MANAGED FUNDS ASSOCIATION

VIA ELECTRONIC MAIL: p.vulpes@iosco.org

May 31, 2006

Ms. Pamela Vulpes
IOSCO General Secretariat
c/ Oquendo 12
28006 Madrid
SPAIN

Re: Comment on Consultation Report on Hedge Funds Offered to Retail Investors

Dear Ms. Vulpes:

Managed Funds Association (MFA) appreciates the opportunity to comment on the above-referenced IOSCO Consultation Report entitled, "The Regulatory Environment for Hedge Funds" (IOSCO Report). The purpose of this comment letter is to provide IOSCO with information about the role of MFA in representing the interests of the hedge fund industry and to stand as a resource for IOSCO for information about our policy work.

Founded in 1991, MFA is the U.S.-based global membership organization dedicated to serving the needs of the professionals who specialize in the alternative investment industry. MFA's over 1,000 members include professionals who represent hedge funds, funds of funds, and managed futures funds. MFA members manage a substantial portion of the estimated $1.5 trillion invested in these investment vehicles. Members include representatives of a majority of the 50 largest hedge fund groups in the world. The larger hedge fund managers represented within MFA collectively manage in excess of $500 billion in assets and pursue a wide range of investment strategies.

MFA's activities include educational outreach to and representation before the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Federal Reserve, Treasury Department, state and international regulatory agencies, and Congress. MFA also participates in a number of private sector initiatives, including the publication of *MFA's 2005 Sound Practices for Hedge Funds Managers* (*MFA Sound Practices*) (enclosed herein), participates in Treasury-sponsored private sector advisory committees, and is working with the major dealers in improving credit derivative market practices.

MFA's 2005 Sound Practices covers key topics that are intended to promote sound business practices for hedge fund managers and, in doing so, enhance investor protection while contributing to

market soundness. The recommendations contained in *MFA's 2005 Sound Practices* are divided among the following seven topics:

- Management and Internal Trading Controls;
- Responsibilities to Investors;
- Valuation Policies and Procedures;
- Risk Monitoring;
- Regulatory Controls;
- Transactional Practices; and
- Business Continuity and Disaster Recovery[1]

We believe our document as a whole is comprehensive and promotes standards of excellence for single-manager hedge fund operations. A central theme emphasized in *MFA's 2005 Sound Practices* is to stress that "one size does not fit all" when it comes to evaluating our recommendations to Hedge fund managers.

Comments to the IOSCO Report

MFA recognizes that the IOSCO Report primarily serves to report the findings of a survey among certain international regulators on a number of hedge fund-related issues. Moreover, the purpose of this survey was to update the previous IOSCO report by its Technical Committee, Standing Committee on Investment Management, "Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds" (SC5 2003 Report). It would be difficult to take issue with any of the findings of IOSCO Report's survey. Rather, MFA would like to point out some of its work on behalf of the industry in the areas of focus in this survey. Moreover, MFA hopes that these comments can provide an industry perspective to IOSCO's review of the hedge fund industry.

Definition

The IOSCO Report noted that none of the jurisdictions responding to the survey has adopted a formal, legal definition of the term "Hedge Fund". The term "Hedge Fund" is not a defined term under the U.S. Federal securities laws, but generally connotes to a private investment fund that is not required to register as an investment company under the Investment Company Act of 1940 (Investment Company Act). MFA, in its *2005 Sound Practices*, recognizes that the term "Hedge Fund" is used to describe a wide range of investment vehicles, which can vary substantially in terms of size, strategy, business model and organizational structure, among other characteristics. The variations in organizational structures are attributable partly to differences in size and partly to the different strategies used by hedge fund managers, which are distinguishable in terms of their complexity, product focus and the breadth of markets covered.

Although there is no statutory or regulatory definition of a hedge fund, MFA uses the term "Hedge Fund" to refer to a fund that meets the following definition:

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[1] In addition, there are five substantive appendices that supplement the recommendations in the seven substantive areas listed above that cover: (1) Risk Monitoring, (2) U.S. Regulatory Filings, (3) Anti-Money Laundering, (4) Checklist for Compliance Manuals, and (5) Checklist for Code of Ethics.

