



April 8, 2011

VIA EMAIL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF; File Number S7-05-11

Dear Ms. Murphy and Mr. Stawick:

Managed Funds Association (“MFA”)¹ appreciates the opportunity to provide comments in response to the joint release of the Securities and Exchange Commission and Commodity Futures Trading Commission, “Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF,”² which would implement Section 404 and Section 406 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Proposed Rule 204(b)-1 under the Investment Advisers Act of 1940 (“Advisers Act”) and proposed Rule 4.27(d) under the Commodity Exchange Act would require registered investment advisers to report information about private funds on new Form PF for the assessment of systemic risk by the Financial Stability Oversight Council (the “Council”).

MFA strongly supports the goals of the Dodd-Frank Act to address potential systemic risks before they arise and enhance regulation of systemically significant financial companies. MFA also supports efforts by regulators to gather data from different types of market participants, including investment advisers and the funds they manage, which we believe is a critical component of effective systemic risk monitoring and regulation.

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.

² Investment Advisers Act Rel. No. 3145, 76 Fed. Reg. 8068 (Feb. 11, 2011) (the “Release”).

We support the approach proposed by the SEC and CFTC to collect information from registered private fund managers through periodic, confidential reports on Form PF. Through these reports, and provisions of the Dodd-Frank Act that ensure appropriate oversight of hedge funds and their advisers, including registration and recordkeeping requirements, the Commissions and members of the Council will have full access to information about hedge fund advisers and the funds they manage. Our comments below are designed to enhance the usefulness of the Form for regulators, eliminate any unintended consequences to systemic risk assessment that could result from inconsistent or unclear information, and reduce the Form's complexity and the substantial burden it would impose on fund managers.

I. Executive Summary

We commend the Commissions for their work in preparing proposed Form PF. Since the Council and the Office of Financial Research ("OFR") are still in the process of issuing proposed rules to determine criteria for assessing systemic risk, the proposed Form is necessarily a work in progress. We recognize the significant challenge in creating an entirely new reporting framework for private fund managers, and believe it will be important for regulators and the industry to continue to revisit and amend the Form as they gain experience with the collection and analysis of information obtained from this Form. In particular, we encourage the Commissions to undertake a formal review of the Form within two years following the initial filing in which they would evaluate the effectiveness of the Form for systemic risk assessment, determine its impact on hedge fund managers, and analyze its overall costs and benefits to regulators, markets and investors.

We have spent a considerable amount of time reviewing the proposal, comparing it to information requested by other global regulators and information that most private fund managers regularly prepare for their investors, counterparties, and other outside parties, and assessing the cost and impact on managers from gathering the requested information and completing the Form. Based on our review, we are quite concerned that completing the Form will impose a significant burden on managers. Given the interconnected nature of global securities and financial markets, any "overcounting" or "undercounting" of risks due to inconsistent definitions is likely to frustrate the goal of reducing systemic risk on a global basis. Therefore, we believe further coordination with international regulators, who are gathering information from many of our members and other non-U.S. firms, is imperative to achieve these broad goals.

In our view, the following would significantly improve the potentially substantial costs to managers while retaining, and even enhancing in some cases, its utility for regulators:

- The threshold for enhanced reporting for large managers should be increased to \$5 billion of hedge fund assets under management, a level that would still capture 50-60% of industry assets;
- Managers should have at least 120 calendar days from the end of the reporting period to submit the Form;
- Managers should submit Form PF semi-annually and provide information as of the end of each reporting period;

- The Commissions should provide managers with at least nine months from the publication of the final version of Form PF to the due date of the initial filing;
- The SEC should propose related recordkeeping rules for private fund managers at the same time as it implements Form PF;
- The Commissions should carefully consider further steps they should take to implement the confidentiality protections in Section 404 of the Dodd-Frank Act and prevent the inadvertent disclosure of the highly sensitive information managers will report on the Form;
- Managers should be required to certify that they have completed the Form after reasonable inquiry and to the best of their knowledge, and based on consistent internal procedures for each question, provided that the Form does not explicitly specify a methodology; and
- Managers should have flexibility to provide information about funds and accounts in a manner that best represents their activities.

