MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

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MANAGED FUNDS ASSOCIATION

For the Hearing on

Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

JULY 17, 2009

TESTIMONY OF MANAGED FUNDS ASSOCIATION

Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals
July 17, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Financial Services' hearing, "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals" held on July 17, 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 prudential 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 market participants, 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 pose a threat to 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 pose systemic risks despite their losses. 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 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 in and 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 appropriate, 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 mean increasing regulatory requirements in some areas, modernizing and updating antiquated financial regulations in other areas, and working to reduce redundant, overlapping, or inefficient responsibilities, where identified.

The first step in creating a smart regulatory framework is identifying the risks or intended objectives of regulation with the goal of strengthening investor protection and

market integrity and monitoring systemic risk. Identifying the underlying objectives of proposed regulation will help ensure that proposals are considered in the appropriate context relative to addressing the identified risks or achieving the intended objectives. Regulation that addresses the key objectives of efficient capital markets, market integrity and investor protection is more likely to improve the functioning of our financial system, while regulation that does not address these key issues can cause more harm than good. We saw an example of the latter with the significant, adverse consequences that resulted from the SEC's bans on short selling last year.

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 also not a panacea for the structural market breakdowns that currently 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 continues 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

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

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.

We believe that regulatory reform objectives generally fall into three key categories, discussed in separate sections below. 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.

II. HEDGE FUND MANAGER REGISTRATION

In adopting a smart and effective approach to the regulation of unregistered managers of private pools of capital, it is important to recognize that many, if not all, of these regulatory issues will be relevant to all such managers, including firms that manage hedge funds, private equity funds, venture capital funds, commodity pools and real estate funds. The Obama Administration, in its release *Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation* (the "Administration Proposal"),[2] is supportive of this approach, calling for the registration of advisers of hedge funds and other private pools of capital with the SEC. MFA supports the registration of currently unregistered investment advisers to all private pools of capital, subject to a limited exemption for the smallest investment advisers with a *de minimis* amount of assets under management.

MFA has publicly supported this comprehensive approach to adviser registration over the past several months, even when the Administration called for a narrower registration requirement only for advisers to the largest and most systemically relevant private pools of capital. We strongly encourage policy makers also to consider the issue of registration in the context of all private pools of capital and the unregistered managers of those pools. Likewise, we strongly encourage regulators to consider regulations that apply to all private investment firms and not just hedge fund managers. This approach will both promote better regulation as well support the many benefits private investment firms provide to the US markets.

MFA and its members recognize that mandatory SEC registration for advisers of private pools of capital is one of the key regulatory reform proposals being considered by policy makers. We believe that the general approach set out in the Administration Proposal of requiring the registration of currently unregistered investment advisers, including advisers to private pools of capital, under the Investment Advisers Act of 1940 (the "Advisers Act") is a smart approach in considering this issue. I note that more than half of MFA member firms already are registered with the Securities and Exchange Commission (the "SEC"), as investment advisers. Applying the registration requirement

[2] Available at: http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

to currently unregistered investment advisers to all private pools of capital, instead of focusing solely on hedge fund managers is also consistent with the objective of a "smart" approach to this type of reform. We believe that removing the current exemption from registration for advisers with fewer than fifteen clients would be an effective way to achieve this result.[3] The form and nature of registration and regulation of investment advisers to private pools of capital should be evaluated in the context of how to best promote investor protection, market integrity and systemic risk monitoring, each of which may be best achieved by different types of regulation.

We believe that the Advisers Act provides a meaningful regulatory regime for registered investment advisers. The responsibilities imposed by Advisers Act registration and regulation are not taken lightly and entail significant disclosure and compliance requirements, including:

- Providing publicly available disclosure to the SEC regarding, among other things, the adviser's business, its clients, its financial industry affiliations, and its control persons;
- Providing detailed disclosure to clients regarding, among other things, investment strategies and products, education and business background for adviser personnel that determine investment advice for clients, and compensation arrangements;
- Maintaining of books and records relevant to the adviser's business;[4]
- Being subject to periodic inspections and examinations by SEC staff;
- Adopting and implementing written compliance policies and procedures and appointing a chief compliance officer who has responsibility for administering those policies and procedures;
- Adopting and implementing a written code of ethics that is designed to prevent insider trading, sets standards of conduct for employees reflecting the adviser's fiduciary obligations to its clients, imposes certain personal trading limitations and personal trading reports for certain key employees of the adviser; and
- Adopting and implementing written proxy voting policies.

