MANAGED FUNDS ASSOCIATION

December 14, 2007

Via: Email

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Re: MFA Comments on the Hedge Fund Working Group's Consultation Paper

INTRODUCTION

Managed Funds Association[1] ("MFA") appreciates the substantial work the Hedge Fund Working Group (the "HFWG") has done in drafting the Consultation Paper (the "Paper"). In November of 2007, MFA updated its *Sound Practices for Hedge Fund Managers* ("*Sound Practices*"), a dynamic, industry created guide designed for hedge fund managers to strengthen business practices and internal policies and procedures. *Sound Practices* and the Paper embody many of the same principles and there is a significant amount of agreement between the two documents. MFA welcomes the opportunity to identify those areas of commonality between *Sound* Practices and the Paper as well as to provide comment on some of the specific recommendations in the Paper. For ease of reference, we have included in our comments the recommendation numbers or page numbers, as applicable, from the Paper.

The Executive Summary of the Paper states that it, "aims to stimulate discussion leading to a consensus on a broad range of best practices for the industry. Although the initiative has been taken in the United Kingdom, we believe that the recommendations should have global relevance."[2] The Paper further states, "industry best practice may

[1] MFA is the voice of the global alternative investment industry. Its 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.

[2] Page 7, Part 1.

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differ from country to country for a number of reasons, including legal, regulatory and practical considerations."[3]

MFA agrees with the HFWG that recommendations for sound practices within the hedge fund industry should have global application. It is MFA's view that there are multiple means by which a hedge fund manager can implement those globally recommended practices. We believe that the focus of global recommendations should be on ensuring that hedge fund managers address identified issues in a meaningful manner rather than on prescribing the particular means of implementing those recommendations.[4] Within the global hedge fund industry, there are a variety of business models and jurisdictional requirements and MFA understands that any set of global recommendations need to be sufficiently flexible to allow tailoring to meet hedge fund managers' businesses and local jurisdictional requirements. It is for these reasons that, although MFA agrees with the principles underlying many of the recommendations in the Paper, we believe that the specificity and prescriptive nature of certain of the recommendations would make it impractical or impossible for many hedge fund managers to adopt those recommendations.

Our comments are made in the spirit of identifying both the principles on which MFA and the HFWG agree and the recommendations (or portions thereof) that MFA believes would not be able to be implemented globally. Our comments generally fall into one of four categories, separated into the four sections below. The first section has comments that apply to the entire Paper and encompass multiple recommendations. The second section contains recommendations in the Paper that we believe would be difficult to implement for U.S. based hedge fund managers and, therefore, may not be suitable for a set of global recommendations.[5] The third section of comments contains topics that are addressed in *Sound Practices* that we believe would be useful additions to the revised set of guidelines on which the HFWG is working. The final section contains general comments on other topics and recommendations in the Paper.

GLOBAL COMMENTS

Fund Governing Bodies and Third Party Administrators

The Paper has a number of recommendations regarding the appropriate role of a Fund Governing Body or board of directors, including recommendations regarding either disclosure to, or obtaining approval or consent from, the Fund Governing Body or board of directors. U.S. based hedge funds, however, typically do not have an independent

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[3] Page 6, Part 2.

[4] The Paper similarly states, "[t]he key issue which the HFWG has identified in relation to the establishment of appropriate fund governance mechanisms is therefore: do hedge fund managers provide a satisfactory mechanism or vehicle to handle potential conflicts of interest as between themselves and investors?" Page 39, Part 2.

[5] These recommendations may be suitable for a U.K. based hedge fund manager and may be suitable as part of the tailoring process of global recommendations for U.K. managers.

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Fund Governing Body or a board of directors.[6] As such, MFA believes that recommendations that require a Fund Governing Body or a board of directors are not able to be implemented on a global basis. We suggest, therefore, that references to Fund Governing Bodies and boards of directors not be included in a set of global recommendations, but rather be considered as a tailored subset of recommendations for appropriate types of hedge funds in appropriate jurisdictions.

The Paper also contains a number of references to third party administrators. Though a number of U.S. based hedge funds retain third party administrators, many do not. Further, the services provided by third party administrators to U.S. based hedge funds can differ significantly from the services provided by administrators in other jurisdictions. Administrators to U.S. based funds, for example, will assist in calculating the fund's net asset value, but the calculation is based on values reported by the hedge fund manager. U.S. based administrators do not typically conduct the actual valuation of the fund's assets. A significant reason that many U.S. hedge funds do not retain third party administrators, and why administrators to U.S. funds provide different services than elsewhere, is that administrators in the U.S. often do not have the expertise to provide certain services relating to the more complex investments made by hedge funds. As a result, many U.S. based hedge funds have built up their internal infrastructure to acquire the necessary expertise to deal with these instruments. In light of the significant differences in the use of and services provided by third party administrators, MFA believes that recommendations regarding the role of third party administrators should not be included in a set of global recommendations. MFA also believes that background sections in the Paper should note that practices with respect to the use of third party administrators vary across jurisdictions.

