MANAGED FUNDS ASSOCIATION

VIA FEDEX & ELECTRONIC MAIL: dp05_04@fsa.gov.uk

28 October 2005

Mr. Andrew Shrimpton & Ms. Rebecca Jones
Asset Management Sector Team/Capital Markets Sector Team
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS United Kingdom

Re: Discussion Paper 05/4:
"Hedge funds: A discussion of risk and regulatory engagement"

Dear Mr. Shrimpton and Ms. Jones,

Managed Funds Association ("MFA") is pleased to submit this letter in response to the request for comments by the Financial Services Authority ("FSA") set forth in the above-referenced Discussion Paper 05/4 (the "Discussion Paper"). We commend FSA for producing the Discussion Paper and we hope our discussion below can help provide useful guidance to FSA as it reviews the way in which it exercises regulatory oversight of the alternative investment industry in the United Kingdom.

Introduction

As background, MFA's membership includes over 1,000 professionals in the alternative investment industry—including hedge funds, funds of hedge funds and managed futures funds. Our members have the discretionary management over a substantial portion of the over US$1 trillion invested in these investment vehicles. They are representative of the great variety that exists within the hedge fund industry in terms of assets under management, geographic and product focus, and size of operations. A significant part of MFA's constituency represents many of the 100 largest hedge fund groups in the world, a number of whom have offices or affiliates in the United Kingdom and that are registered with FSA. Our members operate in all the leading financial centers worldwide, including the United States, Canada, the United Kingdom and the Far East. Though a hedge fund management business may be based in New York or London, the funds which they operate may be organized under the laws of various jurisdictions, as wide ranging as Delaware, various Caribbean nations and certain European financial centers (e.g.

Luxembourg, Dublin). Moreover, for those funds that are only based in the U.S., and perhaps the U.K., they invest in various different countries. MFA's constituency is truly representative of the global nature of the hedge fund industry. Accordingly, MFA believes that it is well-placed to comment on the issues raised by FSA.

MFA has previously taken the opportunity to comment to FSA on soft commissions and short selling.[1] This year, MFA responded to the United Kingdom Takeover Panel's Consultation Paper: "Dealings in Derivatives and Options; Outline Proposals Relating to Amendments Proposed to be Made to the Takeover Code and the SARs."[2] MFA also facilitated an important discussion on the implications of the U.S. Securities and Exchange Commission's ("SEC") 2004 rulemaking for hedge fund advisers[3] for offshore managers at an educational seminar we sponsored in London on July 12, 2005, which was moderated by SEC Commissioner Roel Campos. These and other initiatives by MFA illustrate our commitment to confronting issues facing the global hedge fund industry in the United Kingdom and elsewhere, as they are relevant, and of keen interest, to our members. This response has been prepared by a working group comprised of some of MFA's members that are authorized and regulated by FSA.

As an overriding principle, MFA believes that hedge fund managers should comply with all applicable rules and regulations. MFA and its members have welcomed rules to protect the integrity of the markets and, as responsible market participants, hedge fund managers are concerned to ensure that their business practices meet the highest standards.

As a preliminary comment, MFA believes that the growth of the alternative investment industry in the United Kingdom is due in part to the balance achieved by FSA, and its predecessor self-regulatory organizations, in establishing a framework of regulation appropriate and proportionate to the nature of the industry and the nature of the investors. Given the undoubted size and profile of the current industry and its expected continued growth, it is right that FSA should revisit the way in which it regulates the industry and should also reassess the perceived risks associated with the industry.

However, the size and profile of the industry does not in itself mean that any change is required. Indeed, MFA believes that the current level and method of regulation is appropriate. Further, it is vital to the continued success of the industry, and thus very much in the interests of the market place and the investors (and thus consistent with the statutory objectives of FSA), that the level of regulation remains proportionate to the level of protection considered necessary. Even more importantly, it is vital that the industry be encouraged to stay within FSA's regulatory framework rather than move offshore or seek regulatory arbitrage. This is a risk identified by FSA itself[4] and with which MFA would very much agree.

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[1] See MFA Comment Letter to FSA, dated January 31, 2003 (regarding Discussion Paper 17, "Short Selling"), and MFA Comment Letter to FSA, dated October 10, 2003 (regarding Consultative Paper 176, "Bundled Brokerage and Soft Commission Arrangements"). Both of these letters are available on MFA's Web site: www.mfainfo.org.

[2] MFA Comment Letter to Takeover Panel, dated February 28, 2005, available on MFA's Web site.

[3] Securities and Exchange Commission, Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333; File No. S7-30-04; RIN 3235-AJ25 (December 2, 2004).

[4] Discussion Paper at p. 15.