In addition to registration and regulation of advisers through the Advisers Act, the hedge fund industry is subject to other, meaningful regulatory oversight. Hedge funds, like other market participants, are subject to existing, extensive trading rules and

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[3] We note that this approach is consistent with the approach taken by H.R. 711 and S. 1276.

[4] Attachment A sets out the extensive list of books and records required to be kept by registered investment advisers.

reporting requirements under the U.S. securities laws and regulations.[5] Increasing investor confidence and promoting market integrity are carried about by the SEC and other regulators through these regulatory requirements.

With a comprehensive registration framework comes additional burdens on federal regulators. A registration framework that overwhelms the resources, technology and capabilities of regulators will not achieve the intended objective, and will greatly impair the ability of regulators to fulfill their existing responsibilities, as well as their new responsibilities. Regulators must have adequate resources, including the ability to hire and retain staff with sufficient experience and ability, and improve the training of that staff, to properly oversee the market participants for whom they have oversight responsibility. The SEC, which is the existing regulator with oversight of investment advisers, has acknowledged that its examination and enforcement resources are already seriously constrained.[6] This raises the question whether the SEC would have the resources or capability to be an effective regulator when advisers to private pools of capital are required to register under an expanded registration framework. We encourage policy makers to consider the issue of resources and regulatory capabilities as they develop proposals for an expanded regulatory mandate.

In addition to questions regarding the resources and capabilities of the SEC to regulate advisers to private pools of capital, consideration must also be given to the organization of the SEC, and whether changes to the current regulatory structure would lead to a more effective regulatory outcome. We applaud Chairwoman Schapiro, who has announced efforts to review such issues to make the SEC a more effective regulator.

In considering the appropriate adviser registration framework, and in light of concerns about resources, capabilities and regulatory structure, we believe that it is important for there to be an exemption from registration for the smallest investment advisers that have a *de minimis* amount of assets under management. This exemption should be narrowly, though appropriately, tailored so as not to create a broad, unintended loophole from registration. We are supportive of a comprehensive adviser registration regime, however, we recognize that registration carries with it significant costs that can overwhelm smaller advisers and force them out of business. We believe that the amount of any *de minimis* exemption should appropriately balance the goal of a comprehensive registration framework with the economic realities of small investment advisers. As mentioned above, regulatory resources, capabilities and structure should also be considered as policy makers determine an appropriate *de minimis* threshold.[7] We are not

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[5] As discussed in section III below, we are also supportive of providing regulatory authorities, on a confidential basis, with information regarding trading/investment activities to promote better monitoring of systemic risk.

[6] Speech by SEC Chairman Mary L. Schapiro: Address to the Council of Institutional Investors (April 6, 2009), available at: http://www.sec.gov/news/speech/2009/spch040609mls.htm.

[7] We believe that Congress should ensure that any approach in this regard is consistent with state regulation of smaller investment advisers and avoids duplication.

proposing a specific *de minimis* amount, however, we encourage policy makers to determine an amount that is not so high as to create a significant loophole that undermines a comprehensive registration regime, and also not so low that the smallest investment advisers are unable to survive because of regulatory costs.

We would like to share with you today some initial thoughts on some of the key principles that we believe should be considered by Congress, the Administration and other policy makers as you consider the appropriate regulatory framework. Those principles are:

- The goal of any reform efforts should be to develop a more intelligent and effective regulatory framework, which makes our financial system stronger for the benefit of consumers, businesses and investors.

- Regulation should address identified risks or potential risks, and should be appropriately tailored to those risks because without clear goals, there will be no way to measure success.

- Regulation should not impose limitations on the investment strategies of private pools of capital. As such, regulatory rules on capital requirements, use of leverage, and similar types of restrictions on the funds should not be considered as part of a regulatory framework for private pools of capital.

- Regulators should engage in ongoing dialogue with market participants. Any rulemaking should be transparent and provide for public notice and comment by affected market participants, as well as a reasonable period of time to implement any new or modified regulatory requirements. This public-private dialogue can help lead to more effective regulation and avoid unintended consequences, market uncertainty and increased market volatility.

