



June 13, 2008

Via Internet Submission

Mr. Eric Mindich
Chair, Asset Managers' Committee
President's Working Group on Financial Markets

Re: MFA's Comments to the Report of the Asset Managers' Committee of the President's Working Group on Financial Markets

Dear Mr. Mindich:

Managed Funds Association ("MFA")¹ appreciates the opportunity to provide comments to the Report of the Asset Managers' Committee to the President's Working Group on Financial Markets (the "Committee"), titled *Best Practices for the Hedge Fund Industry* (the "Report"). The positions in this letter express the view of MFA, although the Alternative Investment Management Association fully endorses MFA's responses to the Committee. MFA applauds the efforts of the Committee in undertaking this initiative to develop detailed best practice recommendations for the alternative investment industry and to call on hedge fund managers to adopt those practices in all aspects of their businesses. We believe industry best practices are the best means of achieving market discipline, strengthening the U.S. financial markets and enhancing investor protection.

MFA's Sound Practices for Hedge Fund Managers

MFA strongly supports the work done by the Committee in producing a comprehensive and substantive document. We note that the recommendations in the Report are generally consistent with MFA's *Sound Practices for Hedge Fund Managers* ("*Sound Practices*").²

As you know, *Sound Practices* provides peer-to-peer guidance for hedge fund managers in setting forth policies and procedures to operate and manage their funds. In its 2007 version, *Sound Practices* incorporates the President's Working Group on Financial Markets' ("PWG") principles that were published in an agreement dated February 22, 2007 (the "PWG Agreement")³ and provides robust guidance on myriad topics, including all of the topics

¹ MFA is the voice of the global alternative investment industry. Our members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York, NY.

² MFA's *Sound Practices* is available at:
<http://www.managedfunds.org/downloads/Sound%20Practices%202007.pdf>

³ *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, February 22, 2007.



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addressed by the Report, as well as additional topics not covered such as business continuity/disaster recovery and anti-money laundering. MFA is committed to ensuring that *Sound Practices* remains at the forefront of improving standards of excellence in the hedge fund industry. To that end, MFA has already begun the process of updating *Sound Practices* in light of the comprehensive recommendations in the Report.

Consistent Approach to Implementation

We agree with the Committee that hedge fund managers need to assess the particular aspects of their businesses in implementing the best practices frameworks. Hedge fund managers need to tailor their implementation in light of their size, resources, strategies and other important characteristics of their businesses. The Report, like *Sound Practices*, provides that not all of the best practice recommendations will apply to and be appropriate for implementation by all managers at all times. *Sound Practices* provides that not all recommendations will apply to all managers, but instead, managers should tailor the recommendations based on their business and particular circumstances. We agree with the Committee that neither this type of tailoring, nor the inability of a smaller hedge fund manager to implement all of the recommendations should necessarily be viewed as meaning a hedge fund manager's compliance, risk management or operational systems are poor.

We also agree with the Committee (and with the Investors' Committee) that hedge fund investors play a critical role in ensuring that best practice recommendations are appropriately implemented by hedge fund managers.⁴ We also agree with the Report that a hedge fund manager's implementation of best practices should be considered by investors as part of the due diligence process. We further believe that investors should continue to consider a hedge fund manager's implementation of best practices as part of investors' ongoing monitoring of their investment. As noted in the Report, critical to this evaluation process is the need for hedge fund managers to explain to investors how they have implemented and adopted best practices recommendations. MFA has taken a similar approach by including its model due diligence questionnaire in *Sound Practices* and encouraging investors to engage in discussions with hedge fund managers about their implementation of *Sound Practices* as part of the due diligence process when making an investment decision. We believe that open and ongoing dialogue is the approach most likely to ensure meaningful implementation of best practices recommendations and meaningful disclosure of information to investors as they consider their hedge fund investments.

Our Comments

Our comments are divided into two categories: global comments with respect to the Report and comments regarding specific recommendations in the Report. We hope our comments are of assistance to the Committee as it works to finalize the Report.

⁴ See also, PWG Agreement.