Compliance with Recommendations

The Paper contemplates a regime that would require hedge fund managers to make certifications that they comply with the recommendations in the Paper, or else provide sufficient explanations for why the manager does not comply with the recommendations ("Comply or Explain"). MFA agrees that the best way to promote compliance with global sound practices is through having the industry, including managers, investors and counterparties accept the recommendations and foster an expectation of compliance by hedge fund managers.[7] One issue with the proposed Comply or Explain regime is that the determination of whether a manager is in compliance with specific recommendations is not necessarily a bright line test. As such, a statement or certification by a hedge fund manager that it is in compliance with a set of

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[6] Although U.S. based hedge funds do often have a Fund Governing Body (typically a general partner or managing member, depending on the type of legal entity of the hedge fund), the individuals who control the Fund Governing Body are generally the same individuals who control the hedge fund manager.

[7] We note that MFA's approach is similar to that set out by the President's Working Group on Private Pools of Capital on February 22, 2007 in the PWG's Principles and Guidelines Regarding Private Pools of Capital, available at -- http://www.treasury.gov/press/releases/reports/hp272_principles.pdf.

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recommendations could expose the manager to potential liability if an investor or a regulator were to disagree with the manager's assessment. Rather than relying on statements or certifications of compliance from hedge fund managers, MFA believes that market pressure created by having all industry participants agree on and expect compliance with a set of recommendations is the most appropriate method to encourage compliance with those recommendations. We further believe that it is most appropriate to create market pressure by having investors and counterparties engage in discussions with hedge fund managers regarding the manager's compliance. Many investors in U.S. hedge funds conduct extensive due diligence reviews of the fund and the manager, which provides the opportunity for discussions about the manager's compliance with established sound practices. MFA's *Sound Practices* includes a model due diligence questionnaire to be used by investors to assist them in their due diligence review.

Retail Investors and Exchange Listings

The Paper contains a discussion of the "retailization" of hedge fund investors and raises the question of how the inclusion of retail investors in hedge funds should affect the recommendations. In the U.S., retail investors cannot invest in hedge funds because of statutory and regulatory limitations.[8] As such, MFA believes that global sound practices should not be designed to address hedge funds with retail investors. Instead, global recommendations should be tailored for those jurisdictions in which retail investors are permitted to invest in hedge funds to account for the effects of retail investors.

The Paper also makes references to listed or quoted hedge funds. U.S. based hedge funds are precluded from being listed or quoted on any exchange, as they must be sold only through private placements.[9] As discussed above with respect to retail investors, MFA believes that global sound practices should not include recommendations relating to hedge funds that are listed or quoted on exchanges, but rather the global sound practices should be tailored in those jurisdictions in which hedge funds may be listed or quoted on exchanges to account for the effects of being listed or quoted on an exchange.

SPECIFIC RECOMMENDATIONS THAT MAY NOT BE GLOBALLY APPLICABLE

Part 1, Section 5.2 -- Information on Individual Firms

In light of the strict limitations on U.S. based hedge funds marketing and selling their interests and on unregistered investment advisers holding themselves out to the public, posting information on a fund manager's Website creates potential liability

[8] The U.S. Securities and Exchange Commission has acknowledged the lack of retail investors in hedge funds. See, speech by Brian Cartwright, General Counsel Securities and Exchange Commission: *The Future of Securities Regulation* (October 24, 2007), available at -- http://www.sec.gov/news/speech/2007/spch102407bgc.htm.

[9] We note that offshore hedge funds, even if managed by a U.S. based manager, are often listed (but not traded) on non-U.S. exchanges, such as the Irish Stock Exchange or the Luxembourg Stock Exchange.

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concerns for U.S. based hedge funds and U.S. based fund managers. As such, MFA believes that this suggestion should not be considered part of the global sound practices and hedge fund managers should consider the statutory and regulatory implications prior to posting information on publicly available Websites.

Part 2, Section 1.1 – Fund Governance

> "[Maintain] segregation of duties where potential conflicts exist, including identifying with whom ultimate decision making authority lies."

MFA agrees with the HFWG that segregation of duties, to the extent practicable, is both appropriate and desirable. For many smaller hedge fund managers, however, segregation of duties is not likely to be a practicable solution to addressing conflicts of interest. Even for larger managers, segregation of duties to address potential conflicts is not always practicable. As such, MFA believes that hedge fund managers should create policies and procedures that seek to reduce conflicts of interest when practicable and adequately disclose such conflicts. Such policies and procedures may include segregation of duties. We believe that the creation and consistent application of policies and procedures designed to address conflicts of interest is more appropriate as a recommended global sound practice.

> "[Obtain] assurance from third parties (such as auditors) that governance processes and controls are fit for purpose."

MFA agrees in principle that obtaining assurances from third parties could help ensure compliance with established sound practices. Obtaining such assurance from many third parties may not be possible, however, as audit firms, administrators and other counterparties in the U.S. are typically reluctant to provide those kinds of assurances. As such, many U.S. based hedge fund managers may be unable to implement this recommendation. Further, implementation of this recommendation is, to a large extent, outside of the control of the manager as it is largely dependent on the willingness of third parties to provide such assurance. For these reasons, MFA believes that many hedge fund managers would be unable to comply with this requirement and, as such, it should not be included as a recommendation in a set of global sound practices.

