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

February 29, 2008

Via Electronic Mail

The Honorable Michael Crapo
Chairman
Senate Republican Capital Markets Task Force
239 Dirksen Senate Building
Washington, DC 20510

Re: Request from Senate Republican Capital Markets Task Force regarding United States Capital Markets Competitiveness in the Global Financial Services Marketplace

Dear Mr. Chairman:

Managed Funds Association (MFA)[1] appreciates the opportunity to respond to the Senate Republican Capital Markets Task Force (Task Force) request for five recommendations that would assist the United States in reclaiming its preeminent position in the global financial services marketplace.

MFA applauds the efforts of the Task Force in undertaking this initiative to further the global competitiveness of the U.S. capital markets by considering specific legislative or regulatory proposals for the reform of the U.S. financial regulatory system. MFA believes that legislative or regulatory changes are necessary to modernize this system in order to meet the dynamic changes we have seen in the marketplace and to allow for future innovations.

We are pleased to provide the following five recommendations discussed in more detail below.

- Congress should enact tax legislation that promotes capital formation, encourages efficiency in the U.S. capital markets and does not adversely affect the ability of US.-based firms to compete globally.

- Congress should enact a uniform set of basic principles for the regulation of financial markets and should require financial regulatory agencies to adopt principles-based regulation.

[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.

- Congress should simplify the U.S. financial regulatory system by eliminating duplicative or conflicting regulation and improving coordination among federal agencies and between the state and federal government.

- Congress should amend the charter of the Securities and Exchange Commission to require the agency to take a prudential approach to supervision that encourages constructive engagement and not a prescriptive law enforcement approach.

- Congress should encourage the appropriate financial regulatory agency/agencies to take a leadership role in promoting market regulation and market access for financial services across borders.

Principal Recommendations

1. *Recommendation: Congress should enact tax legislation that promotes capital formation, encourages efficiency in the U.S. capital markets and does not adversely affect the ability of US.-based firms to compete globally.*

For the U.S. capital markets to remain competitive, U.S. tax policy should promote capital formation and encourage savings and investment. MFA believes that Congress should enact tax legislation that encourages investment in all phases of the U.S. capital markets, which are among the deepest and most liquid in the world. MFA also believes that any tax legislation adopted by Congress in the future should further the ability of U.S.-based firms to compete globally both in attracting non-U.S. investors and in obtaining and retaining the services of talented individuals. The competition for capital and talented individuals is global and U.S. tax laws should take this fact into account. Moreover, U.S. tax legislation should promote financial innovation, which has been a historical hallmark of the U.S. capital markets. Finally, U.S. tax laws should treat similarly situated firms such as hedge funds, venture capital, and oil/gas partnerships that are based in the U.S. the same.

2. *Recommendation: Congress should enact a uniform set of basic principles for the regulation of financial markets and should require financial regulatory agencies to adopt principles-based regulation.*

The United States has a complex regulatory system composed of multiple regulators, each operating under a distinct regulatory framework written to uphold distinct statutes. In today's rapidly changing and evolving financial markets, however, our regulatory model has become outdated, and in many cases, a hindrance to financial innovation and an impediment to the ability of U.S. financial services firms to compete globally. MFA proposes Congress unify U.S. financial regulators through the adoption of a common set of principles for financial market regulation that takes into consideration investor protection, the viability of U.S. businesses, as well as the overall competitiveness of the U.S. capital markets. The Financial Services Roundtable's *"Blue Print for U.S. Financial Competitiveness"* provides a great example of the uniform set of basic principles that we believe Congress should enact. Their "Guiding Principles

for Financial Regulation" include fair treatment for consumers; competitive and innovative financial markets; proportionate, risk-based regulation; prudential supervision and enforcement; options for serving consumers; and management responsibilities.[2]

MFA believes a principles-based approach to regulation, which sets out fundamental principles that provide guidance in the application and review of policies, laws and rules, best addresses the safety and soundness of our markets without stifling innovation. This flexible approach would help regulators to easily adapt and respond to changing market forces. MFA recommends that Congress encourage financial regulatory agencies to adopt principles-based regulation. Some claim a principles-based approach sacrifices legal certainty for flexibility. The Commodity Futures Trading Commission's (CFTC) regulation of futures exchanges and derivatives clearing organizations under the Commodity Exchange Act amendments enacted in 2000 is a prime example of successful principles-based regulation that illustrates a useful approach to resolving the legal certainty issue. The CFTC establishes a safe harbor of accepted practices that allow exchanges to conduct their affairs with certainty that compliance with the acceptable practices will necessarily involve compliance with the applicable principle. In this manner, if an exchange wants or needs to comply with a core principle in a special way not accommodated by the "acceptable practice," it may discuss these special circumstances with the CFTC and reach some understanding of how it may best comply. Most exchanges, however, simply follow the acceptable practices to ensure their activities are being conducted within the framework of enacted statutory principles.