- Reporting requirements should provide regulators with information that allow them to fulfill their oversight responsibilities as well as to prevent, detect and punish fraud and manipulative conduct. Overly broad reporting requirements can limit the effectiveness of a reporting regime as regulators may be unable to effectively review and analyze data, while duplicative reporting requirements can be costly to market participants without providing additional benefit to regulators. It is critical that regulators keep confidential any sensitive, proprietary information that market participants report. Public disclosure of such information can be harmful to members of the public that may act on incomplete data, increase risk to the financial system, and harm the ability of market participants to establish and exit from investment positions in an economically viable manner.[8]

[8] MFA also believes that regulators should also ensure that they share information with foreign regulators only under circumstances that protect the confidentiality of that information. For example, the SEC has adopted Rule 24c-1 under the Exchange Act (17 CFR §24c-1), which

Regulations should not force market participants publicly to reveal information that would be tantamount to revealing their trade secrets to competitors.

- We believe that the regulatory construct should distinguish, as appropriate, between different types of market participants and different types of investors or customers to whom services or products are marketed. While we recognize that investor protection concerns are not limited to retail investors, we believe that a "one-size fits all" approach will likely not be as effective as a more tailored approach. One such relevant distinction is that between private sales of hedge funds to sophisticated investors under the SEC's private placement regulatory regime and publicly offered sales to retail investors. This private/public, sophisticated/retail distinction has been in existence in the United States for over 75 years and has generally proven to be a successful framework for financial regulation. We do not believe this distinction should be lost, and we strongly believe that regulation that is appropriate for products sold publicly to retail investors is not necessarily appropriate for products sold privately to only sophisticated investors.

- Regulation regarding market issues that is applicable to a broad range of market participants, such as short selling and insider trading, should be addressed in the broader context of all market participants. Market issues are not specific to the hedge fund industry and, therefore, regulatory reform regarding these issues should be considered in the broader context and not in the context of hedge fund regulation.

- Lastly, we believe that industry best practices and robust investor diligence should be encouraged and recognized as an important complement to prudential regulation. Regulators will tell you that their oversight is no substitute for a financial firm's own strong business practices and investors' robust diligence if we are to promote market integrity and investor protection concerns.

Initial Views on Administration's Proposed "Registration of Advisers to Private Funds" Language

As mentioned above, MFA is supportive of the general approach taken in the Administration Proposal – a comprehensive registration regime under the Advisers Act designed to ensure that there is appropriate regulatory oversight over investment advisers to private pools of capital. We recognize and appreciate the Administration's objective of registering and regulating important market participants that have previously been exempt from registration. It is critical that this objective be done in a way that creates a

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allows the SEC in its discretion to share nonpublic information with a foreign financial authority if the authority receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate. MFA believe that US regulators should employ this type of approach when sharing information with foreign regulators.

"smart" regulatory framework, and we believe the removal of the so-called 'private adviser' exemption currently in the Advisers Act achieves that objective with respect to investment adviser registration.

Ensuring that the registration framework is comprehensive is an important component of a "smart" regulatory framework; however, it is equally as important to ensure that any new regulatory framework does not impose unnecessary, duplicative and costly requirements on advisers to private pools of capital. Such action would have adverse consequences for markets and investors while providing little to no benefit with respect to enhancing investor protection and market integrity, promoting greater transparency to either markets or regulators, or monitoring systemic risk. In that regard, we believe that, as drafted, the Administration's proposed legislation would impose overlapping registration requirements for a number of commodity trading advisers that are already registered with, and well regulated by, the Commodity Futures Trading Commission. We are continuing to review the Administration's proposed legislation, and we look forward to working with Congress and policy makers to discuss this issue and other details of the proposed legislation to ensure that ultimately we achieve a comprehensive, "smart" regulatory framework.

III. SYSTEMIC RISK REGULATION

The second area of regulation that I would like to discuss today is systemic risk regulation. Today, 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 Proposal.

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, should be considered within the systemic risk regulatory framework. As policy makers and regulators seek to determine whether any individual hedge fund is of systemic relevance, however, 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, hedge fund losses have not caused systemic risk during this global crisis.

As stated in my previous testimony, MFA believes that a systemic risk 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 to a systemic risk regulator, from those entities that it determines (at any point in time) to be of systemic relevance, 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;
- 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; 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 believes that the above approach is generally consistent with the approach taken in the Administration Proposal. In particular, we are supportive of the Proposal's approach of creating a central systemic risk regulator, while creating a mechanism designed to foster greater communication and coordination among financial regulators. We also support risk reporting to the systemic risk regulator, though it is critical that such reporting be done on a confidential basis. We also generally support the Proposal's approach to systemic risk regulation, which calls for stronger 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. We look forward to continuing to work with Congress and the Administration in considering the details of a smart framework for systemic risk regulation.

