American Federation of Labor and Congress of Industrial Organizations

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April 12, 2011

Ms. Elizabeth M. Murphy
Secretary Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Mr. David A. Stawick
Secretary Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington DC 20581

RE: File # S7-05-11, Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF

Dear Ms. Murphy and Mr. Stawick,

Thank you for the opportunity to comment on the proposed rule, "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF" ("Proposed Rule"), on behalf of the AFL-CIO. The AFL-CIO strongly supports the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act requiring advisers to hedge funds and private equity funds to register with the SEC. We support the Proposed Rule, but believe it should be strengthened in a few key areas by requiring more frequent reporting, omitting the arbitrary distinction by investment strategy, and adding additional disclosure requirements necessary to protect investors and prevent systemic risks.

The AFL-CIO is the country's largest labor federation and represents 12.2 million working people. Union-sponsored pension and employee benefit plans hold more than $480 billion in assets. Union members also participate in the capital markets as individual investors and as participants in pension plans sponsored by corporate and public-sector employers. The Proposed Rule will determine to what extent the SEC and the Financial Stability Oversight Council (FSOC) can collect data essential to monitoring systemic risks that, as we saw in 2007 and 2008, cause substantial damage to the financial markets and the broader economy when they go unchecked. Comprehensive disclosure requirements for private funds will provide important protections for our members' retirement savings.

Introduction

The fact that opaque, highly-leveraged pools of capital – or "shadow banks" – can pose systemic threats is well acknowledged. A July 2010 report from the Federal Reserve Bank of New York, "Shadow Banking," identifies a variety of shadow banks including, but not limited to, money market funds, hedge funds, structured investment vehicles, non-bank lenders and CDOs.[1]

According to the report:

> A special feature of wholesale funding markets—and hence the funding of shadow banking system—is that it intermediates predominantly institutional cash balances, such as those of corporations, institutional investors and municipalities... The concentration of institutional cash balances in wholesale funding markets is important to highlight, since, as the crisis has shown, institutional cash balances are well-informed, herd-like and fickle, and as such, any entity, vehicle or activity that relies on them for funding and lacks contagion-free, alternative sources of liquidity, is an inherently fragile structure.[2]

In other words, shadow banks are subject to runs in the same way that traditional banks can face runs when the market has doubts about its solvency. This is precisely what happened when Bear Stearns failed.

Later, the FRBNY report states that the emergency lending facilities established by the Federal Reserve following the failure of Lehman Brothers "amount[ed] to a 360° backstop" of the shadow banking system.[3] During the financial crisis, the Federal government was forced to backstop unregulated financial institutions in order to prevent a systemic crisis.

Long Term Capital Management is the primary example of the systemic risks that hedge funds can pose. The fund had less than $5 billion in equity but had a leverage ratio as high as 28-to-1 at times.[4] At one point, LTCM held $1.4 trillion notional value of derivatives in off balance sheet vehicles. Its footprint in the financial markets was far greater than its assets would suggest. When it was on the verge of failure, the Federal

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[1] Pozsar, Zoltan, Adrian, Tobias, Ashcraft, Adam B. and Boesky, Haley, Shadow Banking (July 1, 2010). FRB of New York Staff Report No. 458 *at* Abstract. Available at SSRN: http://ssrn.com/abstract=1645337.
[2] *Id at 58-59.*
[3] *Id at 61.*
[4] As of December 31, 1997, LTCM had $4.67 billion in assets. Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk (GAOGGD-00-3, Oct. 29, 1999) *available at* http://www.gao.gov/archive/2000/gg00003.pdf.

Reserve Bank of New York orchestrated a restructuring deal with the hedge fund's major creditors to avoid the systemic implications of the its bankruptcy.

There are more recent examples, however, of the threats posed by hedge fund failures. The onset of the financial crisis was marked by the failure of two hedge funds managed by Bear Stearns. The failure of those funds led to $1.6 billion in losses by investors and fraud charges against fund managers Ralph Cioffi and Matthew Tannin.[5] While Cioffi and Tannin were eventually acquitted, the activities of the fund reported after its collapse illustrate the risks and conflicts of interest that may arise when hedge funds are not subject to comprehensive regulatory oversight.[6]

Citigroup's experience with the hedge funds it managed prior to and during the recent financial crisis provide yet another example. In March 2008, Citigroup injected $1 billion into several of its hedge funds that were bleeding cash.[7] Six months later, U.S. taxpayers were forced to inject billions of dollars into Citigroup to prevent a systemic crisis.

