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

January 24, 2011

VIA EMAIL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Rules Implementing Amendments to the Investment Advisers Act of 1940; File Number S7-36-10

Dear Ms. Murphy:

Managed Funds Association ("MFA")[1] and its members appreciate the opportunity to provide comments to the Commission on its release, "Rules Implementing Amendments to the Investment Advisers Act of 1940,"[2] which would implement provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or the "Act") that establish a framework for private fund managers to register with the Commission (the "Release").

Throughout the careful deliberations by policy makers that preceded the enactment of the Dodd-Frank Act, MFA and its members supported a framework for unregistered private fund managers to register with the Commission under the Investment Advisers Act of 1940 ("Advisers Act"), subject to a limited exemption for investment advisers with a *de minimis* amount of assets under management.[3] Registration under the Advisers Act will enhance existing SEC oversight of private fund managers by ensuring that regulators are provided with appropriate information and authority to detect and prevent fraud, and that managers are able to meet the needs of sophisticated clients seeking flexible, innovative approaches to investment management.

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[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York. For more information, please visit: www.managedfunds.org.

[2] Investment Advisers Act Release No. 3110 (Nov. 19, 2010).

[3] *See e.g.,* Testimony of Richard H. Baker, President and CEO, MFA, Hearing on Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Committee on Financial Services, U.S. House of Representatives (July 17, 2009).

Title IV of the Dodd-Frank Act ("Title IV") amends the Advisers Act to require most large, U.S.-based private fund managers, other than managers to venture capital funds, to register as investment advisers with the Commission. Section 403 of the Act eliminates existing Section 203(b)(3) of the Advisers Act, the exemption from registration for advisers with fewer than fifteen clients and that do not hold themselves out to the public as investment advisers, referred to as the "private adviser exemption." Private fund managers that are currently not registered with the Commission in reliance on the private adviser exemption must register by the effective date of Title IV, July 21, 2011 (the "Effective Date"), unless they are otherwise exempt from registration.

In addition to eliminating the private adviser exemption, the Dodd-Frank Act further alters the existing registration requirements for investment advisers under the Advisers Act by excluding certain "mid-sized" managers from registering with the Commission. Under Section 410 of the Act, advisers with at least $100 million in assets under management will generally be subject to registration with the SEC, while managers with assets under management between $25 million and $100 million will generally register with, and be subject to examination by, the securities commissioner (or similar agency) of the state in which they maintain their principal office and place of business. The Act also creates a new exemption from registration for managers of solely private funds with less than $150 million of assets under management in the U.S.

Together, these new registration requirements impose significant changes on the hedge fund industry by requiring many currently unregistered managers to register with the SEC, and many SEC-registered managers to de-register from the Commission and register instead with one or more states. We commend the Commission for proposing rules implementing these provisions in a comprehensive manner well in advance of the Effective Date. It is important that the registration provisions of Title IV be implemented in a smart, efficient manner that sets out clear guidelines, provides managers with sufficient opportunity to adjust their businesses to comply with the substantive provisions of the Advisers Act, if applicable, and avoids unintended consequences to the private fund industry.

We believe the following recommendations, as more fully described below, would enhance the implementation of the Dodd-Frank Act and facilitate private fund managers in transitioning to registration with the Commission:

- The Commission should provide additional guidance to ensure that the activities of unregistered private fund managers that must register with the Commission are not unnecessarily disrupted;

- Private fund managers that register in advance of the Effective Date should be able to file a single, comprehensive Form ADV;

- The calculation of an investment adviser's regulatory assets under management should continue to: (i) provide flexibility with respect to including certain assets, (ii) represent an adviser's net assets, and (iii) be based on the valuation methodology described in a private fund's offering documents;

- Sensitive information about a private fund and its manager should only be reported to the Commission on Form ADV; and

- Private fund managers generally should not be subject to regulations that prohibit certain types of incentive-based compensation arrangements.

