MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

April 30, 2009

Via Electronic Mail: FinancialEntities@iosco.org

Greg Tanzer
Secretary General
International Organization of Securities Commissions
C/Oquendo 12
28006 Madrid
Spain

Re: Managed Funds Association Comments on Hedge Funds Oversight: Consultation Report

Dear Mr. Tanzer:

Managed Funds Association ("MFA")[1] welcomes the opportunity to provide comments to the Technical Committee of the International Organization of Securities Commissions ("IOSCO") in response to the Hedge Funds Oversight: Consultation Report (the "Consultation Report"). We also appreciate having had the opportunity for Stuart J. Kaswell, MFA Executive Vice-President and General Counsel, to share MFA's thoughts at IOSCO's April 20, 2009 meeting in Madrid, Spain. MFA and its members share IOSCO's concern about the global crisis and recognize the importance of restoring investor confidence to capital markets. During this volatile period, it is important that policy makers adopt measured responses that will enhance market confidence and lead to greater market stability. MFA and its members recognize that hedge funds play an important role in global financial markets. Our members have a shared interest with policy makers in ensuring a sound financial system. We believe that, to achieve this shared interest, policy makers and market participants should address the following key subjects: systemic risk, efficient capital markets, market integrity, investor protection, and the restoration of investor confidence in markets. We are committed to working with policy makers to develop appropriate and effective regulation to address these areas and our comments in this letter are intended in that spirit of constructive dialogue.

For regulation to be effective, it should address identified risks or potential risks, and should be appropriately tailored to those risks. To achieve this result, it is critical to consider the

1 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

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appropriate regulatory approach for private pools of capital, including hedge funds, in the context of the benefits that those private pools bring to capital markets, as well as the risks that such pools actually present. It is also important that regulation be consistent for similarly situated market participants. We believe that regulatory considerations are similar for hedge funds, private equity funds, venture capital funds, and other private pools of capital and, as such, these private pools of capital should be treated similarly from a regulatory perspective.

We appreciate the work of the Task Force on Unregulated Financial Entities (the "Task Force") in preparing the Consultation Report. We believe that certain of the risks ascribed to the hedge fund industry in the Report, however, and the discussion of current practices that mitigate some of the risks that do exist, appear to be based on inaccurate assumptions about the industry or fail to appropriately recognize the mitigating factors that already exist in the industry.

In the background section of our comment letter, we discuss the benefits that hedge funds provide to capital markets and investors and the fact that hedge funds were not the cause of the current financial crisis, each of which is an important factor to consider in developing the appropriate regulatory framework for hedge funds. In the next section of our letter, we address certain of the risks identified in the Consultation Report, including what we believe are certain fundamental misconceptions about the risks associated with the hedge fund industry. Section three of our letter addresses some industry initiatives in addition to those discussed in the Consultation Report, which we believe mitigate some of the risks addressed by the Consultation Paper. In the fourth section of our letter, we provide suggestions regarding regulatory reform recommendations and identify concerns with certain prudential regulatory considerations, such as standardized disclosures, minimum capital requirements, and limits on investment types and use of leverage.

MFA and its members have a shared interest with policy makers, regulators and other market participants in ensuring an effective and efficient regulatory structure and a sound financial system. Each of the comments in our letter is provided in the spirit of working with the Task Force and IOSCO as they consider regulatory reform proposals for private pools of capital.

BACKGROUND

BENEFITS OF HEDGE FUNDS TO MARKETS AND INVESTORS

As noted in Chapter 1 of the Consultation Report, hedge funds provide many benefits to capital markets and to their investors. The Report notes that hedge funds provide liquidity, price efficiency, and risk distribution, and contribute to the global integration of markets. Importantly, in their role as liquidity providers, hedge funds help dampen market volatility. Recent experience has demonstrated the importance of having hedge funds as vibrant and active participants in financial and capital markets. In particular, events of the past year have clearly demonstrated the adverse effects when investors, such as hedge funds, are not participating in these markets.

Hedge funds also often act as a counter-cyclical force in markets as buyers of distressed assets and sellers of overpriced assets. Their broader, more flexible investment mandates and their greater ability to use all types of financial instruments enable hedge funds to provide capital to the markets when other investors are not able or willing to do so. By doing so, hedge funds bring price efficiency to markets and help dampen market volatility. As an example, several recent studies have demonstrated the negative impact on market liquidity this fall when firms, mainly hedge funds, were barred from selling short certain equities.[2]

The Consultation Report notes that hedge funds provide investors with diversification, excess returns and capital protection in down markets. Hedge funds also provide sophisticated risk management and investment returns that have low correlations to traditional asset classes. Each of these benefits is of great value to investors, such as pension plans and endowments, as those investors seek to reduce their overall portfolio risk and generate the risk-adjusted returns that are necessary to meet their obligations.