Organization of MFA's Comments to Discussion Paper

MFA has organized its response to the Discussion Paper focused on seven issues raised by FSA and of importance to our constituency and the industry as a whole. These are: (1) whether there is need for a hedge fund code of conduct;[5] (2) whether there is a need to distinguish hedge fund managers and how does one draw the distinction;[6] (3) liquidity mismatch concerns with respect to the stability of the marketplace;[7] (4) valuation issues; (5) hedge fund governance and reputational issues;[8] (6) confirmation backlogs with derivatives transactions;[9] and (7) FSA's "data collection" concept.[10] MFA has elected to focus on these seven particular areas because we have had significant experience addressing these issues in conjunction with our hedge fund member base and, thus, we believe that we can make a valuable contribution to FSA's thinking on these particular areas.

I. Hedge Fund Code of Conduct Is Best Achieved Through Industry Initiatives

As already mentioned, as an overriding principle, MFA believes that hedge fund managers should comply with all regulations applicable to their operations and that they should create an environment that ensures this goal is achieved.[11] MFA supports governmental efforts, in the U.S. and elsewhere, aimed at prosecuting fraudulent conduct by participants in financial services. Generally, instances of fraud, though few in number, attract media headlines and disproportionately detract from the positive message that hedge fund activities provide important benefits to the global financial marketplace.

With respect to the Discussion Paper, MFA believes that the risks outlined by FSA are broadly correct. However, such risks are not specific to the hedge fund industry, but rather to financial services as a whole. There does not seem to be any suggestion that incidences of fraud or malpractice are any higher in the alternative investment industry than in the traditional asset management industry. Indeed, the SEC staff in its 2003 report, *Implications of the Growth of Hedge Funds*, specifically stated that they found that there was no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity.[12] Nevertheless, the increased amount of money invested through hedge funds and the amount of trading undertaken in the market (which FSA notes can add liquidity to the market) means that it may be appropriate for the regulatory authorities to deal with hedge funds as a distinct area of business.

However, MFA firmly believes that industry-led initiatives are more appropriate to deal with particular issues that arise and are better suited to dealing with changes in the market-place and the new issues that arise as a result. Indeed, such industry-led initiatives already exist and

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[5] *Id*. at p. 64.
[6] *Id*. at p. 39.
[7] *Id*. at p. 30-32
[8] *Id*.
[9] *Id*. at p. 35.
[10] *Id*. at pp. 41-42.
[11] See Recommendation 5.1 and see generally Section V, *MFA's 2005 Sound Practices for Hedge Fund Managers* (discussed below).
[12] SEC Staff Report to the U.S. Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (September 2003), at p. 73.

address the issues about which FSA raises questions in the Discussion Paper. We point to *MFA's 2005 Sound Practices for Hedge Fund Managers* ("*MFA's 2005 Sound Practices*"), which we enclose for FSA's review and make reference to herein. *MFA's 2005 Sound Practices* builds upon the sound practices that first were published for the hedge fund industry in February 2000 and subsequently revised in 2003.[13] We also commend the work of AIMA and other private sector groups in promoting sound practices for the industry and are committed to sharing information with them on these types of initiatives.[14]

MFA's 2005 Sound Practices covers key topics that are intended to promote sound business practices for hedge fund managers and, in doing so, enhance investor protection while contributing to market soundness. The recommendations contained in *MFA's 2005 Sound Practices* are divided among the following seven topics:

- Management and Internal Trading Controls;
- Responsibilities to Investors;
- Valuation Policies and Procedures;
- Risk Monitoring;
- Regulatory Controls;
- Transactional Practices; and
- Business Continuity and Disaster Recovery.

In addition, there are six appendices that supplement the recommendations in the seven substantive areas listed above.[15] We believe our document as a whole is comprehensive and promotes standards of excellence for single-manager hedge fund operations.

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[13] The original sound practices were produced by the industry in response to a 1999 recommendation by the U.S. President's Working Group on Financial Markets that hedge funds establish a set of sound practices for their risk management and internal controls. See *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (April, 1999) ("PWG Report"), which included a recommendation that hedge funds: "draft and publish a set of sound practices for their risk management and internal controls. Such a study should discuss market risk measurement and management, liquidity risk management, identification of concentrations, stress testing, collateral management, valuation of positions and collateral, segregation of duties and internal controls, and the assessment of capital needs from the perspective of hedge funds.'' PWG Report, at p. 37. In the U.S., the President's Working Group or ("PWG") is comprised of the Secretary of the Department of the Treasury, as Chairman of the PWG, as well as the Chairman of the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission and the SEC.
MFA updated and expanded upon the original recommendations in 2003 (the "*2003 Sound Practices*") as a response to industry developments. Since then, industry participants and regulators have regarded MFA's sound practice guidance as a highly useful resource. Recognizing the valuable guidance provided by the *2003 Sound Practices*, MFA published its latest sound practices document on August 2, 2005 so that we continue to provide useful and timely guidance to hedge fund managers and other industry participants.

