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

January 13, 2016

Via Electronic Filing:

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Managed Funds Association Comments on Liquidity Risk Management Open-End Fund Liquidity Risk Management Programs; Swing Pricing; File No. S7-16-15

Dear Mr. Fields:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "SEC" or the "Commission") proposed rules, "Liquidity Risk Management Open-End Fund Liquidity Risk Management Programs; Swing Pricing" (the "Proposed Rules"). MFA supports the underlying goal of the rule proposal, which is to ensure that registered investment funds and their managers have appropriate liquidity risk management practices and procedures. For the reasons discussed below, we support the activities-based approach of the proposed rule and the proposed scope of application to open-end registered investment companies, given the particular liquidity risks they face. We encourage the SEC to adopt final rules that provide registered investment companies and managers appropriate flexibility to tailor their liquidity risk management programs to their asset and liability profiles. We believe that mandating an overly rigid risk management framework could give rise to potential unintended consequences, including herd-like behavior that increases rather than mitigates system-wide liquidity risk.

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1 The Managed Funds Association (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.

In general, MFA supports an activities-based approach to addressing market-wide concerns. We agree with the Commission's statement that the Proposed Rules may mitigate potential systemic risk concerns that have been identified by systemic risk regulators and believe that an activities-based approach is the appropriate way to address those types of policy concerns. We believe that the Commission has appropriately identified the scope of investment funds and managers for coverage under the Proposed Rule. As discussed below, funds that do not offer daily liquidity are significantly less exposed to liquidity risks and have several powerful tools at their disposal to structure their liability profiles in accordance with the liquidity profiles of their assets.

Private Funds are Appropriately Excluded from the Scope of the Proposed Rules

We agree with the Commission's proposal to exclude private funds from the scope of the rule. As noted in the Commission's release, private funds structure investors' redemption rights in light of the strategy and liquidity of their portfolios and use a variety of liquidity risk management tools to manage and mitigate liquidity risk.[2] Perhaps most importantly, private funds are not subject to regulations requiring prompt redemption and generally limit investor redemption rights to specific points in time, with advance notice requirements.[3] These measures support a more stable capital profile than an open-end fund structure that has daily redemptions.

Private funds, such as hedge funds, use a broad array of contractual tools to manage capital outflows, including:

- *Limited investor redemption rights*. Hedge funds have established redemption periods, sometimes monthly, and often quarterly, annually, or even less frequently, depending on the fund's investment strategy.

- *Lock-up periods*. Hedge funds also often limit investors' ability to withdraw some or all of their investments for periods of time after their initial investment. For example, a fund that normally allows for monthly redemptions may institute an initial six-month or one-year lock-up period during which investors are not able to redeem their interests.

- *Advance notice requirements*. Hedge funds require investors to notify the fund manager of their desire to redeem a specified number of days (usually 30 to 90 days) prior to the requested withdrawal date. Advance notice provides managers time to generate cash to meet redemption requests.

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2 As noted in the SEC's release, MFA's March 2015 letter to the Financial Stability Oversight Council, *available at*: https://www.managedfunds.org/wp-content/uploads/2015/03/MFA_Response_to_Dec_2014_FSOC_Notice1.pdf, discussed in detail the key characteristics of the hedge fund industry, the risk management tools used by hedge fund managers, and the regulatory regime applicable to the hedge fund industry.

3 For example, private funds are not subject to Section 22(e) of the Investment Company Act of 1940, or the rules thereunder.

- *Fees for early redemptions*. Some funds provide investors with the ability to redeem earlier if they pay an early redemption fee. That fee not only deters investors from making premature redemptions, but also serves to defray any costs associated with the sale of assets for the benefit of the remaining investors.

- *Side pockets*. Hedge funds' contracts may also allow managers to establish side pockets to hold investments that are illiquid or difficult to value. Side pockets have more restrictive redemption provisions than their associated main funds, and redemptions from side pocket vehicles are generally only allowed when realizations occur.