As the Task Force and IOSCO consider an appropriate regulatory framework for hedge funds, it is important to keep in mind these important benefits that hedge funds provide. The important functions that hedge funds fulfill, and the benefits to markets and investors that result from hedge fund investment activity, are critical to the orderly functioning of capital markets and the global financial system as a whole. As such, recommendations for regulation should be designed to address identified risks without inappropriately or inadvertently preventing hedge funds from fulfilling their valuable market functions.

HEDGE FUNDS WERE NOT THE CAUSE OF THE CURRENT CRISIS

Although the Consultation Report appears not to draw a conclusion about the role of hedge funds in the current crisis, it must be said plainly: hedge funds were not the cause of the global financial meltdown. The European Commission draft directive on alternative investment fund managers acknowledges the fact that hedge fund managers "were not the cause of the crisis".[3] Additionally, hedge funds did not cause the losses suffered by prime brokers, banks and other financial institutions. Those losses were caused by inadequate risk management practices by those institutions primarily in their "traditional" lines of business such as residential mortgage lending. Lending by banks and brokers to hedge funds is collateralized, and so any hedge fund failures which have occurred appear to have been managed reasonably well with minimal losses, if any, to the regulated institutions. The same can not be said for failures by banks and brokerage firms, which have harmed the businesses and operations of many hedge funds this year, the most notable example of which is the bankruptcy of Lehman Brothers Holdings Inc. ("Lehman Brothers").

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[2] Ekkehart Boehmer, Charles M. Jones and Xiaoyan Zhang, Shackling Short Sellers: The 2008 Shorting Ban (Nov. 18, 2008) (preliminary); Ian W. Marsh and Norman Niemer, The Impact of Short Sales Restrictions (Nov. 30, 2008), available at: http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf.

[3] European Commission Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/…/EC ("EC Directive"), page 4, available at: http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf.
This conclusion has also been reached by other groups studying the financial crisis. *See*, Report of The High-Level Group on Financial Supervision, page 24 (February 25, 2009), which states, "Concerning hedge funds, the Group considers they did not play a major role in the emergence of the crisis.", available at: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

Indeed, hedge funds, which invest in and rely on these institutions as counterparties for their investment activities, are suffering along with other market participants as a result of the difficulties these institutions are facing. Despite suffering losses, hedge funds still performed significantly better than the overall market, to the benefit of their investors. Hedge funds also functioned as one of the last providers of liquidity to capital markets, without which, the crisis likely would have been even more severe.

Although hedge funds and their investors did suffer losses, those losses did not pose a threat to global capital markets or the global financial system as a whole. Indeed, according to one report, 1,471 hedge funds went out of business in 2008, though none of these liquidations or failures caused systemic risk during this extremely difficult economic period.[4] This is a critical fact to remember as IOSCO considers regulation, particularly regulation designed to address systemic risk concerns. While hedge fund losses and liquidations have not caused systemic risk during this crisis, MFA and its members do 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.

In considering the hedge fund industry from a systemic risk perspective, the industry should be considered in the context of the larger 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 U.S. mutual fund families alone are in excess of $1.9 trillion.

RISKS IDENTIFIED IN CONSULTATION REPORT

The Consultation Report identifies a number of potential risks related to hedge funds that are meant to be addressed by the regulatory recommendations in the Report. We believe that many of the areas of risk identified in the Consultation Report are not specific to hedge funds, but instead are generally relevant to a wide variety of market participants. While we do not believe that regulation should be a "one size fits all" approach to all financial system market participants, we do believe that it is important to consider issues of general relevance in a broader context rather than just in the context of the hedge fund industry. Consideration of issues of broad relevance solely in the context of hedge funds is likely to lead to ineffective regulation as proposed regulations would not address all appropriate market participants. Moreover, regulation in such a context likely would create inappropriate and unjustified disadvantages for certain market participants based solely on their class of institution. As such, we recommend that the Task Force and IOSCO consider the issues identified in the Consultation Paper in the broader context of all participants in financial and capital markets.

The Consultation Paper also identifies risks associated with hedge funds, which we believe are based on inaccurate assumptions or misconceptions about the industry. As stated

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4 Anita Raghavan, New Record For Hedge Fund Failures, Forbes, March 18, 2009, citing Hedge Fund Research, available at: http://www.forbes.com/2009/03/18/hedge-fund-failures-business-wall-street-funds.html.

above, we believe that, for regulation to be effective, it should address identified risks or potential risks, and should be appropriately tailored to those risks. The first step in such an approach is accurately identifying the risks and potential risks of market participants. Following is a discussion of some of the key inaccuracies and misconceptions about the hedge fund industry, which we strongly believe should be corrected before policy makers and regulators consider the appropriate regulatory framework for hedge funds.

