**MANAGED FUNDS ASSOCIATION**

June 21, 2007

Communications Division
Public Information Room
Mail Stop 1-5
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, DC 20219

Re: Docket No. 06-09

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, DC 20551

Re: Docket No. R-1261

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W. Washington, DC 20552

Re: No. 2006-33

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corp.
ATTN: Comments/Legal ESS
550 17th Street, N.W.
Washington, DC 20429

Re: RIN 1550-AB56

Re: Notice of Proposed Rulemaking on Risk-Based Capital Standards: Advanced Capital Adequacy Framework

Dear Sir or Madam:

Managed Funds Association ("MFA")[1] is writing this letter to express our strong concern that the Joint Notice of Proposed Rulemaking: Risk-Based Capital Standards: Advanced Capital Adequacy Framework[2] (hereinafter "Basel II regulatory proposal") will be interpreted as imposing an unreasonably high and punitive capital charge on equity investments in hedge funds. This capital charge will unnecessarily interfere with

[1] MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. MFA is the primary source of information for policymakers and the media, and the leading advocate for sound business practices and industry growth. Established in 1991, MFA's more than 1,300 members represent the vast majority of the 100 largest hedge fund groups in the world, and include advisers who manage a substantial portion of the over $1.5 trillion invested in absolute return strategies.

[2] 71 Fed. Reg. 55830 (2006)

the efficient operation of the U.S. hedge fund industry, is inconsistent with the Basel II framework being implemented internationally, and puts U.S. institutions at a distinct competitive disadvantage in the global marketplace.

## I. Potential Interpretation of the Proposed Rule

Under the Basel II framework, capital charges for equity investments are adjusted according to the "risk weight" of the holding. The higher the risk weight assigned to the position, the higher the capital requirement.

The Basel II regulatory proposal does not state how investments in a hedge fund should be risk weighted; however, we understand from regulatory staff that these investments may be considered equivalent to the lowest tranche of a two tranche "securitization" exposure. If that interpretation is adopted, equity investments in a hedge fund will be risk weighted at 1,250 percent, e.g. they will be deducted, dollar for dollar, from the bank's regulatory capital. Other equity investments, on the other hand, are subject to much lower risk weights. For non-publicly traded equities, banks are given a choice of methodologies, and depending on which method is used, the risk weight will be either 400 percent, or a minimum of 300 percent with an adjustment based on the bank's internal models. Equity investments in publicly traded companies would be generally risked weighted 100 basis points lower. Equity investments in mutual funds are subject to different rules, and banks would essentially be able to "look through" the investment company and base the risk weight on the make up of the underlying assets. However, under the U.S. proposal, this treatment would not be available to funds with "material liabilities."

The 1,250 percent risk weight suggested for hedge fund equities is a punitive capital charge that is not supported by facts or policy considerations. It would significantly diminish investments in hedge funds by banking organizations. It is inconsistent with the proposed capital requirements for other equity investments and the terms of the Basel II Accord. It cannot be justified by safety and soundness concerns, and is inconsistent with the goal of making the U.S. financial services industry more internationally competitive.

## II. The Role of Hedge Funds in the U.S. Financial System

Hedge funds play an important and productive role in the U.S. financial system. As noted last February by the President's Working Group on Financial Markets, "private pools of capital bring significant benefits to the financial markets."[3] These benefits include enhanced diversification opportunities for investors, increased liquidity for the

[3] Agreement among the President's Working Group and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, February 22, 2007.

financial markets, more efficient pricing of capital instruments, and decreased market volatility.[4] Hedge funds also provide protection to regulated institutions through the intermediation of credit risks.

Recently, Tim Geithner, President of the New York Federal Reserve Bank, summarized the important role played by hedge funds as follows:

> "...Private leveraged funds have become an important source of protection to regulated institutions by being large sellers of credit insurance in the rapidly growing market for credit default swaps.
>
> In terms of enhancing overall market efficiency, the growth of these private leveraged institutions can be expected to provide benefits in terms of improved liquidity, price discovery via arbitrage, diversity of opinion and diversification opportunities for investors. The increase in share of assets managed by private pools of capital devoted to arbitrage activity should improve the overall functions of markets. In most circumstances, increased trading and participation contributes to market liquidity and makes markets less volatile. The ultimate benefit should be lower risks for all market participants. This in turn should ... ultimately reduce the cost of capital."[5]

These benefits depend upon a hedge fund industry that has access to investment capital. The imposition of a punitive capital charge on such investments will restrict the flow of investment to hedge funds, thereby limiting the ability of these funds to participate in the capital markets and provide the benefits noted above.