- *Gates*. If redemption requests in a given redemption period exceed a certain specified threshold (*e.g.*, 10% of assets), a fund may have a so-called "gating" mechanism that limits redemptions beyond the threshold level. In subsequent periods, the gate can be triggered again until all redemption requests can be met or the fund is wound down. Although the precise terms of gates can vary from fund to fund, common types of gates include fund-level gates, which limit the percentage of assets a fund is obligated to redeem on any given redemption date, and investor-level gates, which are applied on an investor-by-investor basis and limit the amount any one investor can redeem at a time (*e.g.*, 25% of its investment per quarter). These gates are clearly stated in investor subscription agreements, and it was not uncommon for funds to apply gates during the global financial crisis.

- *Limited suspensions of redemptions*. Fund agreements often permit the general partner or board of a fund to suspend redemptions during the course of unusual events (*e.g.*, a significant market disruption such as severe market-wide liquidity issues or market dislocations) at the manager's discretion. This kind of provision is used infrequently in practice but provides another tool to manage acute liquidity issues that can arise during periods of severe market stress.

- *Redemptions in-kind*. Fund agreements often permit redemptions in-kind. If a fund does not have enough cash on hand to meet redemptions in cash or believes that redeeming in-kind is in the best interest of all fund investors (*e.g.*, to avoid selling assets at depressed prices to the detriment of redeeming and remaining investors), the manager may distribute the assets held by the fund to redeeming investors on a *pro rata* basis. We note that this is extremely rare in practice, as the other liquidity mechanisms discussed above are usually more than sufficient to allow the manager to ensure that any outflows are orderly.

Although hedge funds, to various degrees, have implemented the tools described above to address liquidity risks related to investor redemptions, managers generally avoid using tools such as side pockets, suspensions of redemptions or redemptions in-kind unless, pursuant to their fiduciary obligations, the fund's interests as a whole would be better protected. In fact, as fiduciaries and in accordance with the Investment Advisers Act of

1940, all private fund managers are obligated to make decisions with respect to redemptions that are in the best interests of their clients.

Hedge funds also use a variety of tools to monitor and manage financing risks.[4] The hedge fund industry has exhibited consistent and modest use of leverage over time, as exhibited in the Commission's reporting on Form PF submissions. The Commission's report also shows that funds that hold illiquid or hard to value assets generally utilize less leverage than funds that hold more liquid assets.[5] In addition, the Commission has shown that hedge funds rely much more on secured than unsecured borrowings. Secured borrowing structures, pursuant to which borrowers pledge assets to lenders on a mark-to-market basis, reduce lender credit risk. See below for a summary of some of the hedge fund industry's most prominent funding risk management practices:

- *Asset Liquidity Assessments*. Managers often assess asset liquidity on an ongoing basis, taking into account key asset characteristics such as instrument type, historical trading volume, bid-ask spreads, etc. This work helps them understand their ability to liquidate assets when necessary to reduce risk or meet redemption requests.

- *Balanced Term Structure*. Hedge funds manage the term structure of their credit arrangements in light of their investor profiles, including contractual restrictions on redemptions, as well as the liquidity of their assets. Hedge funds frequently negotiate for term financing and, since the financial crisis, have extended the duration of their borrowing arrangements to provide greater funding stability.[6]

- *Collateral Requirements*. Hedge fund borrowing is generally collateralized on a daily mark-to-market basis. Daily variation margin requirements, which require both counterparties to post margin if their position begins to lose money, considerably reduce the risk of a sizeable, destabilizing margin call at

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4 *See* MFA, SOUND PRACTICES FOR HEDGE FUND MANAGERS (ed. 2009), *available at* https://www.managedfunds.org/wp-content/uploads/2011/06/Final_2009_complete.pdf, *see also*, ASSET MANAGER'S COMM., PRESIDENT'S WORKING GRP. ON FIN. MKTS., BEST PRACTICES FOR HEDGE FUND MANAGERS (Jan. 2009), *available at*: http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/bestpractices.pdf.