LEVERAGE

The Consultation Report identifies the use of leverage by hedge funds as an area of risk to markets, primarily through the exposure of counterparties, such as banks and prime brokers, to hedge funds. The Report focuses on hedge fund leverage despite noting that hedge funds generally have much lower levels of leverage than many regulated entities and that the average leverage ratio for the industry was only 1.7:1 in 2007 and 1.4:1 in 2008.[5] MFA and its members agree that excessive leverage can pose risks to markets. Despite the common misconception, which appears to be based on the reported amounts of leverage used by Long Term Capital Management in the late 1990s, the hedge fund industry has for a number of years used relatively low amounts of leverage, particularly compared to other financial institutions.

A recent study of more than 6,000 hedge fund managers revealed that 26.9% used no leverage and that, of the managers reporting to use leverage, 21.7% engaged in strategies that typically use less than 2:1 leverage.[6] Similarly, a March 2009 report by Lord Adair Turner, Chairman of the U.K. Financial Services Authority, found that the leverage of hedge funds was, on average, two or three-to-one, significantly below the average leverage of banks.[7] Lord Turner's report demonstrates that this low use of leverage is not just a recent phenomenon in response to the global crisis, but has been the industry norm for a number of years. As noted in MFA's response to the European Commission's Consultation Paper on Hedge Funds,[8] hedge funds use of leverage is substantially less than the leverage of other financial institutions, such as banks and brokers, many of which had leverage ratios in excess of 25:1 or 30:1 (including some in excess of 60:1). These ratios for other financial institutions far exceed even the 10:1 leverage ratio used in certain arbitrage strategies that was noted in the Consultation Report.

The low amounts of leverage used by hedge funds is one of the key reasons that hedge fund losses have not posed the same systemic risk concerns that losses at more highly leveraged institutions, such as brokers and investment banks, did. As the Task Force and IOSCO consider the need to address risks relating to leverage, it is important for those considerations be made in

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5 Consultation Report, paragraph 50.

6 *See* A Broad View of Hedge Fund Performance Reveals Plenty of Strong Performers, Low Leverage and Additional Myth-Busters, Meredith Jones, PerTrac Financial Solutions (Dec. 4, 2008) available at: http://www.pertrac.com/per0020/web/me.get?web.websections.show&PER0020_1328.

7 *See*, "The Turner Review A regulatory response to the global banking crisis", pages 72-73 (March 2009), available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

8 Available at: http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/hedge_funds/organisations/managed_associations/_EN_1.0_&a=d

light of the facts regarding the use of leverage by hedge funds, and not based on misconceptions of the industry.

TRANSPARENCY AND COUNTERPARTY RISK

A second area of risk identified in the Consultation Report is the reported lack of transparency by hedge funds to counterparties and investors. MFA and its members fully support counterparties and investors having appropriate information to allow them to make informed decisions. With respect to both counterparties and investors, hedge funds establish relationships with sophisticated parties who have the ability to request the information necessary to make an informed decision about transacting with or investing in a hedge fund. Along with the ability to request the information necessary to make an informed decision, sophisticated counterparties and investors have the ability to decide not to transact with, or invest in, a hedge fund. To the extent that an investor or a counterparty believes that it has not received sufficient information during its diligence process, that investor should decline to make an investment (or remain invested) in the fund, and the counterparty should decline to transact with the fund.

Hedge fund investors request and receive a substantial amount of information from hedge fund managers prior to investing and during their investments, pursuant to agreements between the investors and the funds.[9] In the United States, once a hedge fund or a hedge fund manager provides information regarding the fund to a current or potential investor, then any intentional misrepresentation or material omission would be a violation of the anti-fraud provisions of U.S. securities laws. As a result of these market and regulatory forces, we believe hedge fund investors do receive sufficient information to enable them to make informed investment decisions.

In considering issues of counterparty risk, it is important to focus not just on the risk that hedge funds cause to their counterparties, but also the risks that counterparties can cause, and have caused, to hedge funds. Indeed, the failure of Lehman Brothers created substantially more counterparty risk than the losses or failures of any hedge funds. In considering issues related to counterparty risk, therefore, it is important to address adequate transparency from counterparties to hedge funds as well as adequate transparency from hedge funds to their counterparties.[10] Of even greater importance from an investor confidence and market stability standpoint is the need for stronger protection of customer collateral posted with counterparties. The lack of segregation and protection of customer collateral in the failure of Lehman Brothers, and the resulting consequences of that lack of protection clearly demonstrated the importance of addressing this issue.

