February 1, 2019

Via Email: consultation-08-2018@iosco.org

International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Re: **MFA, AIMA and ACC Comments on IOSCO Report: Leverage**

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 International Organization of Securities Commissions' ("IOSCO") consultation report on assessing the use of leverage by investment funds (the "Consultation Report"). The Associations welcome IOSCO's constructive approach to consulting with stakeholders, and we are pleased that that the Consultation Report includes a number of helpful recommendations regarding the collection and assessment of leverage

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. 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 140 members that manage $350bn 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.

information in the broader context of assessment of risk. In this letter we identify those IOSCO recommendations that we strongly support, including that the risk metrics proposed for step one only be expressed by asset class and not in aggregate across heterogenous asset types. We also enumerate several areas where we believe the IOSCO recommendations could be further improved, including with respect to the proposed second step on assessing risk. The Associations recommend that the Consultation Report state clearly that leverage metrics should be used to consider whether a fund's leverage might increase risk to the financial system as a whole and that this not be conflated with firm-level market or other idiosyncratic risks in a portfolio.

Comments on Proposed Metrics

Measuring Leverage by Asset Class

The Associations strongly support the Consultation Paper's recommendation that leverage metrics for a fund be assessed on an asset class by asset class basis, rather than as a single aggregate number. The Consultation Report expressly acknowledges the benefits of measuring leverage by comparing asset class-by-asset class exposures to net asset value, and we encourage IOSCO to strengthen that recommendation in its final report. Further, we understand that the intent in drafting the Consultation Report was to recommend that regulators assess any of the three potential leverage metrics (gross notional exposure, adjusted gross notional exposure, and net notional exposure) *by asset class* and not as an aggregated single number.

The structure of the Consultation Report creates some confusion as to whether the asset class approach is intended to be an alternative approach to the use of the three metrics set out in step one. Accordingly, we encourage IOSCO to clarify that the recommendation is not an alternative 'fourth approach', but rather a clear recommendation that national securities/capital markets regulators assess leverage on an asset class basis regardless of which of the step one leverage metrics, or combination of one or more step one metric(s) and supplementary information, that the appropriate national securities/capital markets regulator determines to use.

Such a recommendation supports the key policy objectives of the Financial Stability Board to develop measure/s which address the shortcomings of existing measures and allow for more meaningful monitoring of leverage for financial stability purposes. We also believe the asset class breakdown included in the table on page 11 of the Consultation Paper would be a reasonable approach for regulators to use for a fund's exposure amount in any leverage metric.

Because asset classes each have distinct risk exposures,[4] 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 supervisors in step two.

The significant differences in the relative riskiness of underlying asset types in derivatives contracts make a single aggregated leverage number meaningless or spurious; 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.

[4] For example, a $10 million position in interest rate swaps is very different from a comparably sized position in credit default swaps.

Avoiding the shortcomings of a single aggregated number by adopting a by-asset class model also gives regulators the ability to sum and compare similar asset 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 appreciate that the Consultation Report sets out multiple metrics as well as discusses the respective strengths and weaknesses of the proposed metrics to measuring and assessing the use of leverage by investment funds. We continue to believe that gross 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.

We believe the adjusted GNE metric ("Adjusted GNE") provides regulators with a more meaningful measurement than unadjusted GNE by permitting adjustments to interest rate derivatives in terms of ten-year bond equivalents and permitting delta adjustments for options. We, therefore, recommend that IOSCO discourage the use of unadjusted GNE as a metric 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 also believe that including certain types of netting or hedging in calculating Adjusted GNE would provide a more refined metric to regulators. Accordingly, we encourage IOSCO to provide that regulators can choose to include appropriate netting or hedging arrangements as part of an Adjusted GNE metric.

We also appreciate the Consultation Report's inclusion of net notional exposure ("NNE") as a potential metric for assessing an investment fund's use of leverage. We would specifically 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 as a way to measure leverage. However, depending on the type of risk assessment a regulator is considering, NNE may be a useful metric in conducting an initial assessment of investment funds, especially in combination with Adjusted GNE. To maximize the potential utility of NNE, we encourage IOSCO to clarify that national securities/capital markets regulators should apply NNE in a flexible manner to permit appropriate netting and hedging arrangements. Accordingly, we welcome IOSCO's acknowledgement of the strengths and weaknesses of a regulator using NNE as a standalone metric in making an initial assessment, similar to the discussion regarding GNE and Adjusted GNE.

Appendix B of the Consultation Paper also requests comment on whether regulators should consider any of the additional metrics included in the Appendix. We believe that the "cons" listed in the Appendix with respect to stress-based leverage/worst loss measures accurately reflect the problems in trying to standardize those approaches and why those approaches can mislead regulators. We, therefore, encourage IOSCO not to include those additional metrics in its recommendations to regulators.

