Managed Funds Association
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

June 19, 2015

By upload to EBA website
European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA
United Kingdom

Re: EBA consultation paper on limits on exposures to shadow banking entities (19 March 2015)[1]

Dear Sir or Madam:

Managed Funds Association ("**MFA**")[2] welcomes the opportunity to provide comments on the European Banking Authority's ("**EBA**") consultation paper, "Draft EBA Guidelines on limits on exposures to shadow banking activities which carry out banking activities outside a regulated framework" (the "**Consultation Paper**").

We have set out in the Appendix to this letter our responses to the specific questions raised in the Consultation Paper.

As a threshold issue, although we note that the term "shadow banking entities" is embedded in the relevant legislative provisions we believe the term shadow banking is prejudicial and unhelpful, particularly in light of the recognized need to promote market-based finance to support the real economy. We further believe that the term shadow banking is inaccurate and misleading as applied to the hedge fund industry. Hedge funds are not in the shadows; they are subject to robust regulatory frameworks, such as the EU Alternative Investment Fund Managers Directive ("**AIFMD**") and the U.S. Investment Advisers Act of 1940 (the "**Advisers Act**"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). Moreover, like other

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[1] EBA/CP/2015/06, available at: https://www.eba.europa.eu/documents/10180/1019894/EBA+CP+2015+06+%28CP+on+GL+on+shadow+Banking%29.pdf

[2] Managed Funds Association 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 organisation 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 organisations, 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, the Americas, Australia and other regions where MFA members are market participants.

investment funds, hedge funds pool risk capital from underlying investors to invest in capital markets activities, which is fundamentally different than engaging in banking activities.

We note also that in the cost-benefit section of the Consultation Paper, the EBA refers to macro-economic benefits of its proposals but makes no references to potential macro-economic costs of its proposals. Imposing limits on exposures is, by its nature, a form of restriction on the free allocation of capital, albeit one that may be justified where it is a proportionate response to genuine systemic risks or market failures. Moreover, determining which categories of entities are subject to such limits may have broader consequences for the markets in question. We therefore submit that the EBA should consider the potential for its proposals to impose broader costs on markets in addition to the process costs on institutions identified in its cost-benefit analysis.

We would be very happy to discuss our comments or any of the issues raised in the Consultation Paper. If the EBA has any comments or questions, please do not hesitate to contact Benjamin Allensworth or the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice President & Managing Director, General Counsel

APPENDIX

MFA comments on EBA consultation paper on limits on exposures to shadow banking entities (19 March 2015)

Q1 Do you agree with the approach the EBA has proposed for the purposes of defining shadow banking entities? In particular:

- **Do you consider that this approach is workable in practice? If not, please explain why and present possible alternatives.**
- **Do you agree with the proposed approach to the exclusion of certain undertakings, including the approach to the treatment of funds? In particular, do you see any risks stemming from the exclusion of non-MMF UCITS given the size of the industry? If you do not agree with the proposed approach, please explain why not and present the rationale for the alternative approach(es) (e.g. on the basis of specific prudential requirements, redemption limits, maximum liquidity mismatch and leverage etc).**

We respectively submit that the proposed definition of "shadow banking entities" is overly broad as it would include many entities engaged in traditional capital markets activities, which we believe are fundamentally different than banking or bank-like activities. This can be seen, for example, in the EBA's linking the concept of "shadow banking" to the activities under points 7 (trading for own account or for account of customers) and 11 (portfolio management and advice) of Annex 1 of the recast Capital Requirements Directive (2013/36/EU) ("CRD IV"), which are not inherently "bank-like" activities. Similarly, we submit that the proposed blanket inclusion, *prime facie*, of all alternative investment funds ("AIFs") as defined under the AIFMD (2011/61/EU) is inappropriate for restrictions that are intended to be targeted at limiting exposures to entities performing "bank-like" activities.

We have set out below the main reasons that hedge funds and their managers should not be included *prima facie* within the definition of "shadow banking entities." Broadly, these are that:

- hedge funds and their managers do not generally perform bank-like activities and are less susceptible to the types of risks identified at section 3.1.1 ("Concerns regarding shadow banks") of the Consultation Paper; and

- the hedge fund industry is subject to a range of robust regulatory requirements, which address a number of perceived risks associated with the industry, particularly with respect to transparency and risk management.