It is clear that a large hedge fund could trigger a systemic crisis. The activities of smaller funds, however, can also have a systemic impact when they exhibit herding behavior.[8] A report released by the CFTC last year explained herding as follows:

> Financial herding, the propensity for market participants to trade together on one side of the market, can result from common information signals, common trading strategies, or traders mimicking other market participants. In the first case, herding might represent effective price discovery as information is impounded into prices. Common trading strategies and mimicking behavior, however, may drive prices away from fundamental values if positive feedback traders buy in a rising market and sell in a falling market.[9]

There is substantial evidence that hedge funds exhibited herding behavior during the financial crisis. For example, the Wall Street Journal reported in January, "Hedge funds are crowding into more of the same trades these days, amplifying market swings during crises and unnerving investors. Such trading has stoked market jitters in recent months and helped to diminish the impact of corporate fundamentals on stock-market

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5 http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aIAqjbY8Q7aY

6 http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aIAqjbY8Q7aY

7 http://www.nytimes.com/2008/03/11/business/11bank.html?scp=7&sq=citigroup%20and%20hege%20fund%20and%20old%20lane&st=cse

8 Bikhchandani, Sushil and Sharma, Sunil, Herd Behavior in Financial Markets: A Review (March 2000). IMF Working Paper No. 00/48. Available at SSRN: http://ssrn.com/abstract=228343.

9 Boyd, Naomi E., Buyuksahin, Bahattin, Harris, Jeffrey H. and Haigh, Michael S., The Prevalence, Sources, and Effects of Herding (September 13, 2010). Available at SSRN: http://ssrn.com/abstract=1359251. (Internal citations omitted.)

movements. Droves of small investors have reacted by pulling money from the market, questioning its stability and whether fast-moving traders are distorting prices."[10]

According to the Wall Street Journal article, MIT professor and hedge fund manager Andrew Lo found in a recent study that hedge fund returns have become more correlated over the last five years. "There is a roughly 79% chance any randomly selected pair of hedge funds will move up and down in tandem in a given month from 2006 to 2010, compared with a roughly 67% likelihood from 2001 to 2005, according to his analysis." [11]

The systemic risks that private equity, or leveraged buyout funds, may pose are not as well-acknowledged as the risks posed by hedge funds. Those who oppose regulating leveraged buyout funds often argue that such funds do not pose systemic risks.[12] A more appropriate examination of the potential systemic risks associated with leveraged buyout activities must consider financial intermediaries' exposures to LBO debt and the impact of LBOs on corporate equity prices.

Banks and other lenders provided $1.1 trillion in debt financing for LBOs between 2005 and 2007 alone.[13] The risky loan-products offered to home buyers had counterparts in the leveraged buyout arena. Instead of "NINJA loans", referring to the risky loans made to home buyers with "no income, no job and no assets," banks often made "covenant-lite" loans to PE funds that omitted important items from lending agreements that were intended to allow the lender to avoid unnecessary losses. LBOs also used financing similar to the option adjustable rate mortgages (Option ARM) mortgages, the riskiest type of subprime mortgage. The LBO loan product that is substantially similar to an Option ARM allows the borrowing company to make interest payments by issuing additional debt to the lender instead of paying in cash (payment-in-kind or "PIK").[14] As with the Option ARM, this increases the principal owed on the loan. Interest payments are then based on a higher loan value, and when the bill finally comes due the borrower often suffers "payment shock" because of inadequate funds available to pay off the debt.

While leveraged buyout activity receded during the financial crisis, as creditors became more wary of risky lending, the LBO market is roaring back. According to the Financial Times, "covenant-lite loans that strip out safeguards for investors, dividend

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[10] Jenny Strasburg and Susan Pulliam, Hedge Funds' Pack Behavior Magnifies Swings in Market, Wall St J (Jan 14, 2011) *available at* http://online.wsj.com/article/SB20001424052748704361504575552462233274960.html.
[11] *Id.*
[12] Press Release: Private equity's business model sets it apart from institutions at center of financial crisis, PE Council study finds, Private Equity Council (Oct. 16, 2008). "The new Administration and Congress that take office next year will have to quickly put in place a fresh framework to minimize the possibility that the credit crisis now facing average Americans and U.S. businesses of all sizes will be repeated," said PE Council President Douglas Lowenstein. "We hope the Shapiro-Pham study will help provide useful context to public officials who are working to design a more modern and dynamic system that will ensure a stable and growing global economy."
[13] US Government Accountability Office, Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention, GAO-08-885 (Sept. 9, 2008).
[14] Caroline Salas, *Bondholders Lucky to Get 10 Cents in Looming Defaults*, Bloomberg (April 23, 2008), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ah5Lg9TW9B_M.

