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April 4th, 2014

Secretariat of the Financial Stability Board,  
c/o Bank for International Settlements  
CH-4002 Basel  
Switzerland

**Re: Consultative Document on Assessment Methodologies for  
Identifying Global Systemically Important Non-Bank, Non-  
Insurers**

Dear Secretariat of the Financial Stability Board,

Brevan Howard Investment Products Ltd (“**Brevan Howard**”)<sup>1</sup> appreciates the opportunity to comment on the Consultative Document published by the Financial Stability Board (“**FSB**”) and the International Organization of Securities Commissions (“**IOSCO**”) proposing assessment methodologies for the designation of non-bank, non-insurer (“**NBNI**”) financial entities as globally systemically important (the “**Consultative Document**”).

We generally support the FSB and IOSCO’s efforts to develop an NBNI systemic risk assessment methodology that recognizes the important differences between the operations and structures of banks and insurance firms and those of investment funds. As recognized by the Consultative Document, these differences have significant implications for the types and levels of potential systemic risk that may be posed by investment funds and asset management activities. In particular, we support the explicit recognition by the FSB and the IOSCO in the Consultative Document that investment funds “contain a specific ‘shock absorber’ feature that differentiates them from banks” and that fund investors seek to gain exposure to market and other investment risks through their participation in investment funds, in contrast with bank depositors, who do not.<sup>2</sup>

We also support the FSB and IOSCO’s analysis and identification of the potential transmission channels of systemic risk that are most relevant for the types of activities

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<sup>1</sup> Brevan Howard is a global alternative asset manager that manages institutional assets in excess of USD 38 billion across a number of diversified strategies.

<sup>2</sup> Financial Stability Board and International Organization of Securities Commissions, *Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, 29 (2014), [http://www.financialstabilityboard.org/publications/r\\_140108.pdf](http://www.financialstabilityboard.org/publications/r_140108.pdf) [hereinafter *Consultative Document*].

in which investment funds engage. We believe that any assessment methodology for investment funds adopted by the FSB and IOSCO should focus on addressing the channels of transmission that the FSB and IOSCO have identified as relevant for investment funds. Specifically, we believe that the FSB and IOSCO should ensure that its assessment methodology, as applied to investment funds, sets materiality thresholds that capture funds that, if they fail, would cause either:

- systemically significant losses to creditors or counterparties, particularly those that are globally systemically important banks (*i.e.*, the “**Exposures / Counterparty channel**”) or
- systemically significant disruption in trading or funding in key markets as a result of rapid, forced liquidations (*i.e.*, the “**Asset Liquidation / Market channel**”).

We believe that such materiality thresholds would help to focus any additional regulatory measures on firms and activities that might pose risks to global financial markets while ensuring that firms that do not, and could not, pose such risks are not subject to unnecessary and burdensome regulation.

The remainder of our comment letter focuses on our specific concerns with one aspect of the proposed assessment methodology applicable to investment funds: applying a delta-adjusted gross notional exposure (“**GNE**”) threshold to determine which investment funds meet the initial materiality threshold for determining the assessment pool. Under the proposed assessment methodology, a hedge fund with a GNE in excess of between USD 400 and 600 billion would be subject to further assessment for systemic importance by national regulators. This materiality threshold would apply in addition to the more general USD 100 billion of net assets under management (“**AUM**”) threshold under which investment funds of all types would be subject to further assessment. In addition, the proposed assessment methodology would employ GNE as a component of leverage-related indicators of systemic importance.

For the reasons discussed below, we believe that the FSB and IOSCO should not adopt the GNE materiality threshold or use GNE as a component of leverage-related indicators under its assessment methodology. We respectfully submit that GNE is a fundamentally flawed metric and that the use of GNE would result both in false positives (*i.e.*, funds seen to be above the threshold that are not systemically important) and false negatives (*i.e.*, funds seen to be below the materiality threshold that are in fact systemically important). Furthermore, GNE-based measurements do not inform whether a fund poses the levels of risk that would be systemic if transmitted through the risk transmission channels identified by the FSB and IOSCO as relevant to investment funds.