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[9] 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.

[10] MFA raised this issue in its June 13th, 2008 comment letter in response to the President's Working Group's Asset Manager's Committee report, Best Practices for the Hedge Fund Industry, available at: http://www.managedfunds.org/downloads/MFA%20--%20Comment%20Letter%20to%20PWG%20AMC%20--%20FINAL.pdf.

PERFORMANCE COMPENSATION

The Consultation Report also addresses potential risks associated with the performance compensation of hedge fund managers. We believe that a number of the conflicts of interest identified in the Consultation Report are relevant to compensation for investment advisory services generally and are not particular to performance based compensation structures. We also believe that the Report does not fully reflect the alignment of interest between hedge fund managers and investors that results from performance-based compensation and manager investments in the hedge funds they manage.

The Consultation Report identifies a number of potential issues that the Task Force believes may result from performance-based compensation structures.[11] A number of the risks identified do not seem specific to performance-based compensation structures. False valuations, inappropriate calculation of fees and expenses, and undisclosed conflicts of interest with counterparties, among others are also relevant to investment advisory relationships with other types of compensation structures.[12] Moreover, the investment performance of any investment adviser, regardless of compensation structure, is highly relevant to that adviser's ability to maintain clients and attract new clients (and, therefore, generate compensation in any form). As such, we believe the potential conflicts identified in the Consultation Report arise under most, if not all, varieties of advisory relationships and that the focus should be on an adviser's having adequate controls to monitor, manage, reduce (when possible) and disclose the conflicts of interest that arise in its business, rather than a focus on the particular compensation structure.

We believe that performance-based compensation creates a greater alignment of interest between investors and managers than other types of compensation structures. This is particularly the case because the performance-based compensation received by hedge fund managers is typically subject to a "high water mark", which means that a manager has to earn back any previous losses before earning compensation on additional earnings to investors. This structure provides an incentive to managers not to take on excessive risk to generate short-term profits so as to avoid large losses that could preclude compensation for an extended period of time, thereby jeopardizing the ability of a manager to hire and retain talented employees. The Consultation Report notes that this structure provides an incentive to managers to wind down and open new funds. The reputational risk to a manager that engaged in such practices, however, provides a strong disincentive to taking such action. Sophisticated investors are unlikely to continue investing with a manager who follows such a business model. We believe that performance-based compensation aligns manager and investor interests, and structures such as high water marks significantly mitigate the conflicts of interest that arise in any compensation structure for providing investment advice.

Moreover, another typical component of the compensation structure for hedge fund managers is a management fee, which is based on assets under management rather than performance over a given time frame. Compensation based on assets under management provides a strong incentive for hedge fund managers to grow their asset bases over an extended period of time, which is achieved through successful long-term, risk-adjusted investment performance. Excessive risk tasking and focusing on short-term performance at the expense of

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11 Footnote 22 to paragraph 43 of the Consultation Report.

12 Issuing inflated valuations, for example, would also be a risk for compensation structures that pay a fee based on assets under management.

long-term performance would likely cause investors to remove their assets from a fund, thereby costing a manager the opportunity to continue earning a management fee on those assets.

Another key mitigating factor that greatly reduces the perceived risks associated with performance-based compensation is the fact that hedge fund managers typically invest significant amounts of their own money in the funds they manage, and they typically maintain large investments in those funds. Moreover, the performance-based compensation earned by managers also typically remains invested in the fund. The manager's personal investment in the fund provides an even greater alignment of interest with investors, and largely mitigates the type of excessive risk taking and short-term profit strategies that the Consultation Report identifies as concerns.

Taking into account all of these factors, we strongly believe that the compensation structure for hedge fund managers aligns the interest of the manager and the investors, which greatly mitigates the conflicts of interest that are inherent in any structure that provides compensation to a person for providing investment advice on behalf of clients. We also believe that, in considering potential risks associated with compensation structures, it is important for policy makers and regulators to recognize existing contractual arrangements agreed to among market participants. New regulation that retroactively changes the terms of agreed upon contracts creates significant uncertainty for market participants. This uncertainty works against efforts to restore financial stability as market participants are reluctant to re-enter markets when the rules of participation may be changed at a future date.