deals in private equity-controlled companies, and a third class of instruments, payment-in-kind toggle notes, were widely criticized as part of the easy lending that led to the credit crunch."[15] So far this year, more than $30 billion of covenant-lite loans have already been issued. This surpasses 2006, the second-biggest year of covenant-lite loan issues on record, when $24 billion were issued. The largest annual issuance was 2007, when $100 billion in covenant-lite loans were issued.[16] The resurgence of these risky loans led Moody's to issue a warning earlier this month that these loans "may be laying the groundwork for painful fallout from the next credit downturn."[17]

According to Moody's, "The relatively swift recovery of debt markets following the credit crisis masked the true risk of covenant-lite loans... In a more prolonged credit downturn, companies with lenient covenant terms would be more likely to default, and their lenders would likely recover less than would investors in defaulted companies with more restrictive covenants."[18]

Proposed Rule

The Proposed Rule would give regulators the opportunity, for the first time, to collect data on private funds that could allow them to analyze and predict potential systemic threats. It attempts to distinguish among hedge funds, liquidity funds and private equity funds and sets out varying disclosure requirements for each type of fund. These comments will focus on the components of the proposed rule related to hedge funds and private equity funds.

Who Must File Form PF

The SEC and CFTC ("Commissions") propose to require "Large Private Fund Advisers" to file Form PF on a quarterly basis. The Proposed Rule would define Large Private Fund Advisers as advisers to hedge funds or liquidity funds with $1 billion or more in assets under management at the close of business on any day during the relevant quarter or advisers to private equity funds with $1 billion or more in assets under management at the close of business on the last day of the relevant quarter. Registered private fund advisers with less than $1 billion in assets under management would be required to file minimal disclosures with the SEC on an annual basis whereas large private fund advisers would be required to file limited, but more substantial disclosures, on a quarterly basis.[19]

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[15] Nicole Bullock, *Risky loans stage comeback*, FT (March 13, 2011), *available at* http://www.ft.com/cms/s/0/9f7c528c-4da3-11e0-85e4-00144feab49a.html#ixzz1GchehYL7.
[16] Id.
[17] Nicole Bullock, *Moody's warns on covenant-lite loans*, FT (March 10, 2011), *available at* http://www.ft.com/cms/s/0/2795693a-4a9b-11e0-82ab-00144feab49a.html#ixzz1GcjtWQ2M.
[18] Moody's Investor Services, *Announcement: Moody's: Covenant-Lite May Lead to Larger Investor Losses in Next Credit Downturn*, Moody's Global Credit Research (March 10, 2011), *announcement available at* http://www.moodys.com/viewresearchdoc.aspx?lang=en&cy=global&docid=PR_215517.
[19] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8067, 8075 (Feb. 11, 2011) (to be codified at 17 C.F.R. pts. 275 and 279. ("Release")

We are concerned that the SEC will not be collecting comprehensive information from private fund advisers with between $150 million and $1 billion in assets under management. As discussed above, when mid-size funds act in concert they can pose systemic threats. The SEC and FSOC will not be able to detect or monitor herding behavior that can cause systemic threats if substantially more data is not collected from mid-size private fund advisers. At minimum, mid-size private funds should be required to complete all applicable sections of Form PF on a semi-annual basis.

Types of Funds

The Commissions propose to create a regulatory distinction among various types of funds. As a general matter, we appreciate the attempt to distinguish among private funds, which to-date have largely been characterized not by their investment strategies but by their reliance on certain exemptions from Investment Company Act regulation.

One alternative approach we could take is to not define a hedge fund in Form PF and simply require that all advisers managing in excess of $1 billion in private fund assets (regardless of strategy) complete section 2 of Form PF. Would this be a more effective approach?[20]

Private funds are known for having transient investment strategies. This is acknowledged by the United Kingdom's Financial Services Authority in a 2005 report on hedge funds and potential systemic risks, in which it states that a primary characteristic of hedge funds is that they "broader mandates than traditional funds which give managers more flexibility to shift strategy."[21]

The Managed Funds Association defined "hedge fund" as a pooled investment vehicle that "generally meets the following criteria: (i) it is not marketed to the general public (i.e., it is privately-offered), (ii) it is limited to high net worth individuals and institutions, (iii) it is not registered as an investment company under relevant laws (e.g., U.S. Investment Company Act of 1940, as amended), (iv) its assets are managed by a professional investment management firm that shares in the gains of the investment vehicle based on investment performance of the vehicle, and (v) it has periodic but restricted or limited investor redemption rights."[22] This definition would include hedge funds, liquidity funds and private equity funds as defined by the Proposed Rule.