[14] See AIMA's *Guide to Sound Practices for European Hedge Fund Managers* (August 2002); *Guide to Sound Practices for Hedge Fund Administrators* (September 2004); *Guide to Sound Practices for Asia Hedge Fund Managers* (December 2004) and *Offshore Alternative Fund Directors' Guide* (June 2005). See also, *The Greenwich Roundtable, "Best Practices in Hedge Fund Investing: Due Diligence for Equity Strategies"* (Spring 2005).

[15] Appendix I (Risk Monitoring Practices for Hedge Fund Managers) supplements the risk monitoring recommendations in Section IV of the main document. Appendix II summarizes many of the US regulatory filings that may apply to hedge fund managers. Appendix III provides MFA's anti-money laundering guidance. Appendix IV provides a "Checklist for Developing Compliance Programs" and Appendix V provides a "Checklist for Developing a Code of Ethics." Finally, Appendix VI is a glossary of terms of technical phrases used

The recommendations contained in *MFA's 2005 Sound Practices* are intended to provide a framework, rather than a definitive statement, for internal policies, practices and controls for hedge fund managers from a "peer to peer" perspective. These recommendations serve primarily to educate hedge fund managers, as well as investors and those who monitor the industry, such as the SEC and FSA.

The evolution of industry sound practices from their origins in 2000 through MFA's 2005 edition illustrates that the industry itself is capable of and committed to self-evaluation combined with the development of strong internal controls. MFA believes that such industry-led initiatives are the best way to achieve high standards in the industry and are consistent with FSA's statutory objectives and the Statements of Principles. It is important that FSA does not look at the issue just from a United Kingdom perspective. The hedge fund industry is a truly global industry and thus it is important that the regulation of it is addressed from a global perspective, which is offered by MFA and other industry bodies. As mentioned above, many of our members representing the world's large hedge funds operate not only in the U.S. and in the U.K. but also operate or trade in jurisdictions worldwide.

The recent paper by the Counterparty Risk Management Policy ("CRMP") Group II published on July 27, 2005, *Toward Greater Financial Stability: A Private Sector Perspective,* ("CRMP Group II Report") addressed market risks similar to those raised in FSA's Discussion Paper. The CRMP Group II Report cited *MFA's 2005 Sound Practices* favorably and one of its recommendations for hedge funds is that they follow MFA's document as a means for promoting financial stability.[16] For these reasons and for the purposes of our response to the Discussion Paper, MFA highlights the recent publication of our *2005 Sound Practices* recommendations as an example of a code of conduct that has been drafted by and for the industry.

II. MFA Recognizes the Difficulties in Creating a Legal Definition of "Hedge Fund" Given the Variance Among Industry Participants

MFA believes that FSA's existing approach to authorization of all firms should serve to identify applicants that are hedge fund managers. As such, such firms can easily be put under the mantle of the Hedge Fund Centre of Expertise. For firms which are already authorized, this could as easily be addressed by a notification as by a change of permission.

As mentioned above, one of the central themes in *MFA's 2005 Sound Practices* is to stress that "one size does not fit all" when it comes to evaluating our recommendations to hedge fund managers. MFA encourages policymakers to recognize that the strategies, investment approaches and amount of assets managed by individual hedge fund managers vary greatly. MFA, in its *2005 Sound Practices*, recognizes that the term "hedge fund" is used to describe a wide range of investment vehicles, which can vary substantially in terms of size, strategy, business model and

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throughout the document. By and large, these appendices address requirements as related to U.S. regulations applicable to hedge fund managers but, working with a body such as AIMA, could be extended to cover other rules and regulations.

[16] The CRMP Group II Report states, "CRMPG II recommends that hedge funds, on a voluntary basis, adopt the relevant Recommendations and Guiding Principles contained in this Report as well as the relevant Sound Practices contained in the 2005 report of the MFA. Consistent with that, senior managers of hedge funds should systematically monitor the progress being made relative to these standards." CRMP Group II Report, at p. 40.

organizational structure, among other characteristics. The variations in organizational structures are attributable partly to differences in size and partly to the different strategies used by hedge fund managers, which are distinguishable in terms of their complexity, product focus and the breadth of markets covered.

Although there is no statutory or regulatory definition of a hedge fund, for purposes of *MFA's 2005 Sound Practices* document, the term "hedge fund" refers to "a privately offered, pooled investment vehicle that is not widely available to the public and the assets of which are managed by a professional investment management firm."[17] Our definition is not intended to capture private equity, venture capital or real estate funds.