MARKET ABUSE CONCERNS

Although the Consultation Report notes that market abuse concerns are not specifically a hedge fund related concern, the discussion in the Report implies that such concerns (insider trading, for example) are of greater concern with respect to hedge funds than with respect to other market participants. We strongly disagree with this implication. Hedge funds and their managers are subject to the same trading restrictions as other market participants, including rules against insider trading. Hedge fund managers are also subject to the same enforcement and penalty regimes, both civil and criminal, as other market participants for violations of those trading restrictions. Moreover, registered hedge fund managers are required under U.S. Securities and Exchange Commission regulations to have written policies and procedures designed to prevent such market abuses, including insider trading. Even for non-registered hedge fund managers, MFA's *Sound Practices for Hedge Fund Managers*[13] includes a recommendation that hedge fund managers have written policies designed to prevent insider trading.

CURRENT REGULATORY AND INDUSTRY INITIATIVES TO MITIGATE RISKS

In addition to identifying the perceived risks of the hedge fund industry, the Consultation Report summarizes some of the key regulations and industry initiatives that are currently applicable to hedge funds. We would like to provide an update on two key areas in which MFA and its members have been active in working to promote investor protection, greater transparency and protection against systemic risks. Those areas are initiatives regarding over-the-counter ("OTC") derivatives and harmonization of industry best practices.

[13] *Sound Practices for Hedge Fund Managers*, available at: http://www.managedfunds.org/files/pdf's/mfa%20Sound%20Practices%2009_final5.pdf.

INDUSTRY INITIATIVES REGARDING OTC DERIVATIVES

MFA believes that issues regarding OTC derivatives are relevant to the discussion of hedge funds and their activities because, as noted in the Consultation Report, a considerable number of funds trade OTC derivatives as part of their overall investment strategy. Hedge funds trade both standardized and bespoke OTC derivative products across multiple regions. Over the last ten years, OTC derivatives, including credit default swaps ("CDS"), have become a critical means by which hedge funds have achieved absolute returns for their investors and managed the risk and returns of the assets in the funds' portfolios. For that reason, MFA and its members have a significant interest in strengthening the efficiency and integrity of the OTC derivatives market and mitigating systemic risks.

MFA believes that any regulatory measures that seek to affect the functioning of the OTC derivatives market must be balanced against the significant benefits of these products realized by global capital markets and market participants who trade them. We believe that the optimal framework to strike this balance is through industry-led initiatives, which are organized in coordination and cooperation with U.S. and European policy makers.

MFA has consistently supported and participated in several industry-led initiatives to reduce risks and improve market efficiency and operational infrastructure across all OTC derivatives markets. In addition, MFA and its members have played an important role in improving market practices through collaboration among U.S. and European regulators, major derivatives dealers, investment managers (such as hedge funds and traditional 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 related to OTC derivatives trading.

One noteworthy initiative in which MFA and its members have been active participants is an industry-wide group called the Operations Management Group (the "OMG"). Since its inception in 2005, the OMG has regularly met with regulators (including the U.S. Federal Reserve Bank of New York, the U.K. FSA and the Commission Bancaire of France) and has held weekly meetings to establish, implement and monitor stringent industry-wide targets, deadlines, bilateral solutions and business-process objectives.

In recent years, the OMG and other industry-led initiatives have made notable progress in the OTC derivatives space. Some of the more recent market improvements and systemic risk mitigants have included: (i) the reduction by 80% of backlogs of outstanding CDS confirmations since 2005; (ii) the establishment of electronic processes to approve and confirm CDS novations; (iii) the establishment of a trade information repository to document and record confirmed CDS trades; (iv) the establishment of a successful auction-based mechanism actively employed in 14 credit events including those involving Fannie Mae, Freddie Mac and Lehman Brothers, allowing for cash settlement; and (v) 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 success of coordinated, industry-led 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), it has quickly achieved a level of standardization and trading efficiency that has made it ripe for centralized clearing. MFA and its members are generally supportive of clearing of standardized CDS contracts, if the clearinghouse platforms are appropriately structured. Recently, MFA and its members also have been very involved in the establishment of one or more CDS central clearinghouse platforms.

OTC derivatives continue to be a significant part of the trading strategies of hedge funds and play an important role in global capital markets. MFA believes that the growth of the use of these financial products is a testament not only to the innovation and sophistication of market participants, but also to the success of collaborative and coordinated regulatory involvement. MFA believes that this cooperation remains the best solution to meet the challenges and risks of the OTC derivatives market.

HARMONIZATION OF INDUSTRY BEST PRACTICES STANDARDS

The Consultation Paper notes the various best practices standards for the hedge fund industry that are currently available and encourages industry groups to work to unify those standards into one global standard for hedge funds. MFA has recently updated its best practices document, *Sound Practices for Hedge Fund Managers*, to fully incorporate the recommendations contained in the President's Working Group's Asset Managers' Committee best practices report. MFA has also committed, along with the Asset Managers' Committee, the Alternative Investment Management Association, the President's Working Group's Investors' Committee and the Hedge Fund Standards Board to providing the Financial Stability Forum with a set of unified principles of best practices. MFA is actively working with those groups to finalize those principles. We expect that these groups will continue to work to achieve greater harmonization of the various standards.