A privately offered, pooled investment vehicle that is not widely available to the public and the assets of which are managed by a professional investment management firm (referred to by MFA as a "Hedge Fund Manager").[2]

MFA's definition of the term hedge fund is not intended to capture private equity, venture capital or real estate funds. Some common principles common to hedge funds would also include:

- The net worth and, presumably, sophisticated nature of investors - both institutional and individual;
- Subscription packages where many representations are obtained from investors by fund managers prior to acceptance of the investment;
- The concomitant opportunity for investors to provide managers with due diligence questionnaires prior to the investment commitment;
- "Absolute return" strategies that are not tied to a benchmark such as the FTSE-250 or S&P 500; and
- Active management, rather than traditional "buy and hold", strategies that utilize a range of investment products.

We recommend that IOSCO understand hedge funds in terms of these (or similar) guiding principles in characterizing the hedge fund industry.

Hedge Fund Adviser Regulation

In the U.S., hedge funds and their managers are subject to ample regulatory oversight among a variety of federal and state regulators. The most significant regulatory development for the hedge fund industry has been the SEC's adoption by the SEC in October 2004 of a rule requiring hedge fund advisers to register as investment advisers with the SEC. Section 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act) provides that an investment adviser may be exempt from SEC registration requirements if such adviser (i) had fewer than 15 "clients" during the preceding 12 months; (ii) does not hold itself out generally to the public as an investment adviser; and (iii) does not act as an adviser to any registered investment company.

The new hedge fund adviser rule requires a hedge fund adviser to count each "owner" of a "private fund"[3] it advises as a "client" for purposes of determining the adviser's eligibility for the private adviser exemption cited above. The term "private fund" was intended to capture advisers to hedge funds and not other private investment vehicles, such as private equity or venture capital funds. Under this new rule, hedge fund advisers are required to "look through" clients that are private funds and count the underlying investors to determine the number of clients to whom the adviser provides

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[2] *MFA's 2005 Sound Practices for Hedge Fund Managers*, Introduction at 4.

[3] Under Advisers Act Rule 203(b)(3)-2, a "private fund" is defined as a company that: (i) would be an investment company under the Investment Company Act of 1940, as amended, but for an exception from the definition of "investment company" provided under either Section 3(c)(1) or 3(c)(7) thereunder; (ii) permits an investor to redeem its investment within two years of investment; and (iii) is offered based on its adviser's expertise. A pooled investment vehicle that does not meet any one of the above three elements is not a "private fund." Advisers to unregistered funds that are not "private funds" may continue to rely on the language of Rule 203(b)(3)-1 that permits an adviser to count these unregistered funds as a single client. This would include advisers to hedge funds that have redemption periods for their investors that are longer than two years.

investment advisory services. If, after taking into account the aggregate number of investors in the private funds it advises, an adviser had 15 or more clients in the prior 12 months, and has in the aggregate at least $30 million in assets under management, then the adviser will be required to register with the SEC as an investment adviser. Hedge fund advisers that advise "private funds" were required to comply with this new rule by February 1, 2006.

The CFTC also serves as a principal regulator of hedge fund managers that are commodity pool operators (CPOs). Registration with the CFTC as a CPO is required under the Commodity Exchange Act for managers of hedge funds that trade futures and options contracts on a futures exchange. A hedge fund manager that provides advice to a hedge fund regarding such futures and options contracts may also become subject to regulation as a commodity trading advisor (CTA). In 2004, 63 of the 100 largest hedge funds were registered with the CFTC. CPOs and CTAs are subject to recordkeeping, reporting requirements and fraud prohibitions under the Commodity Exchange Act and the regulations of the CTFC and the National Futures Association (NFA).[4] Hedge funds that are significant traders in the futures markets may also become subject to the CFTC's large trader reporting system, which requires the reporting of certain information on exchange-traded contracts to the CFTC for purposes of market surveillance. For example registered CPOs must file annual reports with the NFA. Hedge funds and their managers are subject to a number of reporting requirements by a variety of other U.S. regulators. They may be subject to large position reporting requirements with the Federal Reserve on positions in specific Treasury security issues, for example. See *MFA's 2005 Sound Practices,* at Appendix II, for a more detailed summary of the different regulatory filings to which hedge fund managers may be subject.