Part 2, Section 2.1.3 – Investment Policy and Risk Disclosure

> "A statement of the manager's view of the fund's risk profile relative to other types of funds."

MFA recognizes that it is important for hedge fund managers to adequately disclose the risk profile of their funds to investors and counterparties. We believe that this disclosure provides investors and counterparties with the information they need to compare the risk profiles of different funds. We do not believe that it is appropriate, however, for a fund manager to make statements comparing the risk profile of its fund to

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other funds. Making such statements carries potential liability if a manager were to incorrectly assess the risk profile of another fund. This is particularly true because hedge fund managers may not have access to sufficient information about other funds to adequately assess the risk profile of those funds. MFA believes that hedge fund managers should only be responsible for disclosing the risk profile of the fund or funds they manage and should not be responsible for making statements regarding the risk profiles of other funds.

Part 2, Section 2.3.3 – Performance Measurement Disclosure

> "Whenever performance is disclosed and funds have significant exposure to non-marketable or illiquid securities, reference should be made to factors which may be material to the robustness of the performance calculation, for example: The percentage of the portfolio in non-marketable securities."[10]

MFA supports the principle that hedge fund managers adequately disclose the risks associated with having certain assets that are illiquid or more difficult to value. MFA believes that the specificity of this recommendation, however, requires hedge fund managers to make a subjective determination whether particular securities are non-marketable or hard to value because there is no universally accepted definition of non-marketable or hard to value securities. Being required to make such a determination every time performance is disclosed could lead to less frequent performance disclosure by hedge fund managers because of concerns of potential liability such as, for example, if a manager did not disclose an asset as hard to value or as non-marketable and a later dispute arose over the valuation of that asset. It could also potentially be viewed as misleading if a manager were to disclose assets as being hard to value if an investor or regulator disagreed with that characterization. In light of the subjective nature of a determination that an asset is hard to value, and differences in the definition of marketable securities, we believe that this recommendation should be a more general recommendation that hedge fund managers disclose factors that may be material to their performance or valuation determinations.

> The Paper suggests that the Chartered Financial Analyst Institute review its Global Investment Performance Standards to determine if there is a need for the disclosure of the independence of valuation service providers and of the percentage of the portfolio not subject to stock market values.

MFA agrees that adequate disclosure regarding independent valuation service providers is important, to the extent a hedge fund manager uses such a service. In considering this suggestion, however, MFA believes it is important to note that not all

[10] A similar recommendation is made in Part 2, Section 3.2.4, "Hedge fund managers should disclose… the proportion of the portfolio that is hard to value." See also, the recommendation in Part 2, Section 4.2.6 that the hedge fund manager should disclose the "[l]imits to the percentage of the portfolio which can be invested in non-marketable securities (or another measure of liquidity)."

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hedge fund managers use independent valuation service providers and that any recommendations regarding independent valuation service providers for global sound practices be limited to disclosure of their use, as applicable. As discussed in the section on global comments above, many U.S. hedge fund managers have invested in acquiring in-house personnel with the relevant expertise to handle valuation and other issues associated with more complex investments and the internal infrastructure at such funds may have more expertise in determining values of complex investments than independent valuation service providers. As such, MFA does not believe it would be an appropriate recommendation that all hedge fund managers should be expected to use independent valuation service providers.

Part 2, Section 3.1.3 – Segregation of the Valuation and Portfolio Management Functions

> "A hedge fund manager should seek to ensure that conflicts of interest over asset valuation are avoided by arranging for the fund to appoint an independent third party valuation agent and/or (where agreed with the fund governing body) by operating a segregated independent in-house valuation function."

MFA recognizes the importance of managing, reducing and disclosing the conflicts inherent in the valuation process for persons involved in portfolio management, and that the use of independent third parties or independent in-house functions can serve to mitigate those conflicts. The use of independent parties, however, whether in-house or third parties, may not be practicable for all hedge fund managers, particularly smaller managers. Further, MFA believes that the personnel responsible for portfolio management will often have the most information regarding the fair value of an asset, particularly with respect to illiquid assets. In light of the above concerns, we do not believe that it would be appropriate to require the exclusion of portfolio management personnel from the valuation process. We believe that it is most important for a manager to have a written, verifiable valuation policy that clearly identifies the process to be followed, for the manager to disclose that policy to investors and for the manager to consistently follow that policy. In creating a valuation policy, MFA believes that it is appropriate for managers to consider whether it is practicable to incorporate some level of independence into the valuation process, and if so, determine the appropriate level of independence. To the extent that it would be practicable for a manager to add some level of independence to its valuation process, MFA believes that would be desirable, but we do not believe it should be required.