Lastly, we have set out briefly our concerns regarding the risks of unintended consequences and international divergence that could arise from determinations made by the EBA on this issue.

In light of these concerns, we urge the EBA to remove the references to points 7 and 11 of Annex 1 of CRD IV in the definition and to reconsider its proposals that AIFs, such as hedge funds, should *prima facie* be considered as falling within the definition.

Hedge funds and their managers are not "bank-like"

AIFs, such as hedge funds, are not structured similarly to, and are not engaged in similar activities as, banks. Hedge funds do not have deposit-like funding structures and do not present a risk of high, hidden leverage. Significantly, hedge fund failures do not present a significant risk to the stability of the banking system or the financial system more generally.

We have addressed each of the "concerns regarding shadow banks" set out at section 3.1.1 of the Consultation Paper in turn below in respect of the hedge fund industry in order to demonstrate that the policy concerns identified by the EBA do not warrant the *prima facie* inclusion of hedge funds within the definition of "shadow banking entities."

Less vulnerable to runs and/or liquidity problems

A fundamental difference between banking activities and capital markets activities is the nature of deposit funding for banks versus risk-based capital funding for capital markets activities. Unlike bank depositors who expect to receive the full amount of their money back from a bank on demand, investors in capital markets consciously choose to accept the risk of loss of their principal in exchange for the potential to earn enhanced returns over time. As a starting point, we believe, the EBA should focus on activities outside of banks that are funded by deposit-like assets and distinguish traditional capital markets based investment.

The financial crisis arguably demonstrated the potential for "runs" on certain types of entities that are not banks. Hedge funds, which faced investor redemptions during the financial crisis were not subject to "runs" because of the redemption restrictions agreed to between funds and their investors and because of investor expectations when allocating risk capital to investment funds. Consequently, while many hedge funds liquidated during the financial crisis, the hedge fund liquidations did not create systemic risk or require government intervention.

Unlike many other financial market participants, hedge funds generally do not rely on unsecured, short term financing to support their investing activities. Instead, hedge funds typically rely on secured borrowings, which are designed to more closely match the term or expected liquidity of the asset and the financing which funds it. The then UK Financial Services Authority ("FSA") (which has now been replaced by the UK Financial Conduct Authority) conducted several studies on the hedge fund industry which confirmed these practices, finding 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.[3]

Hedge funds are not subject to mandatory redemption requirements under any statute or regulation and their organizational documents generally impose certain limits on investors' ability to redeem their interests. Because hedge funds are able to limit their investors' ability to withdraw their investments, managers can seek to ensure that the liquidity of the fund's portfolio is consistent with their funds' redemption obligations.[4] For example, funds that invest in less liquid or longer maturity assets, like certain less liquid credit instruments, will typically allow annual or less frequent redemptions with 90-day notice periods and substantial up-front waiting periods, called initial lock-up periods. A manager of a more liquid portfolio, such as a managed futures fund, might provide quarterly

[3] Available at: http://www.fsa.gov.uk/static/pubs/other/hedge-fund-report-feb2012.pdf

[4] *See* OFFICE OF FIN. RESEARCH, 2013 ANNUAL REPORT 94 (2013), *available at* http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2013.pdf ("[O]n average, funds with higher leverage have a lower proportion of hard-to-value assets. 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 (mean ratio of debt to net asset value of about 2.8), the corresponding fraction was less than 5 percent. That suggests funds with larger leverage ratios may be choosing assets that are relatively easier to dispose of during a crisis.").

redemptions with a 30-day notice period. With respect to maturity/liquidity transformation activities, most hedge funds build strong liquidity protections into their contractual relationships with investors who are subject to a variety of restrictions, including:

a) limited periods of redemption (sometimes monthly, and often quarterly, annual, or longer);
b) significant advance notice requirements (often 30 to 90 days) prior to the requested withdrawal dates;
c) the right of advisers to impose gates to manage outflows or even suspend redemptions (at the investor and/or the fund level), if deemed necessary; and
d) side pocket vehicles for highly illiquid assets that allow redemptions only when realizations occur.