IV. MARKET-WIDE ISSUES

As stated above, issues that are relevant across market participants should be considered in that broader context, rather than in the specific context of hedge funds. One such issue, which has been the focus of a great deal of discussion recently, is short selling, specifically the role of short selling in capital markets. Short selling, as recognized by the SEC "plays an important role in the market for a variety of reasons,

including providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities and, importantly, limiting upward market manipulations."[9] Similarly, the FSA has noted that short selling is, "a legitimate investment technique in normal market conditions," and "can enhance the efficiency of the price formation process by allowing investors with negative information, who do not hold stock, to trade on their information." In addition, short selling can "enhance liquidity by increasing the number of potential sellers," and increase market efficiency.[10] We strongly agree with the SEC and the FSA that short selling, along with derivatives trading, provides capital markets with necessary liquidity and plays an important role in the price discovery process. Markets are more efficient, and securities prices are more accurate, because investors with capital at risk engage in short selling.

Short selling and other techniques, including listed and over-the-counter derivatives trading, are important risk management tools for institutional investors, including MFA members, and essential components of a wide range of *bona fide* cash and derivatives hedging strategies that enable investors to provide liquidity to the financial markets. Additionally, hedged investors primarily use short sales and derivatives to prudentially reduce their long side investment risk, so this activity can enable such investors to invest more on the long side. Thus, when the SEC restricted short sales in late 2008, overall volume and investing declined, not just short sales.

We are supportive of providing proprietary nonpublic information to regulatory authorities on a nonpublic, confidential basis. We are concerned, however, that requirements that investors publicly disclose short position information, or that create the potential for public disclosure, would negatively reduce overall market efficiency by undermining the important role that short selling plays in providing liquidity and price discovery to markets. Public disclosure of short trades/positions can be misleading to the public as implying that an investor has a negative view regarding a particular public company stock when the opposite may be true, such as when the investor is primarily long and is using the short sale or short derivative as a prudential risk reduction hedge.

We believe that concerns which have led some to propose public disclosure of short positions could be substantially mitigated through effective, comprehensive reporting of short sale information by prime brokers and clearing brokers. Regulators could require short sales and short position information to be provided by brokers on an aggregate basis. A regulator could request specific information as to short sales and short positions of individual investors if it suspected or became concerned about manipulation of a particular security. Such reporting also would provide regulators with a more effective means by which to identify manipulative activity.

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[9] Statement of Securities and Exchange Commission Concerning Short Selling and Issuer Stock Repurchases, SEC Release 2008-235 (Oct. 1, 2008).

[10] Temporary Short Selling Measures, FSA Consultation Paper 09/1 (January 2009), at page 4.

We commend the SEC for their thoughtful, deliberative approach to considering short sale regulation which included holding a roundtable on these issues and publishing notice and seeking comment on the proposals recently put forward. MFA has filed a comment letter in response to the SEC's short selling release.[11]

V. MARKET-BASED INITIATIVES

MFA and its members recognize the importance of a smart regulatory framework designed to protect investors, prevent systemic risk and ensure appropriate oversight by regulators. In addition to regulation, it is important for market participants to promote investor protection and limit systemic risk through high standards of business conduct, as reflected in industry best practices. MFA and its members are actively engaged in efforts to promote and implement those high standards. I would like to discuss two particular initiatives, MFA's *Sound Practices* and MFA's work on initiatives to reduce risks with respect to the credit default swaps market.

MFA's Sound Practices for Hedge Fund Managers

As mentioned earlier, MFA has been at the forefront of developing and promoting industry best practices through the recommendations in its *Sound Practices*. Over the past ten years, MFA and its members have regularly updated and enhanced *Sound Practices* to ensure that the recommendations in that document are at the forefront of best practices for the hedge fund industry. Most recently, MFA and other industry groups have developed global, unified principles of best practice for the hedge fund industry. These unified principles are designed to be applicable to hedge fund managers in all jurisdictions. MFA's *Sound Practices* contains robust recommendations that address, among other things, important investor protection considerations such as robust disclosure from managers as well as risk management, which can help guard against systemic risk concerns. Adoption of these recommendations by hedge fund managers will help managers develop strong business practices. Strong business practices are an important complement to regulation to achieve the goals of investor protection and prevent systemic risk.[12]