3. *Recommendation: Congress should simplify the U.S. financial regulatory system by eliminating duplicative or conflicting regulation and improving coordination among federal agencies and between the state and federal government.*

A consequence of financial product innovation, market crises and convergence has been that many firms find themselves faced with multiple regulators vying for jurisdiction, including various federal and state agencies. As a result, firms are frequently forced to follow multiple (and sometimes inconsistent) regulatory directives. This results in substantial inefficiency, confusion and undue costs for market participants, as well as a waste of taxpayers' money. MFA believes firms should only be subject to one regulator. A system with one regulator and one regulatory framework for a firm would best simplify and streamline regulation, facilitate and reduce the cost of compliance and promote innovation and development. We urge Congress to remove duplicative or conflicting regulation among federal agencies and between the state and federal government.

Specific examples of duplicative or conflicting regulation include:

- *Public Commodity Pools:* The regulation of public commodity pools is a prime example of how overregulation can stifle the growth of a financial product and further limit an investor's diversification options. Public commodity pools are subject to regulation by the CFTC, the Securities and

[2] Financial Services Roundtable, *The Blue Print for U.S. Financial Competitiveness*, Executive Summary at 12-15 (Nov. 2007) .

Exchange Commission (SEC), the National Futures Association, the Financial Industry Regulatory Authority and the states. As a result of the steep overhead costs and the increasing costs of compliance, there are few public commodity pools available to investors. MFA urges Congress to establish the CFTC as the exclusive regulator over public commodity pools.

- *Futures Markets*: Notwithstanding the CFTC's exclusive jurisdiction over the commodity futures markets (including those involving energy-related commodities), the Federal Energy Regulatory Commission (FERC) has attempted to assert "shared" jurisdiction over natural gas futures markets. The CFTC and FERC have resorted to seeking resolution of this jurisdictional issue through the judicial system. Court judgments of this magnitude take a substantial period of time and the legal uncertainty during the adjudication process adversely affects market participants. If FERC prevails in its litigation position, it would be possible for other agencies like the SEC and the Federal Trade Commission to follow FERC's blue-print and eviscerate the CFTC's exclusive jurisdiction. That outcome would cause duplicative or conflicting multi-agency regulation of futures markets which would handicap the U.S. futures markets ability to compete globally.

In MFA's view, it is most important that regulatory policy be well-informed, balanced and coordinated. MFA believes that the PWG's coordination role is a real source of strength for the U.S. financial regulatory system. The PWG effectively addresses pertinent issues and coordinates regulatory policy in a wide-array of areas affecting MFA members and their various businesses activities. We believe that the PWG can do the same for the capital markets and financial services industry generally.

To improve coordination among regulatory agencies, MFA recommends that Congress codify and expand the powers of the President's Working Group on Financial Markets (PWG) so that it becomes the over-arching regulator over the financial services industry. The PWG, chaired by the Secretary of the Treasury and composed of the chairmen of the Federal Reserve Board, the SEC, and the CFTC, was formed in 1988 to further the goals of enhancing the integrity, efficiency, orderliness, and competitiveness of financial markets and maintaining investor confidence. MFA believes that a system with one umbrella regulator responsible for the entire financial services industry would help ensure that regulatory and policy determinations are considered in the context of the entire industry. In this role, the PWG would oversee the implementation of principles-based regulation and regulatory coordination across the financial regulatory agencies. As the coordinator of financial services regulators, the PWG would address the jurisdictional issues mentioned. Moreover, an "enhanced" PWG would be able to respond to changes in market conditions much faster than our current regulatory system.

Finally, Congress should ensure that state securities regulators are not undercutting the federal pre-emptive regime established by Congress in the National Securities Markets Improvement Act of 1996 through the assertion of jurisdiction over federal issues. State attempts at requiring registration for investment advisers with $25 million or more in assets under

management is a key example. These advisers are addressed at the federal level, and therefore, state involvement is unnecessary and should be pre-empted. MFA believes that state securities regulators should remain focused on protecting retail and inexperienced investors through antifraud legislation and regulation, and not sophisticated market participants-- for whom Congress has determined do not need the type of safeguards required for retail investors.