The vast differences in strategies, investment vehicles and products utilized by hedge funds make difficult a statutory definition. A single hedge fund management firm may operate a variety of funds, some of which may resemble private equity firms and others may be similar to traditional bank lenders. MFA believes that any attempt to employ a definition that may be overly rigid or overly broad would lead to difficulties in enforcement from a regulatory standpoint. FSA would have to treat all funds that met a statutory definition consistently irrespective of whether it was a stand-alone company or part of a large organization (i.e., an investment bank, or private equity firm with a hedge fund unit) and may well discover that a number of funds which might commonly be regarded as hedge funds, are outside the scope of the statutory definition.

MFA believes there could be "guiding principles" that intend to identify the aspects of this industry that set it apart from other private funds and retail funds, in particular, rather than the development of a statutory definition by FSA. As an overriding principle, we believe that there exists a "regulatory compact" that essentially distinguishes between retail funds and non-retail funds, including hedge funds. Retail funds must limit their investment strategies in exchange for wide latitude in marketing to the investing public; hedge funds must limit their marketing to only certain sophisticated investors in exchange for wide latitude in pursuing different investment strategies. Accordingly, FSA could set forth guiding principles to classify hedge funds that include:

- The net worth and, presumably, sophisticated nature of investors - both institutional and individual;
- Subscription packages where many representations are obtained from investors by fund managers prior to acceptance of the investment;
- The concomitant opportunity for investors to provide managers with due diligence questionnaires prior to the investment commitment;
- "Absolute return" strategies that are not tied to a benchmark such as the FTSE-250 or S&P 500; and
- Active management, rather than traditional "buy and hold", strategies that utilize a range of investment products.

[17] Introduction, *MFA's 2005 Sound Practices,* at p. 4.

We recommend that FSA set forth guiding principles, similar to those set forth above, in characterizing the hedge fund industry rather than a formulaic definition. A rigid definition may have the effect of encouraging fund operators to structure themselves around or outside of the definition.[18]

III. Financial Stability and Market Confidence, Particularly Regarding "Liquidity Mismatches"

This section addresses some of the risks to statutory objectives (i.e., financial stability and market confidence) as identified by FSA. In the Discussion Paper, FSA recognizes that the probability of an event on a scale that could significantly affect the financial stability of the UK is relatively low.[19] Similarly, the CRMP Group II Report also found that financial "shocks", similar to the market crash of 1987 or the Asian, Russian and Long-Term Capital Management crises in 1998, are very low probability events.[20] Among the issues raised in the Discussion Paper related to financial stability and market confidence, FSA is concerned about "liquidity mismatches" resulting from the increase in the incidence of hedge funds collectively making concentrated investments in complex financial instruments, usually on a leveraged basis, and the increase in the sensitivity of hedge fund investors to performance, which may lead to forced asset disposals and the potential for volatile and potentially disorderly markets.

MFA agrees with FSA that robust risk management is essential within the hedge fund sector. Moreover, MFA believes that it is incumbent upon hedge fund managers to take account of the potential for these liquidity mismatches through strong risk controls and liquidity management. A hedge fund manager's implementation of our recommendations in *MFA's 2005 Sound Practices* will not only contribute meaningfully to the internal soundness of individual hedge funds, but to the soundness of the financial markets in which they participate. Our recommendations stress that hedge fund managers set up strong risk monitoring controls for their operations.[21] Our document provides hedge fund managers with the basic framework for establishing the monitoring process as an essential element of its operations, just as it would establish trading, legal and regulatory compliance and valuation functions. *MFA's 2005 Sound Practices* provides hedge fund managers with a framework for understanding and dealing with the three major categories of risk that relate to financial marketplace stability.

In our risk monitoring recommendations, MFA first identifies the three main categories of risk that are measurable—market risk, credit risk, and liquidity risk (both funding and asset liquidity risk).[22] MFA stresses that it is crucial for hedge fund managers to recognize and evaluate the overlap that exists between and among market, credit and liquidity risks.

MFA first recommends that hedge fund managers establish a "risk monitoring function"[23] which may be a hedge fund employee or a team of employees that is responsible for measuring and tracking the risk assumed by a hedge fund. In most cases, the risk monitoring function

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[18] Sections 3.63 and 3.64, Discussion Paper, at p. 39.
[19] Discussion Paper at p. 6.
[20] See CRMP Group II Report at pp. 5-6.
[21] Section IV, "Risk Monitoring", *MFA's 2005 Sound Practices*.
[22] In addition, the Risk Monitoring section also addresses "operational" risk.
[23] See Recommendation 4.1, *MFA's 2005 Sound Practices*, at p. IV-2.

provides an independent source of information about, and analysis of, a hedge fund's performance, current risk position, sources of risk and exposures to changes in market factors. The risk monitoring function generally does not make decisions about how much risk or the types of risk the hedge fund should assume.

