MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

RICHARD H. BAKER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing on

Systemic Regulation, Prudential Matters, Resolution Authority and Securitization

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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TESTIMONY OF MANAGED FUNDS ASSOCIATION

Systemic Regulation, Prudential Matters, Resolution Authority and Securitization
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Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Financial Services' hearing, "Systemic Regulation, Prudential Matters, Resolution Authority and Securitization" held on October 29, 2009. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies around the world.

MFA appreciates the opportunity to express its views on financial regulatory reform, including the important subjects of investor protection, systemic risk and regulation for managers of private pools of capital, including hedge fund managers. In our view, any revised regulatory framework should address identified risks, while ensuring that private pools of capital are still able to perform their important market functions. It is critical, however, that consideration of a regulatory framework not be based on misconceptions or inaccurate assumptions.

Hedge funds are among the most sophisticated institutional investors and play an important role in our financial system. They provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or improve their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. Hedge funds engage in a variety of investment strategies across many different asset classes. The growth and diversification of hedge funds have strengthened U.S. capital markets and provided their investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, hedge funds help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

To perform these important market functions, hedge funds require sound counterparties with which to trade and stable market structures in which to operate. The recent turmoil in our markets has significantly limited the ability of hedge funds to conduct their businesses and trade in the stable environment we all seek. As such, hedge funds have an aligned interest with other stakeholders, including retail investors and policy makers, in reestablishing a sound financial system. We support efforts to protect investors, manage systemic risk responsibly, and ensure stable counterparties and properly functioning, orderly markets.

Hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were, and remain, substantially less leveraged than banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance despite the fact that our industry, and our investors, have suffered mightily as a result of the instability in our financial system and the broader economic downturn. The losses suffered by hedge funds and their investors did not threaten our capital markets or the financial system.

Although hedge funds are important to capital markets and the financial system, the relative size and scope of the hedge fund industry in the context of the wider financial system helps explain why hedge funds did not and do not pose systemic risk. With an estimated \$1.5 trillion under management, the hedge fund industry is significantly smaller than the U.S. mutual fund industry, with an estimated \$9.4 trillion in assets under management, or the U.S. banking industry, with an estimated \$13.8 trillion in assets. According to a report released by the Financial Research Corp., the combined assets under management of the three largest mutual fund families are at \$1.9 trillion, which exceeds the total assets of the entire hedge fund industry. Moreover, because many hedge funds use little or no leverage, their losses did not pose the same systemic risk concerns that losses at more highly leveraged institutions, such as brokers and investment banks, did. A study by PerTrac Financial Solutions released in December 2008 found that 26.9% of hedge fund managers reported using no leverage. Similarly, a March 2009 report by Lord Adair Turner, Chairman of the U.K. Financial Services Authority (the "FSA"), found that the leverage of hedge funds was, on average, two- or three-to-one, significantly below the average leverage of banks.

Though hedge funds did not cause the problems in our markets, we believe that the public and private sectors (including hedge funds) share the responsibility of restoring stability to our markets, strengthening financial institutions, and ultimately, restoring investor confidence. Hedge funds remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to our capital markets. We are committed to working with the Administration and Congress with respect to efforts that will restore investor confidence, stabilize our financial markets, and strengthen our nation's economy.

I. A "SMART" APPROACH TO FINANCIAL REGULATORY REFORM

MFA supports a smart approach to regulation, which includes focused, effective, and efficient regulation and industry best practices that (i) promote efficient capital markets, market integrity, and investor protection and; (ii) better monitor and reduce systemic risk. Smart regulation will likely entail increasing regulatory requirements in some areas, modernizing and updating antiquated financial regulations in other areas, and working to reduce redundancies, overlaps, and gaps between agencies wherever possible.

A key step in creating a smart regulatory framework is identifying the intended objectives of regulation – strengthening investor protection and market integrity and reducing systemic risk. Doing so will help ensure that proposals are considered and applied in a focused manner to achieve those objectives, which is likely to improve the functioning of our financial system. Not doing so runs the risk of creating more harm than good, as we witnessed last year with the SEC's ban on short selling.