4. *Recommendation: Congress should amend the charter of the Securities and Exchange Commission to require the agency to take a prudential approach to supervision that encourages constructive engagement and not a prescriptive law enforcement approach.*

MFA believes that the promotion of regular and open communication between financial regulators and firms through prudential supervision will encourage better regulation across the U.S. financial markets. The Financial Services Roundtable has defined prudential supervision as "the regulator working with firms to correct practices, to address impacts of practices on consumers, and inform other firms of best practices developed from the process."[3] Prudential supervision fosters the development of a cooperative, not combative, regulatory relationship for businesses and their regulators, and avoids the problems a rigid one-size-fits-all approach may impose on an ever-evolving array of business structures and operations.

Although the facilitation of capital formation is part of the SEC's mission, it has not been a priority. We believe the SEC could pay more attention to the competitiveness of U.S. capital markets. Historically, the SEC has taken a prescriptive approach to regulation with an emphasis on enforcement measures. Unfortunately, this approach has resulted in an "arms-length" relationship between the SEC and regulated firms with such firms being unwilling to approach the SEC immediately when an issue arises. As a result, we urge Congress to amend the SEC's charter to require the agency to take a prudential approach to supervision and make the enforcement environment more constructive. In such an environment, firms would be able to work with the SEC to address and correct issues in a timely and effective manner. As Secretary of the Treasury Henry M. Paulson, Jr. has already noted, "[t]he combination of enforcement and guidance is likely to be more effective and more efficient than relying on enforcement alone, particularly in an environment in which there is a greater degree of trust between the regulators and the regulated."[4]

MFA recommends that Congress direct the SEC to implement the following initiatives in its system of prudential supervision:

- Fold the Office of Compliance Inspections and Examinations (OCIE) back into the four SEC divisions. We believe that that this move would facilitate consistent interpretations of applicable rules by ensuring communication and

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[3] Financial Services Roundtable, *supra* note 2 at 19.

[4] Remarks by Secretary of the Treasury Henry M. Paulson, Jr. on the Competitiveness of the U.S. Capital Markets at the Economic Club of New York (Nov. 20, 2006), available at http://www.treas.gov/press/releases/hp174.htm.

coordination between those individuals responsible for the policy and examination processes.

- Publish the OCIE examination manual and other supervisory policies and procedures and post such information on the SEC's website. We believe that making the examination protocol publicly available would increase transparency and accountability.

- Create a clear and non-actionable process for firms to engage with the SEC when they have questions or need clarification. Such process should be significantly less formal and costly than the current practice of seeking no-action letters from the SEC.

- Clarify that the prohibition on general solicitation and advertising by hedge funds does not prohibit open communication between hedge fund managers and the media or speaking at public conferences as long as there is no express solicitation made. We believe that this clarification or guidance would foster greater transparency of the industry.

- Create a risk-based product approval process. We believe that the SEC's current regulatory scheme has an adverse affect on innovation and U.S. competitiveness as the approval of new financial products takes a considerable period of time, and may result in firms issuing new products overseas. A risk-based approval process would ensure the review of new product applications in a timely manner and promote U.S. capital markets competitiveness.

5. *Recommendation: Congress should encourage the appropriate financial regulatory agency/agencies to take a leadership role in promoting market regulation and market access for financial services across borders.*

MFA suggests that the U.S. take a leadership role in developing new approaches to cross-border regulation. As a result, we recommend that Congress encourage the appropriate financial regulator(s) to actively promote increased interaction between U.S. and non-U.S. financial markets and institutions. Among other benefits, this expanded market access would accelerate the development of such markets and support sustainable economic growth, which is mutually beneficial to the U.S. and the other countries. Additional measures recommended by MFA include the following:

- *Amend Immigration Policies to Increase Access to Non-U.S. Talent.* Congress should amend U.S. immigration policies to ease certain restrictions on skilled non-U.S. professional workers, including raising the annual cap on H-1B visas, eliminating the time lag between student visas expiring and the granting of H-1B visas, adopting more flexible standards for training programs that would qualify for H-1B visas, and providing clearer guidelines on how to exercise discretion in granting business visitor visas. Such reforms to U.S. immigration policies would significantly ease the imbalance between the supply and demand for talent in the

financial services industry. This will allow the United States to retain its position as the world's largest pool of financial services talent, which in turn makes the United States more attractive to both domestic and non-U.S. financial institutions. A larger pool of highly skilled workers will benefit not only financial services firms, but also many other industries in the United States.