We believe that other metrics, which are already reported to regulators, are more suitable and informative and would be more appropriate for establishing a materiality threshold under systemic importance assessment methodology.

**I. GNE should not be used to determine whether a hedge fund is subject to assessment under the methodology or as a component of leverage-related indicators under the assessment methodology.**

GNE is defined to mean the delta-adjusted absolute sum of the notional value of all long and short positions of a hedge fund, including derivatives positions of the fund. The GNE threshold seems to be based on the mistaken premise that hedge funds do not use derivatives to “hedge exposures and gain exposures to certain asset categories” but instead use them to “obtain (synthetic) leverage.”<sup>3</sup> This is far from accurate. Hedge funds use derivatives for many different purposes, including hedging and obtaining exposure to asset classes. The FSB and IOSCO provide no support for their assertion regarding the use of derivatives by hedge funds, which we respectfully assert is overbroad and inconsistent with many hedge funds’ investment activities.

The FSB and IOSCO acknowledge that GNE does not directly represent an amount of money (or value) at risk and instead is merely a “referential figure used to calculate profits and losses.”<sup>4</sup> Nonetheless, the FSB and IOSCO state that GNE is a better estimate of the economic or market exposure of a fund’s positions because it “[looks] through to the underlying asset or reference.”<sup>5</sup>

For the reasons discussed below, we strongly disagree with the proposed alternative materiality threshold for hedge funds based on GNE and believe that the FSB and IOSCO should not adopt such a threshold. Similarly, we believe that GNE should not be used as a measure of leverage in the indicator as part of the assessment methodology.

***GNE does not reflect any relevant measure of exposure to financial markets, risk, size, or potential to cause losses to creditors or counterparties.***

The FSB and IOSCO characterize GNE in the Consultative Document as a measure that captures all of the leverage, financial and synthetic, employed by a hedge fund to gain market exposure. The Consultative Document states that GNE “represents a fairer appreciation than NAV of the economic or market exposure (*i.e.*, market footprint) of a fund’s positions.”<sup>6</sup>

This characterization is incorrect and misleading for several reasons. First, GNE does not reflect the economic or market exposure of an investment fund. Indeed, that GNE is not a relevant measure of market or other economic or risk exposure has long been recognized by global financial regulators in developing capital requirements and other prudential measures for large, global financial institutions. For instance, the United States Office of the Comptroller of the Currency has stated that “the notional amount

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<sup>3</sup> *Consultative Document*, *supra* note 2, at 33 n.43.

<sup>4</sup> *Consultative Document*, *supra* note 2, at 33.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

of a derivative contract is a reference amount from which contractual payments will be derived, but it is generally not an amount at risk.”<sup>7</sup>

To assist the FSB and IOSCO in considering the use of GNE in the assessment methodology, we discuss several specific examples of how GNE fails to reflect economic or market exposure. First, it provides no adjustment for positions that offset risks arising from a fund’s investment portfolio. For example, GNE would count the full notional value of a swap that offsets currency or interest rate risk of an equity or debt position held by a fund, despite the swap serving to *decrease* the risk exposure of the fund. Similarly, GNE would count twice the full notional values of two perfectly offsetting positions, even though the fund’s net economic exposure would be zero.

Furthermore, GNE does not account for the relative riskiness of different types of derivatives positions held by a fund. In related contexts, regulators have consistently recognized that derivatives referencing short-term interest rates are less risky, given a particular amount of notional exposure, than those referencing long-term interest rates or other asset classes such as currencies, equities and commodities.<sup>8</sup>

GNE also does not take account of the nonlinear nature of the potential risk of loss arising from options and other similar derivatives positions. A fund whose derivative positions consist only of purchased options may have a high GNE, but the maximum possible loss to counterparties is the current value of the options, a figure that may be orders of magnitude lower than the notional, even after delta-adjustment. For example, a one-month at-the-money call option on the S&P 500 index generally will have a value of approximately 1% of its notional amount compared to its delta of 50%. Conversely, a fund whose derivative positions consist of sold options could cause losses well in excess of the delta-adjusted GNE. For example, a one-week S&P 500 put option with a strike 10% out of the money has a delta of 1% of the notional. In the case of a severe market move, this option could have a value much greater than 1% of its notional amount.