A. Transitional Registration Issues for Unregistered Private Fund Managers

As described above, by eliminating the private adviser exemption, the Dodd-Frank Act requires many private fund managers that rely on the exemption to register with the Commission by the Effective Date. While such unregistered managers are subject to the general anti-fraud provisions of the Advisers Act, they are not required to, and in many instances do not, operate their business in accordance with the other substantive provisions of the Advisers Act and its rules. As a result, these private fund managers will need to ensure that their long-standing business operations comply with the Advisers Act prior to registration with the Commission. The SEC should ensure that the transition of private fund managers to SEC-registration avoids unnecessary disruptions to a manager's business by, among other things, applying the Advisers Act to newly registered managers on a forward-looking basis, and clearly identifying the date when a manager will become registered.

I. Performance Books and Records

We strongly support the proposed amendment to Rule 204-2 under the Advisers Act to allow a newly registered investment adviser to continue to use its performance record with respect to any of its advised accounts for periods ended prior to the Effective Date without maintaining records of such prior performance required pursuant to Rule 204-2, as long as the adviser retains the performance records it has compiled prior to registering. If a newly registered manager were not permitted to comply with this requirement in such a manner, it would be precluded from advertising its performance records to prospective clients. As a consequence, a manager's business would be severely impaired and the manager would suffer a substantial competitive disadvantage as compared with currently registered managers that could advertise their performance records. We note that the Commission previously determined to provide similar relief when it adopted its hedge fund manager registration rule, and similar policy considerations would apply to a private fund manager registering under the Act.[4]

II. Performance Fees

Under Section 205 of the Advisers Act, a registered investment adviser is prohibited from entering into an advisory contract that provides for compensation based on the performance of a client's funds. Most SEC-registered private fund managers, and many other types of investment advisers, rely on the exception to this prohibition provided in Rule 205-3, which permits a manager to charge a performance fee to qualified clients, as defined in the Rule. Together, these provisions ensure that investment advisers, including private fund managers, only charge performance fees to sophisticated investors that meet certain wealth, investment, or income thresholds.

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[4] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004).

As would be expected, many unregistered managers have not structured their businesses to ensure that clients, including investors in private funds, are qualified clients as defined in Rule 205-3. Rather, these managers ensure that the private funds they advise comply with the limitations set out in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 ("Investment Company Act"), which require that a private fund not make a public offering of its securities, and, respectively, either limit the number of beneficial owners of the fund or require that each investor is a qualified purchaser.[5] As a result, the interests of private funds managed by unregistered advisers are generally owned only by sophisticated individuals and institutions; however, some of the beneficial owners of private funds that rely on Section 3(c)(1) may not meet the specific thresholds to qualify as a qualified client under Rule 205-3.

As part of its hedge fund adviser registration rule, the SEC in 2004 amended Rule 205-3 to permit managers that registered with the Commission pursuant to the rule to continue to charge performance fees to their existing clients that were not qualified clients. In adopting the grandfathering provisions to Rule 205-3, the Commission explained that the amendments were designed to avoid disrupting existing arrangements between hedge fund managers and their clients. The registration requirement under the Dodd-Frank Act will have a substantially similar effect on unregistered private fund managers as the hedge fund adviser registration rule, and it is appropriate to provide the same period of transition for managers to comply with Rule 205-3. Accordingly, the SEC should permit newly registered investment advisers to continue to charge performance fees to clients that are not qualified clients if and to the extent that the performance fee is charged to either: (1) the account of an existing client pursuant to an investment advisory contract that was entered into prior to the Effective Date, or (2) an equity owner in a fund that relies on Section 3(c)(1) who or that was an equity owner prior to the Effective Date.

If the SEC intends to address this issue in a subsequent rulemaking, we encourage the SEC to indicate such intention so that managers preparing for upcoming registration have sufficient notice to adopt any necessary changes to their businesses.[6]

III. Effective Date of Registration

Under Section 419 of the Dodd-Frank Act, the amendments to the Advisers Act in Title IV, including the elimination of the private adviser exemption, will become effective as of July 21, 2011, and private fund managers that do not qualify for any other exemption will need to be registered at such time. While the Release provides transitional relief for SEC-registered advisers that must de-register and register with one or more states, it does not appear to address the steps that an unregistered private fund manager should take in order to register with the SEC by the Effective Date. We respectfully request that the Commission provide certainty to such private fund managers with respect to the timing of the registration process and the status of their registration.