Due to the history within the private fund market in which private fund advisers are frequently allowed substantial leeway to pursue a wide range of investment strategies, we are concerned that imposing regulatory distinctions among types of funds when these distinctions may not exist in practice could provide opportunities for regulatory arbitrage. In order to avoid this, we urge the Commissions to require all

[20] Release at 1076.

[21] Financial Services Authority, *Hedge funds: A discussion of risk and regulatory engagement* (Jun. 2005), available at http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf.

[22] Managed Funds Association (MFA), *Sound Practices for Hedge Fund Managers*, Washington, 2007.

private fund advisers to complete all sections of Form PF. If certain portions do not apply, the private fund adviser should be permitted to respond that those sections or questions are not applicable.

The SEC proposes to require private fund advisers to combine liquidity fund and registered money market fund assets under management to determine whether the adviser has $1 billion in assets under management and, therefore, should be required to file Form PF.[23] We agree that this is the correct approach and urge the SEC to also require managers to combine hedge funds, private equity and liquidity fund assets under management and to require managers with more than $1 billion in combined private fund assets under management to file Form PF. As the Commissions recognize in the Proposed Rule, it is often difficult to distinguish among the investment strategies pursued by each type of fund. To ensure that the arbitrary distinction between hedge funds and private equity does not become a mechanism for funds to evade filing, the Commissions should require that the assets under management in hedge funds, liquidity funds and private equity funds be combined for purposes of determining a managers' filing status on Form PF.

Frequency of Reporting

The Commissions propose to require large private fund advisers to file quarterly, within 15 days of the end of each quarter. The AFL-CIO is concerned that quarterly filing will be insufficient for the SEC and the FSOC to identify areas where they should focus more attention. As we saw in 2008 with the failure of Bear Stearns, during times of economic distress, financial entities that appear to be on solid financial footing can very quickly spiral into systemic threats. In addition, private fund advisers engaged in strategies that focus on investments in liquid securities often move in and out of positions so quickly that the SEC and FSOC would not be able to gain an understanding of its impact on the markets absent more frequent data collection. For these reasons, we urge the Commissions to require more frequent and timely filing by private fund advisers.

Information Required on Form PF

The Proposed Form PF will be divided into four sections. All private fund advisers would be required to complete Section 1 and the remaining sections apply to specific categories of large private fund advisers. As stated above, we believe a sounder approach would be to require all private fund advisers to complete all sections of Form PF. If certain portions do not apply, the private fund adviser could simply state that those sections or questions are not applicable.

Section 1

The AFL-CIO strongly supports the requirement in Section 1c that all hedge fund advisers that are required to complete Form PF disclose basic information about their

[23] Release at 8076.

derivatives exposures, including the percent of cleared and uncleared derivatives. We urge the Commissions to strengthen this disclosure by requiring all private fund advisers to complete this disclosure, as applicable, and by adding a requirement that private fund advisers disclose the gross notional value of their derivatives exposures and the amount and types of capital they have posted for the uncleared derivatives exposures. This will assist the regulators in analyzing the riskiness of the fund's derivatives positions and the extent to which it is providing sufficient buffers against losses in derivatives trading. In addition, it will allow the regulators to aggregate derivatives data to analyze trends in risk acceptance of derivatives counterparties.

Section 2

Section 2 of Proposed Form PF would include information specific to large hedge fund advisers. The Commissions propose to require large hedge fund advisers to provide disclosures about individual hedge funds in Section 2B if the hedge fund has a net asset value of $500 million or more.[24] According to the Proposed Rule, the reason for limiting disclosure to hedge funds of this size is that the Commissions believe that smaller funds are less likely to pose systemic threats and "setting thresholds at this level would minimize reporting burdens on advisers to smaller or start up hedge funds." We believe it is inappropriate to limit disclosure requirements to hedge funds with $500 million or more in net assets.

The Dodd-Frank Act directs the Commission to collect information that is "necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk."[25] Nowhere in the Act did Congress direct the Commissions to temper their information collection to avoid inconveniencing certain hedge funds. It may be true that the impact of $500 million in certain markets may not be sufficient to bring down the financial system, however, there is substantial evidence, as discussed above, that hedge funds exhibit herding behavior. The collective action of multiple small hedge funds can clearly impact financial markets and the only way for the SEC and FSOC to determine whether such herding behavior is occurring is to collect data about all funds managed by advisers that are required to register under the Advisers Act.