Credit Default Swaps

MFA and its members have also actively worked with other market participants and regulators to reduce risks and improve market efficiency and the operational infrastructure in the CDS market and other OTC derivatives markets. MFA and its members have played an important role in improving market practices through collaboration with global regulators (including the SEC, Commodity Futures Trading

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[11] MFA's comment letter is available at: http://www.managedfunds.org/downloads/MFA.Amendments%20to%20Reg%20SHO.6.22.09.pdf

[12] To assist investors in their diligence process, MFA has published a model due diligence questionnaire, which illustrates the types of information commonly requested by investors prior to investing. MFA's model DDQ is available at: http://www.managedfunds.org/downloads/Due%20Dilligence%20Questionnaire.pdf

Commission, Federal Reserve Bank of New York, FSA, Bank of England, Federal Financial Supervisory Authority (BaFin), Bank of Japan, European Central Bank, *et al.*), major OTC derivatives dealers, asset managers and other market participants. Specifically, MFA and its members currently engage in a myriad of initiatives, hold educational events and also participate in a number of projects that focus on standardizing transaction documentation and industry practices/conventions related to OTC derivatives trading.

Some of the more recent market improvements and risk mitigating measures in which MFA and its members have participated include:

- The reduction by 80% of backlogs of outstanding CDS confirmations since 2005;
- The establishment of electronic processes to approve and confirm CDS novations;
- The establishment of a trade information repository to document and record confirmed CDS trades;
- The establishment of an auction hardwiring completed April 8, 2009, to allow for auction-based settlement of CDS;
- More than 40 credit events have been processed globally since October 2008;
- The reduction of 74% of backlogs of outstanding equity derivative confirmations since 2006 and 53% of backlogs in interest rate derivative confirmations since 2006;
- The first central counterparty ("CCP") for central clearing of CDS trades went live for U.S. index CDS as of March 2009 and, to date, has cleared U.S. $600 billion notional amount of CDS contracts;
- The roll out of a restructuring credit event protocol (also known as the "small bang" protocol) to further standardize CDS contracts for centralized clearing; and
- Major Dealer clearing will expand to European CDS by July 31, 2009.

The success of coordinated, industry initiatives with regulatory involvement is also evidenced by the relative speed in which the CDS market has grown. Although the CDS market emerged approximately ten years ago (which is relatively young as compared with other OTC derivatives and financial products), the majority of contracts have quickly achieved a level of standardization and trading efficiency that has made them amenable to centralized clearing. MFA and its members are generally supportive of clearing of standardized CDS contracts, provided that the CCPs are appropriately structured as discussed below. Recently, MFA and its members have been very involved in industry working groups that have been tasked to analyze ways in which asset managers and other customers of the Major Dealers can access one or more CCPs to centrally clear their standardized CDS contracts.

In a recent letter addressed to global regulators, the major OTC dealers, several asset management firms and industry trade associations (including MFA) proposed a

series of industry-wide best practices (the "Recent Industry Letter") to address key concerns raised by global regulators and legislators (notably the G20, European Commission and the U.S. Department of Treasury) regarding the risk profile and trading infrastructure of CDS and other OTC derivatives.[13] With respect to transparency concerns, the Recent Industry Letter provides that all market participants are strongly encouraged to report all CDS trades (both standardized and non-standardized CDS trades) by August 14, 2009 and other OTC derivatives trades based on an aggressive timeline. The purpose of this best practice, as reported in the Recent Industry Letter, is to assist global supervisors with oversight and surveillance activities related to the OTC derivatives market.

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 acknowledge that smart regulation helps to ensure stable and orderly markets, which are necessary for hedge funds to conduct their businesses. We also acknowledge 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.

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[13] *See* Operations Management Group, Letter to William Dudley, President of the Federal Reserve Bank of New York, June 2, 2009, under the heading "Reporting of Trades in Central Repositories." A copy of the Recent Industry Letter is available at: http://www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html

ATTACHMENT A

§ 275.204-2 Books and records to be maintained by investment advisers.[1]

(a) Every investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b–3) shall make and keep true, accurate and current the following books and records relating to its investment advisory business;

(1) A journal or journals, including cash receipts and disbursements, records, and any other records of original entry forming the basis of entries in any ledger.

(2) General and auxiliary ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income and expense accounts.