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Part 2, Section 3.1.4 – Disclosure of the Segregation of the Valuation and Portfolio Management Functions

> "Hedge fund managers should disclose in the fund's marketing materials the expected level of involvement of the portfolio management team in the valuation process and regularly report to investors on the actual level of such involvement (for example, via the fund's annual reports or newsletters) and the reasoning for such involvement."

MFA agrees that hedge fund managers should disclose their valuation policies so that investors and counterparties understand how the process works. Because we believe that members of the portfolio management team will likely often be involved in the valuation process, the disclosure of the manager's policy should be adequate, and should not require continued disclosure on the actual involvement of members of the portfolio management team, unless such involvement is materially different from what has been disclosed. Continued disclosure about the involvement of members of the portfolio management team, to the extent that no new material information is being disclosed, can detract from the value of other disclosures being made by the manager.

Part 2, Section 3.2 – Difficult To Value Assets

> "It is important to bear in mind that the valuation of exchange traded positions can also be subject to uncertainty, particularly if they are large, because a recent price published by an exchange may be very different from the price at which the investment could be liquidated."

MFA believes it is appropriate for managers to consider relevant factors when fair valuing a fund's securities. We note that hedge fund managers are subject to different regulatory and accounting standards on valuation based on the jurisdiction in which they operate. Because these standards differ from jurisdiction to jurisdiction, we believe this recommendation is too specific to be globally applicable. In the U.S., for example, recently approved accounting standards preclude managers from applying blockage discounts for large position in securities that are traded on a liquid market. Further, regulatory guidance in the U.S. provides that the fair value of a security does not need to be based on the liquidation of an entire position (i.e., a "fire sale" of the assets). Indeed, such an approach to valuation would likely serve to consistently undervalue the securities of a fund, which can be harmful to investors. We believe that a manager's valuation policy should provide for consideration of relevant factors when fair valuing a fund's securities, in light of the regulatory and accounting standards that apply to the manager and/or the fund.

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Part 2, Section 3.2.4 – Disclosure of Difficult to Value Assets

> "Hedge fund managers should ensure periodic reporting of side pockets' value in the fund's audited annual accounts (usually at cost, unless a market price has been observed)."

MFA agrees that periodic reporting of the value of a hedge fund's entire portfolio, including side pockets is important. Hedge fund managers in the U.S. have an obligation to fair value all of the securities in a fund's portfolio. This recommendation appears to suggest that a manager value a security held in a side pocket at cost, unless a market price has been observed. Such an approach as a rule would not appear to be consistent with the fund manager's obligation to determine fair value. MFA believes that this recommendation absent the parenthetical would be appropriate.

Part 2, Section 4.2.4.2 – Market Risk

> "The risk measurement framework should account for [forced sales to meet redemption requests] by applying valuation discounts for modeling purposes to positions that might have to be liquidated under stressed conditions."

MFA agrees that it is important in determining the risk profile of a fund for the fund manager to consider funding liquidity risk. As noted above, however, a fund manager in determining fair value is not obligated to (nor should it) use the value it would receive if forced to liquidate positions in a fire sale. MFA believes that the fund manager should account for forced liquidations as part of its risk management analysis, but that such stress testing should not necessarily affect the valuation of the fund's securities.

Section 4.2.5 – Control Process of Portfolio Risk

> "Risk reporting should be put in place so that the investment decision makers have a daily or more frequent view of the risk position of the fund and can prevent breaches of limits."

MFA agrees that it is important for those personnel responsible for investment decisions to be aware of the results of risk reports. The recommendation as drafted, however, would be impracticable for smaller advisers who may not have the systems or personnel to produce such frequent risk reports. We believe that an appropriate recommendation would be for investment decision makers to review risk reports as they deem advisable, in light of the business of the fund manager.

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Part 2, Section 4.2.6 – Disclosure of Portfolio Risk

> "Hedge fund managers should also carefully consider whether it would be appropriate to disclose target ranges or averages as anticipated by the manager for specific risk parameters."

MFA agrees that hedge fund managers should adequately disclose material information regarding their risk management processes and risk profile. Certain U.S. regulators have expressed concerns, however, with investment advisers using targets in marketing or sales materials. Although the recommendation calls for managers to consider whether to disclose target ranges, its inclusion could be viewed as implying managers should be making such disclosures. In light of the concerns with the use of targets that have been expressed by certain U.S. regulators, MFA believes that this recommendation should not be included in a set of global sound practices.

Part 2, Section 4.3.3 – Governance of Operational Risk

> "In areas where potential conflicts of interest could arise (valuation, risk management, compliance), hedge fund managers should clearly divide these activities from the portfolio management function with separate reporting lines into the managers' chief executive officer or chief investment officer or similar."

MFA agrees that it is desirable, to the extent that it is practicable, for an adviser to include division of responsibilities as part of its written policies regarding conflicts of interest but that such division should not be required. As discussed above in response to Part 2, Section 3.1.3, MFA believes this recommendation does not provide sufficient flexibility to be included in global sound practices. MFA believes that hedge fund managers should develop written policies that are designed to address the potential conflicts of interest that arise.