REGULATORY REFORM RECOMMENDATIONS

MFA and its members understand that effective regulatory reform will be an important part of stabilizing markets and restoring investor confidence, but it will not, in and of itself, be sufficient to do so. Though regulation cannot, in and of itself, restore financial stability and properly functioning markets, it is a necessary component of any plan to achieve those ends. An effective regulatory framework should include appropriate, effective, and efficient regulation and industry best practices that better monitor and reduce systemic risk and promote efficient capital markets, market integrity, and investor protection. Regulation that addresses these key issues is more likely to improve the functioning of the global financial system, while regulation that does not address these key issues can cause more harm than good. MFA offers its comments on the regulatory reform recommendations in the Consultation Paper in the spirit of working with the Task Force and IOSCO to achieve the shared goal of an effective regulatory framework. We hope that these comments are helpful to the Task Force and IOSCO as they continue to consider these issues.

SYSTEMIC RISK REGULATION

The first step in developing a systemic risk regulatory regime for any jurisdiction 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 and regulators 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 of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants.

MFA and its members acknowledge that the hedge fund industry as a whole is of systemic relevance. 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 relative size of hedge funds compared to other financial institutions, the relatively low levels of leverage used by hedge funds, and the fact that hedge fund losses have not caused systemic risk during this global crisis.

There are a number of additional factors that policy makers and regulators will need to consider as they develop a systemic risk regulatory structure. We believe that an effective systemic risk regulatory structure should have the following elements: a central systemic risk regulator, confidential reporting to that regulator, a clear mandate for the regulator to protect the financial system, and a clearly established authority for that regulator. Each of these elements is discussed in more detail below.

A. CENTRAL SYSTEMIC RISK REGULATOR

For systemic risk oversight to be effective, there must be oversight over 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. We believe that a single central systemic risk regulator should be considered to accomplish this goal. This central regulator should be responsible for oversight of the structure, classes of institutions and products of all financial system participants in a given jurisdiction.

We believe that having multiple regulators with responsibility for overseeing systemic risk likely would not be an effective framework. Jurisdictional conflicts, unintended gaps in regulatory authority, and inefficient and costly overlapping authorities likely would inhibit the effectiveness of such a regulatory framework. Moreover, in a framework with multiple systemic risk regulators, no one regulator would be able to assess potential systemic risks from a holistic perspective, as no regulator would oversee the entire system.

B. CONFIDENTIAL REPORTING TO REGULATOR

MFA and its members recognize that, for a systemic risk regulator to be able to adequately assess potential risks to the financial system, that regulator needs access to information. We support a systemic risk regulator having the authority to request and receive, on a confidential basis, from those entities that it determines (at any point in time) to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system.

In considering the appropriate scope of this authority, we believe that it is important for the systemic risk regulator to have sufficient authority and flexibility to adapt to changing conditions and take a forward-looking view toward risk regulation. Attempting to pre-determine what information a regulator would need would not provide sufficient flexibility and likely would be ineffective as a tool to address potential future risks. We believe that granting the systemic risk regulator broad authority with respect to information gathering, along with ensuring that it has the appropriate resources and capabilities to effectively analyze that information, would be a more effective framework.

While we support a systemic risk regulator having access to whatever information it deems necessary or advisable to assess potential systemic risks, we believe that it is critical for such information to be kept confidentially and granted full protection from public disclosure. We recognize the benefit of a regulator having access to all important data, even potentially sensitive or proprietary information from systemically relevant entities. A systemic risk regulator can fulfill its mandate to protect the financial system without publicly disclosing all the proprietary information of financial institutions. We do not believe that there is a public benefit to such information being publicly disclosed.

Moreover, public disclosure of such information could be misleading, as it would likely be incomplete data that would be viewed by the public outside of the proper context. Public investors may be inclined to take action based on this data without fully understanding the information, which could lead to adverse consequences for those investors, for the investors in systemically relevant entities, and for the stability of the financial system as a whole. Public disclosure of proprietary information also harms the ability of market participants to establish and exit from investment positions in an economically viable manner. Such disclosure also could lead to systemically relevant entities being placed at an unfair competitive disadvantage compared to non-systemically relevant entities, as sensitive and proprietary information of only the systemically relevant entities would be publicly available.