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[5] Under Rule 205-3(d), an investor that meets the requirements of a qualified purchaser in Section 2(a)(51) of the Investment Company Act also qualifies as a qualified client.

[6] We note that, for example, Section 418 of the Dodd-Frank Act requires the Commission to make certain modifications to the qualified client standard.

Section 203(c)(2) of the Advisers Act provides that the Commission will declare an investment adviser's registration effective within 45 days of the date of filing a Form ADV. Together, Section 419 of the Dodd-Frank Act, and Section 203(c)(2), would appear to require an investment adviser currently relying on the private adviser exemption to file its Form ADV with the SEC by June 5, 2011 to ensure a 45-day period before the Effective Date. An adviser must file Form ADV through the Investment Adviser Registration Depository ("IARD"), a secured system that requires an adviser to receive access to the system prior to filing its Form ADV. As a result, the process can take several days before an adviser is able to make any filings on the IARD.

In our experience, an investment adviser's registration is typically declared effective by the Commission sooner than 45 days after filing. Under such a scenario, an investment adviser could have its registration declared effective, and be subject to the Advisers Act, well before the Effective Date, yet may not be prepared to comply with all the provisions of the Advisers Act at that time. In the alternative, a manager that experiences an unintended delay in its preparation for registration and submits its registration to the SEC fewer than 45 days prior to the Effective Date, may not have its registration declared effective by July 21, 2011, and would consequently be unregistered in violation of the Advisers Act. Both potential outcomes introduce significant uncertainty into the registration process and create unnecessary obstacles for private fund managers that must register with the Commission.

We recommend that the Commission provide a greater degree of certainty to the registration process by confirming that an investment adviser that files a Form ADV that is complete in all material respects by July 7, 2011 will be treated as having met the July 21, 2011 Effective Date. In such a case, the adviser's registration would be deemed effective as of the Effective Date.[7]

B. Comments to Specific Proposals in the Release

I. Transition Form ADV Filing

Under new proposed rule 203A-5, each investment adviser registered with the Commission on July 21, 2011 would be required to file an amendment to its Form ADV no later than August 20, 2011. The filing would be the first step by which an adviser no longer eligible for registration with the Commission would transition to state registration, and the 30-day period would provide additional time for advisers to determine their status under the new registration rules and avoid a large number of filings on July 21, 2011. In the Release, the SEC explains that by giving advisers 30 days from the Effective Date to prepare and submit the amended Form ADV, it would avoid requiring an adviser to respond to items about its eligibility to register with the Commission before the statutory changes affecting that eligibility will be effective.

[7] We note that in 2004 the SEC provided similar relief in connection with the implementation of its hedge fund adviser registration rule. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004).

This additional Form ADV filing, which is designed to aid the Commission in its oversight of SEC-registered investment advisers that transition to state registration, would unnecessarily complicate the registration process for newly registered private fund managers by requiring them to file two Form ADV's. We expect that, due to the potentially significant changes that managers will need to implement to their businesses in order to be fully compliant with the Advisers Act, many private fund managers will prepare and submit their initial Form ADV filing to the Commission in the weeks prior to the Effective Date. As a result, new proposed rule 203A-5 would require a number of managers to submit two separate Form ADV filings within a few months, or even weeks.[8]

It is not clear from the Release when the proposed amendments to Form ADV will become effective, due in part to the need for the SEC's contractor to make modifications to the IARD system. If the amendments become effective close to or following the Effective Date, private fund managers will prepare and submit the current, and soon-to-be out-dated, Form ADV. If, on the other hand, the amendments become effective at an earlier time, managers would be able to complete the amended Form ADV for their initial registration filing. In either case, proposed rule 203A-5 would require unregistered private fund managers that register with the Commission to file two Form ADV's.