> "The hedge fund manager should ensure that material aspects of its operational procedures are adequately documented and training is provided to staff. This should include, among others, areas such as compliance procedures, back-up/disaster recovery procedures, personal account dealing policies and client confidentiality."

MFA agrees that material aspects of a manager's operational procedures should be adequately documented and appropriate training be provided. Not all hedge fund managers are required to have personal account dealing policies, however, so we believe that this recommendation should state that the areas listed should be included, to the extent they are applicable to a manager's operational procedures, to make clear that the list is meant to be illustrative and not a statement about the procedures that a manager should be required to have.

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> "To prevent trading and execution failures, it is considered best practice to have effective trading and counterparty procedures in place, incorporating the following aspects: …"

MFA agrees that hedge fund managers should have in place effective trading and counterparty procedures. As part of this recommendation, the Paper lists a number of specific aspects that such procedures should contain, all of which may not be appropriate for all managers, depending on the type of investments that the managers enter into on behalf of their fund clients. The inclusion of specific aspects of a manager's operational risk procedures as part of this recommendation makes it difficult for the recommendation to be implemented on a global basis. MFA believes that the recommendation without the inclusion of the specific aspects would be appropriate.

> "Hedge fund managers who adhere to best practice will appoint an independent compliance officer."

MFA agrees that it is important for a hedge fund manager to have someone responsible for the compliance function of the manager. For smaller and even some mid-sized managers, however, it may not be practicable to hire someone who is independent of the manager. For these managers, the compliance officer often times has other responsibilities at the adviser. To the extent that a manager can hire someone who is independent of the portfolio management function, that is desirable, but MFA believes the more appropriate recommendation for global sound practices is for hedge fund managers to have someone who is responsible for developing and monitoring compliance at the manager.

Part 2, Section 4.4.3 – Governance Regarding Outsourcing Risks

> "The [service level agreement] should include Key Performance indicators ("KPis") to provide hedge fund managers and fund governing bodies with a means of measuring whether the objectives set out in the SLA are met by the third party administrators."

MFA believes that it is important for hedge fund managers to monitor the service providers they have retained and for the managers to ensure that such service providers are adequately performing their responsibilities. We believe that the manner in which a manager performs such oversight should be left to the judgment of the manager. As such, we believe that this recommendation should be a recommendation that managers monitor service providers, such as administrators, to ensure that such service providers are adequately performing their responsibilities.

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Part 2, Section 5.4 – Fund Governance Disclosure

> "The hedge fund manager should disclose the outcome of its assessment as to the location of the fund's governance requirements on the "spectrum" and its reasoning in the fund's prospectus."

MFA believes that it is important for hedge fund managers to provide adequate disclosure so that investors and counterparties can determine for themselves the nature and quality of the manager's governance. Disclosure of a fund's location on the "spectrum" would appear to require managers to make determinations which are subjective in nature and open to different interpretations. This is particularly true because hedge fund managers may not have access to sufficient information about the governance structures of other managers to adequately determine where on the spectrum they lie. As such, this type of disclosure could subject a fund manager to potential liability if a regulator or an investor were to make a different assessment. MFA believes that disclosure of the manager's governance policies and procedures is sufficient to allow investors and counterparties to determine where they believe the manager lies on the spectrum and to question the manager about why it has developed the governance structure that it has.

Part 2, Section 6.1.3 – Prevention of Market Abuse[11]

Insider dealing. The Paper lists a number of specific procedures that hedge fund managers should implement regarding insider dealing. MFA agrees that it is important for hedge fund managers to have procedures regarding insider dealing. Because the Paper lists specific procedures it would be difficult to implement this recommendation on a global basis, as different advisers will likely implement different policies based on the types of investments they make and the structure of the adviser. MFA believes that an appropriate global sound practice would be for advisers to develop adequate procedures to prevent and detect insider dealing by personnel of the adviser.

Dissemination of inside information.[12] The question of what type of information constitutes inside information is highly fact specific and varies based on the rules in each jurisdiction. In light of the fact specific nature of inside information, MFA believes that a set of global sound practices should not attempt to give examples of information that constitutes inside information.

Non-disclosure of concert parties when disclosure thresholds have been exceeded. U.S. securities laws and regulations have rules regarding the disclosure of persons acting as "groups" with respect to a security. The recommendation in the Paper appears to be more appropriate for jurisdictions that do not contain rules setting out when persons

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[11] MFA believes that it would be beneficial for this topic to be addressed by a group with representatives from both the buy side and the sell side, working to establish sound practices to prevent insider trading.

[12] See also side box: Examples of inside information, page 45, Part 2.

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acting in concert should disclose their collective position. As such, MFA believes this recommendation is more appropriate for a tailored subset of sound practices rather than as part of a set of global sound practices.