II. Systemic Risk Assessment of Non-Bank Financial Companies

The Release explains that hedge funds may have the potential to pose systemic risk if, through their investment activities or use of leverage, they experience stress and affect lending institutions or financial markets, or if, through the simultaneous failure of several similarly positioned hedge funds that liquidate their positions at the same time, they depress the price of assets held by other investors.³ A system of confidential reporting by private fund managers of the type proposed in the Release will provide regulators with the quantitative data they need to monitor potential sources of risk to the financial system.

As you know, the Council has issued a proposed rule that organizes the statutory criteria set out in Section 113 of the Dodd-Frank Act into six categories: size; lack of substitutes for the financial services and products the company provides; interconnectedness with other financial firms; leverage; liquidity risk and maturity mismatch; and existing regulatory scrutiny. We refer you to our response to the Council's proposal, which is attached hereto, for a detailed discussion of the key characteristics of hedge funds with respect to each of these categories.⁴ We believe that, in light of the structure of hedge funds, and the market and regulatory changes regarding counterparty risk management, leverage and use of collateral, applying the criteria in Section 113 of the Dodd-Frank Act to hedge funds should lead to the conclusion that it is highly unlikely that any hedge fund is systemically significant at this time. We recognize, however, that circumstances can change and that there is a possibility that a hedge fund may, in the future, become systemically significant.

³ 76 Fed. Reg. at 8073.

⁴ See Letter from Richard H. Baker, President and CEO, Managed Funds Association, to The Honorable Timothy F. Geithner, Chairman, Financial Stability Oversight Council, dated Feb. 25, 2011, attached, and available at: <http://www.managedfunds.org/downloads/MFA.letter.on.systemically.significant.institutions.pdf> ("MFA February Letter").

III. Framework for Reporting Systemic Risk Information

Under the Dodd-Frank Act, the Council must assess systemic risk and, among other things, determine whether non-bank financial companies should be deemed systemically significant and subject to supervision by the Board of Governors of the Federal Reserve System (the “Fed”). Section 112 of the Act authorizes the Council to collect information from non-bank financial companies for these purposes. Separately, Sections 404 and 406 of the Act authorize the SEC and CFTC to require private fund managers to maintain records and submit reports for investor protection and the assessment of systemic risk, and provide that such information shall be made available to the Council. Under these provisions, the SEC and CFTC will implement recordkeeping and reporting rules for private fund managers, and the Council will request any additional information.⁵

In our view, the most effective method to implement this framework is for the SEC and CFTC to collect systemic risk information from private fund managers initially through a single report, Form PF, and then for the Council to determine whether to seek additional information from any specific firm or firms. As part of this process, the SEC and CFTC should combine their systemic risk reporting requirements into a single Form PF, instead of requiring advisers to file both Form PF and Forms CPO-PQR and CTA-PR, as applicable, as a combined form would be the most efficient and least costly for respondents to complete and regulators to analyze.⁶

As the primary reporting form, Form PF should be designed to provide members of the Council with an overall view of individual private funds and the industry to enable them to identify any potential systemic risk concerns. The type of detailed information the Council would ultimately need to designate an individual private fund for Fed supervision could not be communicated through a general reporting form, and the Form should not be designed to include all information about funds’ activities. Instead, the Council should seek more detailed information either directly from any funds whose activities raise such concerns, or through other types of targeted requests. We believe this tiered approach is consistent with the objectives of the Dodd-Frank Act and the purpose of the Form as described in the Release.⁷

We encourage the Council to engage in regular dialogue with market participants regarding relevant industry and market practices and, when appropriate, firm-specific activities. For example,

⁵ We expect that the Council will prepare reporting forms for other non-bank financial companies similar to Form PF.

⁶ The forms are not identical, and asset managers that advise both private funds and commodity pools (that are not also private funds) would be required to track and file two parallel sets of information with the SEC and the CFTC. A combined form would address issues relating to duplication of reporting and inconsistency among definitions and instructions. By including an additional schedule the CFTC could request information that is unique to commodity pools. A joint reporting form would allow regulators to monitor systemic risk using consistent data reported in a consistent manner, would improve the quality of systemic risk analysis and reduce the regulatory expense associated with that analysis. At the same time, it would substantially reduce the compliance burden for advisers.