5 *See* 2013 OFR Annual Report stating that "funds with larger leverage ratios may be choosing assets that are relatively easier to dispose of during a crisis." More specifically, the 2013 OFR Annual Report explored the relationship between a hedge fund's leverage and the portion of its assets that are less liquid by sorting hedge funds into five categories, with the first category containing funds that reported zero leverage on Form PF and the other four categories containing the remaining funds, broken into quartiles. The OFR report showed: "Hard-to-value assets represent a little more than 20 percent of the assets of funds with no leverage. For the category of funds with the highest leverage . . . the corresponding fraction was less than 5 percent." OFR report at 94 (citations omitted).

6 This is supported, for example, by the FSA studies on the hedge fund industry which found that the assets of the surveyed hedge funds could be liquidated in a shorter timeframe than the period after which their liabilities (to investors and finance providers) would become due. *See, e.g.*, FSA, ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS 8 (July 2010), *available at* http://www.fsa.gov.uk/pubs/other/hf_report.pdf.

any point in time. Providing collateral to lenders also increases the likelihood that financing will be provided on an ongoing basis, since lenders take less counterparty credit risk under secured funding structures than if they were to lend on an unsecured basis.

- *Counterparty Diversification*. Hedge funds seek to diversify their financing relationships to ensure ongoing availability of funds. They also conduct diligence on their counterparties to understand their risk management practices and assess the risk of counterparty default. Counterparty exposures are disclosed to regulators in Form PF, Form CPO-PQR and Form CTA-PR filings. Funds benefit from customer protection rules, and we have advocated for additional rules that would further buttress protection of customer collateral and margin, even in the event of a counterparty default. The MFA has also advocated for increased access for buy-side market participants to central clearing facilities.

- *Cash Buffers*. Hedge funds often hold a portion of their assets in cash and cash equivalents, generally referred to as a cash buffer, and use cash buffers to address liquidity pressures. Excess cash can be used to meet margin calls, and balances held are often calibrated to reflect potential increases in margin requirements associated with portfolio market risk.

- *Back-Up Credit Facilities*. A small number of hedge funds enter into back-up credit agreements that provide liquidity on an as-needed basis. These funds can be used to meet redemption requests, fund margin requirements or for other purposes.

- *Stress Tests*. Many hedge funds run periodic liquidity stress tests on their funds' assets and liabilities. Managers consider a range of possible scenarios as part of their testing, including, for example: what would happen if certain categories of financing dry up or lenders pull back on the amount of leverage they are willing to offer? These tests do not deliver pass/fail results, but ensure awareness of key liquidity factors and highlight potential risks. Managers also monitor liquidity risk metrics, such as the ratio of available cash to the amount of financing or the levels of margin and risk of demand for additional margin. These approaches help managers develop an understanding of risks and potential mitigating actions.

As noted above, private fund managers of larger funds report information in Form PF filings that allows the SEC, the Office of Financial Research ("OFR") and the Financial Stability Oversight Council (the "Council") to monitor fund liquidity, taking into account asset liquidity profiles as well as investor redemption rights.[7] This transparency allows regulators to confirm that the protections that we describe above are in place. According to the SEC, data collected on Form PF reflected that funds expected to be able to liquidate

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7 The Commodity Futures Trading Commission collects similar information from commodity pool operators and commodity trading advisors in its Form CPO-PQR and Form CTA-PR, respectively.

more than 50% of their assets within seven days, and more than 80% within 90 days,[8] suggesting that the liquidity terms commonly used in hedge fund structures are well matched to the assets in the funds. It is also important to note that private fund investors, who are generally sophisticated investors, as well as their third-party consultants, also monitor these issues diligently.[9] Private fund investors understand that their ability to redeem funds may be limited and generally do not view these investments as short-term sources of cash.[10]

We believe that the liquidity risk management tools and approaches described above are well-suited to the broad array of asset classes that private funds hold. These practices help mitigate liquidity risks across the private fund industry and therefore benefit the system as a whole.