A smart regulatory framework should include comprehensive and robust industry best practices designed to achieve the shared goals of monitoring and reducing systemic risk and promoting efficient capital markets, market integrity, and investor protection. Since 2000, MFA, working with its members, has been the leader in developing, enhancing and promoting standards of excellence through its document, *Sound Practices for Hedge Fund Managers ("Sound Practices")*.[1] As part of its commitment to ensuring that *Sound Practices* remains at the forefront of setting standards of excellence for the industry, MFA has updated and revised *Sound Practices* to incorporate the recommendations from the best practices report issued by the President's Working Group on Financial Markets' Asset Managers' Committee. MFA and other industry groups have also created global, unified principles of best practices for hedge fund managers.

Because of the complexity of our financial system, an ongoing dialogue among market participants and policy makers is a critical part of the process of developing smart, effective regulation. MFA and its members are committed to being active, constructive participants in the dialogue regarding the various regulatory reform topics.

Regulation is not a panacea for the structural market breakdowns that still exist in our financial system. One such structural breakdown is the lack of certainty regarding major public financial institutions (*e.g.*, banks, broker dealers, insurance companies) and their financial condition. Investors' lack of confidence in the financial health of these institutions has been, and may continue to be, an impediment to investors' willingness to put capital at risk in the market or to engage in transactions with these firms, which, in turn, are impediments to market stability. The comprehensive stress tests earlier this year on the 19 largest bank holding companies were designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. While those stress tests appear to have helped develop greater certainty, we believe that it is also important for policy makers and regulators to ensure that accounting and disclosure rules are designed to promote the appropriate valuation of assets and liabilities and consistent disclosure of those valuations.

Though regulation cannot solve all of the problems in our financial system, careful, well thought out financial regulatory reform can play an important role in restoring financial market stability and investor confidence. The goal in developing regulatory reform proposals should not be to throw every possible proposal into the regulatory system. Such an outcome will only overwhelm regulators with information and added responsibilities that do little to enhance their ability to effectively fulfill their agency's missions. The goal should be developing an "intelligent" system of financial regulation, as former Fed Chairman Paul Volcker has characterized it.

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[1] MFA's *Sound Practices* is available at: http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf

We believe that regulatory reform objectives generally fall into three key categories. Those categories are: investor protection, market integrity and prudential regulation, including registration of advisers to private pools of capital; systemic risk regulation; and regulation of market-wide issues, such as short selling. I would like to focus my testimony today on systemic risk regulation, including a resolution authority framework.

II. SYSTEMIC RISK REGULATION

I would like to highlight what we believe are the key aspects of systemic risk regulation as well as offer some thoughts on some of the key aspects of the systemic risk framework set out in the Administration's *"Bank Holding Company Modernization Act of 2009"* and the discussion draft of the *"Financial Stability Improvement Act of 2009"* (together, the "Systemic Risk Proposals") as well as the Administration's and discussion draft of the *"Resolution Authority for Large, Interconnected Financial Companies Act of 2009"* (together, the "Resolution Authority Proposals").

The first step in developing a systemic risk regulatory regime is to determine those entities that should be within the scope of such a regulatory regime. There are a number of factors that policy makers are considering as they seek to establish the process by which a systemic risk regulator should identify, at any point in time, which entities should be considered to be of systemic relevance. Those factors include the amount of assets under management of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants. MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, as Chairman Bernanke said in response to a question at the October 1st hearing before the Committee,[2] the industry should be considered within the systemic risk regulatory framework, especially in terms of information gathering. We also agree with the statement made by Chairman Bernanke in response to a question at that hearing that no individual hedge fund is likely to become systemically relevant. As policy makers and regulators seek to determine whether any individual hedge fund is of systemic relevance, it is important that consideration be given to the relatively small size of hedge funds compared to other financial institutions, the relatively low levels of leverage used by hedge funds, and the narrower focus of hedge funds. As institutional investors, hedge funds do not provide payment and settlement services to the public nor are hedge funds licensed to open bank accounts or brokerage accounts for the public. For these reasons, and others, any losses that hedge funds may have experienced may have disappointed their investors and managers, but did not cause systemic risk during this global crisis.

It is also important to define the intended objectives of systemic risk and resolution legislation. It is our understanding that the intended objectives are to develop enhanced prudential regulation that allows systemically relevant firms to continue to conduct business, but do so in a manner that reduces the likelihood of systemic risk and of a firm becoming "too big to fail", but to provide a resolution framework that is capable

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[2] Hearing on *"Federal Reserve Perspectives on Financial Regulatory Reform Proposals"* before the House Committee on Financial Services.

of dealing with any situation when a failing firm could jeopardize the entire financial system.