⁷ 76 Fed. Reg. at 8072 (“Based upon the information we propose to obtain from advisers about the private funds they advise, together with market data it collects from other sources, FSOC should be able to identify whether any private funds merit further analysis or whether OFR should collect additional information. We have not sought to design a form that would provide FSOC in all cases with all the information it may need to make a determination that a particular entity should be designated for supervision by the FRB”).

the Council may seek additional information from managers in response to specific market events through targeted requests, and MFA would be pleased to help organize groups to consult with the Council or OFR as appropriate. We believe this type of direct contact is critical to enable the Council to gain a better understanding of the activities of a particular fund and the industry generally.

IV. Reporting Systemic Risk Information on Form PF

A. Threshold Level for Large Hedge Fund Managers

Form PF would require each SEC-registered investment adviser that manages hedge funds with at least \$1 billion in assets to provide additional information about the funds. The Commissions estimate that 200 U.S.-based advisers that manage 80% of hedge fund industry assets would report such additional information.⁸ While we support a tiered reporting system based on size that would require more information from large managers, we believe a higher threshold would provide the Council with substantial information about the industry and any managers that could merit further review, and would avoid more managers' reporting information that is unlikely to be material to assessing systemic risk.⁹

A threshold level for additional reporting by hedge fund managers of \$5 billion of hedge fund assets would include a large majority of assets of the industry. Based on estimates, 77 hedge fund managers representing approximately 50-60% of hedge fund industry assets would exceed this threshold.¹⁰

In addition to managing a majority of hedge fund assets, firms that exceed this threshold would also be highly representative of the industry. Large managers often have diversified businesses and collectively engage in a broad range of trading and investment strategies, portfolio management practices, borrowing arrangements, and collateral practices and other activities. In some cases, the activities of these managers may be useful to regulators in seeking to assess the impact of any particular investment strategies on markets or asset classes. Firms that manage this level of hedge fund assets may also have more reporting and operational capabilities than smaller managers.

Completing the Form, and in particular the sections requiring more detailed information, will impose a substantial additional cost of doing business on managers. We urge the Commissions to carefully design the Form to limit the impact of the requirements to information and managers that is most likely to be relevant to assessing systemic risk. As part of the comment process some of our members have attempted to complete the proposed Form with respect to one or more of their private funds. Based on their experience, and recognizing that efficiencies will develop over time, we estimate that large managers on average will expend 150-300 hours to submit the initial Form, and managers with more complex strategies will expend considerably more time. Regulators should, to

⁸ 76 Fed. Reg. at 8076.

⁹ The registration of all managers with over \$150 million in assets under management will also provide substantial information about the industry.

¹⁰ Absolute Return, Billion Dollar Club, available at: <http://www.absolutereturn-alpha.com/Article/2775999/Billion-dollar-club.html>.

the greatest extent possible, create reporting requirements that are consistent with the framework set up by the Dodd-Frank Act, and such reports should provide the Council with the type of information that will be material to assessing systemic risk. In addition, the Commissions should seek to ensure that the costs imposed on the industry are reasonable and not overly burdensome.

For these reasons, we believe a reporting threshold of \$5 billion would provide substantial information to regulators to enhance assessment of systemic risk and oversight of the industry while reducing the impact on smaller firms.

B. Time Period for Managers to Submit Form PF

The proposed rules would require small managers to file Form PF annually within 90 days of their fiscal year end, and large managers to file the Form within 15 calendar days of each quarter end. We strongly recommend that regulators provide all managers with 120 calendar days to submit Form PF. Anything less than a 120-day reporting period would severely limit the ability of managers to properly value illiquid assets, diverge significantly with industry practice, conflict with periods for other reports by investment advisers, financial companies, and public companies, and could ultimately result in less meaningful information provided on Form PF.

Form PF would require large managers to report, among other things, the values of the assets held by a fund as of the end of each quarter within 15 calendar days. Many fund managers across a wide range of investment strategies would not be able to complete valuations of illiquid assets within this time period.