- *Embrace the Global Convergence of Regulatory Standards.* MFA believes that the global convergence of regulatory standards is necessary for the U.S. capital markets to remain competitive. For example, with respect to U.S. generally accepted accounting principles (GAAP) and the International Financial Reporting Standards (IFRS), we urge Congress to direct the SEC to accelerate its efforts to offer both U.S.- and non-U.S.-based companies the option of reporting financial information using either GAAP or IFRS. We believe that having a GAAP or IFRS reporting option would increase non-U.S. investment in the U.S capital markets as the expense associated with reconciling IFRS with GAAP for those non-U.S. firms interested in listing their shares on U.S. exchanges would no longer be applicable.

- *Consider the Recognition of Comparable Non-U.S. Regulatory Regimes.* MFA agrees with Secretary Paulson that "mutual recognition between countries with regulatory schemes comparable to the United States could increase international investment opportunities and enhance risk diversification while preserving investor protection."[5] MFA recommends that Congress direct the PWG to perform a study of the potential recognition of other regulatory regimes with the goal of determining the feasibility of U.S. regulators such as the SEC taking a "lite" approach to regulating those firms that are regulated under comparable schemes in non-U.S. jurisdictions, similar to the more-streamlined approach that regulators in certain other jurisdictions have adopted with respect to SEC-regulated firms. Evidence of the SEC's cooperation with other regulators already exists in the form of the multi-jurisdictional disclosure system between the U.S. and Canada, and also in the form of information-sharing agreements and cross-border enforcement measures between the SEC and its non-U.S. counterparts. Greater mutual recognition of regulatory schemes would be a beneficial extension of such existing cooperation arrangements.

Securities Litigation and Sarbanes-Oxley Reform

MFA believes that securities litigation and Sarbanes-Oxley reform are significant areas for review and reform in order to maintain U.S. capital markets competitiveness.

The current litigation environment continues to be a significant threat to the competitiveness of our capital markets. Securities class action settlements in 2006 totaled $10.6 billion (not counting the Enron-related settlements of approximately $7.1 billion), up 255 percent

[5] "Paulson Announces Next Steps to Bolster U.S. Markets' Global Competitiveness" (Treasury Press Release, June 27, 2007), available at http://www.treas.gov/press/releases/hp476.htm.

from 2004, up more than 500 percent since 2000 (not including the $3.1 billion Cendant settlement), and up an astonishing 7,000 percent since 1995.[6] Moreover, according to its 2007 Global Capital Markets Survey, the Financial Services Forum noted that 43% of the companies surveyed who de-listed from a U.S. exchange cited the litigation environment in the United States, accounting standards, or Sarbanes-Oxley as the most important factor in their decision to go private.[7] Therefore, we recommend that Congress initiate a bipartisan effort aimed at devising effective proposals for reform. This effort should include a review of U.S. litigation relative to other countries as private shareholder class action suits do not exist in the U.K. and other EU countries. We believe that improving the litigation environment is a significant step that policymakers could take to make the U.S. markets more competitive.

The cost of compliance with the Sarbanes-Oxley Act of 2002 (SOX) has had a chilling effect on the capital formation of public companies. These costs also have been a deterrent to non-U.S. firms that meet U.S. listing requirements from participating in the U.S. equity markets.[8] We encourage Congress and the financial market regulators to engage in SOX reform and consider enacting legislation that expressly incorporates SOX into the Securities Exchange Act of 1934 (1934 Act). By incorporating SOX in the 1934 Act, the SEC would have the clear authority to issue exemptions and rules on important aspects of SOX that may require revision in order to meet the changing dynamics of the U.S. capital markets. MFA believes that SOX reform will improve the attractiveness of these markets.

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[6] Financial Services Forum, *2007 Global Capital Markets Survey*, at 7 (Dec. 2007).

[7] Id. at 6.

[8] Mayor Michael Bloomberg and Senator Charles Schumer, *Sustaining New York's and the U.S.' Global Financial Services Leadership*, at 87 (Jan. 2007).

Conclusion

MFA appreciates the Senate Republican Capital Markets Task Force commitment to address these important issues. We look forward to working with the Task Force as it prepares legislation to implement the recommendations outlined above. If the Task Force has any additional questions, please contact me or Lisa McGreevy at 202-367-1140.

Respectfully submitted,

John G. Gaine
Special Counsel