In light of GNE’s limitations, we respectfully submit that GNE is not an informative measure of the economic or market exposure of a fund’s positions and therefore does not provide an informative measure of the potential for an investment fund to cause systemic risk through losses to counterparties via the Exposures / Counterparty channel. Instead, as recognized by the FSB and IOSCO in the Consultative

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<sup>7</sup> Office of the Comptroller of the Currency, *OCC’s Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2013* (2013), <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq313.pdf>.

<sup>8</sup> For example, bank regulatory capital requirements apply different conversion factors to short-term and long-term derivatives, in effect treating longer-term derivatives in commodity and equity classes as more risky than short-term interest rate and foreign exchange derivatives. In addition, for purposes of reporting under the U.S. Securities and Exchange Commission’s (“SEC”) Form PF, which was specifically designed to assist regulators in assessing potential systemic risk of hedge funds and other private funds, funds report GNE after adjusting all interest rate derivatives to ten-year equivalent, reflecting the SEC’s recognition that the measures of risk under interest rate derivatives must be adjusted for their duration.

Document, notional amounts are merely “referential values” that are used as a basis for calculation of payments and do not represent amounts at risk.

***The FSB and other global regulatory authorities have previously rejected GNE as an inappropriate measure of risk.***

The Consultative Document is not the first instance in which regulatory authorities have considered how hedge funds and other investment funds may contribute to systemic risk. In the wake of the demise of Long Term Capital Management L.P. (“LTCM”) in 1998, various groups studied measures to help identify firms whose failures could disrupt markets or cause the failures of their counterparties. For example, the Counterparty Risk Management Policy Group report “Improving Counterparty Risk Management Practices” considered different potential measures of risk and explicitly rejected Gross Economic Leverage (*i.e.*, GNE) as inappropriate.<sup>10</sup>

The FSB itself also uses measures other than GNE to identify global systemically important banks. The FSB/Basel methodology for identifying global systemically important banks sets a similar materiality threshold for the largest 75 banks based on the Basel III leverage ratio exposure measure.<sup>11</sup> The Basel III leverage ratio generally uses the current exposure method (“CEM”) to measure risk exposure arising from derivatives – not the full notional amount of those positions. CEM provides a more appropriate measure of economic exposure than notional amount because it recognizes legally enforceable netting arrangements (albeit to a limited extent) and takes into account the potential future volatility in the market value of the underlying asset and the remaining maturity of derivative contracts. Specifically, under the CEM, the exposure attributed to a derivative position is the sum of the replacement cost (*i.e.*, the greater of the current mark-to-market value and zero) and a measure for potential future exposure, which is determined by multiplying the notional amount of the derivative position by a conversion factor ranging from 0.0% to 15%, depending on the derivative’s underlying asset type and its remaining maturity.

In March 2014, the Basel Committee on Banking Supervision (“**Basel Committee**”) adopted a new methodology to replace the CEM for measuring derivatives exposures, called the Standardised Approach (SA-CCR). As the Basel Committee stated, SA-CCR is designed to be *more* risk sensitive than CEM by, among other things, differentiating between margined and unmargined trades and providing greater recognition of hedging and netting benefits. SA-CCR is thus further away from the blunt GNE approach proposed in the FSB and IOSCO assessment methodology and reflects a recognition that these more risk-sensitive measures are also more effective in measuring a firm’s market and economic exposures.<sup>12</sup> We urge the FSB and

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<sup>9</sup> *Consultative Document, supra* note 2, at 33.

<sup>10</sup> Counterparty Risk Management Policy Group, *Improving Counterparty Risk Management Practices*, Appendices A and B (1999), <http://archives.financialservices.house.gov/banking/62499crm.pdf>.

<sup>11</sup> See Basel Committee on Banking Supervision, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* (2013), <http://www.bis.org/publ/bcbs255.pdf>.

