regulation of capital markets participants and their activities. U.S. capital markets are a strength of the U.S., and global, economy and provide economic growth and resilience. We believe that bank-like regulation of capital markets activities, such as those of investment funds, would distort and undermine the risk taking and risk allocation that are fundamental to the operation of our capital markets. For these reasons, we not only support the Council's proposal that primary financial regulatory agencies should address identified financial stability risks through the activities-based process, but also suggest that any decision by the Council to designate a nonbank financial company for prudential regulation through the Section 113 process require the affirmative consent of the company's primary financial regulatory agencies.

Pre- and Post-Designation "Off-Ramp"

We believe that activities-based regulation rather than Council designation of non-banks is the better regulatory framework. We recognize, however, that the Proposed Guidance maintains Council designations as a regulatory tool if the activities-based approach does not successfully address an identified financial stability risk. In that regard, we support the Council's proposal to provide so-called "off-ramps" from Council designation for companies under consideration for designation and for companies that have been previously designated. Providing a company the opportunity to address activities that the Council has identified as posing financial stability risk, both pre- and post-designation, should be viewed as a preferable outcome from the standpoint of regulators and market participants as it would allow market participants to avoid the adverse consequences of being designated as systemically important (which for an investment fund could put the fund out of business because of the imposition of bank-like rules) and would allow regulators to avoid having to develop rules to try to manage the identified financial stability risk(s).

Future Modification of Proposed Guidance

The Associations welcome the Council's rulemaking related to the Proposed Guidance, which provides that the Council will not amend or rescind the interpretive guidance without providing the public an opportunity for notice and comment under the Administrative Procedure Act. Given the important implications of financial stability risk regulation for firms and capital markets generally, we believe it is critical for the Council to provide the opportunity for public review and comment of changes to the guidance. As the Council and its member agencies work to further develop the proposed activities-based approach to financial stability risk regulation, we encourage the Council and its member agencies to provide as much transparency through public notice and comment as practicable.

Additional Proposals

While the Associations believe the issues discussed above, along with the Council's consideration of leverage, are of most importance, we recognize that the Proposed Guidance makes a number of other proposed changes to prior guidance from the Council. We believe that a number of the proposed changes are valuable modifications to the Council's prior guidance. In particular, we support the Council's proposal to assess the likelihood of a nonbank firm's material financial distress as part of the designation process, as both the likelihood of a firm's material financial distress and the effects if a firm were in material financial distress are important factors in assessing whether a firm poses financial stability risk. We also support the Council's proposal to conduct a cost-benefit analysis prior to making a decision to designate a nonbank financial firm.

Comments on Assessment of Leverage

The Proposed Guidance requests public comment in several questions with respect to leverage and the potential for leverage to create financial stability risk concerns. The Associations have consistently engaged with U.S. and non-U.S. regulators, as well as international bodies, regarding how regulators should collect data and assess the use of leverage, the broader framework in which regulators can assess whether leverage increases or decreases risk, and the extent to which any financial stability risk may arise from the use of leverage.

As noted above, the Associations believe it is important for the Council and its member agencies to assess leverage in a manner consistent with the following principles. First, it is important to acknowledge that leverage by itself does not equal risk. Second, because leverage can decrease risk, it is important for regulators to develop an analytical approach that distinguishes between leverage that increases risk and leverage that decreases risk. Finally, it also is important for regulators, as they assess leverage and risks arising from leverage, to distinguish "investment risk" or "counterparty risk" from risks that pose a "threat to financial stability." In that regard, we believe that the Council's proposed definition of "threat to financial stability" is appropriately focused on risks that could inflict severe damage on the broader economy, which we believe is consistent the types of financial stability risks that Congress sought to address in enacting Title I of the Dodd-Frank Act.

We further believe that it is important that the Council be clear that its assessment process does not mean that an investment fund or activity necessarily will be identified as potentially posing a risk to financial stability. We believe that the Council's proposed two-step approach is consistent with that principle as it contemplates that further consideration and regulatory work must be done *if* the Council identifies a financial stability risk concern. In that regard, we encourage the Council to state in the guidance that a possible result of the Council's assessment of leverage is that no financial stability risk concerns exist.