With respect to "market risk", MFA recommends that managers evaluate the risk for each hedge fund portfolio, each portfolio manager and relevant subcomponents of a portfolio and employ a consistent framework for measuring this risk. We recommend managers allocate the overall market risk among portfolio managers, strategies or asset classes and utilize the risk monitoring function to identify and quantify the factors affecting the risk and return of the hedge fund's investments, among other duties.[24]

FSA states that while it has not observed any material weakness in risk management techniques being employed by hedge fund managers, there are possible improvements that could be made to "stress testing." MFA provides guidance on stress-testing to help managers determine how potential changes in market conditions impact the value of a hedge fund's portfolio and also recommends back-testing of market risk models.[25] Appendix I of *MFA's 2005 Sound Practices* ("Appendix I") provides more detail to the recommendations in the main document regarding the potential changes in market conditions that should be considered in stress testing.[26] The fact that these issues are covered extensively within our sound practices, and in other industry initiatives, such as the CRMP Group II Report, in a much more thorough way than would be possible within the framework of a rulebook, adds weight to the argument that industry-led initiatives are the best way to achieve high standards in a global industry.

With respect to liquidity risk, MFA recognizes that it is critical for hedge fund managers to continue trading in times of stress. As part of its risk monitoring program, we recommend that a manager take into account the legal contractual terms governing the rights of hedge fund investors to redeem their interests, recognizing, for example, that the longer the expected period necessary to liquidate assets the greater the potential funding requirements.[27] There is extensive discussion on this topic contained in Appendix I, which provides detailed information on the importance of analyzing funding liquidity risk. MFA encourages managers to "focus significant attention on funding liquidity given the impact it can have on the viability of a hedge fund."[28]

As part of the liquidity risk evaluation process, hedge fund managers are encouraged to consider "leverage." MFA stresses, however, that "leverage is not an independent source of risk; rather it is essential to consider what leverage means – or does not mean – in the context of a hedge fund."[29] MFA's document provides extensive guidance for hedge fund managers on this topic.

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[24] See Recommendation 4.2, *MFA's 2005 Sound Practices*, at p. IV-3.
[25] See Recommendations 4.3 & 4.4, *MFA's 2005 Sound Practices*, at p. IV-4.
[26] Such changes include: changes in price, changes in interest rate term structures and changes in correlations between prices. For more detail, see Appendix I (Risk Monitoring Practices for Hedge Fund Managers) *2005 Sound Practices*, at p. AI-9.
[27] See *MFA's 2005 Sound Practices* at p. IV-5.
[28] See *MFA's 2005 Sound Practices*, Appendix I, at p. AI-1.
[29] See *MFA's 2005 Sound Practices*, Appendix I, at p. AI-2.

Additional specific recommendations to address liquidity risk as provided by MFA include, but are not limited to:

- Evaluation of the effectiveness of the cash management process and the cash flow needs based on the risk and funding profile of the portfolio and investor subscription and redemption windows.[30]
- Assessment of cash and borrowing capacity under the worst historical drawdown and stressed market conditions, taking into account potential investor redemptions and contractual arrangements that impact a hedge fund's liquidity.[31]
- Periodic forecasting of the liquidity requirements and potential changes in liquidity measures.[32]
- Performance of scenario tests to determine the impact of potential changes in market conditions and a hedge fund's liquidity.

Hedge fund managers have developed specific mechanisms with the aim of minimizing liquidity risk and we also recommend that managers evaluate their cash and borrowing capacity under the worst historical draw down and stressed market conditions, taking into account potential investor redemptions and contractual arrangements that affect liquidity.[33] Furthermore, hedge fund managers employ measures to ensure that they trade with acceptable counterparties based on the analysis of their creditworthiness and the strict monitoring thereof.[34]

Overall, FSA's deliberations with respect to liquidity mismatches, which we believe are appropriate areas to consider, have already been thoroughly considered by MFA and its members in developing our sound practices. Again, therefore, MFA believes that industry-led initiatives are more appropriate than prescriptive rules.