Hedge funds frequently invest in illiquid assets that are not listed on any exchange or traded regularly in an active market, lack regular or transparent pricing information, are offered and sold through private transactions, or take the form of bespoke contracts between the fund and counterparty. Examples of these types of assets include private equity, privately issued convertible bonds, equity derivatives, investments in underlying private funds, and distressed debt. Hedge funds play a critical role in these markets by investing capital and taking on risk, and many investors seek the types of less correlated returns associated with these assets.

Managers value fund assets on an annual basis in preparing audited financial statements, and also typically on a quarterly or monthly basis in an unaudited manner to distribute to fund investors, facilitate subscriptions and redemptions, or for other purposes. Under applicable accounting standards and their own internal policies, at each valuation point managers engage in a rigorous process that often includes obtaining critical pricing information from unaffiliated third party sources.

Many of the illiquid assets held by hedge funds are categorized under generally accepted accounting principles (“GAAP”) as having Level 2 or Level 3 inputs.¹¹ Level 2 inputs are observable, either directly or indirectly, but do not include quoted prices in active markets for the

¹¹ See Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157, Fair Value Measurements (“FAS 157”).

same assets.¹² Managers of funds that hold assets with Level 2 inputs need to obtain pricing information directly from third party sources, including valuation agents, underwriters and other participants in the markets for those assets.

Level 3 inputs are unobservable, and are used when observable inputs are not available and there is little, if any, market activity for the asset. In valuing assets with these inputs, managers often develop their own models and assumptions to price the asset based on the best information available, and engage third party valuation firms to review their valuation methodology and provide any relevant data or assumptions about the valuation of the assets.

Managers seeking to obtain inputs for these assets depend on valuation agents, underwriters, brokers and other market participants to provide accurate, timely information. It is important that managers have sufficient time to receive this information, to then use the information to prepare their portfolio valuations for investors, and finally to use this final information as a basis for their Form PF calculations. In this manner, managers will ensure that Form PF information is consistent with information provided to investors. While the length of time each manager will need to complete this process will depend on a manager's valuation methodology, the type and proportion of illiquid assets, the fund's investment strategy, and the availability of information from third party sources, managers would not be able to obtain the necessary information within 15 days.

Additionally, managers provide extensive reporting to fund investors. Compressing this regulatory reporting process would require managers to create multiple valuation procedures, independent of those that support investor reporting and would diminish the value and accuracy of information on the Form. Much of the information requested on Form PF is unique and will have to be generated solely for this report, so the burden on managers will be substantial. Having to complete this task in only two weeks would be unreasonable and would increase the cost to managers substantially.

It is important to recognize that many fund managers, including managers to funds that invest in illiquid assets, also provide estimated valuation or other information to investors within 15 days of the end of a month or quarter. Managers generally perform some of their valuation procedures to determine this estimated information, however they typically have not yet obtained information from third party sources. When providing this type of information, managers clearly identify the information as only an estimate and subject to further revision. This type of estimated information would not be suitable for managers to report on Form PF.

In determining an appropriate reporting period, we encourage regulators to consider the amount of time needed for managers to prepare a fund's audited financial statements. Managers generally distribute audited financial statements to fund investors within 120 days of a fund's fiscal year end, in compliance with a provision of the SEC's custody rule.¹³ While fund managers will not be able to provide audited financial information on Form PF, the 120-day time period is indicative of the extensive procedures and verifications required to determine final valuations. We believe this

¹² A Level 2 input would include, for example, a quoted price for an identical or similar asset in a market that is not active (*i.e.*, markets in which there are few transactions for the asset, prices are not current, or price quotations vary substantially either over time or among market makers, or in which little information is released publicly).

¹³ Advisers Act Rule 206(4)-2(b)(4).

time period for ensuring that accurate information is reported to investors is also appropriate for ensuring that managers have sufficient time to calculate accurate information for regulators assessing systemic risk.

A 15-day period would be significantly shorter than reporting periods for other filings by hedge fund managers, financial companies, and public companies. As you know, since 2009 the U.K. Financial Services Authority (“FSA”) has distributed a survey to hedge fund managers on a semi-annual basis to identify any potential sources of systemic risk associated with hedge fund activities. The most recent FSA survey provided hedge fund managers with 43 days to submit the survey.¹⁴ To our knowledge, the survey has served as an effective tool for the FSA to assess systemic risk. In comparison, Form PF would require managers to submit substantially more data than the FSA survey, and the Commissions have proposed a substantially shorter time to report.