Requiring private fund managers to file two Form ADV's would be costly, inefficient and potentially confusing. Private fund managers in particular would need to devote significant resources to the completion of the amended Form ADV, due to the substantial amount of information about each private fund that the SEC has proposed to require.[9] In addition, if a manager experiences a delay or fails to complete the amended Form ADV for any reason, the SEC intends to cancel its registration.[10]

We recommend that instead, the SEC endeavor to make available the amended Form ADV so that private fund managers that register under the Act are able to complete the amended Form ADV with their initial registration.[11] Newly registered managers that have submitted amended Form ADV should then not be required to submit a duplicative filing. As a result, the SEC would receive the necessary additional information from private fund managers proposed in

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[8] The SEC adopted a similar process in implementing the new registration provisions for investment advisers in the National Securities Markets Improvement Act of 1996 ("NSMIA"), which resulted in a significant number of the approximately 23,350 advisers then registered with the SEC to de-register. The registration provisions in NSMIA, however, unlike the Dodd-Frank Act, did not result in a large number of unregistered managers becoming subject to registration with the Commission.

[9] The Release does not appear to address the additional costs for such newly registered advisers.

[10] Release at page 10.

[11] In implementing the amendments to the registration provisions of the Advisers Act imposed by NSMIA, the SEC at that time permitted advisers to file Form ADV-T prior to the date upon which it became effective. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997) ("NSMIA Adopting Release").

the Release, and managers could make a single, comprehensive Form ADV filing to register with the Commission.

II. Regulatory Assets Under Management

1. Types of Assets Included

In implementing the registration thresholds in the Dodd-Frank Act, the SEC proposes to adjust how managers calculate their assets under management, referred to in the Release as regulatory assets under management. Among other changes to the current calculation of assets under management, managers would be required, rather than have the option as they currently do, to include in their regulatory assets under management assets held in family accounts, proprietary accounts of the manager, accounts for which the manager receives no compensation for its services, and accounts of clients who are not U.S. persons.[12]

The SEC adopted the existing instructions to Form ADV for an investment adviser to calculate its assets under management as part of its rules designed to implement the registration provisions of the National Securities Markets Improvement Act of 1996 ("NSMIA"), which set the existing threshold of $25 million of assets under management for an adviser to register with the Commission. In our experience, the method of calculating assets under management that has been in effect since 1997 is widely understood and provides clear guidance to advisers, and is consistent with the underlying policy objectives of the Advisers Act.

The Advisers Act defines assets under management as "securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services,"[13] and the detailed instructions on Form ADV for calculating an adviser's assets under management apply this general definition. In determining the types of assets that should be included under this provision, we believe it is instructive to look to the types of assets and investment management services that the Advisers Act was designed to address, namely those included in the definition of investment adviser that subject an adviser to the Advisers Act. Under Section 202(a)(11), an investment adviser is "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." Notably, the definition applies only to the provision of investment advisory services for others, and of these services, it applies only to those for which a manager receives compensation. As a result, an adviser that manages its own proprietary assets, or the accounts of others not for compensation, is not an investment adviser under Section 202(a)(11), and would not be subject to the registration or substantive provisions of the Advisers Act. In addition, the SEC has regularly provided to managers of family offices exemptions from the definition of investment adviser, and Section 409 of the Dodd-Frank Act amends Section 202(a)(11) to explicitly exclude such managers from the definition.

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[12] Form ADV Part 1A, Instruction 5.b.

[13] Advisers Act Section 203A(a)(2).

Clearly under the definition, the concern of the Advisers Act is with the accounts of a manager through which it advises clients as to investing in securities, and receives compensation for its services. We believe the existing instructions for calculating assets under management – which permit, but do not require, an adviser to include these types of assets as part of its assets under management – are consistent with Section 202(a)(11).

In explaining the basis for proposing to now include these assets in the calculation, the SEC notes that as a result of the Dodd-Frank Act, there are potentially more significant regulatory consequences to a manager electing to not include certain assets in the calculation of its regulatory assets under management and remaining below the threshold for registration with the Commission. We note that the Dodd-Frank Act was designed to ensure that there are no regulatory gaps in the framework for private fund managers to register at either the state or federal level. The Act prevents regulatory gaps by excluding from registration with the SEC only those managers with assets under management of less than $100 million that are registered as an investment adviser with, and subject to examination by, a state securities commission. These requirements ensure that a mid-sized manager that does not register with the SEC will nevertheless be subject to meaningful regulation and oversight by a state securities commission. We believe this framework, which will shift approximately 4,100 SEC-registered investment advisers to state regulation, will establish an effective division of oversight responsibility for investment advisers that are registered with the SEC or with a state securities commission.