## III. Proposal is Inconsistent with Basel II

Unlike the U.S. proposal, the Basel II Accord that was agreed to internationally does not distinguish equity investments in hedge funds from other equity investments. Under the Accord, these investments are risk weighted at 400 percent, or given a risk weight based on a bank's internal models with a floor of 300 percent. If the equity holding qualifies as an investment in an investment company, the look through approach would also be available. The Basel Committee has issued numerous studies concerning the risks posed by "highly leveraged" institutions, and issued supervisory recommendations for bank interactions with these institutions in 1999.[6] The Basel II

[4] Financial Stability Forum, "Update of the FSF Report on Highly Leveraged Institutions" at 8-9 (May 19, 2007).
[5] Tim Geithner, "Hedge Funds and Derivatives and Their Implications of the Financial System" (Sept. 15, 2006).

[6] Basel Committee on Bank Supervision, "Banks' Interactions with Highly Leveraged Institutions," (Jan. 1999). See also, Basel Committee on Banking Supervision, "Review of Issues Relating to Highly Leveraged Institutions," (March 2001).

Accord does not attempt to limit bank investments in hedge funds through punitive capital charges, but instead considers any concerns in this area to be a matter for bank supervision under Pillar 2 of the Accord.[7]

Imposing higher capital charges for investments made by U.S. institutions than foreign banking organizations provides a direct competitive advantage to those foreign banks. From the point of view of a banking organization, capital requirements directly relate to the cost of the asset, and the higher the capital charge the higher the cost. A 1,250 percent capital charge is prohibitive, and the ability and willingness of U.S. banking organizations to make equity investments in these funds will be significantly impaired. Foreign banks will not be so disadvantaged and will be able to hold equity in the hedge fund industry to a far greater extent then U.S. institutions. This is not sound public policy at a time when U.S. international competitiveness needs to be strengthened, not diminished.

## IV. Punitive Risk Weight For Equity Investments in Hedge Funds is Arbitrary and Capricious

Under the Administrative Procedures Act, agencies may not be "arbitrary or capricious" when promulgating regulations. The imposition of a 1,250 risk weight for equity investments in hedge funds can be viewed as nothing other than arbitrary and capricious.

The arbitrary nature of the proposal is evidenced in several ways. It applies inconsistent rules for *equivalent* investments in other companies. For example, an equity investment in non-publicly traded start up companies will often be more highly leveraged than an investment in a typical hedge fund, but would be risk weighted at 300 to 400 percent, not 1,250 percent.

Further, the proposal makes no differentiation based on the risk of the fund, its overall investment strategy, or whether the fund has made information available to investors regarding the degree, maturity, or terms of its leverage. It also ignores other factors, such as valuation methodology, risk management systems, value at risk limits, the historic returns of the fund through various economic cycles, and the other indicia of risk noted by the President's Working Group.[8] In fact, recent studies indicate that many

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[7] Pillar 2 of the Accord provides for on-going supervisory review of the banking organization's operations, and permits refinements in capital requirements based on that review. It is institution specific rather than an across-the-board capital requirement.

[8] The President's Working Group recommends that investors in hedge funds should evaluate the objectives, strategies, risks, fees, liquidity, performance history, and other relevant characteristics of the fund. The Basel II proposal would ignore the very factors that the PWG found to be important criteria in assessing and controlling the risk of bank involvement in hedge funds.

hedge funds exhibit a low rate of volatility[9] and can provide an important hedge that reduces the overall risk in a bank's investment portfolio.[10]

The arbitrary nature of the proposal is also evidenced by the fact that the published proposal fails to explain the rationale for such a punitive capital charge, or to discuss potential adverse impacts. It does not provide any justification for this treatment.

Finally, the imposition by the U.S. only of this charge is inconsistent with the two underlying principles of Basel II: (i) to more closely align capital to risk; and (ii) to establish internationally uniform capital standards.

V. The Proposal Is Not Justified By Safety and Soundness

The safety of bank involvement with hedge funds, both through credit and equity exposures, has been the subject of numerous studies, reports and regulatory scrutiny. The Federal banking agencies issued guidance on risk management practices for bank involvement with hedge funds to assure that banks have the necessary systems and policies in place.[11] Federal supervisors actively monitor and conduct targeted reviews of bank's dealings with hedge funds.[12] Recently Federal Reserve Board Chairman Bernanke concluded that "ongoing improvements in counterparty risk management and the resultant strengthening of market discipline appear to have limited hedge fund leverage and improved the ability of banks ... to monitor risk..."[13] Chairman Bernanke also stated that "banks have become more diligent in their dealings with hedge funds... Now risk managers can more accurately measure their current and projected exposures to hedge fund counterparties, and more firms use stress-testing methodologies to assess the sensitivity of their exposures to individual counterparties ...."[14]