IV. MFA Has Developed Recommendations on Valuation Policies and Procedures for Hedge Fund Managers

FSA has asked whether regulatory action is required with respect to hedge fund valuation.[35] Issues related to valuation are also a concern of members of the International Organization of Securities Commissions ("IOSCO") Standing Committee 5, as well as other regulators. Indeed, valuation concerns are often a subject of significant debate and discussion among hedge fund industry participants and regulators alike. As with risk controls, it is another area in which it is difficult to be too prescriptive in terms of regulation, given the complexity and breadth of investment instruments and markets used by hedge fund managers for their trading strategies. Further, we note that very often the hedge fund administrator, which is generally responsible for valuation, will be subject to a different regulator than the manager. Accordingly, *MFA's 2005 Sound Practices*' Valuation Policies and Procedures section[36], consistent with the

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[30] See Recommendation 4.5, *MFA's 2005 Sound Practices*, at p. IV-5.
[31] See Recommendation 4.7, *MFA's 2005 Sound Practices*, at p. IV-5.
[32] *Id*.
[33] See Recommendation 4.7, *MFA's 2005 Sound Practices*, at p. IV-5.
[34] See Recommendations 4.8 & 4.9, *MFA's 2005 Sound Practices*, at p. IV-6.
[35] Discussion Paper at p. 52.
[36] Section III, "Valuation Policies and Procedures", *MFA's 2005 Sound Practices*.

general theme that "one size does not fit all", provides recommendations to cover a series of special valuation issues.

MFA's recommendations for the development of a hedge fund manager's valuation policies and procedures recognize that a hedge fund manager's valuation procedures will vary depending on the hedge funds' strategies. In addition, *MFA's 2005 Sound Practices* sets forth a number of general principles, but also provide guidance for cases where a general principle may not yield a fair valuation in the view of the hedge fund manager. Among the general principles covered by MFA's valuation section, we recommend that:

1) Investments should be valued according to applicable generally accepted accounting principals, or GAAP, which typically requires the use of "fair value";[37]
2) Valuation policies and procedures should be "fair, consistent, and verifiable;"[38]
3) Pricing policies and procedures should assure that net asset value ("NAV") is marked at fair value;[39] and
4) Reliable and recognized pricing sources should be used to the extent practicable.[40]

For each of these types of general principles, MFA provides guidance for the cases where a hedge fund manager may need to establish policies that permit it to deviate from a general rule, recognizing, of course, that hedge fund investors may both subscribe to and redeem interests in the hedge fund in reliance on the values derived from such policies and procedures. For example, if there are circumstances where the application of "fair value" might not produce an accurate or fair valuation for a given instrument, our recommendations provide that alternative means to value an instrument, as permitted by agreement, may be employed.[41] Our recommendations stress that the existence of written policies and procedures "is a critical element of the control structure surrounding a Hedge Fund Manager's pricing of portfolio investment instruments" and should be established by senior management.[42] However, we recommend that those same written policies also explicitly authorize that where their application "would not produce an accurate or fair price for a given instrument, senior management may use alternative procedures to price an instrument."[43] As another example, MFA recommends that a manager fully document the process it uses to determine whether to implement recommendations of a pricing service, as well as to document the circumstances in which it may determine to override that service's recommendations.[44] Overall, the key, in MFA's view, is that the hedge fund manager should establish written policies, seek to ensure that material aspects of such policies are appropriately disclosed to investors and ensure that such policies are consistent with any agreements between the hedge funds it manages and investors.

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[37] Recommendation 3.1, *MFA's 2005 Sound Practices*, at p. III-1.
[38] Recommendation 3.2, *MFA's 2005 Sound Practices*, at p. III-1.
[39] Recommendation 3.3, *MFA's 2005 Sound Practices*, at p. III-2.
[40] Recommendation 3.4, *MFA's 2005 Sound Practices*, at p. III-3.
[41] See Recommendation 3.1, *MFA's 2005 Sound Practices*, at p. III-1.
[42] See Recommendation 3.3, *MFA's 2005 Sound Practices*, at p. III-2.
[43] *Id*.
[44] See Recommendation 3.2, *MFA's 2005 Sound Practices*, at p. III-2.

MFA's 2005 Sound Practices also covers new and more challenging issues such as valuing illiquid investments,[45] certain derivatives[46] and instruments that may have "multiple" official settlement prices.[47] For example, for funds that may invest in illiquid (or otherwise hard-to-value) investment instruments, our recommendations suggest that a manager could consider use of "side pocket" methodology for purposes of valuation, so long as use of this methodology has been disclosed. Under one approach to the side-pocket methodology, among many, investments that are illiquid or otherwise hard to value are removed from the valuation process that applies to the rest of the portfolio and are held at cost until there is an event that makes the instrument a marketable security.[48] Thereafter, investors that hold a position in the hedge fund at the time that the transaction designated for the side-pocket is executed may typically participate in the profit and loss when the position is eventually disposed or there is an event that makes it become a marketable security.[49] However, there are a number of different approaches to the "side-pocket" methodology, and some managers may not use this methodology in its policies for valuing illiquid investments. The issue of side-pockets in valuation is one example of why valuation procedures cannot be too prescriptive.