C. Mandate to Protect the Financial System

Setting a clear and specific mandate is important for any regulator to be effective. This is particularly true in a regulatory framework that has multiple regulatory entities, as a lack of clarity in the mandates of regulators can lead to gaps in oversight, or costly and inefficient overlapping regulation. We believe that the systemic risk regulator's mandate should be the protection of the financial system. Investor protection and market integrity should not be part of its mandate, but should instead be addressed by other regulatory entities. Policy makers should be clear in stating that the risk regulator should collect information only for its mandate to protect the financial system, and should not use that authority for other purposes.

To fulfill its mandate to protect the financial system, we recognize that the regulator would need to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system. Absent such a concern about broad systemic consequences, however, the systemic risk regulator should not focus on preventing the failure of systemically relevant entities. Systemically relevant market participants do not necessarily pose the same risks or concerns as each other. There likely are entities that would be deemed systemically relevant for purposes of reporting information, but whose failure would not threaten the broader financial system. For this reason, we believe that the systemic risk regulator should focus on preventing failures of market participants only when there is concern about the consequences to the broader financial system, and should not focus on preventing the failure of all systemically relevant entities.

Consistent with this mandate, the systemic risk regulator should not equate systemically relevant entities with entities that are too big, or too interconnected, to fail. An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against its failure. Also consistent with this mandate, it is important that systemic risk regulation does not prevent market participants from taking positions that express contrarian or counter-cyclical views with respect to firms, including systemically relevant firms, and products. Such contrarian or counter-cyclical positions are important market-based checks, which also help to mitigate potential systemic risks.

D. SCOPE OF REGULATORY AUTHORITY

We believe that whatever authority the systemic risk regulator has should ensure that the regulator has the ability to be forward-looking to prevent potential systemic risk problems, as well as the authority to address systemic problems once they have arisen. The systemic risk regulator's authority must be sufficiently flexible to permit it to adapt to changing circumstances and address currently unknown issues. An attempt to specifically define the regulator's authority must avoid unintentionally creating gaps in authority that would prevent the systemic risk regulator from being able to fulfill its mandate to protect the financial system in the future.

We do believe that the systemic risk regulator needs the authority to ensure that a failing market participant does not pose a risk to the entire financial system. In the event that a failing market participant could pose such a risk, the systemic risk regulator should have the authority to directly intervene to ensure an orderly dissolution or liquidation of the market participant. The significant adverse consequences that resulted from the failure of Lehman Brothers this past fall is an example of what can happen when there is not an intervention to prevent a disorderly dissolution of such a market participant. The continuing market disruption caused by the failure of Lehman Brothers also demonstrates the importance of ensuring that there is a coordinated global effort with respect to such interventions.

Whatever the scope of authority that a systemic risk regulator has, its implementation of that authority will be critical to the effectiveness of any regulatory regime. We believe that the systemic risk regulator should implement its authority by focusing on all relevant parts of the financial system, including structure, classes of institutions and products. Because systemic risk concerns may arise from a combination of factors, rather than from the presence of any particular factor, a holistic approach is more likely to successfully identify and assess potential systemic risks.

PRUDENTIAL REGULATION

In addition to regulation to recommendations designed to address systemic risk concerns, the Consultation Report also makes recommendations with respect to prudential regulation of hedge funds. We believe that any prudential regulatory framework for hedge funds should be based on the following principles:

1. The goal of regulatory reform should be to develop intelligent regulation, which makes the financial system stronger for the benefit of businesses and investors.

2. Prudential regulation should address identified risks or potential risks, and should be appropriately tailored to those risks.

3. 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.

4. Reporting requirements should provide regulators with the right information to 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. Any reporting of sensitive, proprietary information by market participants should be kept confidential. As discussed in the section above on reporting to a systemic risk regulator, 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.

5. Registration requirements for private pools of capital, to the extent being considered by policy makers and regulators, should focus on the advisers, rather than on the pools themselves. This approach achieves the goals of oversight, monitoring and regulatory reporting, without placing unnecessary and inappropriate limitations on the ability of funds to operate.

6. We believe that any prudential 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 should not be limited only 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 and publicly offered sales of investments to retail investors. This private/public, sophisticated/retail distinction has been in existence in the United States for over half a century 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.

7. Lastly, we believe that industry best practices and robust investor diligence should be encouraged and viewed as an important complement to prudential regulation. Strong business practices and robust diligence are critical to addressing investor protection concerns.

