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Re: Amendments to Form PF to Amend Reporting Requirements for All Filers and Large Hedge Fund Advisers (File No: S7-22-22/RIN 3038-AF31)

Secretary Countryman & Kirkpatrick,

The Americans for Financial Reform Education Fund appreciates this opportunity to comment on the Securities and Exchange Commission's (SEC) and Commodity Futures Trading Commission's (CFTC) joint proposal that would update private fund adviser reporting to the SEC on Form PF as well as the CFTC's Form CPO-PQR. The proposed changes are particularly important given the rapid growth and risks of assets in this space.

Visibility into large private fund advisers, and in particular the risks from highly concentrated and leveraged positions and the extent of interconnectedness with other financial institutions is important, and regulators currently have very little information. Despite the "private funds" label, the public has repeatedly borne the costs of aiding large private fund advisers that suddenly posed risks to the financial system, whether it was the implosion of hedge fund Long Term Capital Management in 1998, the Financial Crisis of 2008, or several hedge funds caught off-guard by highly leveraged relative value trades on U.S. Treasuries in March 2020.

We support the SEC and CFTC proposals to collect additional information. Having and sharing this information and with the Financial Stability Oversight Council (FSOC) will help financial regulators fully understand the risks across the financial system so that they can better address issues that may arise from future economic downturns or sudden disruptions to the financial system.

Reporting of digital assets is long overdue

We strongly support the SEC and CFTC's proposal to require private fund advisers to report an additional field detailing their holdings of digital assets. We also suggest that the SEC and CFTC make a distinction in reporting between "stablecoins" and other cryptocurrencies. The size of the digital asset market has grown exponentially in the past few years from practically non-existent over a decade ago when Form PF was first adopted to about $920 billion today.[1]

Although digital assets are frequently marketed as an alternative to the traditional finance system, hedge funds, private equity firms, and banks have been getting more involved in investing and lending those assets. Examples range from the largest asset manager BlackRock investing in[2] and offering several Bitcoin related products to its clients[3] to investment bank Goldman Sachs offering cryptocurrency derivatives to hedge fund clients.[4]

Some hedge funds especially focused on digital assets have already caused sizeable losses. For example, the mismanagement of Three Arrows Capital ("3AC") has been estimated to be responsible for about $1 trillion in losses across the entire cryptocurrency market.[5] 3AC's bankruptcy has in turn led to other creditors filing $3.5 billion in claims such as other crypto focused hedge funds such as Genesis Global Trading who lent 3AC $2.3 billion, crypto exchange Voyager Digital who is owed $650 million, and crypto company Blockchain.com $270 million.

As more private funds continue to invest and lend a variety of cryptocurrencies it is imperative that the SEC, CFTC, and FSOC understand how much exposure private funds have to this asset class, and the ways in which other funds and Global Systemically Important Banks (G-SIBs) are exposed to funds that have especially concentrated holdings of various cryptocurrencies and loans.

We believe both the SEC and CFTC should go further to differentiate between stablecoins and other digital assets. Unlike digital assets such as Bitcoin or Ethereum, stablecoins such as Tether and Circle Financial's USDCoin invest in a portfolio of short-term assets such as commercial paper, U.S. Treasury bills, and repurchase agreements. Stablecoins therefore may be more similar to money market mutual funds than other digital assets and therefore should be a distinctly different reporting category.

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[1] CoinMarketCap. Accessed on Oct 11, 2022. Coinmarketcap.com

[2] Crawley, Jamie. CoinDesk. BlackRock Has Almost $400M Invested in Bitcoin Mining Stocks. Aug 20, 2021. https://www.coindesk.com/markets/2021/08/20/blackrock-has-almost-400m-invested-in-bitcoin-mining-stocks-report/

[3] Macheel, Tanaya. CNBC. BlackRock launches a private trust to give clients exposure to spot bitcoin. Aug 11, 2022. https://www.cnbc.com/2022/08/11/blackrock-launches-a-private-trust-to-give-clients-exposure-to-spot-bitcoin.html

[4] Yang, Yueqi. Bloomberg News. Goldman Sachs Starts Trading New Derivative Tied to Ether. Jun 13, 2022. https://news.bloombergtax.com/crypto/goldman-sachs-starts-trading-new-derivative-tied-to-ether

[5] Wieczner, Jen. New York Magazine. The Crypto Geniuses Who Vaporized a Trillion Dollars. Aug 15, 2022. https://nymag.com/intelligencer/article/three-arrows-capital-kyle-davies-su-zhu-crash.html

Both long and short positions, whether physical or synthetic, need to be reported to provide an accurate picture of holdings

We also strongly support the proposal to require private fund advisers to report both the long and short positions across U.S. Treasury bonds, corporate debt, as well as the swaps and derivatives that reference them to ensure that FSOC has a complete picture of the risk exposure across private funds.

As the SEC has found, including when looking back to the turmoil in the U.S. Treasury bond market in March 2020, the current aggregated reporting of U.S. Treasuries failed to provide regulators with insight into a relative value trade several hedge funds were using that soon required a bailout from the Federal Reserve.[6]

In this notable instance, involving arguably the most systemically important market in the world, several private funds attempted to profit from the difference between the prices of U.S. Treasury bonds versus their corresponding futures contracts to the tune of 400 to 500 billion dollars.[7] The trade is typically conducted by a hedge fund selling a Treasury futures contract short, while purchasing the underlying U.S. Treasury bond that could later be delivered to fulfill that short obligation. The small differences in price between the U.S. Treasury bond and its corresponding futures contract is captured by the hedge fund and often magnified by additional leverage to provide a greater return.[8]

Under the current Form PF reporting, a hedge fund conducting such a trade would report its U.S. Treasury bond holdings, (and in some cases has done so as “cash and cash equivalents”) while the short U.S. Treasury bond futures are lumped in with other unrelated derivatives and reported in a broad aggregate, providing little usable information to the SEC and FSOC.