MFA believes that adherence to its *2005 Sound Practices* in the hedge fund industry would alleviate concerns that FSA has expressed in the Discussion Paper with respect to valuation. We understand that valuation is one key area in which there is a potential for a conflict of interest between a hedge fund manager and the hedge fund's investor. But we also believe that our recommendations offer meaningful guidance to address a number of particular challenging areas where there is no single approach to calculating NAV and we underscore the importance of developing policies and procedures that address valuation issues unique to each hedge fund manager.

V. Reputation and Governance in the Industry

The hedge fund industry is premised on the ability of a portfolio manager with certain expertise to deliver "absolute returns" and important portfolio diversification to certain institutional and high net-worth (or non-retail) sophisticated investors. These activities by hedge fund managers have an added beneficial impact to financial markets in terms of price discovery and added liquidity. Hedge funds tend to be generally smaller in terms of assets under management and their operations[50] than retail financial institutions and are characterized by a closer relationship between the fund manager and investors. Investments in hedge funds are entirely voluntary arrangements by investors who are themselves, or through their representatives, sophisticated and capable of understanding the need for portfolio diversification,

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[45] See Recommendation 3.6, *MFA's 2005 Sound Practices,* at p. III-4.
[46] See Recommendations 3.3, 3.4 and 3.5, *MFA's 2005 Sound Practices,* at p. III-2 to III-4.
[47] See Recommendation 3.4, *MFA's 2005 Sound Practices,* at p. III-3.
[48] See Recommendation 3.6, *MFA's 2005 Sound Practices*, at p. III-4.
[49] *Id*.
[50] While there are many retail funds that have over US$100 billion, fewer than 200 hedge fund groups in the world have over US$1 billion in assets (see e.g., *Absolute Return* Magazine 2005 ranking of 196 hedge fund groups with over US$1 billion in assets under management. (*Absolute Return,* "Billion Dollar Club Keeps Growing", September 2005). As Robert Jaeger points out in his book, *All About Hedge Funds*, "Hedge fund management firms tend to be small firms dominated by one or two key investment people… The client does not merely hire the manager. Instead, the client and the manager become partners, co-investing in situations that the manager finds attractive." (Jaeger, Robert A., *All About Hedge Funds* (2003), at p. 1).

the types of absolute return strategies that would provide this diversification, and the level of risk they are willing to tolerate in order to obtain absolute returns on their investment. Likewise, the nature of this industry requires that hedge fund managers employ strong governance and controls to protect against any "reputational risk." Without protecting against this risk, sophisticated investors would flee and the industry as a whole would suffer.

These reasons counter any assertions that hedge funds are more likely to engage in fraud or questionable market practices and draw attention to the fact that hedge fund managers in the United Kingdom are already covered by the existing regulatory regime (anti-fraud/market abuse provisions exist also under other regimes). *MFA's 2005 Sound Practices*, a document drafted with the input of leading hedge funds, stresses key recommendations to preserve the regulatory, operational and reputational practices of hedge fund managers. Our document looks at specific areas that fund managers should address to preserve their reputation with investors and other market participants. These areas include, but are not limited to: (i) operational risks,[51] (ii) disclosure by funds to their investors on a number of issues such as conflicts of interest and risk factors,[52] (iii) counterparty risk,[53] (iv) documentation management,[54] (v) regulatory controls,[55] and (vi) business continuity and disaster recovery.[56] We also facilitate the development of compliance manuals and codes of ethics for all managers and discourage over-reliance on the use of "off the shelf" models, emphasizing that such manuals or codes should be tailored to the business of the manager and the funds it operates.[57] MFA supplements its work in the development of sound practices with educational seminars for its members to give these recommendations real-world perspectives as to how the recommendations may be implemented in practice.[58]

As the Discussion Paper points out, "there is a degree of moral hazard for regulators in supervising hedge fund managers in that it might lead to unrealistic expectations of the results."[59] The input by our members, many of whom represent the world's largest funds, into MFA's programs illustrates the industry's commitment to preserving its integrity in the financial markets. MFA also commends the work of other private sector initiatives, such as those by AIMA and the Greenwich Roundtable, aimed at bringing the investors and hedge fund managers together to agree upon due diligence standards.[60] Regulators worldwide should encourage and sponsor such initiatives.