<u>Measuring Leverage by Asset Class</u>

The Associations strongly recommend that leverage metrics for a fund be assessed on an asset class-by-asset class basis, rather than as a single aggregate number.[5] Because asset classes each have distinct risk exposures,[6] leverage metrics based on a single aggregate number across asset classes do not provide a meaningful basis on which to make an assessment of the risks associated with an investment fund's use of leverage and are likely to mislead regulators. The IOSCO Consultation expressly acknowledges the benefits of measuring leverage by comparing asset class-by-asset class exposures to net asset value and recommends that regulators assess leverage metrics *by asset class* and not as an aggregated single number. This approach supports the key policy objective

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5 We note that this is consistent with recommendations from the International Organization of Securities Commissions' ("IOSCO") November 2018 consultation report on assessing the use of leverage by investment funds (the "IOSCO Consultation").

6 For example, the risk profile of a $10 million position in interest rate swaps is very different from the risk profile of a comparably sized position in credit default swaps.

to develop measures that allow for meaningful monitoring of leverage for financial stability purposes. We note that the IOSCO Consultation provides what the Associations believe is a reasonable approach to determine the asset class breakdown.[7]

The significant differences in the relative riskiness of underlying asset types in derivatives contracts make a single aggregated leverage number meaningless; for example, a fund may have higher exposure to derivatives to gain exposure to low-risk assets, while a different fund may have more modest derivatives exposure, but to higher risk assets. In this scenario, a single aggregated measure of leverage can make funds with very different investment strategies appear similar, obscuring important differences. Avoiding the shortcomings of a single aggregated number by adopting an asset class-by-asset class model also gives regulators the ability to sum and compare similar exposures across relevant sets of leveraged funds allowing for a better assessment of the leverage-related risks posed by different funds across the financial system.

Gross Notional Exposure (GNE), Adjusted GNE, and Net Notional Exposure

We recognize that different leverage metrics have respective strengths and weaknesses to measure and assess the use of leverage by investment funds. We continue to believe that notional measures of leverage, particularly unadjusted gross notional exposure ("GNE"), are misleading in that they do not represent the amount of leverage or risk of an investment fund's investment positions. To the extent that regulators decide to use notional based metrics however, certain adjustments and netting should be used in an effort to make the metrics more risk sensitive, as outlined below. In that regard, we welcome the Proposed Guidance's acknowledgement that "leverage can be measured by the ratio of … *economic risk* to capital" and that such a "measurement can better capture the effect of derivatives…"[8] We believe this speaks to the need to develop risk-based, as opposed to pure notional-based, metrics.

We believe that adjusted GNE metrics ("Adjusted GNE") can provide regulators with a more meaningful measurement than unadjusted GNE, for example, by permitting adjustments to interest rate derivatives in terms of ten-year bond equivalents and permitting delta adjustments for options. Therefore, to the extent that regulators decide to use notional-based metrics, we recommend that the Council and its member agencies discourage the use of unadjusted GNE and instead clarify that it is mainly useful as a building block for calculating Adjusted GNE, on an asset class basis as opposed to a single aggregated number. We believe that including certain types of netting or hedging in calculating Adjusted GNE would provide a more refined metric to the Council and its member agencies.

In addition, we believe that net notional exposure ("NNE") may be an incrementally more useful and risk-sensitive metric. To the extent that regulators use notional-based metrics, we encourage the use of NNE either as an additional and complementary step to be considered alongside Adjusted GNE or as a standalone metric. Permitting the netting or hedging of eligible positions would add further refinement to the identification of risk, on an asset class basis. As with Adjusted GNE, we understand that NNE has strengths and weaknesses. However, depending on the type of risk assessment the Council or one of its member agencies is considering, NNE may be a useful metric in conducting an assessment of investment funds, especially in combination with Adjusted GNE. To maximize the potential utility of NNE, we encourage the Council and its

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7 *See* table on page 11 of the IOSCO Consultation.

8 84 Federal Register at 9043 (May 13, 2019).

member agencies to take a flexible approach in considering NNE to permit appropriate netting and hedging arrangements.