Hedge fund managers and other institutional investors regularly report less extensive information about their portfolio holdings on Form 13F within 45 days of the end of each reporting period.¹⁵ Public companies have at least 60 days to file a Form 10-K, and at least 40 days to file a Form 10-Q. While the purpose and scope of these filings are distinct from Form PF, the reporting periods reflect a common policy consideration to ensure that firms have time to respond with appropriate care and diligence so that the information is accurate and useful to regulators, investors and market participants. The complexity of Form PF requires a much longer reporting period than these forms to ensure the accuracy of the information.

A 15-day reporting would impose a substantial burden on managers and divert resources from their core advisory function. Many large managers will seek to automate the reporting process as much as possible; however, as described above, the Form will nevertheless require substantial hours to complete, and the involvement of personnel across a number of departments, including risk management, legal, compliance, and trading and portfolio management. Requiring that managers complete this process in only 15 days would significantly increase the costs that managers will incur, divert personnel from their primary job functions and increase the risk of inaccurate or erroneous information.

For these reasons, we urge the Commissions to provide managers with 120 days from the end of the reporting period to submit Form PF.

C. Frequency of Filings and Information Reported on Form PF

Under the proposal, small managers would file Form PF annually, and large managers would file quarterly and report certain information on a monthly basis. We recommend that all managers submit the Form semi-annually. Additionally, we recommend that managers provide calculations as of the end of the reporting period. Requiring managers to provide monthly information would be

¹⁴ FSA, Hedge Fund Survey (Sept. 2010) (“FSA Hedge Fund Survey”). The survey requested that managers include information as of September 30, 2010, and submit the survey by November 12, 2010.

¹⁵ Form 13F requires disclosure of the name of the manager, and, for each section 13(f) security over which it exercises investment discretion, the name and class, the CUSIP number, the number of shares as of the end of the calendar quarter for which the report is filed, and the total market value.

inconsistent with the intended purpose of the Form, would not materially enhance the assessment of systemic risk, and would impose a burden on managers disproportionate to any potential benefit.

Semi-annual reporting would be more consistent with the purpose of the Form to enable the Council to identify whether any private funds merit further analysis. Information about private funds' investments, use of leverage and collateral, counterparty exposures, and portfolio management practices provided semi-annually would provide the Council with meaningful data to monitor and assess the extent to which large private funds could have systemic effects. As an alternative, the Commissions could start this new reporting on a semi-annual basis, and then re-evaluate the process after two years to determine if more frequent reporting would add substantial value.

We agree with the statements in the Release explaining that Form PF should not be designed to provide the Council with all the information it would need in every case to make a determination that an entity should be designated for Fed supervision.¹⁶ The Form should instead take a balanced approach that obtains relevant information on a periodic basis and avoids inundating regulators with the significant market "noise" that would result from receiving overly frequent data about hedge fund portfolio movements. Like other money management firms and financial companies, a private fund's investment positions, exposures to counterparties, performance and other metrics are subject to short-term market fluctuations. This type of information is unlikely to be material to the Council's consideration of systemic risk, and could cause regulators to focus on these market movements rather than the overall picture of a fund's activities within the financial system. We respectfully believe that information reported more frequently than semi-annually would generally be this type of market "noise" that would be of minimal use to Council members.

In the absence of existing, comparable systemic risk reporting by other non-bank financial companies, we recommend that regulators consider the frequency with which hedge funds and other firms provide similar information. The most comparable filing is the FSA hedge fund survey, and we recommend that U.S. regulators consider its approach and results in requesting that managers provide information on a semi-annual basis.

The most recent FSA survey, covering April through September 2010, included information from roughly fifty investment managers with approximately \$380 billion of hedge fund assets, representing roughly 20% of global hedge fund assets. The key conclusions of the survey are: (i) the footprint of surveyed hedge funds remains small within most markets and leverage is largely unchanged, so that risks to financial stability through the market channel seem limited, (ii) counterparties increased margin requirements and tightened other conditions on their exposures to hedge funds since the financial crisis, increasing their resilience to hedge fund defaults, and (iii) some risks to hedge funds remain, particularly if they are unable to manage a sudden withdrawal of liabilities during a crisis period.¹⁷

We believe U.S. regulators can benefit from, and build upon, the experience of the FSA in preparing Form PF. In particular, we think the frequency of information reported in the survey is a useful starting point for Form PF. The increased number of managers that will file the Form as

¹⁶ 76 Fed. Reg. at 8072.