Finally, small hedge funds are just as likely to engage in improper activities, such as insider trading, as large hedge funds. The SEC will be better equipped to identify, investigate and punish bad actors if it collects comprehensive data from all private funds on a regular basis.

Section 4

The Commissions proposed that Section 4 of Form PF would include information specific to private equity fund advisers with $1 billion or more in assets under management. To the extent that hedge funds invest in controlling stakes in portfolio

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[24] Release at 8080.
[25] 15 USC 80b-4

companies, they should be required to complete Section 4 as well. Again, this may be accomplished by requiring all categories of private funds to complete the entire Form, as applicable. The proposed rule would require large private equity fund advisers to disclose aggregate information about the funds' borrowing and portfolio company leverage. In addition, large private equity advisers that invest in financial industry portfolio companies would be required to disclose the debt-to-equity ratio, percent of the fund's gross assets invested in the company and the perfect of the company beneficially owned by the fund.[26]

Private fund advisers should be required to report comprehensive information about each portfolio company's borrowings and portfolio company leverage to the SEC. As discussed above, the financing mechanisms used by private equity funds must be the focus of the SEC's and FSOC's data collection to allow them to analyze potential systemic threats.

More specifically, private equity advisers should be required to disclose a comprehensive list of their portfolio companies, lenders to their portfolio companies, the underwriters for debt offerings if they issue debt in the public or private markets, the identity of any investor that purchased or owns 5 percent or more of the debt from a specific offering, and the identity of any investor that holds 5 percent or more of a portfolio company's outstanding debt. The Commissions should require private equity fund advisers to disclose the debt-to-equity ratios of all portfolio companies in which they own equity. Furthermore, disclosure of the maturity profile for each company's debt should not be limited to payment-in-kind or zero coupon notes. Disclosures should include aggregate information about all debt on a company's books before the private equity fund invested in it and specific information about all debt the company takes on from the time of the buyout. This information will be useful to the SEC because it will allow the Commission to monitor potential conflicts of interest that may arise when private equity fund managers are excessively reliant on specific providers of credit.

The private equity business model is based upon private equity funds using a small portion of equity and a large amount of debt to buy large stakes in operating companies. The debt-to-equity ratio is an important component of determining a portfolio company's ability to continue debt servicing. In the height of the leveraged buyout boom in 2003-2007, consortium deals became popular for the purchase of large operating companies for a variety of reasons such as the sheer amount of equity required to complete a leverage buyout and the interest of the private equity fund LPs in being more diversified. The largest companies, where it may be difficult for a private equity fund to acquire a large enough stake for it to be considered "controlling" under the SEC's definition, are also those whose failure is likely to have the largest ripple effects on the financial markets. These are the companies where it is more important for the SEC and FSOC to obtain comprehensive information about the debt-to-equity ratio but, under the proposed rule, they may not collect such information because multiple private equity funds own a portion of the company, none of which holds a controlling stake.

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[26] Release at 8083.

Conclusion

The Commission has been tasked with the responsibility of acting as gatekeeper to the financial stability regulators in collecting data necessary to detect and prevent systemic risks. MIT professor Andrew Lo stated in testimony before Congress, "Without access to primary sources of data-data from hedge funds, their brokers, and other counterparties – it is simply not possible to derive truly actionable measures of systemic risk."[27] The Commission must collect comprehensive data on all private fund advisers if it is to be successful in its responsibility of detecting and preventing systemic risk. We urge the Commission to strengthen the Proposed Rule by requiring private fund advisers to report more information on a more frequent basis.

On behalf of the AFL-CIO, thank you for the opportunity to comment on the Proposed Rule. If you have any questions, please contact Heather Slavkin Hslavkin@aflcio.org or 202-637-5318.

Sincerely,

Richard L. Trumka
President

RLT/DFP/sdw
opeiu #2, afl-cio

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[27] Andrew W. Lo, HEDGE FUNDS, SYSTEMIC RISK, AND THE FINANCIAL CRISIS OF 2007-2008: WRITTEN TESTIMONY FOR THE HOUSE OVERSIGHT COMMITTEE HEARING ON HEDGE FUNDS, Congressional Testimony, November 2008 *available at* http://web.mit.edu/alo/www/.