We recommend that the SEC continue to permit investment advisers to determine whether to include in the calculation of regulatory assets under management the types of assets and advisory services that generally would not subject a firm to regulation under the Advisers Act, including family accounts, proprietary accounts, and accounts for which the manager receives no compensation. Advisers should be permitted to make this determination with respect to such accounts that are managed as part of a pooled investment vehicle (*e.g.*, a private fund interest of a principal of the manager, that is not charged a fee) or as a separate account structure.

2. Indebtedness and Other Liabilities

In addition to requiring advisers to include additional assets in its regulatory assets under management, the SEC proposes to preclude a manager from deducting outstanding indebtedness or other accrued but unpaid liabilities from the calculation. As a result, a manager's regulatory assets under management would no longer represent its net assets, which best reflects investor capital that is at risk, but would instead represent its gross assets. We believe that a gross assets calculation would be applied inconsistently, create confusion for market participants, and lead to uncertainty for investors and regulators.

Hedge funds generally do not use a significant amount of leverage and typically post collateral in connection with their borrowing, thereby reducing risk to their counterparties.[14] The types of arrangements that funds enter into with counterparties, however, are often complex, and the amount of leverage applicable to a particular transaction is often not easily calculated. As a

[14] Hedge fund borrowings are done almost exclusively on a secured basis (*i.e.*, secured by each fund's overall assets or specifically posted collateral), which limits the amount of leverage that any fund may obtain.

result, there is no generally accepted definition of how to calculate the amount of borrowing and leverage that many private funds regularly use as part of their investment strategies. This feature of the use of leverage by hedge funds and other financial institutions has been described and considered in a variety of regulatory contexts, and by a wide range of policy makers in the U.S. and foreign jurisdictions.

For example, the FSA in its recent report on its periodic hedge fund surveys that are designed to assess possible systemic risk from hedge funds, explained that the "concept of 'leverage' is difficult to define in a consistent way across hedge funds, particularly because of the range of trading strategies and products used." As a result, the FSA's survey did not ask managers to calculate the amount of leverage that hedge funds used. Instead, the FSA gathered underlying data from managers about the investment strategies and other characteristics of hedge funds, which it then used to assess leverage through a number of different methods.[15] Similarly, the European Central Bank and the Basel Committee on Banking Supervision have considered various methods to define and measure leverage for hedge funds and other financial institutions.[16] Recent studies of the hedge fund industry have used different formulas for calculating leverage ratios for hedge funds, and found different leverage ratios.[17] We believe these different results are representative of the different ways in which individual managers would calculate their leverage for purposes of their regulatory assets under management.

Such disparate methods of calculating leverage across the industry would lead to potentially significant differences in advisers' regulatory assets under management, in particular for private fund managers and other advisers that manage complex investment strategies, and would create confusion for managers, investors and regulators. Under the proposed definition, managers could face substantial legal uncertainty in determining whether their regulatory assets under management exceed the new asset thresholds for registration with the Commission. For example, the calculation of leverage by a manager with net assets between $25 million and $100 million would determine whether the manager is required to register with the Commission or a state; however, a manager would not know with certainty how the Commission expected it to

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[15] FSA study, Assessing Possible Sources of Systemic Risk From Hedge Funds (Feb. 2010), at page 5, available at: http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf. ("We did not ask hedge fund managers directly about their funds' 'leverage', instead we have gathered the basic building blocks that might make up any assessment of risk. This allowed us to reassemble the data we gathered in different ways across strategies, funds or groups of funds to assess leverage in a number of ways.")

[16] European Central Bank paper, Hedge funds and Their Implications for Financial Stability (August 2005), available at: www.ecb.int/pub/pdf/scpops/ecbocp34.pdf; Basel Committee on Banking Supervision paper, Strengthening the resilience of the banking sector (Dec. 2009), available at: http://www.bis.org/publ/bcbs164.pdf.