<sup>12</sup> Basel Committee on Banking Supervision, *The Standardised Approach for Measuring Counterparty Credit Risk Exposures* (Mar. 2014), <http://www.bis.org/publ/bcbs279.pdf>.

IOSCO, for these same reasons, to reject the use of GNE as part of the assessment methodology.

***The FSB’s proposed assessment methodology is inconsistent with that for other NBNI financial entities.***

The FSB’s assessment methodology proposed in the Consultative Document does not set a GNE-based materiality threshold for finance companies and market intermediaries. Indeed, the methodology treats the derivatives activities of these types of firms quite differently in assessing their potential risks. For example, for finance companies, in assessing the “complexity” factor, the methodology as proposed would consider only the GNE of “OTC derivatives that are not cleared through a central counterparty.” Similarly, no GNE measure would be applied to market intermediaries, where instead the methodology would assess off-balance sheet assets “to the extent possible.”

This approach contradicts the one outlined by the FSB in its 2013 policy recommendations for reforms to financial markets to address concerns with shadow banking. In that report, the FSB stated, “Authorities will identify the potential sources of shadow banking risks in non-bank financial entities in their jurisdictions from a financial stability perspective by categorising these with reference to five economic functions, ***independent of the entities’ legal form***” (emphasis added).<sup>13</sup> We believe that the FSB and IOSCO should, consistent with its report, not adopt a GNE-based materiality threshold for hedge funds under the assessment methodology.

***A GNE-based materiality threshold would generate both false positives and false negatives in terms of market footprint and potential losses to counterparties.***

Should the FSB and IOSCO decide to use GNE as a threshold measure, it will generate both false positives (*i.e.*, funds seen to be above the threshold that are not systemically important) and false negatives (*i.e.*, funds seen to be below the materiality threshold that are in fact systemically important) in terms of market footprint, potential market impact and potential losses to creditors or counterparties. As discussed above, GNE does not reflect adjustments for relative riskiness of different types of derivatives positions. Therefore, a GNE threshold will overcount derivatives positions with large notional amounts but relatively low risk exposures, and conversely will undercount relatively riskier derivatives positions that have lower notional amounts.

We provide a simple illustration of this result. The table at the end of this section shows current market size, in terms of notional amounts of open contracts, for various derivatives markets.

The size of the market and turnover in interest rate derivatives is vastly larger than other market sectors. For example, USD 500 billion notional in interest rate derivatives (an amount equal to the proposed alternative threshold) represents 0.1% of

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<sup>13</sup> Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking: Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities*, 6 (Aug. 29, 2013), [http://www.financialstabilityboard.org/publications/r\\_130829a.pdf](http://www.financialstabilityboard.org/publications/r_130829a.pdf).

open contracts and 6% of daily trading volume. The same USD 500 billion amount represents 103% of open contracts and eight times the daily trading volume in West Texas Intermediate Crude Oil (“WTI”) futures and options. If a USD 500 billion notional position in interest rate derivatives had to be liquidated rapidly, the liquidation would create a much smaller potential for disruption in that market compared to that created by the rapid liquidation of USD 500 billion of WTI-linked derivatives, and consequently the potential cost of such liquidations would be very different. Similarly, the CEM weighting, which as described above serves as a proxy for riskiness under Basel III, ranges from 0% to 1.50% for interest rate derivatives, while the weighting for the WTI futures is much higher, at 10.00%.

Neither the differences in size of market nor the CEM weighting would be reflected in GNE thresholds. Thus, interest rate swaps would be overrepresented in a GNE measurement relative to their market size and CEM weighting, while WTI futures would be underrepresented. This simple example illustrates how setting a fixed threshold in terms of GNE will create both false positives and false negatives, which would subject funds that would not have a systemic market impact to further assessment and may fail to identify funds that could pose systemic risk. Such a misidentification would prevent any meaningful analysis of risks that could be transmitted through the Asset Liquidation / Market channel and the Exposures / Counterparty channel.