Retailization

From all available information, hedge funds it appears that remain an investment vehicle for institutional investors and high-net worth individuals, both in the U.S. and abroad. The IOSCO Report states that few jurisdictions reported any significant retailization of hedge funds. Some regulators reported in your survey that they anticipate greater retailization of hedge funds in the near future. Recently in the U.S., a concern has grown among domestic regulators that hedge funds are becoming investment vehicles open to the retail public. This concern, coupled with the legally required non-public nature of hedge funds, has led regulators to inquire whether investors without the requisite financial means or sophistication are being exposed to investments that might not be suitable for them.

The SEC in recent years has permitted the registration of investment companies that themselves invest in hedge funds. In these circumstances, the Investment Company Act, the Advisers Act, and all the investor protection mechanisms of the Federal securities laws come into play. These funds are subject to the rule range of protections afforded by SEC registration and oversight, as they are registered with the SEC and sold in registered public offerings. In addition, advisers of registered funds of hedge funds are required to be registered under the Advisers Act. The SEC therefore has authority to address any investor protection issues that may be presented.

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[4] See NFA's comments to IOSCO for their description of their regulatory oversight of hedge funds that are CFTC-registered CTAs and CPOs.

Under the Securities Act of 1933, Regulation D defines "accredited investors" to include natural persons with individual or joint net worth of $1 million or individual income in each of the last two years in excess of $200,000, or joint income for the same period of $300,000. In the 25 years since the SEC last updated Regulation D, these dollar thresholds have come within the range of a larger number of investors. MFA believes that the SEC should consider raising the Regulation D thresholds for investments in private funds, and has made this recommendation in past submissions to U.S. regulators and legislators over the years.[5]

It should also be noted that publicly-offered funds of hedge funds in the U.S. are subject to the full range of protections afforded by SEC registration and oversight, as they are registered with the SEC as investment companies and sold in registered public offerings. In addition, advisers of funds of hedge funds are required to be registered under the Advisers Act. The SEC therefore has authority to address any investor protection issues that may be presented by these registered funds.

We believe that there exists a "regulatory compact" that essentially distinguishes between retail funds and non-retail funds, including hedge funds. Retail funds must limit their investment strategies in exchange for wide latitude in marketing to the investing public; hedge funds must limit their marketing to only certain sophisticated investors in exchange for wide latitude in pursuing different investment strategies.

Fraud

The IOSCO Report supports the notion that there does not seem to be any suggestion that incidences of fraud or malpractice are any higher in the alternative investment industry than in the traditional asset management industry. Indeed, the SEC staff in its 2003 report, *Implications of the Growth of Hedge Funds*, specifically stated that they found that there was no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity. MFA believes that hedge fund managers should comply with all regulations applicable to their operations and that they should create an environment that ensures this goal is achieved. MFA supports governmental efforts, in the U.S. and elsewhere, aimed at prosecuting fraudulent conduct by participants in financial services. Generally, instances of fraud, though few in number, attract media headlines and disproportionately detract from the positive message that hedge fund activities provide important benefits to the global financial marketplace.

MFA as a Resource for IOSCO

MFA notes, the IOSCO Report suggests that possible future work by the IOSCO Standing Committee 5 of its Technical Committee would focus on two investor protection principles.[6] First, the IOSCO Reports states that the SC5 should ensure that "there is clear, concise and effective disclosure of the features of the Hedge Fund." Second, the IOSCO Report suggests that principles around valuation issues should be an area of future focus. *MFA's 2005 Sound Practices for Hedge Fund Managers* offers hedge fund managers guidance on these areas, which we highlight below.

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[5] See MFA "White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds" (Submitted to SEC, July 7, 2003); see "Testimony of Managed Funds Association Before the Subcommittee on Securities and Investment of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate" (May 16, 2006).
[6] See IOSCO Report at 12.