¹⁷ FSA, Assessing the possible sources of systemic risk from hedge funds (Feb. 2011) (describing the results of the FSA Hedge Fund Survey), available at: http://www.fsa.gov.uk/pubs/other/hf_survey.pdf.

compared to the FSA survey, and the resulting volume of information, is further reason for reporting at a reasonable frequency.

The Release explains that monthly reporting is in part designed to prevent managers from manipulating information at the end of a reporting period.¹⁸ While we appreciate that these concerns have arisen in the financial industry, we believe such activity is unlikely with respect to Form PF, and that the burden from monthly or quarterly reporting would outweigh any benefits. We believe semi-annual reporting would best enable the Council to monitor systemic risk and identify any private funds with activities that merit further review. Monthly information in particular is unlikely to be material to assessing systemic risk, and would impose a substantial burden on managers by requiring them to expend significant time to complete the Form on a monthly basis.

D. When a Manager or Fund is Subject to Enhanced Reporting

Under the proposal, a manager would be deemed a “large private fund manager,” and a hedge fund would be deemed a “qualifying fund,” if the manager or fund exceeds the applicable threshold (*i.e.*, for a manager, \$1 billion in hedge fund assets under management, and for a fund, a net asset value of \$500 million) as of the close of business on any day during the most recent calendar quarter.¹⁹ We are concerned that such a standard could lead to uncertainty for hedge fund managers, and we respectfully recommend that the Commissions adopt a standard that would allow a manager to determine with more precision whether it, or a hedge fund it manages, has exceeded a reporting threshold.

We note that the SEC has not yet finalized the proposed definition of “hedge fund assets under management,” which would be defined as “regulatory assets under management” in accordance with the instructions to Form ADV. The proposed instructions to Form ADV would require managers to include in the calculation of regulatory assets under management, among other things, outstanding indebtedness and other accrued but unpaid liabilities.²⁰ As described in a separate letter, we are concerned that there is no generally accepted definition of how to calculate the borrowing and leverage that many private funds use, and we urge the SEC to provide a clear definition of this term.²¹

Under the proposed reporting thresholds, managers would need to calculate their assets under management and the net asset value of hedge funds they manage on a daily basis. As discussed above, the valuation of illiquid fund assets takes significantly longer than one day, and initial calculations are only an estimate and subject to further revision. A requirement that managers make these determinations on a daily basis would increase the cost of doing business for private fund

¹⁸ 76 Fed. Reg. at 8082.

¹⁹ 76 Fed. Reg. at 8080.

²⁰ Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Rel. No. 3110, 75 Fed. Reg. 77052 (Dec. 10, 2010).

²¹ Letter from Stuart J. Kaswell, Executive Vice President and Managing Director, Executive Vice President and Managing Director, General Counsel, Managed Funds Association, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated Jan. 24, 2011, available at: <http://www.managedfunds.org/downloads/MFA.Comments.to.SEC.Proposed.Implementing.Rules.1.24.2011.pdf> (“MFA Implementing Letter”).

managers and create significant uncertainty, especially for those managers with assets under management or individual hedge fund assets that are near the relevant thresholds.

We suggest that hedge fund managers instead determine their assets under management and fund net asset values for purposes of Form PF as of the end of each calendar year. Under this standard, most managers would be able to use the values in their audited financial statements, which would provide certainty for both managers and regulators. In the alternative, managers should make these determinations as of the end of the reporting period.²²

E. Initial Form PF Filing

Large managers would need to make their initial Form PF filing by January 15, 2012, and most small managers would need to file their initial Form by March 31, 2012. While the Release does not provide an estimated date of adoption, it indicates that small managers would have at least eight months after adoption to file their initial Form. We request that all hedge fund managers have at least nine months following publication of the final version of Form PF to submit their initial filing.