[17] *See e.g.*, Bank of America Merrill Lynch study, which found the leverage ratio for the hedge fund industry was 1.16 as of July, 2010, available at: http://www.reuters.com/article/idUSTRE67G28220100817; Columbia University study, Hedge Fund Leverage (Nov. 2010), available at: http://www2.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf; FSA study, Assessing Possible Sources of Systemic Risk From Hedge Funds (July 2010) (finding a leverage ratio of 2.72, as of April, 2010), available at: http://www.fsa.gov.uk/pubs/other/hf_report.pdf; The Turner Review, A Regulatory Response to the Global Banking Crisis (March 2009) (finding that the leverage ratio of the hedge fund industry since 2000 has been two- or three-to one), available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

calculate its amount of leverage and gross assets. We believe that this critical determination should continue to be based on a straightforward, easy to use calculation of a manager's net assets.

Regulatory assets under management that are calculated differently by managers would also be of limited use to the Commission for its data collection purposes, and potentially misleading to investors. Defining regulatory assets under management as a manager's net assets would ensure that the Commission has precise, useful information about the amount of assets that private fund managers and other advisers manage on behalf of their clients.

If the Commission nevertheless determines to include leverage in the calculation of regulatory assets under management, it is important that it include in the instructions to Form ADV a simple, easy to apply description of how an adviser should calculate its indebtedness and other liabilities. A single, uniform definition is essential to enable managers to understand the types of leverage that should be included in the calculation, and to ensure consistency across the industry.[18]

In addition, any gross asset amount that the Commission requires managers to report should be provided only to regulators, and should not be disclosed to the public. A private fund's use of leverage, like other trading positions or investment techniques, is proprietary information of the fund, and its public disclosure could impair a manager's ability to implement its investment strategy and ultimately harm the performance of a fund. Instead, a private fund manager's use of leverage should be reported to the SEC either on Form ADV in a form that is not viewable by the public, or in the types of reports that the Commission is authorized to collect in order to obtain sensitive and proprietary information about a private fund under new Section 204(b) of the Advisers Act.[19]

3. Valuation Methodology

The amended instructions to Form ADV would require an adviser to calculate its regulatory assets under management by determining the fair value of its assets, including those held in a private fund. Currently, an investment adviser must determine the market value of its assets under management using the same method that it uses to report account values to clients or to calculate fees for investment advisory services.[20] As the SEC explains in the Release, many, but not all, private funds value their assets based on fair value in accordance with U.S. generally accepted accounting principles ("GAAP"). Requiring private funds that use another type of valuation methodology to fair value their assets only for purposes of calculating its regulatory

[18] For example, the Commission should apply a leverage ratio (*i.e.*, debt-to-equity), which is based on GAAP balance sheet leverage.

[19] New Section 204(b) requires that such reports include, among other things, a private fund's amount of assets under management, including its use of leverage. We believe such reports are the appropriate method for the Commission to collect information about the use of leverage.

[20] Form ADV, Part 1A, Instruction 5.b(4). At the time of their adoption, commenters supported these existing instructions. *See* NSMIA Adopting Release at page 20.

assets under management would impose a substantial burden on these funds, increase costs for managers and investors in the funds, and potentially lead to confusion for investors that expect the fund to use a different valuation methodology.

Private funds may not use a fair value methodology to value assets for various reasons. For example, funds that are organized in a foreign jurisdiction with a significant number of non-U.S. investors may use a valuation methodology prescribed by certain international accounting standards. Private funds organized in the U.S. that segregate assets typically value these assets at cost. Under a typical side pocket arrangement, a fund's difficult-to-value assets, including those that are illiquid or not traded on an exchange, may be held at cost until they are sold, and investors pay fees on any capital gains appreciation at the time the gains are realized. For similar reasons, many private equity funds that hold interests in small, private companies that are difficult to value also value their assets at cost.

Investors in private funds are sophisticated individuals and institutions that are aware of, and often negotiate for, the information they receive from a fund, including regular valuation information and annual audited financial statements. These investors understand at the time they purchase interests in the funds the type of methodology that the manager uses and the underlying reason for the methodology. Many of these investors would not expect a fund to be required to adopt a valuation methodology other than that described in the fund's offering materials, and would not choose for the fund to incur the additional administrative costs needed to fair value the fund's assets. Indeed, institutions and sophisticated individuals seek to invest in private funds due in large part to the wide range of investment strategies, trading philosophies and operational flexibility that funds employ, including investing in assets that are generally not subject to regular fair valuation.