Long and Short Position Reporting

In question 15 of the Consultation Report, IOSCO notes that GNE and Adjusted GNE represent the sum of the absolute values of an investment fund's long and short positions, without netting or hedging. The Consultation Report also notes that the U.S. Securities and Exchange Commission's Form PF does not require asset managers to report positions that are closed out with the same counterparty and result in no credit or market exposure for a fund. We believe that approach on Form PF is the correct one, because aggregating the absolute values of "matched" long and short positions to assess an investment fund's leverage or risk will provide regulators with spurious and misleading information. If IOSCO disagrees, we encourage IOSCO to recommend that long and short positions be reported separately, at least with respect to long and short positions that do not create credit or market exposure.

Supplementary Data Points

The Associations agree that regulators should consider supplementary data points in combination with the step one leverage metrics to develop a more comprehensive assessment. We support IOSCO's identification of additional data points that would help a regulator 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 encourage IOSCO to recommend that regulators 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 systemic risk.

Closed-ended funds

A further point which we think should be considered is how to assess in step one those 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 IOSCO consider excluding such types of financing from step one.

Comments on Step Two Assessment

The Associations agree with the Consultation Report that leverage by itself does not equal risk (as noted in the Consultation Report, the use of leverage may decrease risk in a portfolio). 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. It also is important for regulators, as they assess leverage, to distinguish "investment risk" from "systemic risk" that arises from the use of leverage. Accordingly, regulators will need to conduct an additional, refined analysis after step one to determine whether the results of the metrics should prompt further regulatory consideration by the primary securities regulator, bearing in mind that asset managers should not be assessed like deposit-taking institutions.

We believe that it is important that the assessment process proposed by IOSCO does not create the impression that investment funds will be identified as potentially posing a risk to financial stability. In that regard, we encourage IOSCO to explicitly state in the Consultation Report that regulators have the discretion to determine that no step two assessment is required following step one and to remove language, such as the initial sentence in Chapter 4 of the Consultation Report, which could be interpreted as suggesting that step one will identify investment funds that require further assessment.

Operational Implementation of the IOSCO Recommendations

We believe it is important to set out at this stage the importance of not subjecting globally active funds to multiple, competing and sometimes contradictory approaches by regulators in multiple jurisdictions. We, therefore, recommend that IOSCO include language on the importance of coordination among national 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. Indeed, the proposed two-step framework may not be appropriate or necessary for funds within jurisdictions that already have well-developed systems for calculating, collecting and analyzing data and information related to fund leverage.[5] For globally-pooled funds, we recommend that IOSCO 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.

In addition to the specific comments on the Consultation Report discussed above, we encourage IOSCO to include guiding principles or other similar language that we believe would help place the actions contemplated by the Consultation Report in the broader context regarding systemic risk. Because the Consultation Report is being issued by IOSCO, we presume that the discussion about regulators conducting assessments is referring to the relevant national securities/capital markets regulators in each jurisdiction. Given that the Consultation Report is being issued following the FSB's work on systemic risk, we encourage IOSCO to clarify that national securities/capital markets regulators that have primary responsibility for investment funds and asset managers should perform the assessments contemplated by the Consultation Report.

We note that the Consultation Report does not contemplate or discuss what regulators may decide to do with the information they collect as part of the two-step assessment process. As a threshold matter, we encourage IOSCO to state explicitly in the final report that the proposed assessment process does not presuppose that regulatory action will be necessary and that national securities/capital markets regulators would need to undertake further steps to determine if any regulatory action is needed and, if so, what action should be taken.

We also encourage IOSCO 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). As such, we believe that a guiding principle for regulators is to undertake further work to determine whether any risks identified in the proposed two-step assessment create policy concerns and, if so, whether regulatory action is needed to address those policy concerns. We also 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 systemic risk concerns. Investor protection issues are not part of this IOSCO mandate, and are the primary responsibility of national regulators. We encourage IOSCO to include language in the final report providing guidance to national regulators on how they may distinguish between such policy objectives.

Finally, given the concerns discussed above regarding GNE, we believe that there is a significant risk that public reporting of GNE figures, particularly figures that aggregate across asset classes, will be misinterpreted and create uncertainty and confusion regarding the use of leverage by

[5] *See* Consultation Report at p. 2 ("In the absence of an existing framework, IOSCO encourages regulators to look to this work to inform any initiatives related to establishing their own measurement processes.")

investment funds. Therefore, if IOSCO continues to recommend GNE as one possible metric in its final report (as explained above, we would discourage using GNE without adjustment), the Associations urge that information be reported privately to regulators and not provided in public reports developed by regulators based on privately reported information. In addition, because of the sensitivity of the data regulators are collecting to assess leverage and risk, it is critical that the data is kept confidential and subject to strict data security processes and robust protections. Public disclosure of this highly sensitive information could not only jeopardize an individual firm but also cause broader market disruption.

The Associations thank IOSCO for the opportunity to provide these comments on the Consultation Report. We welcome the opportunity to continue to work with IOSCO and its members 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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