Supplementary Data Points

The Associations believe that the Council and its member agencies should consider supplementary data points in combination with leverage metrics to develop a more comprehensive assessment.[9] We believe that the IOSCO Consultation contains a useful list of additional data points that would help the Council and its member agencies assess what type(s) of leverage a fund is using, how the fund is using, measuring and managing its leverage, and how the use of leverage might impact the fund if it had to unwind. Consistent with this, we also encourage the Council and its member agencies consider what types of derivatives a fund is using and whether those derivatives are used primarily for hedging/risk management purposes or for other purposes. We believe this additional information and comprehensive approach would enable regulators to better determine what risks, if any, are created by a fund's use of leverage and whether such risks would rise to the level of a threat to financial stability.

Closed-ended funds

A further point which we think should be considered is how to assess leverage in closed-ended funds which raise capital through binding, contractual commitments from institutional investors which are drawn down when required. Those closed-ended funds also commonly arrange for subscription line financing, secured by the capital commitments from investors. This is particularly the case with direct lending funds. As such commitments are not typically reflected in the net asset value of the fund, the proposed metrics may give rise to a misleading impression that those closed-ended funds are leveraged. We, therefore, recommend that the Council and its member agencies consider how best to assess leverage by closed-ended funds to avoid misinterpreting such types of financing.

Implementation Considerations

We appreciate that the Proposed Guidance provides some additional clarity on how the Council and its member agencies will implement an activities-based approach. We believe, however, that the Council should continue to work to provide further clarification for the two-step approach. With respect to step one, the identification of financial stability risk, we encourage the Council to provide additional details on how it will analyze data within the context of the four framing questions and how it will determine how and when identified risks present financial stability risk concerns that require further regulatory action. The Proposed Guidance contemplates further discussions with relevant regulators as part of this additional analysis, but we encourage the Council also to engage with market participants and to utilize the public notice and comment process as it works to develop the analytical framework.

With respect to the proposed second step, implementing regulatory actions to address identified financial stability risk, we believe that a guiding principle for regulators is to clearly determine whether any risks identified in the Council's proposed two-step process create financial stability risk policy concerns and, if so, whether regulatory action is needed to address those policy concerns. As part of that process, we encourage the Council to state explicitly in the final guidance

[9] We note that this is consistent with the recommended approach in the IOSCO Consultation.

that the proposed step one assessment process does not presuppose that regulatory action will be necessary.

We also encourage the Council to develop guiding principles to help primary regulators distinguish risks that pose a threat to financial stability from investor protection or other types of risks that primary regulators also must address. We believe that regulators should be careful to distinguish between risks that may give rise to investor protection concerns from risks that may give rise to financial stability concerns to better focus on the key policy objective of identifying and addressing financial stability risk concerns. In that regard, the Associations also encourage the Council to note that the policy objective of assessing leverage is not to prevent investment funds from taking risks. As capital markets participants, investment funds are required to take market risks for achieving investors' investment objectives (*e.g.,* investment risk).

Coordination

As the Council considers how best to assess leverage for financial stability risk purposes, we believe it is important for the Council and its member agencies to consider how regulators can develop a coordinated approach to this issue, to avoid subjecting globally active firms to multiple, competing and sometimes contradictory approaches by regulators in multiple jurisdictions. We, therefore, recommend that the Council include language recognizing the importance of coordination among regulators to avoid duplicative or unnecessarily burdensome requirements on investment funds, particularly those funds that pool capital from investors in multiple jurisdictions and invest globally. For globally-pooled funds, we recommend that the Council and its member agencies work with their international counterparts to establish the principle of a "Primary Designated Regulator" based on where an asset manager's primary place of business is; this would help to alleviate duplicative and/or contradictory approaches across multiple jurisdictions.

The Associations thank the Council for the opportunity to provide these comments on the Proposed Guidance. We welcome the opportunity to continue to work with the Council and its member agencies and provide any additional information that may be required. Please do not hesitate to contact the undersigned, or Benjamin Allensworth or Laura Harper Powell of MFA at (202) 730-2600, or Jennifer Wood at +44 20 7822 8380 should you have any questions.

Respectfully submitted,

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