In a similar vein, on May 17, 2007, the Financial Stability Forum stated that risk management practices and capacity at core intermediaries have been substantially

[9] Tobias Adrian, "Measuring Risk in the Hedge Fund Sector," 13 New York Federal Reserve Bank Current Issues in Economics and Finance No.3 (March/April 2007)

[10] Bacmann and Gawron, "Fat Tail Risk in Portfolios of Hedge Funds and Traditional Investments," (Jan. 2004). This study found that when a portfolio is dominated by stocks "every addition of hedge fund [to the portfolio] is reducing the risk as measured by VaR or ES." When the portfolio is composed mostly of bonds, the study also found that the additional of hedge fund investments reduces risk.

[11] See, e.g. Federal Reserve Board Supervisory Letter No. 99-3, Feb. 1, 1999.

[12] Federal Reserve Chairman Bernanke, "Hedge Funds and Systemic Risk" (May 16, 2006).

[13] Id.

[14] Id.

enhanced.[15] The report also concluded that the international version of the Basel II capital rules provides strong incentives for financial institutions to use advanced risk measurement and management systems for exposures to hedge funds, and concluded that the international Basel II framework significantly strengthens the capital treatment of such exposures, including equity exposures.[16]

As noted previously, the international version of the Basel II Accord does not impose punitive capital charges on hedge fund investments, but instead relies on Pillar 2 to address any supervisory concerns that may exist in a particular institution. This approach should also be applied in the United States.

## VI. Hedge Fund Investment Is Not Equivalent To Equity Tranches in Securitizations

The 1,250 percent risk weight for equity investments in hedge funds is apparently derived from the assumption that these investments have similar risk characteristics to an equity tranche in a securitization. However, this assumption is factually incorrect.

In a securitization, the goal is to sell debt and the best way to accomplish this is to concentrate the risk in the residual piece. The equity interest merely reflects the residual risk remaining after all the debt is repaid. This residual position is intended to hold almost all of the risk in the securitization in order to provide maximum support for the debt issuance (and thereby get the highest possible rating for each of the various debt issuance tranches). On the other hand, the goal of a hedge fund offering is to sell an interest in the entire portfolio that is expected by the investors to appreciate in value. Such interests are not merely the backstop for debt issuances, and with rare exceptions, there are no such debt issuances by hedge funds. The analogy between a hedge fund equity interest and the equity interest in a securitization is thus inappropriate, and would imply far greater risk to a hedge fund equity interest than is warranted.

## VII. Conclusion

MFA strongly believes that imposing a 1,250 percent risk weight on equity investments in hedge funds is inappropriate and against public policy. It would adversely impact a segment of the financial services industry that provides significant benefits to the capital markets that ultimately result in more efficient markets and lower capital costs. The imposition of this punitive capital charge in this rulemaking would be an arbitrary agency decision that is not supported by any evidence. It would provide for strikingly different capital levies on similar equity investments. It fails to take into account many of the factors that relate to hedge fund risk, and ignores the principles of

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[15] Financial Stability Forum, "Update on the FSF Report on Highly Leveraged Institutions," (May 17, 2007).

[16] Id. at 29

the President's Working Group. It is also inconsistent with the principles of the Basel II Accord, and the implementation of that Accord in Europe and Asia.

The proposal in effect is an attempt to restrict or eliminate U.S. bank investment in hedge funds through an across the board punitive capital charge. It ignores the conclusion of Federal Reserve Board Chairman Bernanke that the U.S. depository institutions have developed and are using sophisticated risk measurement and risk management systems with respect to their involvement with hedge funds that meets current regulatory expectations. The use of these systems should alleviate any supervisory concerns.

MFA urges the agencies to clarify that equity investments in hedge funds will be subject to the same rules as any other equity investment. In conformance with the approach taken by almost all of the foreign financial regulators, the U.S. agencies should rely on Pillar 2 supervisory review to determine if the investments in hedge funds made by any particular institution are inappropriate in light of the risk management systems and policies in place at that institution. If that is the case, supervisory corrective action should be taken with respect to that particular bank.

This approach would be consistent with the world-wide implementation of Basel II. It would place U.S. banks under the same regulatory terms and conditions as foreign banks. To the extent that any one bank is not acting prudently, supervisory action would be authorized. But the remainder of the industry would not be penalized.

If you have any questions concerning this letter please feel free to contact me directly.

Sincerely,

John G. Gaine
President