These provisions help reduce the likelihood that redemptions of investor capital will be disruptive to a fund or to markets over extremely short periods of time, because they allow advisers to better match the assets and liabilities of the funds they manage and to manage orderly outflows of investor funds.

It is true that, like other market participants, hedge funds may obtain financing on the repo market (*i.e.*, short term liability) and use such financing to acquire longer dated assets, and so theoretically engage in "maturity transformation." However, the significant difference between typical hedge fund repo liabilities and the typical liabilities of other entities such as asset-backed commercial paper ("ABCP") conduits, structured investment vehicles ("SIVs") or other types of financial entities is that hedge fund liabilities in repo transactions are constantly marked-to-market as part of the collateral and margining process. In addition to the overcollateralization by hedge funds that is built into the repo transaction via haircuts or initial margin, daily mark-to-market margining allows repo buyers (that is, the lender) to call for additional cash or securities assets from repo sellers (the hedge fund). Thus, if the value of the repo collateral decreases, the repo buyer can make margin calls and the repo seller is required to deliver additional collateral to the repo buyer. This ensures that the hedge fund must always have sufficient assets to meet such potential margin calls. This in turn means that the asset/liability profile of hedge funds when borrowing via repos is very different from the profile of SIVs, for example, where the investors in the paper issued by the SIV have no right to call for additional collateral, even when the value of the SIV's assets substantially reduced over time. Thus, as SIVs' assets declined in value in 2008, SIVs started to breach their capital loss tests. SIV programme documentation typically provided that, when a capital loss test was breached, the SIV had to sell its assets immediately in order to meet maturing debts as quickly as possible; the SIV would also typically be required to be wound up.

In addition, the nature of hedge funds – including their relatively low leverage discussed below – means that such "maturity transformation" is not on the kind of scale which is systemically relevant, unlike that engaged by banks and other large financial institutions. The influential Turner Review on the global banking crisis, published by the FSA, noted that:

> "[Hedge funds] typically have not promised to their investors that funds are available on demand, and are able to apply redemption gates in the event of significant investor withdrawals. They are not therefore at present performing a maturity transformation function

fully equivalent to that performed by banks, investment banks, SIVs and mutual funds, in the run-up to the crisis."[5]

Low risk of contagion

Hedge fund managers do not have substantial assets; though the principals of the manager typically have personal capital invested in the funds they manage. It is the funds that hold the financial assets, that transact with trading counterparties on a collateralised basis, and to which investors commit capital. The risks and rewards of the funds' investment portfolios are borne by a diverse group of underlying sophisticated investors, institutions or ultra-high net worth individuals, who typically invest in hedge funds as part of a diversified portfolio. Hedge funds neither transact with retail investors nor do they take in investments or deposits from retail investors.

Another structural aspect of hedge funds is the legal separation of different funds managed by the same adviser. These legally distinct funds (even when managed by the same adviser) often have different investors and can engage in entirely distinct trading activities in different assets and markets. Any losses at one fund are borne exclusively by the investors in, and counterparties to, that fund (though counterparty losses are typically limited for the reasons discussed below) and do not subject other funds managed by the same adviser directly to losses.

Further, unlike related entities in a financial holding company or other similar structures prevalent elsewhere in the financial services industry, the different funds managed by a common adviser do not typically have the kind of intercompany loans or transactions that can create concentration and tie the risks associated with one company to other companies in the same ownership structure. Unlike bank holding companies and other nonbank financial institutions such as insurance companies, hedge funds engage in one distinct business – namely, making investments for investors in that specific fund, reducing the risk of contagion substantially.

Low leverage

Hedge funds are often thought of as highly leveraged, but many hedge funds are, in fact, less leveraged than many other financial institutions. Several studies of our industry conducted in the past several years have demonstrated that the hedge fund industry has consistently employed relatively low levels of leverage compared to other financial institutions. U.S. regulators collect information about leverage from large hedge fund managers and should be able to analyze this information to confirm industry leverage. Because this information is not available to the public, we rely on other sources in this letter. For example, one study indicates that the average leverage ratio of the hedge fund industry from December 2004 to October 2009 was 2.1x.[6] This compares to average leverage ratios of approximately 13x for the U.S. banking industry[7] and 11.8x for the insurance industry in the same

[5] See page 72 of The Turner Review – A Regulatory Response to the Global Banking Crisis, March 2009 (the "Turner Review"), available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf

[6] Andrew Ang, et al., Hedge Fund Leverage 25 (Nat'l Bureau of Econ. Research, Working Paper No. 16801, 2011), available at http://www.nber.org/papers/w16801.pdf. Please note that we refer to this academic study, and the other sources that provide average hedge fund leverage estimates, for illustrative purposes and that we do not necessarily believe that the methods used to calculate leverage in these studies represents the best method of calculating a hedge fund's leverage.