<u>A. Standardized Disclosure</u>

In light of these six principles, we believe that certain types of suggested regulation for hedge funds would not be appropriate. One such suggestion is to require standardized disclosure by hedge funds to their investors. As mentioned previously, MFA and its members strongly support hedge funds providing sufficient information to investors to allow investors to make informed investment decisions. We believe that because the class of investors who can invest in hedge funds is limited to sophisticated investors only, those investors are able to request and receive any information they believe to be relevant to their investment decisions. Further, we believe that sophisticated investors are better able than regulators to determine what information they need and how they want that information to be presented. Any investor who fails to receive the information that it believes is material to an investment decision can choose not to make an investment. Because investors are best able to determine what information they need, and they have the ability to request and receive that information (or not make an investment if they do not), we believe that it is neither necessary nor advisable to require standardized disclosures by hedge funds.

B. Minimum Capital Requirements

We do not believe that hedge fund managers or hedge funds should be subject to minimum capital requirements, at least outside of the context of a systemic risk regulator deeming such requirements necessary because of an identified risk to the financial system. Hedge funds are not depository institutions and they are sold to sophisticated investors who understand the risks involved with their investment, and who have the financial ability to withstand the loss of their investment. As such, we do not believe that there is a policy rationale for imposing minimum capital requirements on a hedge fund. We also do not believe that there is a policy rationale for imposing a minimum capital requirement on the hedge fund manager. The hedge fund manager does not act as a guarantor of the obligations of the funds it manages, nor does it typically have significant direct exposure to counterparties. Without a clear policy rationale or identified systemic risk, we do not believe that minimum capital requirements on hedge funds or their managers are appropriate. In that regard, we note that the G-20 communique, "Declaration on Strengthening the Financial System",[14] issued following the April 2, 2009 meeting of the G-20, contained recommendations regarding the regulation of private pools of capital such as hedge funds, but did not recommend minimum capital requirements for such pools, or their managers.

C. Restrictions on Investments

It is also our belief that regulatory restrictions should not be placed on the types of investments that can be made by hedge funds, absent an identified systemic risk concern that necessitates such a restriction. We note that the European Commission, in discussing the EC Directive, specifically rejected such regulatory restrictions on investment policies. In its publicly released frequently asked questions on the EC Directive, the European Commission stated, "The proposal does not impose registration requirements directly on funds, nor does it regulate investment policies. Regulation of investment policies would be unnecessarily restrictive given the professional nature of the investor base and would be impractical to implement given the diversity of business models."[15] For capital markets to function properly, it is important for

[14] Available at: http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf

[15] Directive on Alternative Investment Fund Managers (AIFMs) : Frequently Asked Questions, available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/211&format=HTML&aged=0&language=EN&guiLanguage=fr

investors (such as hedge funds) to be able to deploy risk-based capital and make investments that carry higher levels of risk. Prudential regulatory limitations on the types of investments made by hedge funds and other investors of risk-based capital are likely to cause more harm than good to capital markets. Similarly, prudential regulatory restrictions on the use of leverage by investors of risk-based capital are also likely to cause more harm than good to capital markets. These types of prudential restrictions are likely to cause harm to capital markets because, without investors deploying risk-based capital, capital markets would be less liquid and there would be fewer opportunities for market participants to mitigate or transfer risk.

Further, hedge fund investors are limited to sophisticated investors who are capable of understanding the risks associated with the types of investment that will be made by the funds in which they invest, and who have the financial resources to withstand the potential losses associated with risk-based investment strategies. Hedge fund investors are also capable of understanding the risks associated with the use of leverage, and have the financial resources to withstand the potential losses associated with the use of leverage. Unlike retail investors in other pooled investment products, therefore, hedge fund investors do not require prudential regulatory restrictions on the types of investment that can be made by, or the use of leverage by, hedge funds. Prudential regulatory restrictions on the types of investments or the use of leverage by investors of risk-based capital do not serve an investor protection function, and can cause more harm than good to capital markets. We believe, therefore, that such restrictions should be considered only in the context of systemic risk regulation, and not in the context of prudential regulation.

D. Indirect Regulation or Direct Regulation

One of the specific questions asked in the Consultation Report is whether regulation of hedge funds should be done indirectly through counterparties such as prime brokers, or directly on hedge funds and/or their managers. We believe that regulation should be based on an identified risk and then policy makers and regulators should consider the most effective way to address that identified risk. For certain types of risks, indirect regulation might be more effective, while in other circumstances direct regulation may be more effective.

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CONCLUSION

MFA appreciates the opportunity to provide comments to IOSCO in response to the Consultation Paper and we hope that our comments are useful to IOSCO as it considers these important issues. We believe that many of the issues discussed in the Consultation Paper are not specific to hedge funds, but should be considered in the broader context of all participants in financial and capital markets. Our members have a shared interest with policy makers in ensuring a sound financial system and we are committed to working with policy makers to develop appropriate and effective regulation to achieve that goal.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker

President and CEO

John G. Gaine

/s/ John G. Gaine

President Emeritus and
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