We support those objectives and believe that they are best achieved through a framework that addresses participant, product and structural issues that can cause systemic risk. It is important in developing and implementing the systemic risk framework to do so in a manner that avoids the unfair competitive advantages gained by market participants with a government guarantee and also avoids the moral hazards that can result from a company having a government guarantee. It is also important that the framework be developed and implemented in a manner that allows investors, lenders and counterparties to understand relevant rules and have confidence that those rules will be applied consistently in the future. When investors do not have that confidence, they are less likely to put their capital at risk in our markets. The ad hoc nature and lack of clarity with respect to certain government programs over the past year has had adverse effects with respect to the willingness of investors and lenders to put capital at risk, with negative consequences for our markets and our economy.

To achieve the objectives of reducing the potential systemic risks of systemically relevant entities and developing appropriate resolution authorities, MFA believes that the systemic risk and resolution authority framework should have the following components:

- A central systemic risk regulator with oversight of the key elements of the entire financial system, across all relevant structures, classes of institutions and products, and an assessment of the financial system on a holistic basis;
- Confidential reporting by every financial institution, generally to its "functional" regulator, which would then make appropriate reports up to the systemic risk regulator, providing information that the regulator determines is necessary or advisable to enable it to adequately assess, on both a current and a forward-looking basis, potential risks to the financial system;
- Direct, prudential regulation of entities determined to be systemically relevant by the systemic risk regulator;
- A clear, singular mandate for the systemic risk regulator to protect the financial system, including the ability to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system, though such authority should be implemented in a way that avoids the unfair competitive advantages gained by market participants with a government guarantee and also avoids the moral hazards that can result from a company having a government guarantee;
- Clear rules regarding prudential regulation and resolution authorities so that investors, lenders and counterparties have certainty regarding the regulatory framework relevant to their activities; and
- Ensuring that the systemic risk regulator has adequate authority to enable it to be forward-looking to prevent potential systemic risk problems, as

well as the authority to address systemic problems once they have arisen; and implements that authority by focusing on all relevant parts of the financial system, including structure, classes of institutions and products.

MFA Views on the Systemic Risk Proposals

MFA believes that the above approach is generally consistent with the approach taken in the Systemic Risk Proposals. In particular, we are supportive of the Proposals' approach of creating a central systemic risk regulator and a mechanism designed to foster greater communication and coordination among financial regulators. We also support risk reporting, which we believe should generally be made to the financial institution's functional regulator, who will in turn provide reports to the systemic risk regulator, though it is critical that such reporting be done on a confidential basis. We also generally support the Systemic Risk Proposals' approach to systemic risk regulation, which calls for strong, prudential regulation of systemically relevant firms, though we encourage policy makers to consider what type of heightened regulation is appropriate for different types of systemically relevant firms.

Because there will likely be significant differences in the business models of systemically relevant firms, with different risks associated with those businesses, we believe appropriately tailored regulation of systemically relevant firms, rather than one-size-fits-all regulation of those firms, is the appropriate approach to systemic risk regulation. In this regard, we support the approach of the Systemic Risk Proposals in providing the systemic risk regulator with authority to differentiate among systemically relevant firms based on their risk, complexity, financial activities, and other factors the regulator deems appropriate.

We are concerned, however, with the approach taken in the Systemic Risk Proposals of subjecting non-bank, systemically relevant firms to the Bank Holding Company Act (the "BHCA"). The BHCA was designed principally to separate banking and commercial activities for depository institutions. While the BHCA may be an appropriate systemic risk regulatory framework for banks, if it were applied to non-bank, systemically relevant firms, the BHCA's restrictions regarding engaging in commercial activities would impose unfair and inappropriate burdens on those non-bank firms. In particular, we are concerned with several specific aspects of the Systemic Risk Proposals, including those that would:

- Subject non-bank, systemically relevant firms to section 4 of the BHCA, which was designed to impose significant restrictions on the ability of bank holding companies to engage in non-banking activities;

- Fail to protect the confidentiality of potentially proprietary information reported to the systemic risk regulator; and

- Impose the holding company model on all systemically relevant firms, which does not seem appropriate for investment advisers and their funds, which are not structured as parent/subsidiaries.

These BHCA restrictions could effectively preclude non-bank, systemically relevant firms from conducting their primary business (such as investing in a range of commercial entities), which would lead to significant, adverse consequences for our capital markets and our economy.