**Table: Size of various derivative markets**

	<b>Open contracts</b> (USD billions)	<b>Daily trading volume</b> (USD billions)	<b>CEM weight<sup>n</sup></b>	<b>CCP Initial margin<sup>p</sup></b>
Interest rates – OTC <sup>ab</sup>	561,299	2,343	0-1.5%	
Interest rates – ETD <sup>c</sup>	57,007	5,618		
Equity – OTC <sup>a</sup>	6,821		6-10%	
Equity – ETD <sup>c</sup>	7,237	1,011		
FX – OTC <sup>ad</sup>	73,121	5,345	1-7.5%	
Credit – OTC <sup>a</sup>	24,349			
Commodity – OTC <sup>a</sup>	2,458		10-15%	
Selected exchange traded contracts				
Eurodollar <sup>efq</sup>	31,714	2,749	0.0%	0.03%
5 year T-note <sup>eg</sup>	291	103	0.5%	0.99%
10 year T-note <sup>eg</sup>	466	205	1.5%	1.62%
S&P 500 <sup>fhjk</sup>	2,976	392	6%	5.06%
WTI crude oil <sup>lmr</sup>	484	64	10%	3.31%

“ETD” refers to exchange traded derivatives

Sources: The Bank for International Settlements and CME Group

- a OTC market size as at June 2013 <http://www.bis.org/statistics/dt1920a.pdf>
- b OTC interest rates market volume April 2013 <http://www.bis.org/publ/rpfx13ir.pdf>
- c ETD market size & volume December 2013 [http://www.bis.org/statistics/r\\_qa1403\\_hanx23a.pdf](http://www.bis.org/statistics/r_qa1403_hanx23a.pdf)
- d OTC fx market volume April 2013 <http://www.bis.org/publ/rpfx13fx.pdf>
- e CME interest rates open interest 28 March 2014 <http://www.cmegroup.com/market-data/volume-open-interest/interest-rate-volume.html>
- f CME average daily volume February 2014 [http://www.cmegroup.com/wrappedpages/web\\_monthly\\_report/Web\\_ADV\\_Report\\_CME.pdf](http://www.cmegroup.com/wrappedpages/web_monthly_report/Web_ADV_Report_CME.pdf)
- g CBT average daily volume February 2014 [http://www.cmegroup.com/wrappedpages/web\\_monthly\\_report/Web\\_ADV\\_Report\\_CBOT.pdf](http://www.cmegroup.com/wrappedpages/web_monthly_report/Web_ADV_Report_CBOT.pdf)
- h CME equity open interest 28 March 2014 <http://www.cmegroup.com/market-data/volume-open-interest/equity-volume.html>
- j CBOE open interest 28 March 2014 <http://www.cboe.com/data/mktstat2.aspx?Dy=31&Mo=3&Yr=2014&selid=SPX>
- k CBOE average daily volume February 2014 <http://www.cboe.com/publish/MonthlyVolume/FEBRUARY%202014%20News%20Release%20attachment.xls>
- l NYMEX open interest 28 February 2014 [http://www.cmegroup.com/wrappedpages/web\\_monthly\\_report/Web\\_OI\\_Report\\_NYMEX\\_COMEX.pdf](http://www.cmegroup.com/wrappedpages/web_monthly_report/Web_OI_Report_NYMEX_COMEX.pdf)
- m NYMEX average daily volume February 2014 [http://www.cmegroup.com/wrappedpages/web\\_monthly\\_report/Web\\_ADV\\_Report\\_NYMEX\\_COMEX.pdf](http://www.cmegroup.com/wrappedpages/web_monthly_report/Web_ADV_Report_NYMEX_COMEX.pdf)
- n CEM weights <https://www.bis.org/publ/bcbs128d.pdf>
- p CME initial margins 1 April 2014 <http://www.cmegroup.com/clearing/margins>
- q CEM weight is for maturities under 1 year; margin shown is for March 2015 futures
- r CEM weight is for maturities under 1 year; margin shown is for March 2014 futures



**II. If FSB and IOSCO find it appropriate to apply an alternative materiality threshold to hedge funds, the threshold should be based on a risk-sensitive measure.**

If the FSB and IOSCO determine that it is necessary to develop an alternative materiality threshold for hedge funds, we urge that the threshold be based on a relevant measure of the actual potential for losses borne by a fund. Specifically, we believe that the FSB and IOSCO should adopt initial margin as an alternative threshold metric.