SUGGESTED ADDITIONS TO THE HFWG PAPER

The Paper notes that U.K. based hedge funds are subject to a variety of regulations. U.S. based hedge funds and their managers, both registered and unregistered, are also subject to a wide variety of statutes and regulations regarding their conduct. Hedge fund managers in the U.S., for example, are subject to a variety of regulatory reporting requirements, which are included as an appendix to MFA's *Sound* Practices. We believe that providing such a list is useful for hedge fund managers, particularly smaller managers who are less likely to have large, dedicated compliance departments to track such filing requirements. Because U.S. regulation is generally rule based (rather than principles based, as it is in the U.K.), *Sound Practices* also contains a number of recommendations related to regulatory compliance in addition to regulatory filings. Though U.K. based hedge funds may have less need for specific recommendations relating to regulatory compliance, it may be worth considering whether there are any additional recommendations regarding regulatory compliance that could be added to those already addressed in the Paper. Any recommendations relating to compliance with specific regulatory requirements would be appropriately addressed within a tailored subset of global sound practices (as MFA has done by adding an appendix relating to regulatory filings to its *Sound Practices*).

In the 2007 version of *Sound Practices,* MFA significantly enhanced the section on anti-money laundering policies for hedge fund managers. Though U.S. based hedge funds and their managers are generally not yet subject to final regulations requiring AML programs, MFA believes that adopting an AML program is a sound practice for all hedge funds and their managers. We believe that a section on the creation of AML programs would be an appropriate addition to the Paper and should be included in any set of global sound practices.

The Paper contains a recommendation on disclosure of changes to commercial terms and also disclosure of the existence of side letters, but does not have a recommendation relating to the waiver of commercial terms (other than through a side letter). MFA believes that disclosure of waivers of commercial terms, to the extent material, should be disclosed.

MFA's *Sound Practices* now includes a due diligence questionnaire to be used by investors as part of their diligence review of a hedge fund manager. MFA believes that investors play a significant role in ensuring that sound practices are being implemented by hedge fund managers. MFA also believes that it is important for investors and hedge fund managers to engage in substantive discussions about the issues addressed by sound practices and how hedge fund managers have responded to recommendations. By including the due diligence questionnaire in our *Sound Practices,* we believe that we have

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given investors a tool to help conduct their diligence as well as to foster discussions between investors and hedge fund managers about *Sound Practices* and other compliance and risk management procedures. We recommend that the HFWG consider whether adding a due diligence questionnaire to its sound practices to facilitate similar discussions between investors and hedge fund managers.

The Paper mentions that its standards were not created for funds of funds. While there are differences between direct investment hedge funds and funds of hedge funds, there are also many similarities in structures and compliance programs between hedge funds and funds of hedge funds. MFA's *Sound Practices* have been drafted to apply to both hedge funds and funds of hedge funds. We recommend that the HFWG consider whether its recommendations should exclude funds of funds or whether they should be drafted so as to be applicable to funds of funds as well as hedge funds.

Part 2, Section 4.3 – Operational Risk

MFA believes that there are some additional areas that the HFWG may want to consider adding to the list of important aspects of operational risk. Those areas, which are included in MFA's *Sound Practices*, are: reconciliation errors, valuation, legal risks and regulatory risks.

OTHER COMMENTS

Part 1, Section 5.1 – Information About the Sector

The Paper states that the HFWG has agreed to work with the Alternative Investment Management Association to develop a methodology for collating industry data. MFA supports the collaboration of trade associations and as the primary trade association for U.S. based hedge funds, MFA offers its assistance to the HFWG and other trade associations in their efforts to collate industry data.

The Paper states that hedge fund managers should have suitable Websites. MFA agrees that Websites can make it easier for investors and counterparties to have access to important materials. Maintaining, updating and ensuring the security of a Website can require a significant amount of work and expense, however, and may not be practicable for smaller hedge fund managers. We believe that it should not be considered a recommendation that hedge fund managers maintain suitable Websites, but rather hedge fund managers should consider whether it would be appropriate and practicable to maintain a Website and to consider what information it would be appropriate and practicable to place on the manager's Website.

The Paper recommends the creation of an independent board of trustees to oversee the recommendations. MFA's *Sound Practices* have been drafted over the past eight years by committees comprised of industry participants. It is not clear that oversight over global sound practices is best accomplished by an independent body. We

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believe that industry participants, acting through MFA, have done an excellent job of overseeing and updating *Sound Practices* over the past eight years and we believe that by increasing the education and exposure of *Sound Practices* to investor groups, counterparties and regulators, the framework is in place for ongoing monitoring and updating of *Sound Practices*. As such, MFA does not believe that it is necessary to create an independent board of trustees to oversee global sound practices. We believe that oversight and dialogue by and between the industry, investors, counterparties and regulators is the most appropriate method of ensuring that global sound practices are followed and updated as appropriate.

