



June 13, 2008

**Via Internet Submission**

Mr. Russell Read  
Chair, Investors' Committee  
President's Working Group on Financial Markets

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

Dear Mr. Read:

Managed Funds Association ("MFA")<sup>1</sup> appreciates the opportunity to provide comments to the Report of the Investors' Committee to the President's Working Group on Financial Markets (the "Committee"), titled *Principles and Best Practices for Hedge Fund Investors* (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 investors in the alternative investment industry and to impress upon those investors the associated risks and benefits of hedge fund investment. 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*").<sup>2</sup>

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* incorporated the President's Working Group on Financial Markets' ("PWG") principles that were published in an agreement dated February 22, 2007

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<sup>1</sup> 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.

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



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and provides robust guidance on myriad topics, including most of the topics addressed by the Report as they apply to hedge fund operations.

### **Recommendations Consistent with *Sound Practices***

MFA supports the recommendations and approach set out by the Committee in its Report. In particular, the concepts discussed below are of significant importance to a comprehensive understanding of the hedge fund industry and the important function that industry-created best practices serve with respect to potential concerns regarding investor protection and systemic risk. MFA strongly supports the Committee with respect to each of the positions set out in the Report and discussed below.

Investments in hedge funds are only appropriate for sophisticated investors after careful diligence. MFA agrees with the Committee's stance against the retailization of the hedge fund industry. Hedge fund investments are suitable only for sophisticated investors who are able to identify, analyze and bear the associated risks, and investors who follow appropriate practices to evaluate, select, monitor, and exit these investments. We also agree with the Committee that no investor should feel obligated to invest in hedge funds, and that fiduciaries must conduct appropriate diligence prior to determining whether an allocation of assets to hedge funds contributes to an institution's investment objectives and is consistent with the institution's risk profile.

One size does not fit all. The Report notes that not every best practice recommendation will be applicable to every investment opportunity. We agree with the Committee on this point, and we believe it is equally applicable with respect to best practices for hedge fund managers. Any set of best practices, whether targeted at investors or managers, must be tailored in light of the particular circumstances associated with an investor or manager.

Inability to achieve best practices should not be dispositive. The Report provides that there may be situations in which one or more best practices recommendations are applicable, but not achievable. 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. Again, we agree with the Committee on this point, and we believe it is equally applicable with respect to best practices for hedge fund managers. The fact that a best practice has not been met should not necessarily be viewed as a sign of poor compliance or lack of appropriate diligence.

Due diligence questionnaires. We agree with the Committee's recommendation that investors should use due diligence questionnaires ("DDQ") which have been tailored in light of their particular circumstances. We believe that model DDQs, such as MFA's model DDQ, which is included in *Sound Practices*, can serve as useful tools for the creation of an investor's tailored DDQ. Further, MFA's model DDQ serves as a starting point to discuss a



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hedge fund manager's compliance with industry best practices, which, as the Committee notes, can be a useful portion of an investor's diligence process. We believe that the two points discussed directly above demonstrate the importance of investors and managers engaging in substantive discussions about the implementation and adoption of best practices recommendations.

Hedge fund manager risk management recommendations. We agree with the Report's recommendations, which are consistent with the recommendations in *Sound Practices*. We believe that *Sound Practices* provides a useful tool for investors as they conduct diligence on a manager's risk management policies and procedures.

Anti-money laundering procedures and business continuity/disaster recovery plans. We agree with the Committee's recommendation that investors should verify anti-money laundering procedures and business continuity/disaster recovery plans. *Sound Practices* provides recommendations to hedge fund managers with respect to both topics. We note that the report of the Asset Managers' Committee makes specific reference to the recommendations contained in *Sound Practices* on these topics.

Independence of the valuation function. We generally support the Committee's recommendations regarding the valuation process of hedge fund managers, including the acknowledgement of the importance of some level of independence in the valuation process. We believe that the valuation recommendations in *Sound Practices* are consistent with the Committee's recommendations.

Hedge Funds should follow U.S. GAAP or International Financial Reporting Standards ("IFRS"). We support the recommendation that hedge funds should prepare financial statements in accordance with U.S. GAAP or IFRS. We note that *Sound Practices* has a similar recommendation.

### **Requests for Modification**

As demonstrated above, there are numerous recommendations in the Report which we strongly support. There are, however, three recommendations in the Report which raise concerns and may be difficult to implement in practice. These recommendations are discussed below.

Level of Disclosure. In several places, the Report suggests that it may be appropriate for investors to request disclosure to the degree of full position-level transparency. For instance, the Report states that "investors should seek significant transparency and disclosure to assess and monitor effectively within their risk management systems the material risks of a hedge fund investment." We fully support transparency to investors in such detail as to allow an investor to make informed decisions about its investment (e.g., strategy description, scope of investments, risk management and diversification policies).



MFA believes, however, that there are legitimate competitive and regulatory reasons for a hedge fund manager to place reasonable limits on the level of transparency provided to an investor, particularly with respect to position-level transparency. Detailed disclosure that identifies specific strategies and current position levels may not be appropriate in all circumstances and could significantly affect future performance. Indeed, there may be other ways for investors to gain comfort with a hedge fund manager's strategies (e.g., through the disclosure of aged-position levels under certain circumstances, or through the use of reports from risk-aggregation services such as MeasuRisk, which report the risk exposure details of a fund but not specific positions), without compromising the manager's competitive positions. We request that the Committee modify this recommendation by noting that hedge fund managers may have legitimate business or regulatory reasons for limiting the level of transparency and the fact that a manager has set reasonable limits should not necessarily preclude an investment with that manager. Each investor must, of course, decide if it is receiving a sufficient level of transparency to make or continue to hold an investment.

Recommended disclosure of material terms of side letters and/or copies of the letters. The Report suggests that hedge fund managers should disclose material terms available to some investors in side letters or even provide copies of such letters to investors who request them. We strongly agree that material terms available to some investors through side letters should be disclosed to other investors. We believe that the approach recommended by the Asset Managers' Committee, i.e., disclosure of such information about any side letters as reasonably necessary to allow investors to determine the possible impact of such letters on their investment, appropriately addresses a manager's disclosure obligations to investors. This approach ensures that investors receive all material information and reduces the risk that a hedge fund manager could be in breach of confidentiality obligations. We request that the Committee modify this recommendation to conform to the recommendation in the Asset Managers' Committee report.

Valuation committee. The Report sets out a specific list of the personnel that should be included on a hedge fund manager's valuation committee. We believe that this level of specificity is excessive and may not be appropriate in many instances and, therefore, will likely lead to many managers not meeting this recommended best practice. We believe the recommendation in the Asset Managers' Committee's report on the membership of a manager's valuation committee is more appropriate and we request that the Investors' Committee incorporate a similar recommendation into its Report.

The Report makes a suggestion that a valuation committee might include the analyst recommending a particular security. This seems like an unwieldy suggestion, as larger managers may have many analysts and to include each of them on the valuation committee would make the committee excessively large. The role of analysts might be better suited to providing information to the valuation committee, rather than actually being a member of



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the committee. We recommend that the Committee consider removing the suggestion that analysts serve as members of a manager's valuation committee.

**Conclusion**

MFA applauds the efforts of the Committee in undertaking this initiative. We look forward to working with the Investors' 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, reading 'Richard H. Baker'. The signature is written in a cursive, flowing style.

Richard H. Baker  
President and CEO

Cc: Mr. Gary Bruebaker, Incoming Chair  
Mr. Eric Mindich, Chair, Asset Managers' Committee