For many types of financial contracts, in addition to posting margin to cover any mark-to-market losses on the trades (*i.e.*, variation margin), a hedge fund may be required to maintain some extra amount of margin, known as an independent amount, haircut, or initial margin. Examples of contracts under which funds commonly post initial margin include bilateral and cleared over-the counter (“OTC”) derivatives, repos, futures, and security financing transactions such as margin loans. In a scenario where the market moves against the fund, it will be required to post variation margin each day to cover the prior day’s loss. Should the day come where the fund fails to meet a margin call, the fund’s counterparty will close out the trades. The market may continue to move against the fund’s trades during the time required to close out the trades. The initial margin posted by the fund is intended to provide a buffer to the counterparty in order to cover any losses the counterparty might suffer because of the change in value of the positions from the time at which the fund last met a margin call to the time at which closeout is completed. Hence, initial margin is set at a level estimated to cover the potential change in value of a counterparty’s trades over the time it would take to liquidate those trades under stressful conditions. Therefore the total initial margin posted by a hedge fund is a good proxy for the risk of loss of that fund’s total portfolio during the time it would take to liquidate it.

In the case of cleared derivatives, central counterparties (“CCPs”) have strong incentives to set relatively high margin levels in order to avoid any losses that exceed initial margin should there be a default. Also, various regulations, such as the European Market Infrastructure Regulation and rulemakings under the Dodd-Frank Wall Street Reform and Consumer Protection Act, require CCPs to take into account both normal and stressed market conditions when setting margin levels. CCP margin calculations take account of the relative riskiness of different derivative portfolios and their nonlinearity; initial margin is therefore a measure that appropriately reflects the potential losses that could arise upon the failure of the fund. Indeed, margin requirements set by CCPs for most derivatives are similar to the weights used in the CEM method. Therefore using initial margin as a threshold measure for funds would in some ways be equivalent to using the CEM metric as a threshold for banks.

For noncleared derivatives, margins currently set by derivative dealers employ many of the same inputs as CCP margins. Minimum margin requirements for noncleared derivatives are expected to be implemented pursuant to the G-20 agreements in the

next few years. Further, mandatory minimum margin levels are set to come into force gradually over the period 2015 to 2019.<sup>14</sup>

In the case of securities financing transactions, the haircut is equivalent to initial margin for derivatives. Haircuts set by banks and dealers in repo markets are calculated in a risk-sensitive manner and are expected to become subject to minimum standards pursuant to the FSB's proposed regulatory framework.<sup>15</sup>

We believe that the FSB and IOSCO, if they determine to apply a separate materiality threshold to hedge funds, should use a threshold based on a fund's overall initial margin requirement, including haircuts. As noted, the fund's overall initial margin requirement is an estimate by its counterparties of the amount needed to cover possible losses in the event of the failure of the fund during the time it would take to liquidate the fund's positions. Thus, we believe initial margin is an appropriate threshold measurement of a fund's potential to cause losses to its counterparties and creditors via the Exposures / Counterparty channel. Since initial margin is explicitly meant to cover the potential change in value of the counterparty's trades during closeout, it is also a direct measure of the potential for that closeout to cause disruption to the relevant market and hence systemic risk through the Asset Liquidation / Market channel. Furthermore, data on initial margin is already readily available to regulators in Forms PF and CPO-PQR and in the Alternative Investment Fund Managers Directive reporting template.