Part 2, Section 2.4.3 – Disclosure to Lenders/Prime Brokers/Dealers

> "It is recommended "*that credit users and OTC market participants seek a proper balance between preserving proprietary information and providing information that will enable their counterparties to gain an appropriate level of understanding of their management, investment process and philosophy and material risk.*""

MFA agrees that it is important for lenders, prime brokers and dealers to receive sufficient information for them to create and monitor adequate risk control procedures. This recommendation, however, appears to place the burden on the hedge fund manager to determine the appropriate amount of information that counterparties need to create and monitor risk control procedures. MFA believes that such a determination, and the balance referred to in the recommendation, is the responsibility of both the hedge fund manager and the counterparty. In particular, the counterparty should take responsibility for determining the amount of information it needs to create and monitor risk control procedures. This is particularly important because, although hedge fund managers recognize their responsibility to provide adequate information to counterparties, the managers' primary responsibilities are to their hedge fund clients and it may not be in the best interests of those clients for managers to disclose more information (particularly proprietary information) than is necessary to satisfy the needs of the counterparties. In light of these concerns, MFA believes that this recommendation should make clear that the counterparties share in the responsibility to ensure that adequate disclosure is being made by the hedge fund manager and that the counterparties should be prepared to request the information they need for their risk management.

MFA also believes that it is important for the lenders, prime brokers and dealers who are the counterparties to these transactions to provide accurate and timely position and collateral reports to hedge fund managers and other credit users and OTC market participants. MFA believes that a cross-market participant working group for all OTC derivatives transactions similar to the group sponsored by the Federal Reserve Bank of New York for OTC equity derivatives could develop processes to assist broker-dealers in improving the frequency and quality of their OTC electronic transaction positions and collateral reporting to hedge fund managers and other market participants.

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Part 2, Section 3.2.3 – Governance for Difficult to Value Assets

The Paper recommends using the same brokers for price sources at each valuation point to ensure consistency and avoid "cherry picking" of favorable price sources. MFA agrees that hedge fund managers should have policies that establish the process for requesting and using broker quotes as price sources to address concerns regarding consistency of valuations and "cherry picking." The policies should be designed to ensure that the manager gets broker quotes that the manager believes provide a reasonable basis for it to determine the fair value of a security, as appropriate. This may mean using different brokers for price sources, and MFA believes that hedge fund managers should not be precluded from doing so if a manager believes that using different brokers will assist it in determining fair value. We believe that this recommendation should state that hedge fund managers should include in their valuation policies a section regarding the use of broker quotes, which should include the documentation of any decision to deviate from the written policy.

> "Ensure that side-pocketing occurs at the time of purchase of the relevant asset(s) with the initial valuation at cost."

Although side pocketing occurs most frequently at the time of purchase of the relevant asset, there are circumstances when it could be appropriate to move an existing investment into a side pocket at some point in time after the purchase. As such, MFA believes that this recommendation does not provide sufficient flexibility to be included in a set of global sound practices. We also believe that, at whatever point in time an investment is placed into a side pocket, it should be done so at the fair value of the investment at the time of side pocketing, which may or may not be the cost of the investment.

> "Ensure that incentive or performance fees are not charged for side-pocketed assets until a gain or loss is realised."

MFA agrees that hedge funds should not charge performance fees on investments that are in a side pocket. Many hedge funds that utilize side pockets have the right to remove an investment from a side pocket for both actual and deemed realizations. To the extent an illiquid investment that was appropriate for a side pocket is no longer appropriate for a side pocket (for example, if a company elects to be listed and traded on an exchange), it would be appropriate for the hedge fund manager to move that investment from the side pocket to the general account of the fund. In such an event, even if there is no actual realization, it would be appropriate for the manager to begin collecting an incentive or performance fee on that investment. MFA believes that this recommendation should be amended to permit a manager to collect incentive or performance fees once a gain or loss is realized, or deemed realized, in accordance with the fund's disclosure regarding the use of side pockets.

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Part 2, Section 4.2.4.2 – Market Risk

> "The results of the analysis of market risks (stress tests/scenario analyses, etc) should be translated into timely management action (for example, adjustment of positions) as part of the control and management process."

MFA agrees that hedge fund managers should consider the results of market risk analysis and determine if any action should be taken. As drafted, though, this recommendation seems to imply that management must take action such as adjusting the portfolio following an analysis of market risks. MFA believes that this recommendation should be amended to clarify that timely management action should be taken only in those circumstances when management determines action is appropriate. In other circumstances, documentation that the analysis was reviewed by management and that a determination of no required action was made should be considered sound practice.

Part 2, Section 4.2.4.3 – Counterparty Risk

> "Netting agreements and collateral agreements (for example, hedge fund managers making collateral calls/two-way collateral posting) should be put in place."

MFA agrees that it is important for hedge fund managers to have in place arrangements to help reduce counterparty risk. We believe that it should be left to the discretion of the manager to determine the appropriate arrangements. As such, MFA believes that this recommendation does not provide sufficient flexibility and should be amended to recommend that hedge fund managers put in place appropriate arrangements in light of their counterparty risk.

Part 2, Section 4.2.5 – Control Process for Risk Management

> "Limits should be set at the outset for the aggregate portfolio and all individual sub-portfolios."

MFA agrees that it is important for a fund to establish investment objectives and risk profiles. We believe that establishing limits can be a useful tool for managing compliance with those objectives, though we note that such limits may be soft limits, which can be exceeded upon certain determinations by portfolio management personnel, provided adequate disclosure has been made. MFA believes that in addition to establishing limits, hedge fund managers should have an established process that governs what determinations need to be made for any soft limits to be exceeded, and that requires disclosure be made, as appropriate, following such a determination.