[7] Sebnem Kalemli-Ozcan et al., *Leverage Across Firms, Bank and Countries* 14–15 (Nat'l Bureau of Econ. Research, Working Paper 17354, 2011), *available at* http://www.nber.org/papers/w17354.pdf (finding a stable aggregate leverage ratio for

periods.[8] Although different funds use leverage in several different ways to implement their investment strategies and some use more leverage than others, they typically engage in collateralised financing that requires daily margining. In fact, in our members' experience, almost all hedge fund financing is fully collateralised. This means that, in the event that a hedge fund experiences significant losses or closes, its creditors are protected because they have legal rights to seize the fund's assets. If a fund closes or its value falls, its investors bear virtually all of the fund's losses and there is limited impact on the fund's creditors and counterparties.

Hedge fund borrowings are done almost exclusively on a secured basis. The posting of collateral by hedge funds reduces the credit exposure of counterparty financial institutions to those funds. Consequently, hedge funds are substantially less likely to contribute to systemic risk by causing the failure of a systemically significant counterparty, such as a major bank. Given the limited leverage and the collateral posted by hedge funds, any losses that hedge funds incur are almost exclusively borne by their investors, not their creditors, counterparties, the general financial system, or taxpayers. Moreover, it is important to note that hedge funds often diversify their exposures across many counterparties, mitigating the risk that a fund poses to any one counterparty. For example, following the collapse of Lehman Brothers, many large hedge funds increased the number of prime brokers they use, thus reducing their exposure to any individual prime broker.

Like other types of investment vehicles and financial institutions, hedge funds use leverage in a variety of different ways and to varying degrees. Hedge funds use leverage to expand the assets on their balance sheets per unit of investor capital, to enhance returns and to mitigate risk by hedging other investments. Not all hedge funds use leverage, and use of leverage varies among managers and by investment strategy type (*e.g.*, long/short, relative value, event-driven and arbitrage strategies all use leverage to varying degrees, with considerable variability among funds).[9] Additionally, various asset classes and instruments have differing risk and liquidity characteristics that make them more appropriate for increased leverage. While some hedge funds use more leverage than others, managers typically use leverage with terms that more closely match the investment period of the assets they are financing and are not dependent on access to overnight financial markets, like banks and brokerage firms were heading into the global financial crisis. These are important distinctions as not all leverage entails identical risk.

It also is important to recognize that, while leverage can be a source of risk, leverage and risk are not the same. In fact, when conceived not as a means of increasing market exposure but rather as a way of extending "balance sheet" per unit of capital, leverage can be used simultaneously to

U.S. banks from 2000 to 2008, displayed in Figure 4). The authors of this paper derived their statistics from data on global banks for which they had consistent data reporting. Their data set included 1,123 U.S. banks, 7,335 European banks and 9,437 banks from outside of the U.S. and Europe.

[8] FED. INS. OFFICE, ANNUAL REPORT ON THE INSURANCE INDUSTRY 20 (June 2013), *available at* http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/FIO%20Annual%20Report%202013.pdf (average for life and health insurers from 2004 to 2009). For property and casualty insurers, which measure leverage as a ratio of premiums-to-surplus (versus assets-to-surplus), during this period the average leverage was about 1x. *Id.* at 28.