Our proposal that initial margin should be used as a risk measure with which to select funds for further investigation clearly depends both on the quality of the initial margin calculations and their broad application to all funds. As previously noted, we think the first concern has been addressed through developments in CCP models and regulatory mandates to collect margin linked to risk on uncleared trades. As for the latter concern, we note that at the time of the LTCM collapse it was possible for any customer (including hedge funds) to negotiate with its counterparties to receive favorable initial margin terms, much lower than are currently required. This practice made it possible for customers to have derivative portfolios that were much more risky than what is possible today, because a much smaller amount of the customer's capital was required for initial margin. Furthermore, it dramatically increased the risk for the customer's counterparties because the buffer available to them to cover losses on close out was correspondingly much smaller. In the past, therefore, the amount of initial margin posted by a customer could have been irrelevant as a guide to its risk. We believe that the requirement that most OTC derivatives be cleared, the ongoing rollout of rules covering initial margin for bilateral OTC derivatives and the proposed minimum haircuts for repo transactions, eliminate this possibility and will mean that all funds will post initial margin commensurate with their risks. Therefore a

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<sup>14</sup> Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, *Margin requirements for non-centrally cleared derivatives* (Sept. 2013), <http://www.bis.org/publ/bcbs261.pdf>.

<sup>15</sup> *FSB Launches Quantitative Impact Study (QIS2) on Proposed Regulatory Framework for Haircuts on Securities Financing Transactions*, FINANCIAL STABILITY BOARD (Nov. 5, 2013), [http://www.financialstabilityboard.org/publications/r\\_131104.htm](http://www.financialstabilityboard.org/publications/r_131104.htm).

threshold based on initial margin would properly capture a high-risk fund such as LTCM proved to be.

**III. Should the FSB and IOSCO nonetheless determine to establish a GNE materiality threshold, the proposed range of USD 400 to USD 600 billion proposed by the FSB and IOSCO is set far too low to provide a meaningful filter of potentially systemic entities and is inconsistent with the FSB's decisions relating to systemically important banks.**

According to the latest BIS statistics on OTC derivatives markets, notional amounts of outstanding OTC derivatives totaled USD 693 trillion as of the end of June 2013.<sup>16</sup> The proposed threshold range of USD 400 to USD 600 billion therefore represents between 0.06% and 0.09% of the OTC derivatives market, a figure which is almost vanishingly small in terms of the overall market. Further, the average daily trading volume of just one derivatives market – the Chicago Mercantile Exchange's Eurodollar futures and options contract – amounts to a notional of more than USD 2.5 trillion. The FSB and IOSCO's proposed threshold range is less than 20% of the daily volume of that single market. This would hardly appear to be a size that could generate systemic risk.

The FSB has designated certain large banking groups *not* to be systemically significant despite having up to USD 17 trillion in derivative gross notional and gross notional-to-equity ratios of up to 740:1.<sup>17</sup> There is no discernable policy basis for subjecting non-banks, and in particular hedge funds, to review for global systemically important financial institution status using thresholds that are significantly stricter than those used for banks. This is particularly true, since, as recognized by the FSB and IOSCO, funds do not take deposits or engage in traditional bank lending, dealing or brokerage activities, and the losses of a hedge fund are borne by its investors. There is no apparent policy reason for setting the proposed alternative threshold of USD 400 to USD 600 billion (with the implicit ratio of GNE to equity of 4-6x, using the net asset value threshold of USD 100 billion) so far below levels that the FSB has already determined are not systemically significant for banks.

As previously stated, we believe that the FSB and IOSCO should not adopt the alternative GNE materiality threshold. However, if the FSB and IOSCO determine that it is appropriate to impose such a threshold, the threshold should be appropriately calibrated to avoid subjecting clearly nonsystemic investment funds to unnecessary review.

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<sup>16</sup> *OTC derivatives statistics as at end-June 2013*, BANK FOR INTERNATIONAL SETTLEMENTS (Nov. 7, 2013), <http://www.bis.org/press/p131107.htm>.

<sup>17</sup> For example, Nomura Holdings Inc., Royal Bank of Canada (RBC), Danske Bank Group, National Australia Bank, TD Bank Group and Intesa Sanpaolo each report a derivative gross notional of greater than USD 4 trillion, but are not designated as systemically important financial institutions.

Brevan Howard appreciates the FSB and IOSCO's consideration of its views. Please do not hesitate to contact me with any questions at [aron.landy@brevanhoward.com](mailto:aron.landy@brevanhoward.com).

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Aron Landy', with a long horizontal flourish extending to the right.

Dr. Aron Landy  
Partner and Chief Risk Officer  
Brevan Howard Investment Products Ltd