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Part 2, Section 4.2.6 – Risk Management Disclosure to Investors

> The Paper recommends the disclosure of investment instruments used during the period covered during the year.

MFA agrees that it is important for hedge fund managers to make adequate risk disclosure regarding the types of investments being made by the hedge fund so that investors and counterparties can adequately assess their own risk profile. The recommendation is not entirely clear, however, as to exactly what type of disclosure the HFWG is contemplating. MFA believes that this recommendation should be amended to make clear what type of disclosure is contemplated.

Part 2, Section 4.3.3.5 – Model Risk

> "Documentation of models to avoid key man risk."

For certain hedge fund managers, key man risk may not be avoidable. MFA believes that this recommendation should be for managers to document any models used to reduce, to the extent practicable, key man risk.

Section 4.4.3 –Outsourcing Risks

> "Although prime brokers often try to provide "one-stop shop" services, it is recommended that large hedge fund managers have more than one prime broker to ensure sufficient diversification of funding and other services."

Hedge fund managers in the U.S. have an obligation to obtain best execution for their clients. Further, managers should consider all relevant factors when selecting a prime broker or prime brokers and should consider all relevant factors in determining which prime broker, and how many prime brokers, should be used. As such, MFA believes that this recommendation may not be appropriate in all circumstances. We believe this recommendation should be amended to state that hedge fund managers should consider all material risks, including diversification of funding and other services when determining which prime broker or brokers to retain on behalf of their fund clients.

Part 2, Section 6.3 – Disclosure of Derivative Positions

MFA agrees with the HFWG that issues relating to disclosure of derivative positions are not hedge fund issues, as they have broader market policy implications for the entire financial services industry and for a wide range of investors. MFA believes that these issues should be addressed by the appropriate government and regulatory agencies, in consultation with the entire financial services industry. MFA is not opposed to considering the issues, but we believe that they should not be addressed only in the context of hedge funds. In considering these issues, however, it is not clear to us that economic exposure to a security alone (i.e., when there are no voting rights attached to

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the derivative) is the most appropriate basis for requiring disclosure. One concern that appears to underlie the recommendation is the ability of a derivative security holder to easily obtain voting rights. U.S. securities laws already require reporting of beneficial ownership of a security, which includes, among other things, the right to acquire voting rights within 60 days. It is not clear that additional or different tests for regulatory filings are appropriate or necessary. As mentioned above, to the extent that any discussion on these issues takes place, we believe it is of critical importance that those discussions are in the context of the entire financial services industry and for those discussions to take place between the financial services industry and the appropriate government and regulatory agencies.

Part 2, Section 6.4 – Voting of Borrowed Stock

MFA agrees with the HFWG that the issue of voting borrowed stock is not a hedge fund issue, as it has broader market policy implications for the entire financial services industry and for a wide range of investors. MFA believes that this issue should be addressed by the appropriate government and regulatory agencies, in consultation with the entire financial services industry. MFA is not opposed to considering the issue, but we believe that it should not be addressed only in the context of hedge funds.

In considering the issue, we note that the Paper makes a recommendation that hedge fund managers not vote on borrowed stock while not being economically exposed to the stock. It is not clear that there has been any abuse of people borrowing stock for voting purposes without having economic exposure to the stock. It is also not clear that even if some entities did engage in this type of arrangement, that such a practice should be prohibited. Also, as the Paper notes, ownership of the stock generally passes to the borrower of the stock. As such, a hedge fund manager could be viewed as having an obligation to vote those proxies in accordance with its proxy voting policy and its obligations to its clients. The Paper notes that the borrower would not necessarily vote in the interests of the stock lender. While this may be true, the stock lender is not required to lend its securities and it does so knowing that by doing so it is giving up voting rights (in exchange for a fee). In the absence of evidence of abuse or even potential abuse, MFA does not believe that this recommendation is necessary.

CONCLUSION

MFA appreciates the opportunity to provide comments on the Paper. MFA believes that the Paper and MFA's *Sound Practices* embody many of the same principles. We believe that sound practices for the hedge fund industry should be global in nature, and that those practices should focus on ensuring that hedge fund managers address identified issues in a meaningful manner rather than focusing on the particular means of implementing those recommendations. Global sound practices should be tailored, as appropriate, to address the variety of business models within and jurisdictional requirements applicable to the hedge fund industry. Though our comments on the Paper have been categorized into four sections, our overarching comment is that the specificity

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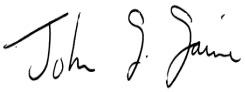
and prescriptive nature of many of the recommendations in the Paper make them difficult or impossible to implement globally, even though we agree with the principle underlying many of those recommendations. In light of this concern, MFA believes that recommendations in the Paper should be revised in a manner that would encourage global implementation. MFA welcomes the opportunity to continue a dialogue with the HFWG on these important issues.

Sincerely,



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