COMMITTEE ON CAPITAL MARKETS REGULATION

April 12, 2011

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW
Washington, DC 20581

Elizabeth M. Murphy
Secretary of the Commission
Securities and Exchange Commission
100 F Street, NE
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Re: Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (CFTC RIN 3038-AD03, SEC Release No. IA-3145, SEC File No. S7-05-11, SEC RIN 3235–AK92)

Dear Mr. Stawick and Ms. Murphy:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the joint Proposed Rules[1] and proposed Form PF of the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) (together, the Commissions) regarding reporting by private funds under §§ 404 and 406 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2]

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.[3] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

The proposed rules, including the proposed version of Form PF, require advisers to hedge funds, private equity funds, and other funds to disclose certain information in regular filings. Hedge funds with a net asset value of $500 million or more will have to file quarterly reports disclosing detailed information about assets, leverage, counterparties, risk, trading practices, investors, geographic exposures, performance, and

[1] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8,068 (Feb. 11, 2011) (hereinafter Proposed Rules).
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 404, 406 (hereinafter Dodd-Frank Act).
[3] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html (hereinafter CCMR May 2009 Report).

other details.[4] Advisers to private equity funds with at least $1 billion in assets under management will have to file quarterly reports detailing financing, geographic breakdowns, and other information.[5]

The Committee is concerned that the Commissions have not adequately evaluated the costs and benefits of the reporting scheme outlined in the Proposed Rules. Specifically, Form PF requires firms to calculate and disclose information with uncertain benefits to regulators, and the broad scope of private funds subject to this burden has not been justified. As a general matter, we are concerned that Form PF, as proposed, demands too much detail, encompasses too many firms, and should be coordinated better with both the Financial Stability Overisght Council (FSOC) and foreign regulators.

Cost-Benefit Analysis

Both the CFTC and the SEC included cost-benefit analysis in the Proposed Rules, as they are generally required to do by statute.[6] Yet neither agency conducted the detailed analysis of the specifics of the rules that is required by agencies subject to review by the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget.[7] Although these independent agencies are not subject to the executive order that requires OIRA review of cost-benefit analysis, the heads of both agencies have suggested they will comply with its principles.[8]

But rather than apply the principles of sound cost-benefit analysis, the Commissions essentially took a gestalt approach to evaluate the reporting regime as a whole. The CFTC, which has interpreted its statutory mandate as not requiring the quantification of costs and benefits,[9] took all of six paragraphs to evaluate the costs and benefits of the new rules. Of those six paragraphs, only one paragraph was devoted to identifying costs and one to identifying benefits. Of the three "costs" the CFTC identified, however, only one should properly be considered a cost. The three costs are: (1) "Without the proposed reporting requirements...FSOC will not have sufficient information"; (2) "the proposed reporting requirements, once finalized will provide the CFTC with better information"; and (3) "the proposed reporting requirements will create

[4] *See* Proposed Rules, Form PF § 2b, 76 Fed. Reg. at 8,119–33.
[5] *See* Proposed Rules, Form PF § 4, 76 Fed. Reg. at 8,040–43.
[6] *See* 7 U.S.C. § 19(a) (CFTC required to "consider the costs and benefits" of its rules); 15 U.S.C. § 78c(f) (SEC required to consider whether its rules "will promote efficiency, competition, and capital formation"); *see also* 15 U.S.C. § 78w(a)(2) (SEC required to consider burden on competition). This rule is also subject to some estimates of cost under the Paperwork Reduction Act, 44 U.S.C. §§ 3501–21.
[7] See Exec. Order No. 12,866, §6(a)(3), 58 Fed. Reg. 51,735 (Oct. 4, 1993); Exec. Order No. 13,563, §1(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).
[8] *See* Testimony of Chairman Gary Gensler Before the H. Comm. on Agric. (Feb. 10, 2011), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html (CFTC Chairman Gary Gensler: "the CFTC's practices are consistent with the executive order's principles."); Testimony of Chairman Mary Schapiro Before the Subcomm. on Fin. Servs. and Gen. Gov't of the H. Appropriations Comm. (March 15, 2011) (SEC Chairman Mary Schapiro: "while the executive order doesn't apply to us, we're trying to act as though it does.").
[9] *See, e.g.*, Proposed Rules, 76 Fed. Reg. at 8,087.

additional compliance costs."[10] Only the last one is a cost the regulation actually imposes; the other two are purported benefits.

The SEC did attempt to quantify some of the reporting costs, and also considered the different costs for the initial and subsequent reports for different types of funds.[11] Yet it, like the CFTC, did not discuss the costs and benefits at a more granular level by looking at the costs and benefits of providing the particular information funds must report.

An interagency group, convened by OIRA, wrote a set of "best practices" to guide agencies when conducting cost-benefit analysis.[12] One of these best practices instructs agencies to evaluate costs and benefits against a baseline, which is "the best assessment of the way the world would look absent the proposed regulation."[13] The SEC recognized that the baseline should take into account the incremental costs over and above what the legislation requires, even though that is difficult in this case.[14] The CFTC, on the other hand, essentially evaluated the overall costs and benefits of the reporting required by § 404 of the Dodd-Frank Act, rather than the particular implementation the agencies proposed.

Nor did either agency discuss alternative reporting regimes that could satisfy §§ 404 and 406. The OIRA interagency report explains that "[a]gencies should identify (with an appropriate level of analysis) alternatives,...as well as identifying statutory requirements that affect the selection of a regulatory approach."[15] The Commissions should consider alternate regimes that satisfy the statute, many of which may involve reduced costs for the funds and the agencies alike, without reducing the benefits.