1. Global Comments

a. Alternative Approaches. As discussed above, we agree with the statements in the Report that the manner in which a manager implements the recommendations will differ in light of the size, strategies, products and other important aspects of its business and that smaller and start-up managers may not be able to implement all of the recommendations in the Report.

Further, we understand and appreciate the Committee's goal of creating substantive and relatively specific recommendations; however, we believe that there may be circumstances when it would be appropriate for a hedge fund manager to adopt an approach other than the best practice recommendation for reasons other than the manager's size or applicability of a recommendation. We note that the Investors' Committee report specifically recognizes that investors may not always fully implement the recommendations in that report.⁵ The report notes that, in these situations, there may be an increased risk associated with an investment, but that it may still be appropriate to make the investment after appropriate consideration of the risk.⁶

There may be many legitimate reasons why a hedge fund manager adopts a policy that is not identical to the best practice recommendation. A hedge fund manager may have, for example, an alternative process that the manager believes better addresses the underlying principle than a particular recommendation does, when applied to that manager's business.⁷ We believe it would be beneficial for the Report to note that simply because a hedge fund manager does not follow a particular best practice recommendation does not necessarily mean that the manager has a poor or weak compliance program, so long as the manager has a practice reasonably designed to achieve the principle underlying the relevant best practice recommendation in the Report.

b. Role of Hedge Fund Counterparties. As mentioned above, the PWG Agreement provides that the vitality, stability and integrity of our capital markets are a shared responsibility of managers, investors, counterparties and regulators. The Report addresses the

⁵ Page 16 of the Investors' Committee report states:

Each best practice may not be applicable to every investment opportunity, and some of the best practices described in this report may be applicable but not possible to achieve.

Investors should decide which best practices are appropriate for their hedge fund investment program and for the individual funds under consideration. They should aspire to implement each applicable best practice fully—understanding that full implementation may not always be possible or practicable.

⁶ Id.

⁷ This is not a critique of any of the best practices recommendations, but a statement that there may be instances where an alternative approach may be just as appropriate for a particular manager.



role of managers and investors, but does not address the role of counterparties. While we recognize that the Report is directed toward hedge fund managers, there are certain recommendations with respect to which we believe it would be beneficial to include some discussion of the role of counterparties. In Section IV, Trading and Business Operations, for example, there are a number of recommendations for hedge fund managers conducting diligence on their counterparties. We believe that it would be beneficial to specifically state that counterparties need to partner with hedge fund managers in this process, as adequate counterparty disclosure and counterparty collateral management are important considerations in a hedge fund manager's diligence process.⁸

2. Specific Comments

In addition to the global comments discussed above, MFA has several comments with respect to specific sections in the Report. Our comments include two additional recommendations relating to disclosure that we encourage the Committee to consider including in its final Report, as well as specific comments on some of the recommendations in the Report.

a. Suggested New Recommendations.

- *Disclosure and Investor Protection Subsection I, Recommendation 4(f), Page 4:* The Committee's recommendation addresses many of the important risks associated with an investment in a hedge fund. We believe there are two additional risk factors relating to the discretion of the hedge fund manager that are of significance to a hedge fund investor. We request that the Committee consider adding to its list of recommended disclosures the following two risk factors: (a) investors are relying on the discretion of the manager and have no ability to make investment decisions; and (b) the manager has flexibility in allocating investments by the fund among the strategies and investment instruments to the extent disclosed in the PPM.
- *Disclosure and Investor Protection Subsection III, page 11:* In addition to the disclosure recommended for parallel managed accounts, hedge fund managers should disclose material conflicts of interest that may arise when a manager has multiple client accounts with overlapping mandates or investment strategies. We request that the Committee consider adding a recommendation for hedge fund managers to disclose these conflicts.

⁸ We note that the Counterparty Risk Management Policy Group II (the "CRMPG"), chaired by E. Gerald Corrigan, issued a comprehensive report in July 2005 proposing recommendations to financial institutions regarding their risk management and risk controls systems in light of potential systemic risk issues. The Committee may be able to work with the CRMPG in creating recommendations that would address the issues discussed above.



b. Disclosure and Investor Protection.