[9] *See* FIN. SERVICES AUTHORITY, ASSESSING THE POSSIBLE SOURCES OF SYSTEMIC RISK FOR HEDGE FUNDS 14 (Aug. 2012) (fund leverage per investment strategy data); *see also* SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 37 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf ("The degree to which a hedge fund uses leverage depends largely on its investment strategy."). We note that this study evaluates hedge fund leverage on the basis of GNE. We think that the same trends would be apparent if alternative measures of leverage were used, and, as discussed in more detail elsewhere in our letter, we do not believe GNE is the appropriate measure of hedge fund leverage.

reduce some kinds of risk and to enhance expected return. As such, leverage can be utilized with constant or even lower risk per unit of capital compared to un-leveraged investing. For example, it is possible that risk as a unit of capital could be high with low balance sheet use, just as risk per unit of capital could be low with high balance sheet use. To see how leverage might be used to mitigate some risks, consider the following example of how leverage might be applied in a relative value investment strategy. An investor wants to put $1 million to work and believes a given automobile stock is expensive relative to its industry peers while a certain technology stock is cheap relative to its own industry peers. This investor is otherwise agnostic on where the overall stock market or the auto or tech sectors in particular are going. Without access to leverage on the long side, the best the investor can probably do is to short the auto stock and buy the technology stock, capturing some of the relative value and hedging the systemic factor risk. But with access to leverage, the investor could more effectively target its desired risk/return by, first, hedging the short position in the auto stock with a basket of long positions in other auto stocks and, second, hedging the long position in the technology stock with a basket of short positions in other tech names. The use of leverage in this second example has two benefits:

- it allows the investor to isolate more precisely the investment thesis (that the stocks are mispriced relative to their industry groups) and focus the investment on his precise area of expertise, which increases expected return; and
- it reduces the portfolio's exposure to industry group risk and expected volatility.

So by using leverage, the investor has increased the expected return of the portfolio and decreased expected volatility and exposure to a big risk factor (industry group moves) with respect to which this investor is not intending to take risk.

This example also shows that when leverage is used precisely and carefully, risk and volatility are not proportional to the amount of leverage employed. That would only be the case if leverage is used to proportionately increase the size of all positions instead of being used (in addition to increasing position size) to reshape the portfolio in potentially helpful, risk-reducing ways. We think it is important for regulators to recognize that while use of leverage can increase risks, it can also be used as a tool through which investors modify their exposure to other risk factors. Leverage is both one of many inputs and one of many risk management tools in the portfolio construction process.

<u>No private or public backstops</u>

We note that the authors of an International Monetary Fund ("IMF") working paper published in 2014[10] proposed that shadow banking should be defined as "all financial activities, except traditional banking, which require a private or public backstop to operate." The paper defines private guarantees by reference to the use of "the franchise value of existing financial institutions" and public backstops by reference to the use of "explicit or implicit government guarantees."[11] Entities involved in shadow banking need to show that they can absorb the perceived risks and therefore need access to a backstop, *i.e.*, a risk absorption capacity external to the shadow banking activity. In this regard, the key test for a shadow banking entity carrying out a bank-like activity should be whether such activity requires access to a backstop to operate. Hedge funds would fall outside the scope of this definition.

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[10] IMF Working Paper WP/14/25, available at: http://www.imf.org/external/pubs/ft/wp/2014/wp1425.pdf
[11] *Ibid.* p. 5

Hedge funds and their managers are subject to robust regulation

Our industry has been, and continues to be, subject to a number of significant regulatory changes since the financial crisis both in the EEA and in third countries with major financial markets. Many of these are aimed at addressing similar issues to those raised at part 3.1.1 of the Consultation Paper ("Concerns regarding shadow banks") such as liquidity and risk management and increasing transparency both to prospective and current investors and to regulatory authorities.

Hedge funds and their investment managers are subject to these robust regulations as capital markets participants and the capital markets regulatory framework has been designed to address the risks and activities of hedge funds. While the capital markets regulatory framework is not the same as the banking regulatory framework, those differences are appropriate in light of the different nature of banking activities and capital markets activities. Imposing bank-like regulation on capital markets would have adverse effects on these markets, including reducing liquidity and increasing the cost of capital for businesses and investors. The European Commission and European policy makers have recognized the importance of capital markets based financing and are promoting capital markets as an important supplement to traditional bank financing as part of the pending capital markets union ("CMU") project. We believe the EBA's characterization of capital markets activities as "shadow banking" is inconsistent with the goals of the CMU and the recognition that capital markets activities are distinct from banking activities.

As noted, above, hedge funds are subject to a robust regulatory framework designed to address the activities investment funds engage in as capital markets participants. Below is a non-exhaustive summary of some of the key areas of relevant regulatory reform in the EU and U.S. that have aimed to address perceived risks in the hedge fund industry.