Disclosure

MFA believes that a hedge fund manager should work together with its hedge funds so that investors are provided with information regarding the investment objectives and strategies, as well as periodic summary performance information. This enhances the ability of hedge fund investors to understand and evaluate for themselves an investment in a hedge fund. The Recommendations set forth in Section II or our *2005 Sound Practices* lay out MFA's views on hedge fund manager's responsibilities to investors. Throughout our *2005 Sound Practices,* it is reemphasized that hedge fund managers' policies be consistent with disclosures to investors, particularly in areas such as conflicts of interest, valuation, risk factors, and soft dollars.

Valuation

IOSCO has asked whether regulatory action is required with respect to hedge fund valuation. Indeed, valuation issues are often a subject of significant debate and discussion among hedge fund industry participants and regulators alike. MFA believes that valuation is an area in which it is difficult to be too prescriptive, given the complexity and breadth of investment instruments and markets used by hedge fund managers for their trading strategies. *MFA's 2005 Sound Practices'* Valuation Policies and Procedures section provides recommendations to cover a series of special valuation issues.

MFA's recommended valuation policies and procedures recognize that a hedge fund manager's procedures will vary depending on the hedge funds' strategies. In addition, *MFA's 2005 Sound Practices* sets forth a number of general principles, but also provide guidance for cases where a general principle may not yield a fair valuation in the view of the hedge fund manager. Among the general principles covered by MFA's valuation section, we recommend that: (i) investments should be valued according to applicable generally accepted accounting principles, or GAAP, which typically requires the use of "fair value"; (ii) valuation policies and procedures should be "fair, consistent, and verifiable;" (iii) pricing policies and procedures should assure that net asset value (NAV) is marked at fair value; and (iv) reliable and recognized pricing sources should be used to the extent practicable.[7]

For each of these general principles, MFA provides guidance for instances where a hedge fund manager may need to establish policies that permit it to deviate from a general rule, recognizing, of course, that hedge fund investors may both subscribe to and redeem interests in the hedge fund in reliance on the values derived from such policies and procedures. Our recommendations stress that the existence of written policies and procedures "is a critical element of the control structure surrounding a hedge fund manager's pricing of portfolio investment instruments" and should be established by senior management.[8] However, we recommend that those same written policies also explicitly authorize that where their application "would not produce an accurate or fair price for a given instrument, senior management may use alternative procedures to price an instrument."[9] The key to the establishment of valuation procedures, in MFA's view, is for a hedge fund manager to establish written policies, seek to

[7] See generally *MFA's 2005 Sound Practices,* Section III.
[8] See *MFA's 2005 Sound Practices,* Recommendation 3.3.
[9] *Id.*

ensure that material aspects of such policies are appropriately disclosed to investors, and ensure that such policies are consistent with any agreements between the hedge funds it manages and investors.

MFA's 2005 Sound Practices also covers new and more challenging issues such as valuing illiquid investments, certain derivatives and instruments that may have "multiple" official settlement prices. For example, for funds that may invest in illiquid (or otherwise hard-to-value) investment instruments, our recommendations suggest that a manager consider use of "side pocket" methodology for purposes of valuation, so long as use of this methodology has been disclosed. We explain in our document that there are a number of different approaches to the "side-pocket" methodology, and some managers may not use this methodology in its policies for valuing illiquid investments.[10] The issue of the use of side-pockets in a hedge fund manager's valuation policies and procedures is one example of why valuation procedures cannot be too prescriptive.

We understand that valuation is a key area in which there is potential for a conflict of interest between a hedge fund manager and the hedge fund's investor. But we also believe that our recommendations offer meaningful guidance to address a number of particularly challenging areas where there is no single approach to calculating NAV, and we underscore the importance of developing policies and prescribed that address valuation issues unique to each hedge fund manager.

Conclusion

MFA hopes that members of IOSCO's SC5 and other IOSCO members interested in hedge fund industry issues review our *2005 Sound Practices* for further guidance. We welcome the opportunity to meet with you as you continue to evaluate hedge fund industry issues. For additional information, you may reach us at 202.367.1140.

Sincerely,

/s/ Stephanie Miranda Pries

Stephanie Miranda Pries
Vice President & Senior Legal Counsel

Enclosure: *MFA's 2005 Sound Practices for Hedge Fund Managers*

[10] See *MFA's 2005 Sound Practices,* Recommendation 3.6.