In addition, we believe the focus on capital requirements is misapplied with respect to investment firms. Capital requirements are primarily intended to provide a cushion, as a form of prudential regulation, to ensure that institutions that have obligations to the public (such as bank depositors, insurance policyholders, or the government) are able to meet those obligations despite losses they may suffer on their lending or other activities. On the other hand, investment firms manage other people's money, not their own capital. They may leverage the equity capital they receive from investors by borrowing from counterparties (usually on a collateralized basis) or making investments with inherent leverage (*i.e.*, futures or options) and putting up margin as collateral. Their counterparties are thus able to protect themselves without capital requirements for the investment firm because they can look to the collateral or margin that has been posted. Moreover, investment firms have no access to taxpayer funding, and any losses the funds they manage experience are borne by the investors in those funds. If the public policy objective is to limit the potential systemic risk that the investing activities of such firms may have, the more effective way to achieve that is through leverage limitations and appropriate collateral and margining regimes.

Instead of subjecting non-bank, systemically relevant firms to the BHCA, we encourage policy makers to develop a new framework for systemic risk regulation of these firms. With respect to the prudential regulation of non-bank, systemically relevant firms, we believe that this new framework should provide a systemic risk regulator with the authority to:

- Require non-bank, systemically relevant firms to report to the systemic risk regulator, on a confidential basis, information that the regulator determines is necessary or advisable to enable it to adequately assess, on both a current and a forward-looking basis, potential risks to the financial system, equivalent to the proposed reporting to the SEC envisioned under the "*Private Fund Investment Advisers Registration Act 2009*";

- Conduct supervision and inspections with respect to non-bank, systemically relevant firms;

- Establish limits on the amount of leverage that a non-bank, systemically relevant firm may use, giving appropriate consideration to factors such as the nature of the firm's strategy and assets and whether the firm posts collateral to protect the counterparty extending leverage;

- Establish margining or collateral requirements for the investment activities of non-bank, systemically relevant firms, giving appropriate consideration to factors such as the nature of a firm's strategy and assets; and

- In extreme cases, require non-bank, systemically relevant firms to reduce their market and counterparty exposure.

MFA Views on the Resolution Authority Proposals

As stated above, MFA supports a resolution authority framework that provides a regulator with the ability to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system. In that regard, MFA is generally supportive of the Resolution Authority Proposals. In particular, we are supportive of the approach of giving the regulator a strong set of authorities to take a variety of actions as it deems appropriate once the regulator has determined that such intervention is necessary to avoid significant, adverse systemic consequences.

It is critical that the regulator implements its resolution authority in a way that avoids the unfair competitive advantages gained by market participants that have a government guarantee and also in a way that avoids the moral hazards that can result from a company having a government guarantee. We are concerned, however, that the Resolution Authority Proposals do not sufficiently protect against this risk because it does not establish a clear policy mandate to the resolution authority with respect to the regulator's implementation of its extensive authority. We believe policy makers should establish a clear mandate to the regulator that the regulator should use its authority only to ensure an orderly resolution of the systemically relevant entity for the purpose of reducing systemic risk. We believe that, without such a mandate, certain systemically relevant entities may be perceived as being "too big to fail", which would create the unfair competitive advantages discussed above.

We also believe that it is important for policy makers to ensure that the resolution authority framework is consistent with the systemic risk framework. We are concerned, however, that the Resolution Authority Proposals and the Systemic Risk Proposals as currently drafted have some ambiguities with respect to how they interrelate. The Resolution Authority Proposals are unclear regarding whether all critically undercapitalized, systemically relevant entities are within their scope, or whether only a subset of such companies are within their scope. It is also unclear, for example, whether critically undercapitalized, systemically relevant entities will be subject to mandatory bankruptcy proceedings, as contemplated by the Systemic Risk Proposals, or an alternative resolution regime, as contemplated by the Resolution Authority Proposals. We encourage policy makers to clarify these ambiguities so that all relevant parties, including market participants and regulators, have a clear understanding of how these related frameworks are intended to work together.

CONCLUSION

Hedge funds, as sophisticated institutional investors, have important market functions, in that they provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or turn around their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. MFA and its members appreciate that smart regulation helps to ensure stable and orderly markets, which are necessary for hedge funds to conduct their businesses. We also appreciate that active, constructive dialogue between policy makers and market participants is an important part of the process to develop smart regulation. We are committed to being constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets.

MFA appreciates the opportunity to testify before the Committee. I would be happy to answer any questions that you may have.