Existing EU regulation

Under the AIFMD, investment managers that manage or market hedge funds in the EEA are subject to a robust regulatory framework which includes investor disclosure and regulatory reporting obligations and restrictions regarding significant investments in EEA companies. Hedge fund managers based in the EEA are also subject to additional prudential requirements, restrictions on delegation. As such, the AIFMD gives the competent authorities of EEA Member States an extensive toolkit to monitor and supervise our industry.

Many of the regulatory requirements applicable to hedge fund managers under the AIFMD are broadly similar to those that apply to UCITS management companies under the revised UCITS Directive. In this regard, the *prima facie* inclusion of all AIFs within the definition, and hence the starting assumption that all AIFs are inherently more risky, or more bank-like, that non-MMF UCITS, creates an arbitrary divide which may have unintended adverse effects on markets. For example, there may be a risk that banks or investment firms will start to concentrate exposures to certain non-MMF UCITS. There could also be adverse consequences down the financing chain for markets dependent upon non-transferable securities and other alternative asset classes. It is particularly important that policymakers and regulators take account of these risks when non-bank financing and investment is needed as a driver of real economic growth in those markets.

The EU also is in the process of implementing a range of market reforms, including the under the revised Markets in Financial Instruments Directive (2014/65/EU) and the accompanying Markets in Financial Instruments Regulation (Regulation 600/2014) (together, "MiFID II") and the European Market Infrastructure Regulation (Regulation 648/2012) ("EMIR"). While MiFID II and EMIR are not specifically targeted at hedge funds, their market-wide reforms impact hedge funds as market participants. For example, many market participants, including hedge funds, are now subject to new margin and collateral requirements in respect of over-the-counter ("OTC") derivatives under EMIR, which will help ensure that market participants do not become overly leveraged through the use of such derivatives. These reforms effectively impose an EU-wide regulatory framework for the hedge fund industry that appropriately focuses on the business models and policy issues relevant to private investment funds and their asset managers.

<u>Existing U.S. regulation</u>

In the U.S., the Dodd Frank Act requires all hedge fund managers with at least $150 million in assets under management ("AUM") to register with the U.S. Securities and Exchange Commission (the "SEC") under the Advisers Act. Hedge fund managers with less than $100 million in AUM generally will be required to register with state securities regulators under state law. The AUM thresholds are based on a manager's "regulatory assets under management," which includes assets acquired through various financing methodologies. As a result, all large hedge fund managers are now registered with the SEC and many managers also are registered with the U.S. Commodity Futures Trading Commission ("CFTC").

Registration with the SEC requires hedge fund managers to, among other things, maintain books and records, be subject to examination and inspection by SEC staff, maintain written compliance programs designed to prevent violations of the U.S. securities laws, and have a chief compliance officer responsible for implementing the compliance programme. The SEC also has enhanced substantially its reporting requirements under the Advisers Act for hedge fund managers.

As in the EU, hedge funds and their managers are subject to a variety of market-based regulations in the U.S., which apply to broad range of other market participants, including:

- increased oversight by the CFTC in respect of funds investing in commodity futures and swaps and margin and collateral requirements in respect of OTC derivatives under the Dodd Frank Act;
- reporting requirements under Section 13(d) of the Securities Exchange Act of 1934 for positions of 5% or greater of public company equity securities;
- requirements for institutional investment managers that manage at least $100 million to report holdings of public company equity securities on a quarterly basis;
- prohibitions against insider trading and other fraudulent conduct in connection with the sale or purchase of securities; and
- regulatory reporting requirements from various agencies, including the U.S. Department of the Treasury, the CFTC, the U.S. Federal Reserve, and the U.S. Bureau of Economic Analysis for investors with large positions in various financial instruments.