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[51] See Recommendation 4.12, *MFA's 2005 Sound Practices*, at p. IV-8.
[52] See Section II, *MFA's 2005 Sound Practices*.
[53] See Recommendation 4.9, *MFA's 2005 Sound Practices*, at p. IV-6.
[54] See Recommendations 6.1-6.5, *MFA's 2005 Sound Practices*, at pp. VI-1-VI-2.
[55] See Section V, *MFA's 2005 Sound Practices*.
[56] See Section VII, *MFA's 2005 Sound Practices*.
[57] As we state in Recommendation 5.4, "Utilizing off the shelf compliance policies may result in a hedge fund manager unwittingly obligating itself to comply with policies for which it does not have the infrastructure or policies that are inapplicable to its business operations." *MFA's 2005 Sound Practices*, at p. V-2.
[58] For example, MFA has recently held seminars on *MFA's 2005 Sound Practices* (Sept 29, 2005, New York City), "The SEC's Hedge Fund Rules & Implications for Managers in Europe" (July 12, 2005, London), and "Practical Guidance for CCOs" (May 5, 2005, New York City).
[59] Discussion Paper, section 3.79.
[60] AIMA Due Diligence Questionnaires (September 2004) and see also documents cited at note 14 above.

VI. MFA is Working with Market Participants to Reduce Confirmation Backlogs in Connection with Credit Derivatives

In its Discussion Paper, FSA expresses concern regarding trade confirmation backlogs that have developed in the credit derivatives markets. MFA and its members have been working with other market participants to address these backlogs by promoting more efficient processes for confirmations including greater use of electronic platforms.

In particular, MFA's efforts have been focused on improved processing of novations. As FSA is aware, the International Swaps and Derivatives Association ("ISDA") published the 2005 Novation Protocol (the "Protocol"), which became effective on 24 October 2005.[61] MFA has been fully engaged with ISDA on this important project since its inception.[62] Over the last several weeks, MFA and its members together with the dealer community devoted many long hours to addressing operational and legal issues raised by novations, including MFA's concerns with respect to certain aspects of the Protocol. Although we disagreed with certain aspects of the Protocol, these recent discussions have led to greater clarity around parties' commitments and expectations when engaging in novation transactions, whether under the Protocol or otherwise. We hope our efforts will help keep this market viable and will resolve concerns that have been raised with respect to the processing of these transactions.

MFA wishes to underscore to FSA that our members are committed to monitoring the implementation of the Protocol in order to ascertain whether it provides an adequate solution to the novation processing/confirmation delays that have been identified in the past. MFA is also committed to collaborating with other trade associations on expediting the development and usage of electronic platforms as a long-term solution to confirmation backlogs.

VII. Calls for Increased Data Collection Would be Difficult to Implement Given the Jurisdictional Limits and Practical Limits on FSA

Finally, the Discussion Paper also raises a "data collection" concept that MFA finds problematic. The SEC and the CRMP Group II Report have similarly explored this concept. We encourage FSA to engage in a dialogue with members of the President's Working Group, the SEC Office of Risk Assessment and other international regulators that have a significant presence of hedge funds within their borders. For any data collection exercise to succeed, the data has to be readily available and easily and meaningfully processed. Hedge funds process their internal data in a variety of ways and whilst it might be possible to download this to FSA, there would be no consistency in method of preparation or presentation and as such we query whether any meaningful analysis could be carried out. To require managers to prepare further reports will add a significant compliance burden. Further, analysis of such information other than from a global perspective will throw up distortions which cannot easily be corrected and we note FSA already reviews various transaction reports and believe that these are sufficient.

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[61] Refer to ISDA's Web site at: www.isda.org.

[62] See MFA Comment Letters to ISDA regarding 2005 Novation Protocol, dated September 12, 2005 and October 6, 2005 (available on MFA's Web site: www.mfainfo.org).

Conclusion: Overall MFA Encourages Regulators to Review Our Sound Practices and Encourage Hedge Fund Managers to Implement Them

This comment letter is not intended to be an exhaustive response to each of the issues identified in the Discussion Paper. MFA chose to identify and explain its views on certain key issues. We believe that many of the concerns in the Discussion Paper are best addressed by industry-led initiatives such as *MFA's 2005 Sound Practices* with respect to areas such as valuation, risk management, regulatory controls, and code of ethics, among many others. As FSA prepares its Feedback Paper and considers any regulatory action, we encourage FSA to review *MFA's 2005 Sound Practices* document for further guidance on possible solutions to hedge fund industry issues raised in the Discussion Paper as an alternative to any further regulatory action.

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We appreciate this opportunity to comment on FSA's Discussion Paper and we would be happy to discuss any questions you or your colleagues may have with respect to this letter. I will reach out to your office to meet with you in the near future. In the interim, please feel free to reach me at 202.367.1140 or jgg@mfainfo.org.

Very truly yours,

/s/ John G. Gaine

John G. Gaine
President

cc: Florence Lombard, AIMA

Enclosure: *MFA's 2005 Sound Practices for Hedge Fund Managers*