- *Subsection I, Recommendation 4(e)(iii), Pages 3-4.* We fully agree with the Committee that adequate disclosure of a hedge fund manager's valuation policies is necessary for an investor to be able to properly evaluate an investment. The recommendation in subsection (e)(iii) provides that, in addition to recommended disclosures, a manager's valuation policy should include specific items. It is our understanding that the Committee did not intend to imply that the specific items listed in subsection (e)(iii) are recommended disclosure items, but instead are recommendations for what a manager's valuation policy should include. By including these items in the disclosure section, however, we believe that it may cause confusion as to whether the Committee's recommendation is for those items to be disclosed in a hedge fund's private placement memorandum ("PPM"). We recommend moving the items in this subsection to the section on the valuation policy itself, so as to remove this potential uncertainty.
- *Subsection II, Recommendation 2(a), Pages 5-6:* The Committee recommends that managers disclose significant shifts in investment strategy or other key risk exposures. PPMs typically disclose that there is a degree of manager discretion that creates some flexibility with respect to the implementation of investment strategy, risk exposure, leverage and other key risks of the fund. We believe that a fund's PPM should adequately disclose the risks associated with this flexibility and that additional disclosure to investors should be recommended only when there is a significant shift in these key areas that goes beyond what has already been disclosed to investors.
- *Subsection II, Recommendation 2(d), Pages 7-8:* The Committee recommends that hedge fund managers disclose on at least a quarterly basis: (i) the percentage of the fund's portfolio value that is comprised of each level of the FAS 157 valuation hierarchy; and (ii) the percentage of realized and unrealized profit and loss that is derived from assets in each of levels 2 and 3.

The Report notes that this recommended disclosure goes beyond the requirements of FAS 157. We recognize the importance of clear and complete disclosure with respect to a fund's financial statements. We are also aware, however, that there remains much ambiguity and a lack of consensus among managers, investors, counterparties and accounting professionals as to the appropriate treatment of a number of products under FAS 157. In light of this lack of consensus, we believe that this recommendation, at present, may not be achievable. Further, the lack of consensus is likely to result in



inconsistent disclosure across the industry, which could be both confusing and potentially misleading to anyone reviewing financial statements. We request that, until such time as greater consensus exists with respect to implementation of FAS 157, the Committee consider deleting this recommendation. We note that managers will, of course, still be required by their independent auditors to follow the procedures specified in FAS 157, as the industry continues to develop consensus on the implementation of those procedures.

- *Subsection II, Recommendation 2(e), Page 8:* The Committee recommends that hedge fund managers should consider disclosing the percentages of a fund's portfolio value for which a manager relied on one dealer quote and multiple dealer quotes. We believe that this disclosure could be misleading to investors as there are certain types of products for which one dealer quote is used in valuing the asset, even though there is a liquid, active and deep market for the product (e.g., certain types of OTC products). There may also be products for which multiple quotes are available, but for which there is not a particularly liquid, active and deep market. While the availability of multiple dealer quotes may be an indication of the level of market activity for an asset, it may be misleading in certain instances. As such, we recommend that the Committee consider deleting this recommendation.
- *Subsection III, Recommendation A.3, Pages 10-11:* We note that the Committee's recommendation to disclose, as appropriate, certain information about side letters, including the existence of such letters and key terms, is significantly different than the Investors' Committee's recommendation on disclosure of side letters. The Investors' Committee report suggests that a manager should provide a copy of a side letter upon request from investors. We agree with the recommendation in the Asset Managers' Committee's Report, which we believe provides adequate disclosure to investors and reduces the potential of putting a hedge fund manager in breach of confidentiality obligations. We urge the Committee to continue working with the Investors' Committee to reach agreement on this issue. We believe that having two distinct recommendations on the issue will lead to confusion among industry participants as to the best practice.
- *Subsection III, Recommendation B, Page 11:* We agree with the Committee that management of parallel managed accounts can give rise to conflicts of interest similar to those of side letters. We believe, however, that the definition of "parallel managed account" in the Report is too broad as currently drafted.