As noted above, rather than evaluating the costs and benefits of the individual components of Form PF, the Commissions performed a holistic version of cost-benefit analysis by evaluating the reporting regime as a whole. The OIRA interagency report recommends looking at costs at a more granular level. Each additional level of detail beyond a baseline, each additional bit of information, and each additional firm that is required to report, contributes to the overall costs to the system. Not all firms and types of information are as important in monitoring systemic risk. A proper analysis of costs and benefits would consider these marginal effects and would establish a reporting regime that required additional information only to the extent that the benefits outweigh the costs.

In the Committee's May 2009 Report, we supported the idea of requiring confidential reporting in order to monitor and manage the stability of the financial system. We noted, however, that "[t]o ensure this requirement does not impose

[10] Proposed Rules, 76 Fed. Reg at 8,087.
[11] *See* Proposed Rules, 76 Fed. Reg. at 8,087–90.
[12] Office of Management and Budget, *Economic Analysis of Federal Regulations Under Executive Order 12866* (Jan. 11, 1996), http://www.whitehouse.gov/omb/inforeg_riaguide (hereinafter OIRA CBA Guide).
[13] *Id.* § III.A.1.
[14] *See* Proposed Rules, 76 Fed. Reg. at 8,088.
[15] OIRA CBA Guide § III.A.2.

unnecessary costs on hedge funds, we believe the relevant regulator must detail its plans for using the information it seeks as well as demonstrate that it has the technical expertise and operational capacity to carry out those plans."[16] The present release neither explains how the government will use the information nor demonstrates that the data will be useful.

For example, Form PF seeks information about a private equity fund's controlled portfolio companies, including metrics about leverage and whether any of those portfolio companies has defaulted on any debt.[17] As the Committee has noted before, however, "the failure of a portfolio company is very unlikely to have knock-on effects to the larger financial system."[18] These questions, therefore, do not seem to be related to monitoring systemic risk, and the Commissions have not justified the demand for this information.

In addition, when considering the costs of each additional reporting element, the Commissions should bear in mind not only the direct costs, but also the costs associated with the risk of disclosure of highly sensitive proprietary information. Although the information collected through Form PF is intended to be confidential, the Commissions note that the Dodd-Frank Act leaves open the possibility that Congress or other federal departments or agencies could request the information.[19] The likelihood that some information will be disclosed is higher if these bodies obtain the information. The Commissions should bear this possibility in mind, particularly when requesting highly sensitive information. It should only be requested if significantly related to the prevention of systemic risk to the financial system.

Scope of Firms Required to Report

The scope of firms that are required to report may be too broad. For example, the proposed Form PF defines hedge fund to include any firm that "*may* sell securities or other assets short."[20] But not all funds that have the *capability* of short selling actually engage in such transactions and not all that do so have significant positions. The United Kingdom's Financial Services Authority (FSA), for example, considers the *use* of short-selling, rather than the capability, in its definition.[21] Although the term hedge fund is hard to define, the Commissions should take care to avoid improperly and unnecessarily subjecting firms to these reporting requirements.[22]

[16] CCMR May 2009 Report, *supra* note 3, at 88–89.
[17] *See* Proposed Rules, Form PF § 4, 76 Fed. Reg. at 8,140–43.
[18] CCMR May 2009 Report, *supra* note 3, at 100.
[19] *See* Proposed Rules, 76 Fed. Reg. at 8,071 n.39; *see also* Dodd-Frank Act § 404.
[20] Proposed Rules, 76 Fed. Reg. at 8,147 (emphasis added).
[21] U.K. FINANCIAL SERVICES AUTHORITY, FSA HEDGE FUND SURVEY (September 2010) at A1:1 (hereinafter FSA Survey).
[22] *See* Proposed Rules, 76 Fed. Reg. at 8,075 & n.84 (quoting *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) ("'Hedge funds' are notoriously difficult to define. The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition.")).

Coordination

Finally, Form PF should be better coordinated with both FSOC and foreign regulators. Explaining how the government will use the information collected by the form requires coordination with FSOC, the new agency tasked with monitoring the financial stability of the United States. FSOC should explain how it plans to monitor for systemic risk and how it will use the information collected through Form PF in that endeavor.

In addition, the Commissions should try to coordinate with foreign regulators as much as possible. The Proposed Rules indicate that the agencies coordinated with the FSA (and its existing survey of hedge funds) and with Hong Kong's Securities and Futures Commission.[23] We applaud the Commissions' existing efforts to coordinate internationally, but more can be done. To start, the FSA conducts its survey semiannually, rather than quarterly, and sometimes requests slightly different information. For example, the FSA and Form PF explain liquidity in slightly different terms. The FSA bases portfolio liquidity on "a maximum of 25% of the average 90 day daily trading volume in a single day";[24] Form PF bases it on 20%.[25] Small differences add costs without much benefit.

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Although we have long supported confidential reporting to public officials, we are concerned that Form PF is too broad and reflects a lack of careful consideration of the costs and benefits of requiring so many firms to report so much information. We are hopeful that a more carefully constructed reporting regime can help FSOC to monitor the financial stability of the country without subjecting firms to burdensome costs.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

Robert Glenn Hubbard

R. Glenn Hubbard
CO-CHAIR

John L. Thornton
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Hal S. Scott
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[23] *See* Proposed Rules, 76 Fed. Reg. at 8,070–71.
[24] FSA Survey, *supra* note 21, at A2:9.
[25] *See* Proposed Rules, 76 Fed. Reg. at 8,122–23.