The need to disaggregate derivatives holdings is also apparent in corporate debt where investment strategies involving a combination of securities and derivatives such as credit default swap basis trades and “net-short debt activism” occur and where a look at only the aggregated data, or a look at the underlying security and not the corresponding derivatives seriously obscures the full picture.

Private funds have also tried to profit from credit default swaps that are trading at a lower level of risk (measured in basis points) to their underlying corporate bonds they reference. The hedge fund may purchase the underlying corporate bond and buy protection (basically

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[6] Vissing-Jorgensen, Annette. Bank of International Settlements. The Treasury market in spring 2020 and the response of the Federal Reserve. Oct 19, 2021. https://www.bis.org/publ/work966.htm

[7] Barth, Daniel and Kahn, Jay. Treasury Office of Financial Research. Hedge Funds and the Treasury Cash-Futures Disconnect. Apr 1, 2021. https://www.financialresearch.gov/working-papers/files/OFRwp-21-01-hedge-funds-and-the-treasury-cash-futures-disconnect.pdf

[8] Younger, Joshua. Council on Foreign Relations. Revisiting the Ides of March, Part II: The Going Gets Weird. Jul 22, 2020. https://www.cfr.org/blog/revisiting-ides-march-part-ii-going-gets-weird

purchasing insurance against a default) through the credit default swap.[9] In isolation, under the current Form PF, the SEC and FSOC would see the corporate bond holdings without also seeing the offsetting credit default swap position. Just as in the prior example of the U.S. Treasury bond cash-futures relative value trade these trades may result in large and sudden losses, in this case if market volatility forces market participants to close any side of the trade early.[10]

Similarly, in recent years, corporate debt investors have seen the rise of "net-short debt activism" where a bondholder holding a long position will have a larger short position using a derivative such as a credit default swap. The net-short debt activist can then improperly utilize its rights as a creditor on its long bond position in a way that flies against the interests of other bondholders in order to profit on its short position.[11] This greater granularity of information collected on Form PF can also help the SEC enforce fraud and manipulation of security-based swaps under Rule 9j-1.[12]

Both the SEC and CFTC should require private funds to report in a more granular manner all long and short positions regardless of whether they are the actual security or synthetic through derivatives. Private funds continue to use a combination of securities and derivatives and as it stands the SEC and FSOC are not seeing a clear picture of which derivatives also match up against the underlying securities they reference.

The SEC should require private funds to report holdings in their base currencies rather than converted to U.S. dollars

The recent sharp movements between the currency pairs of several G-10 countries clearly makes the case for the SEC requiring private funds to report holdings in the base currency in order for the information collected by FSOC to properly assess how much currency risk private fund advisers are exposed to. The British Pound (GBP) for example has lost 18% of its value against the U.S. Dollar so far in 2022 bringing the difference between the currency pair to its all-time lowest levels.[13]

[9] Boyarchenko, Nina and Gupta, Pooja and Steele, Nick and Yen, Jacqueline. Federal Reserve Bank of New York Economic Policy Review. Trends in Credit Basis Spreads. October 2018. https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_trends-in-credit-basis-spreads_boyarchenko.pdf
[10] Fontana, Alessandro. European Insurance and Occupational Pensions Authority. The Negative CDS-Bond Basis and Convergence Trading During the 2007/09 Financial Crisis. Oct 5, 2011. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1939184
[11] Euromoney. CDS market: Beware the net short debt activist. Oct 9, 2018. https://www.euromoney.com/article/b1b9kgb7fyx0m5/cds-market-beware-the-net-short-debt-activist
[12] Securities and Exchange Commission. Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition Against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions. Dec 15, 2021. https://www.sec.gov/rules/proposed/2021/34-93784.pdf
[13] Mellor, Sophie. Fortune. It's the worst ever collapse of the pound but far from the first. Here's a look back at the biggest sterling shocks, all the way back to 1971. Sep 26, 2022. https://fortune.com/2022/09/26/why-is-pound-falling-history-george-soros-liz-truss-uk-economy/

A number of hedge funds lost sizeable sums of money on their currency positions even before the volatility across several currency pairs picked up this year. In 2018 for example, a hedge fund unit of Hong Kong's GF Holdings Corp. lost a sizeable amount of money on its currency trades which in turn lead to investment bank Citigroup incurring $180 million in losses.[14]

We therefore strongly support the proposal to require private funds to report their holdings in their base currencies rather than convert them to U.S. dollars.

Conclusion

We strongly support these proposals from both the SEC and CFTC that would provide both the SEC and FSOC with much more granular data that would provide a more nuanced and complete understanding of the distribution and urgency of risks in the $18 trillion of private fund assets.

Such additional reporting requirements would not be unduly burdensome to private fund advisers as all of them by the nature of their business already conduct extensive analyses on their holdings and risk exposures.[15]

We thank you for your consideration of this important matter. For additional questions please contact Andrew Park at andrew@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform Education Fund

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[14] Griffin, Donal and Surane, Jennifer and Chan, Cathy. Bloomberg News. Citigroup Faces $180 Million Loss on Loan to Asia Fund. Dec 19, 2018. https://www.bloomberg.com/news/articles/2018-12-18/citigroup-is-said-to-face-180-million-loss-on-loan-to-asia-fund

[15] Cassar, Gavin and Gerakos, Joseph. Chicago Booth Research Paper No. 13-13, 26th Australasian Finance and Banking Conference 2013, Fama-Miller Working Paper. Dec 16, 2016. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1722250