Form PF will require managers to collect and calculate an extensive amount of information. Following publication of the final Form PF, managers will need time to identify the information to be included, establish automated systems and procedures to collect and calculate the information, and develop procedures to review, complete and verify the Form. The initial filing in particular will present a significant challenge, and managers will allocate a substantial number of firm personnel and other resources to accomplish this task. Managers will not be able to begin these preparations until regulators publish the final version of the Form, and we expect that due to its scope, complexity and novelty, regulators will need to provide subsequent interpretive guidance to allow managers to complete the Form, as they have following other recent rulemakings.²³

Regulators should provide managers with at least nine months from the time of publication to the due date of the initial filing for these preparations. This time period would also be more consistent with compliance periods for recent proposals affecting private fund managers and other investment advisers.²⁴

F. Recordkeeping Requirements

The SEC indicates that it will issue recordkeeping requirements for private fund managers for systemic risk assessment purposes in a future release. While we recognize that the Dodd-Frank Act

²² Under this test, managers should begin reporting additional information following the subsequent reporting period to ensure that they have sufficient time to establish procedures to calculate the additional information.

²³ *See e.g.*, SEC Staff Responses to Questions About the Custody Rule, available at: http://www.sec.gov/divisions/investment/custody_faq_030510.htm; SEC Staff Responses to Questions About the Pay to Play Rule, available at: <http://www.sec.gov/divisions/investment/pay-to-play-faq.htm>.

²⁴ *See e.g.*, Political Contributions by Certain Investment Advisers, Investment Advisers Act Rel. No. 3043, 75 Fed. Reg. 41018 (Jul. 14, 2010) (compliance dates of March 14, 2011 and September 13, 2011); Amendments to Form ADV, Investment Advisers Act Rel. No. 3060, 75 Fed. Reg. 49234 (Aug. 12, 2010) (compliance date of March 31, 2011 for registered investment advisers, later extended in part).

does not set a deadline for the SEC to adopt these rules, we believe that implementing the rules at the same time as Form PF would be consistent with the policy goals of the Act.

Section 404 provides instructions and authority to the SEC regarding advisers' treatment of records, the type of information that must be included in the records, the maintenance and filing of records, and the availability of such records for examination. Together with provisions relating to reporting, the Section clearly sets out a dual system of data collection for advisers to maintain records for inspection and periodically report certain information in those records.

Under this approach, recordkeeping rules should be complementary to Form PF and serve an important function in the Council's oversight of systemic risk. As discussed above, Form PF is not designed to provide the Council with all the information it may need to make a determination that a particular entity should be designated for supervision by the Fed. Based on its review of Form PF, the Council should obtain additional information from the industry or any individual funds it identifies for further analysis, and recordkeeping rules should facilitate this process by ensuring that regulators and managers know with certainty the types of records that will be maintained and made available for review.²⁵

G. Confidentiality of Information on Form PF

Information that fund managers submit on Form PF will be subject to important confidentiality protections under Section 404.²⁶ We strongly support these protections, and encourage regulators to develop robust measures to implement them and ensure that information is not inadvertently disclosed. Public disclosure of the highly sensitive, proprietary business information on Form PF would result in immediate and irreversible damage to the competitive position of a fund and its investors.

We appreciate that the Release explains that information on Form PF generally is to remain confidential pursuant to Section 404. Among other things, Section 404 limits others from compelling disclosure, extends the confidentiality protections to recipients of the information, and prohibits public disclosure of "proprietary information."²⁷ While we believe these statutory provisions provide appropriate protections, it may be useful for the Commissions to provide further clarification in advance of receiving and sharing substantial amounts of information. For example, the SEC explains that it "does not intend to make public Form PF information identifiable to any particular adviser or private fund."²⁸ If the SEC intends to disclose any information on Form PF to the public, it is important that information is aggregated and anonymous so that it would not identify, either directly or indirectly, any individual private fund, or provide indications of specific activities in a particular market.

²⁵ Managers also need clear guidance about required recordkeeping in order to comply with the periodic inspections and special examinations that the SEC will conduct pursuant to Advisers Act Section 204(b)(6).

²⁶ Advisers Act Section 204(b)(7), (b)(8), (b)(9) and (b)(10).