The Report defines a parallel managed account as an arrangement whereby an investor invests in substantially the same strategies as a fund, but does so



through a separate account. We believe that this definition should be narrowed to define such accounts as situations in which an investor invests in substantially similar strategies and in substantially similar investments as a fund, but does so through a separate account. We think this definition more closely captures the situation when a fund and a separate account are truly being managed in parallel fashion. Having substantially similar strategies between a fund and a separate account does not, in and of itself, give rise to the same types of conflicts as a side letter, though it does give rise to other conflicts of interest, as discussed above.

c. Valuation.

- *Segregation of Valuation Function.* We support the Committee's approach with respect to the valuation process for hedge fund managers. We agree that the valuation function having some degree of independence from the portfolio management function helps reduce the inherent conflicts of interest when portfolio management personnel also have responsibility for valuation of a fund's assets. While we support the Committee's approach, we believe that the recommendations in subsection II.3 are somewhat confusing when read in conjunction with the make-up of the Valuation Committee proposed in the Report.

The recommendation with respect to the Valuation Committee specifically notes that the Committee membership may include members of senior management who have portfolio management responsibilities. The recommendation distinguishes between portfolio management functions and valuation functions. In subsection II.3, however, the recommendations discuss segregation of valuation personnel from portfolio management personnel. To the extent that a Valuation Committee is comprised, in part, by senior management with portfolio management responsibilities, then this segregation of personnel does not seem possible.

We believe that the Committee intended to recommend segregation of valuation and portfolio management functions, and not segregation of personnel. If this is correct, we recommend that the Committee revise subsection II.3 to discuss segregation of functions rather than personnel. To the extent that the Committee did intend to recommend segregation of personnel, we request that the Committee clarify that such segregation is not meant to include any Valuation Committee members who are also portfolio management personnel.



- *Subsection III, Recommendation A.1(b)(ii), Pages 18-19:* We agree that the valuation methodologies discussed in this recommendation should be considered by a hedge fund manager. In certain instances, however, the level of specificity discussed in the Report, such as the source of prices used, may be more appropriate for an internal reference guide rather than a formal valuation policy. We recommend that the Committee clarify that although the information listed in this recommendation should be considered by a manager in developing its valuation policy, a manager may elect to include certain of the specifics in an internal reference guide rather than as part of its formal valuation policy.
- *Delegation to third parties.* We note that there are divergent views around the globe with respect to the delegation of valuation to third parties. Cultural differences in the growth of the hedge fund industry in different jurisdictions are a significant part of the explanation for this difference. Differences can also be attributed to groups identifying a different balancing point between independence of valuation and knowledge about difficult to value instruments. This difference can be seen in pages vi and vii of the Report's Executive Summary, which reads "we do not believe that investors or managers should take undue comfort from the independence a third-party administrator brings to the valuation process", compared to the statement in the Investors' Committee report on page 48, which reads "A third party administrator responsible for independently getting quotes and producing NAV can provide a level of independence that may give an investor additional comfort." We do not believe that either approach is the 'right' approach, but we believe it is important to recognize that this important distinction does exist.

d. Compliance, Conflicts and Business Practices. In subsection III, recommendation C.3(c)(3), the Committee recommends that a hedge fund manager establish a Conflicts Committee to address new or potential conflicts, as they arise, that have not been previously addressed. Managers currently identify and address conflicts of interest through a variety of means, including written policies, other committees and compliance staff oversight. It is not clear to us that the establishment of a Conflicts Committee would necessarily add value to a hedge fund manager's process for managing conflicts of interest, which may be effectively managed through well established methods of identifying and addressing conflicts of interest. As such, we request that the Committee consider modifying this recommendation to state that a hedge fund manager may elect to establish a Conflicts Committee, or may elect to address conflicts of interest through other means.



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Conclusion

MFA applauds the efforts of the Committee in undertaking this initiative. We look forward to working with the Asset Managers' Committee both during the revision process and its ongoing work following the publication of its final Report, including future efforts to update or revise the Report. We remain committed to providing the Committee with information and with direct access to our membership and senior management. If the Committee or any of its members have any additional questions, please feel free to contact me at 202-367-1140.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'Richard H. Baker'. The signature is fluid and cursive, written in a professional style.

Richard H. Baker
President and CEO

Cc: Mr. Russell Read, Chair, Investors' Committee
Mr. Gary Bruebaker, Incoming Chair, Investors' Committee