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8 *See* Form PF Questions 32, 46, 48, 49, 50, 63, 64. The SEC has analyzed hedge fund liquidity information collected on Form PF in the past. The SEC staff has compiled the following chart showing the percent of aggregated qualifying hedge funds reported on Form PF portfolios capable of being liquidated within certain time periods. SEC STAFF REPORT, PRIVATE FUND STATISTICS, at Table 31, page 26 (October 2015).

Percent of Aggregate Net Asset Value	Time Period
29.2%	1 day or less
56.6%	7 days or less
74.3%	30 days or less
83.3%	90 days or less
87.5%	180 days or less
90.8%	365 days or less

9 *See, e.g.*, Deutsche Bank Global Prime Finance, *Third Annual Operational Due Diligence Survey*, at 21, 49 (Summer 2014), *available at* https://www.managedfunds.org/wp-content/uploads/2014/07/Third-Annual-Deutsche-Bank-Operational-Due-Diligence-Survey-Summer-2014.pdf (citing that 73% of investor due diligence teams ranked fund compliance and regulatory framework as one of their top areas of focus, more than any other area, and that 95% of investors plan to review a fund's Form ADV as part of their pre-investment and ongoing due diligence). *See also generally* AIMA Investor Steering Comm., *A Guide to Institutional Investors' Views and Preferences Regarding Hedge Fund Operational Infrastructures* (2011), *available at* http://www.aima.org/download.cfm/docid/CF822EF3-CB7A-4B13-81A7949E4C97C0AA.

10 Regulators have acknowledged that, because hedge fund investors are sophisticated, they may be less likely to withdraw funds during times of stress. As an August 2008 publication from the Federal Reserve Bank of Dallas explained, "[h]edge funds typically require a minimum investment, sometimes $1 million or more. The restriction usually limits participants to relatively sophisticated investors who would conduct considerable due diligence before investing and be unlikely to withdraw their funds on a whim." Jeffery W. Gunther & Anna Zhang, *Hedge Fund Investors More Rational Than Rash*, 2 ECON. LETTER—FED. RESERVE BANK OF DALLAS 3, Aug. 2007, *available at* http://www.dallasfed.org/assets/documents/research/eclett/2007/el0708.pdf. Despite the fact that their investors are sophisticated and are unlikely to withdraw their funds on a whim, hedge funds did face significant redemptions during the financial crisis in 2008. *See* International Financial Services London, *Hedge Funds 2009*, at 1 (Apr. 2009), *available at* http://www.finalternatives.com/node/7511 ("Hedge funds returned 13.2% of investors' assets in 2008. . . . This is only the second time over the past two decades that the industry has suffered an annual net outflow of funds."). Importantly, however, these net outflows did not have any systemic effect on the wider financial system. Rather, hedge funds were able to manage redemption requests by using their contractual tools, such as gates and suspensions. Those funds that were unable to meet their redemptions requests uneventfully liquidated or merged into other funds.

Appropriate Tailoring of Risk Management Practices

Unlike banks, neither asset managers nor their investment funds have access to federal borrowing facilities. Fund managers understand the dire consequences of failing to appropriately manage liquidity risk and invest significant time and effort into ensuring that their liability profiles are appropriate given their asset mix.

We believe that it is critical for all managers to investment funds, private and registered alike, to tailor their liquidity risk management approaches to their strategies and assets. As such, we believe that a prescriptive and potentially overly precise 'one-size fits all' approach to liquidity risk management and reporting, even with respect to rules that are limited to open-end registered investment companies, would not enhance risk management. In fact, we believe that such an approach could give rise to unintended consequences for markets by creating procyclical forces that push asset managers into herd-like behavior. Accordingly, we encourage the SEC to ensure that its final rules provide sufficient flexibility to registered investment company managers in designing and implementing their liquidity risk management programs.

Conclusion

MFA appreciates the opportunity to comment on the Proposed Rules. If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other regulatory issues, please do not hesitate to contact Benjamin Allensworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice-President and Managing
Director, General Counsel