(3) A memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser concerning the purchase, sale, receipt or delivery of a particular security, and of any modification or cancellation of any such order or instruction. Such memoranda shall show the terms and conditions of the order, instruction, modification or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed such order; and shall show the account for which entered, the date of entry, and the bank, broker or dealer by or through whom executed where appropriate. Orders entered pursuant to the exercise of discretionary power shall be so designated.

(4) All check books, bank statements, cancelled checks and cash reconciliations of the investment adviser.

(5) All bills or statements (or copies thereof), paid or unpaid, relating to the business of the investment adviser as such.

(6) All trial balances, financial statements, and internal audit working papers relating to the business of such investment adviser.

(7) Originals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security:

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[1] Available at: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=6143582bf9cd6fce86a19b85a5c4fc21&rgn=div8&view=text&node=17:3.0.1.1.23.0.147.20&idno=17

Provided, however, (*a*) That the investment adviser shall not be required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser, and (*b*) that if the investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if such notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of such notice, circular or advertisement a memorandum describing the list and the source thereof.

(8) A list or other record of all accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities or transactions of any client.

(9) All powers of attorney and other evidences of the granting of any discretionary authority by any client to the investment adviser, or copies thereof.

(10) All written agreements (or copies thereof) entered into by the investment adviser with any client or otherwise relating to the business of such investment adviser as such.

(11) A copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser), and if such notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication recommends the purchase or sale of a specific security and does not state the reasons for such recommendation, a memorandum of the investment adviser indicating the reasons therefor.

(12)

(i) A copy of the investment adviser's code of ethics adopted and implemented pursuant to §275.204A–1 that is in effect, or at any time within the past five years was in effect;

(ii) A record of any violation of the code of ethics, and of any action taken as a result of the violation; and

(iii) A record of all written acknowledgments as required by §275.204A–1(a)(5) for each person who is currently, or within the past five years was, a supervised person of the investment adviser.

(13)

(i) A record of each report made by an access person as required by §275.204A–1(b), including any information provided under paragraph (b)(3)(iii) of that section in lieu of such reports;

(ii) A record of the names of persons who are currently, or within the past five years were, access persons of the investment adviser; and

(iii) A record of any decision, and the reasons supporting the decision, to approve the acquisition of securities by access persons under §275.204A–1(c), for at least five years after the end of the fiscal year in which the approval is granted.

(14) A copy of each written statement and each amendment or revision thereof, given or sent to any client or prospective client of such investment adviser in accordance with the provisions of Rule 204–3 under the Act, and a record of the dates that each written statement, and each amendment or revision thereof, was given, or offered to be given, to any client or prospective client who subsequently becomes a client.

(15) All written acknowledgments of receipt obtained from clients pursuant to §275.206(4)–3(a)(2)(iii)(B) and copies of the disclosure documents delivered to clients by solicitors pursuant to §275.206(4)–3.

(16) All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser); *provided, however,* that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of d accounts shall be deemed to satisfy the requirements of this paragraph.

(17)

(i) A copy of the investment adviser's policies and procedures formulated pursuant to §275.206(4)–7(a) of this chapter that are in effect, or at any time within the past five years were in effect, and

(ii) Any records documenting the investment adviser's annual review of those policies and procedures conducted pursuant to §275.206(4)–7(b) of this chapter.

(b) If an investment adviser subject to paragraph (a) of this section has custody or possession of securities or funds of any client, the records required to be made and kept under paragraph (a) of this section shall include:

(1) A journal or other record showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for such accounts and all other debits and credits to such accounts.

(2) A separate ledger account for each such client showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits.

(3) Copies of confirmations of all transactions effected by or for the account of any such client.

(4) A record for each security in which any such client has a position, which record shall show the name of each such client having any interest in such security, the amount or interest of each such client, and the location of each such security.

(c)

(1) Every investment adviser subject to paragraph (a) of this section who renders any investment supervisory or management service to any client shall, with respect to the portfolio being supervised or managed and to the extent that the information is reasonably available to or obtainable by the investment adviser, make and keep true, accurate and current:

(i) Records showing separately for each such client the securities purchased and sold, and the date, amount and price of each such purchase and sale.

(ii) For each security in which any such client has a current position, information from which the investment adviser can promptly furnish the name of each such client, and the current amount or interest of such client.

(2) Every investment adviser subject to paragraph (a) of this section that exercises voting authority with respect to client securities shall, with respect to those clients, make and retain the following:

(i) Copies of all policies and procedures required by §275.206(4)–6.