Private funds that use an alternative valuation methodology should not be penalized by a requirement that they use a fair value methodology. The Form ADV instructions should instead require advisers to calculate regulatory assets under management for a private fund that it manages using fair value, or in accordance with the valuation methodology that is described in a private fund's offering materials.

III. Reporting Private Fund Information on Form ADV

The SEC proposes to require advisers for the first time to report extensive, detailed information on Form ADV about private funds they manage. In the Release, the Commission explains that the information would enable it to provide better oversight of managers by focusing examination and enforcement resources on those managers that appear to present greater compliance risks, and help investors and other industry participants protect against fraud.[21]

[21] In general, information about a private fund would be reported by the fund's primary adviser, and a subadviser would not report information about the fund on its Form ADV. We agree that reporting by a fund's primary adviser would provide the Commission with complete information about a fund, and would avoid potentially duplicative and confusing information. We support the approach proposed in the Release and believe this approach should also apply to any reporting that the Commission requires under new Advisers Act Section 204(b).

MFA strongly supports private fund managers reporting to the Commission information about their businesses or the funds they manage that would assist the SEC or other regulators in performing their oversight function. We believe, however, that the Commission should carefully consider whether the additional step of publicly disclosing information it collects would enhance its oversight capabilities, and whether any such benefits would outweigh the potentially significant costs to managers in sharing sensitive business information with market participants. In our view, public disclosure of information about a private fund, such as the information described below, would provide little, if any, public policy benefit, and would harm the competitive position of the fund, and ultimately its investors. Public disclosure of certain information about a private fund would also raise difficult questions under the securities laws that prohibit private funds from communicating information about their operations with the public.

The Commission could achieve its goal of acquiring information about private funds in a simple, efficient manner and also protect sensitive information by amending Form ADV so that information that advisers must report to the SEC about private funds they manage is not viewable by the public.

For example, public disclosure of information about the types of beneficial owners of a fund, including the number of beneficial owners, and the approximate percentages of the fund owned by the adviser, certain types of investors, and non-U.S. persons would impair a fund's competitive position by giving other funds knowledge of its investor profile.[22] We do not believe any clear investor protection benefits would result from the public disclosure of this information.

An adviser should also not be required to publicly disclose information about the terms under which individuals may invest in the fund, including the minimum investment that is required and information about the entities that perform marketing services for a fund.[23] Disclosing this type of information publicly would raise concerns for a private fund in seeking to comply with the restrictions on offering its shares publicly, which generally prohibit a fund from communicating with the public through any type of general advertising or solicitation. It is not clear what policy objective would be achieved by public disclosure. We also recommend that Item 20 of Section 7.B.1 be amended so that the identity of another adviser to the fund is kept private. This type of information should not be publicly disclosed for competitive reasons.

In addition, the SEC should not publicly disclose information about a fund's gross asset value, and its assets and liabilities categorized according to the fair value hierarchy under GAAP.[24] The gross asset value of a fund and the amount of leverage used by the fund are important parts of a fund's investment strategy, as discussed above, and should not be disclosed to other market participants without a clear public policy benefit. Similarly, the potential harm to a firm's competitiveness from public disclosure of detailed fair value information about a fund's assets and liabilities would substantially outweigh any benefits.

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[22] Form ADV, Part 1A, Schedule D, Section 7.B.1, Proposed Items 14, 15, 17 and 18.

[23] Proposed Items 13 and 29.

[24] Proposed Items 11 and 12.

IV. Reporting Information about the Investment Adviser on Form ADV

For reasons similar to those described above, certain sensitive information about the business of an investment adviser that may be useful to the Commission in overseeing advisers, but that would not serve a clear policy objective by being publicly disclosed, should not be viewable by the public on Form ADV. Specifically, the SEC should not publicly disclose the number of a manager's employees, the types of clients for which it performs advisory services, or the amount of its regulatory assets under management attributable to each type of client.[25] Private fund managers regard this information as sensitive, and would not voluntarily disclose it to the public. Absent a compelling policy reason for public disclosure, we recommend that this information be reported on Form ADV but not viewable by the public.