Unintended consequences and international harmonisation

Were the EBA to proceed on the basis of its current proposals, there is a significant chance that the proposed definition of a "shadow banking entity" could become the de facto EU definition of shadow banking for the purposes of other regulatory reforms. There may be a number of unintended adverse consequences of defining the concept at the EU level in a manner that focuses only on the requirements under Article 395(2) of the [CRR]. For the reasons outlined above, we respectively submit that the proposed definition in the Consultation Paper is overly broad, particularly to the extent that it links the concept of "shadow banking" to the activities under points 7 (trading for own account or for account of customers) and 11 (portfolio management and advice of Annex 1 of the [CRD], which are not "bank-like" activities. As the EBA acknowledges in the "General background" section of the Consultation Paper, the shadow banking debate is an international concern, and we believe further analysis is necessary to determine the appropriate scope of entities and activities that are bank-like and not subject to existing regulation before regulators impose substantive restrictions that, if not properly tailored, could adversely affect capital markets and the businesses and investors that rely on those markets. To that end, we encourage the EBA to coordinate with other regulatory efforts in this area, for example, the FSB efforts to develop recommendations regarding "shadow banking."[12]

Q2 Do you agree with the approach the EBA has proposed for the purposes of establishing effective processes and control mechanisms? If not, please explain why and present possible alternatives.

No comment.

Q3 Do you agree with the approach the EBA has proposed for the purposes of establishing appropriate oversight arrangements? If not, please explain why and present possible alternatives.

No comment.

Q4 Do you agree with the approaches the EBA has proposed for the purposes of establishing aggregate and individual limits? If not, please explain why and present possible alternatives.

As discussed above, the definition of "shadow banking entities" should not include hedge funds or their managers. However, if the EBA formulates the definition in the manner it proposed, we submit that the criteria that institutions should take into account in setting individual limits on exposures to shadow banking entities should be more heavily weighted towards entities that have deposit-like funding structures or entities which require a public or private backstop to operate (see our response to Question 1 above).

Moreover, to the extent the EBA adopts a broad definition of "shadow banking entities," we are concerned that the proposed 25% aggregate limit could have unintended consequences for capital

[12] See in particular, See in particular, Recommendations of the FSB, available at: http://www.financialstabilityboard.org/wp-content/uploads/r_111027a.pdf?page_moved=1 and Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, available at: http://www.financialstabilityboard.org/wp-content/uploads/r_130829b.pdf?page_moved=1

markets. Given the wide range of entities to which the EBA's limit would apply, we believe imposing a bright line aggregate limit could adversely affect capital market liquidity, a result inconsistent with the EU's CMU project. We also are concerned that reducing market liquidity could increase, rather than reduce systemic risks, by decreasing the existing resiliency and ability of capital markets to withstand stress because of the depth and variety of capital markets participants. As such, to the extent the EBA does adopt limits to shadow banking entities, we believe the limits should be based on a risk-based framework.

Q5 Do you agree with the fallback approach the EBA has proposed, including the cases in which it should apply? If not, please explain why and present possible alternatives. Do you think that Option 2 is preferable to Option 1 for the fallback approach? If so, why? In particular:

- **Do you believe that Option 2 provides more incentives to gather information about exposures than Option 1?**
- **Do you believe that Option 2 can be more conservative than Option 1? If so, when?**
- **Do you see some practical issues in implementing one option or the other?**

We respectively submit that the fallback approach is unlikely to serve as an effective risk management tool. Our main concern with the approach is that it is a relatively blunt method of addressing the perceived risks.

Banks and investment firms are already subject to robust prudential and risk management requirements, including risk-weighted capital requirements under CRD IV. They should also be sophisticated enough and have sufficient information available to make the relevant risk assessments in the vast majority of cases.

Imposing mandatory quantitative limits may have the unintended adverse consequence of leading some banks and investment firms to invest in riskier and less diversified asset classes simply on the basis that they feel more able to justify to regulators that they have collected the appropriate information on the relevant entities to comply with the conditions of the principal approach.

If the EBA does decide to implement the fallback approach in spite of these potential drawbacks, Option 2 would be a more proportionate approach than Option 1 as it at least permits risk assessment for entities. However, this is not an optimal solution as it may lead to some entities being arbitrarily subject to much higher limits than others.

Q6 Taking into account, in particular, the fact that the 25% limit is consistent with the current limit in the large exposures framework, do you agree it is an adequate limit for the fallback approach? If not, why? What would the impact of such a limit be in the case of Option 1? And in the case of Option 2?

For the reasons discussed above, we do not believe the 25% fallback limit is the appropriate approach. To the extent the EBA adopts limits, we believe a risk-based framework is more appropriate.