(ii) A copy of each proxy statement that the investment adviser receives regarding client securities. An investment adviser may satisfy this requirement by relying on a third party to make and retain, on the investment adviser's behalf, a copy of a proxy statement (provided that the adviser has obtained an undertaking from the third party to provide a copy of the proxy statement promptly upon request) or may rely on obtaining a copy of a proxy statement from the Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

(iii) A record of each vote cast by the investment adviser on behalf of a client. An investment adviser may satisfy this requirement by relying on a third party to make and retain, on the investment adviser's behalf, a record of the vote cast (provided that the adviser has obtained an undertaking from the third party to provide a copy of the record promptly upon request).

(iv) A copy of any document created by the adviser that was material to making a decision how to vote proxies on behalf of a client or that memorializes the basis for that decision.

(v) A copy of each written client request for information on how the adviser voted proxies on behalf of the client, and a copy of any written response by the investment adviser to any (written or oral) client request for information on how the adviser voted proxies on behalf of the requesting client.

(d) Any books or records required by this section may be maintained by the investment adviser in such manner that the identity of any client to whom such investment adviser renders investment supervisory services is indicated by numerical or alphabetical code or some similar designation.

(e)

(1) All books and records required to be made under the provisions of paragraphs (a) to (c)(1)(i), inclusive, and (c)(2) of this section (except for books and records required to be made under the provisions of paragraphs (a)(11), (a)(12)(i), (a)(12)(iii), (a)(13)(ii), (a)(13)(iii), (a)(16), and (a)(17)(i) of this section), shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.

(2) Partnership articles and any amendments thereto, articles of incorporation, charters, minute books, and stock certificate books of the investment adviser and of any predecessor, shall be maintained in the principal office of the investment adviser and preserved until at least three years after termination of the enterprise.

(3)

(i) Books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this rule shall be maintained and preserved in an easily accessible place for a period of not less than five years, the first two years in an appropriate office of the investment adviser, from the end of the fiscal year during which the investment adviser last published or otherwise disseminated, directly or indirectly, the notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication.

(ii) *Transition rule.* If you are an investment adviser to a private fund as that term is defined in §275.203(b)(3)–1, and you were exempt from registration under section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)) prior to February 10, 2005, paragraph (e)(3)(i) of this section does not require you to maintain or preserve books and records that would otherwise be required to be maintained or preserved under the provisions of paragraph (a)(16) of this section to the extent those books and records pertain to the performance or rate of return of such private fund or other account you advise for any period ended prior to February 10, 2005, provided that you were not registered with the Commission as an investment adviser during such period, and provided further that you continue to preserve any books and records in your possession that pertain to the performance or rate of return of such private fund or other account for such period.

(f) An investment adviser subject to paragraph (a) of this section, before ceasing to conduct or discontinuing business as an investment adviser shall arrange for and be responsible for the preservation of the books and records required to be maintained and preserved under this section for the remainder of the period specified in this section, and shall notify the Commission in writing, at its principal office, Washington, D.C. 20549, of the exact address where such books and records will be maintained during such period.

(g) *Micrographic and electronic storage permitted. —*

(1) *General.* The records required to be maintained and preserved pursuant to this part may be maintained and preserved for the required time by an investment adviser on:

(i) Micrographic media, including microfilm, microfiche, or any similar medium; or

(ii) Electronic storage media, including any digital storage medium or system that meets the terms of this section.

(2) *General requirements.* The investment adviser must:

(i) Arrange and index the records in a way that permits easy location, access, and retrieval of any particular record;

(ii) Provide promptly any of the following that the Commission (by its examiners or other representatives) may request:

(A) A legible, true, and complete copy of the record in the medium and format in which it is stored;

(B) A legible, true, and complete printout of the record; and

(C) Means to access, view, and print the records; and

(iii) Separately store, for the time required for preservation of the original record, a duplicate copy of the record on any medium allowed by this section.

(3) *Special requirements for electronic storage media.* In the case of records on electronic storage media, the investment adviser must establish and maintain procedures:

(i) To maintain and preserve the records, so as to reasonably safeguard them from loss, alteration, or destruction;

(ii) To limit access to the records to properly authorized personnel and the Commission (including its examiners and other representatives); and

(iii) To reasonably ensure that any reproduction of a non-electronic original record on electronic storage media is complete, true, and legible when retrieved.