V. Reporting $1 Billion in Assets

Under Section 956 of the Dodd-Frank Act, regulators must adopt rules or guidelines that require certain financial institutions to disclose their incentive-based compensation arrangements, and to prohibit arrangements that provide excessive compensation or could lead to a material loss for the institution. Section 956 applies to banks, credit unions, broker-dealers and other institutions, including investment advisers, but excludes any entities with assets of less than $1 billion. The Commission proposes to amend Form ADV to require an investment adviser to indicate whether it had $1 billion or more in assets as of the last day of the adviser's most recent fiscal year.

The proposed instructions to Form ADV explain that for purposes of this calculation, "assets" refers to an adviser's total assets, not the assets it manages on behalf of clients, and that an adviser should determine its total assets using the total assets shown on the balance sheet for its most recent fiscal year end.[26] We agree that Section 956 does not include the assets that an adviser manages for its clients, including private funds, for purposes of calculating an adviser's assets. We recommend that the SEC confirm in the Form ADV instructions and in the Release that a private fund manager should not include in this calculation private fund assets and other assets that it manages for clients.

We further recommend that for purposes of Section 956 the Commission provide additional guidance in the instruction to Form ADV to account for the fundamental differences between hedge fund managers and other types of financial companies. Unlike many banks and other large financial institutions, hedge fund managers are typically privately owned by a small number of individuals and, therefore, do not have public shareholders. The principals who own the hedge fund manager are typically the senior management of the manager with primary responsibility for the portfolio management activities and oversight of other employees of the manager. Unlike financial institutions with public shareholders, this integration of ownership and management ensures an alignment of interest, which provides strong incentives for the individuals responsible for the day-to-day operations of the manager to appropriately manage risks.

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[25] Form ADV, Part 1A, Proposed Items 5.A, 5.D and 5.F.

[26] Form ADV, Part 1A, Proposed Instruction 1.b.

In addition to this strong alignment of interests between management and ownership that distinguishes hedge fund managers from other types of financial institutions with public shareholders, other features shared by hedge fund managers substantially limit any potential risks to the public. Hedge fund managers are not depository institutions and do not put taxpayer money at risk. Although there are some exceptions, in general hedge fund managers do not offer their shares to the public or list their shares on national securities exchanges. In addition, federal securities laws prohibit interests in private funds from being offered to the public, and any purchaser of an interest in a private fund must meet substantial wealth and income requirements. As a result, public investors do not own interests in private funds, and ownership is limited to sophisticated, wealthy investors.

Because hedge fund managers are typically privately owned by a small number of individuals, have strong alignment of interests between management and ownership, and do not pose risks to the public, unless a hedge fund manager were systemically significant and deemed a Tier 1 financial holding company, there would not seem to be any public interest in setting rules on the compensation structure of hedge fund managers. Assets on an investment adviser's balance sheet that are owned by other than public shareholders, including the principal owners of the manager, other family members, and key employees, do not raise the types of concerns that Section 956 was designed to address and should not be included. We recommend, therefore, that only the assets of an investment adviser that are owned by public shareholders be included in the definition of assets under Section 956.

In addition, the Commission should confirm that the definition of assets under Section 956 includes only those assets on the balance sheet of an investment adviser that are the actual proprietary assets of the investment adviser. Other assets that an adviser may include on its balance sheet as a result of accounting rules or other reasons would not be representative of the actual assets of an adviser and should not be included in the definition. For example, an adviser with global operations may be required by accounting consolidation rules to include on its balance sheet the assets (and offsetting liabilities) of an affiliated insurance company for which the adviser provides asset management services. This arrangement may occur, for example, in connection with the use of unit-linked life insurance as an investment vehicle for pension funds in the U.K. Investors may request this type of structure for tax reasons, and as a result advisers with insurance company affiliates would likely show the insurance company assets on their balance sheets. We request that the Commission confirm that an investment adviser should not include such assets in the calculation of its assets under Section 956.

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Conclusion

MFA appreciates the opportunity to provide comments to the SEC in response to proposals set out in the Release. In implementing the provisions of the Dodd-Frank Act, we encourage the SEC to continue its thoughtful approach to the regulation of private fund managers.

If you have any questions regarding any of these comments, or if we can provide further information, please do not hesitate to contact Matthew Newell or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

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