(h)

(1) Any book or other record made, kept, maintained and preserved in compliance with §§240.17a–3 and 240.17a–4 of this chapter under the Securities Exchange Act of 1934, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this section, shall be deemed to be made, kept maintained and preserved in compliance with this section.

(2) A record made and kept pursuant to any provision of paragraph (a) of this section, which contains all the information required under any other provision of paragraph (a) of this section, need not be maintained in duplicate in order to meet the requirements of the other provision of paragraph (a) of this section.

(i) As used in this section the term “discretionary power” shall not include discretion as to the price at which or the time when a transaction is or is to be

effected, if, before the order is given by the investment adviser, the client has directed or approved the purchase or sale of a definite amount of the particular security.

(j)

(1) Except as provided in paragraph (j)(3) of this section, each non-resident investment adviser registered or applying for registration pursuant to section 203 of the Act shall keep, maintain and preserve, at a place within the United States designated in a notice from him as provided in paragraph (j)(2) of this section true, correct, complete and current copies of books and records which he is required to make, keep current, maintain or preserve pursuant to any provisions of any rule or regulation of the Commission adopted under the Act.

(2) Except as provided in paragraph (j)(3) of this section, each nonresident investment adviser subject to this paragraph (j) shall furnish to the Commission a written notice specifying the address of the place within the United States where the copies of the books and records required to be kept and preserved by him pursuant to paragraph (j)(1) of this section are located. Each non-resident investment adviser registered or applying for registration when this paragraph becomes effective shall file such notice within 30 days after such rule becomes effective. Each non-resident investment adviser who files an application for registration after this paragraph becomes effective shall file such notice with such application for registration.

(3) Notwithstanding the provisions of paragraphs (j)(1) and (2) of this section, a non-resident investment adviser need not keep or preserve within the United States copies of the books and records referred to in said paragraphs (j)(1) and (2), if:

(i) Such non-resident investment adviser files with the Commission, at the time or within the period provided by paragraph (j)(2) of this section, a written undertaking, in form acceptable to the Commission and signed by a duly authorized person, to furnish to the Commission, upon demand, at its principal office in Washington, DC, or at any Regional Office of the Commission designated in such demand, true, correct, complete and current copies of any or all of the books and records which he is required to make, keep current, maintain or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the Act, or any part of such books and records which may be specified in such demand. Such undertaking shall be in substantially the following form:

The undersigned hereby undertakes to furnish at its own expense to the Securities and Exchange Commission at its principal office in Washington, DC or at any

Regional Office of said Commission specified in a demand for copies of books and records made by or on behalf of said Commission, true, correct, complete and current copies of any or all, or any part, of the books and records which the undersigned is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the Securities and Exchange Commission under the Investment Advisers Act of 1940. This undertaking shall be suspended during any period when the undersigned is making, keeping current, and preserving copies of all of said books and records at a place within the United States in compliance with Rule 204–2(j) under the Investment Advisers Act of 1940. This undertaking shall be binding upon the undersigned and the heirs, successors and assigns of the undersigned, and the written irrevocable consents and powers of attorney of the undersigned, its general partners and managing agents filed with the Securities and Exchange Commission shall extend to and cover any action to enforce same.

and

(ii) Such non-resident investment adviser furnishes to the Commission, at his own expense 14 days after written demand therefor forwarded to him by registered mail at his last address of record filed with the Commission and signed by the Secretary of the Commission or such person as the Commission may authorize to act in its behalf, true, correct, complete and current copies of any or all books and records which such investment adviser is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the Act, or any part of such books and records which may be specified in said written demand. Such copies shall be furnished to the Commission at its principal office in Washington, DC, or at any Regional Office of the Commission which may be specified in said written demand.

(4) For purposes of this rule the term *non-resident investment adviser* shall have the meaning set out in §275.0–2(d)(3) under the Act.

(k) Every investment adviser that registers under section 203 of the Act (15 U.S.C. 80b–3) after July 8, 1997 shall be required to preserve in accordance with this section the books and records the investment adviser had been required to maintain by the State in which the investment adviser had its principal office and place of business prior to registering with the Commission.

(l) *Records of private funds.* If an investment adviser subject to paragraph (a) of this section advises a private fund (as defined in §275.203(b)(3)–1), and the adviser or any related person (as defined in Form ADV (17 CFR 279.1)) of the adviser acts as the private fund's general partner, managing member, or in a comparable capacity, the books and records of the private fund are records of the adviser for purposes of section 204 of the Act (15 U.S.C. 80b–4).