²⁷ Proprietary information includes sensitive, non-public information regarding: (i) the investment or trading strategies of an adviser; (ii) analytical or research methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property; and (v) any additional information that the SEC determines to be proprietary. Advisers Act Section 204(b)(10)(B).

²⁸ 76 Fed. Reg. at 8071.

The Release indicates that regulators will separately propose a filing system for Form PF with heightened confidentiality protections that would allow secure access to members of the Council, and may be designed as part of the existing Investment Adviser Registration Depository platform operated by FINRA.²⁹ We support this approach, and we encourage the Commissions to consider complementary procedural safeguards to ensure that the system is secure and that access is limited to appropriate personnel. For example, if the SEC uses information on Form PF for purposes other than the assessment of systemic risk, such as for inspections, examinations, or rulemaking, we recommend that it implement policies and procedures for employees to treat the information with the highest degree of confidentiality. We look forward to providing additional views on the features of a filing system that would best ensure the protection of information.

In addition to sharing information with U.S. regulators, the Commissions expect that they may share information with foreign financial regulators under information sharing agreements in which the foreign regulator agrees to keep the information confidential. We support the sharing of information with foreign regulators under appropriate circumstances and with the necessary confidentiality protections. The Commissions should carefully review any existing information sharing agreements and make any appropriate amendments that would help to ensure the confidentiality of information. In particular, information should have the same protection in the foreign jurisdiction from information requests as those included in Section 404 of the Dodd-Frank Act, and any information that regulators share should be in an anonymous form. U.S. regulators should also ensure that foreign regulators use the information in a manner consistent with the purpose of Form PF. As a starting point in developing these protections, it may be helpful to consider existing procedures for sharing information with foreign regulators for enforcement matters.

Finally, in a separate letter to the SEC we have recommended that certain information proposed to be included on Form ADV be provided to the SEC on a confidential basis.³⁰ We believe this information would be more appropriate to be submitted to regulators on Form PF.

H. Individual Certification

In completing Form PF, an individual would need to certify, under penalty of perjury, that the information and statements made in the Form are true and correct. While we appreciate that regulators have provided detailed instructions and definitions, in our view the subjectivity of some information, the difficulty in providing precise data, the volume of data requested, and the general nature of the Form, will inevitably lead to a level of uncertainty that would be inconsistent with such a broad and unprecedented certification. Accordingly, we recommend that managers make the following certification, which is based on the certification provided on Schedule 13G: “After reasonable inquiry and to the best of my knowledge and belief, I certify on behalf of [registrant] that the information set forth in this statement is true, complete and correct in all material respects.” The

²⁹ 76 Fed. Reg. at 8083.

³⁰ MFA Implementing Letter at 12. The information that should be included on Form PF instead of Form ADV is: (i) the number of a fund’s beneficial owners, (ii) the percentages of the fund owned by the adviser, certain types of investors, and non-U.S. persons, (iii) the minimum required investment, (iv) the entities that perform marketing services, (v) a fund’s gross asset value, and (vi) a fund’s assets and liabilities categorized according to the fair value hierarchy under U.S. GAAP.

certification should also indicate that managers should complete the Form based on their internal procedures for each question that does not provide an alternative methodology.

As described above, managers will not have sufficient time to complete their full valuation methodologies, nor will they have time to arrange for an audit of the information or the verifications used in preparing audited financial statements. Information that managers submit on the Form will be as accurate as possible under the circumstances, and will be prepared in good faith; however, it will not be subject to the long-standing procedures that fund managers, together with their auditing firms, have established and implemented for the preparation of audited financial statements, and therefore cannot be certified, under penalty of perjury, as accurate in all instances.

The type of information to be reported on the Form in many cases is different from the type of information that fund managers currently use and far more comprehensive than that reported in audited financials. They will need to first interpret how a question relates to their individual businesses, including their investment techniques, portfolio management, use of leverage, collateral practices, risk management and other operations, and then develop systems and procedures to begin calculating such information. Many questions in the Form also require managers to provide estimates based on their proprietary methodologies, models or assumptions.³¹ It would be impractical for managers to certify that responses to these questions are accurate; managers should instead confirm that they have provided the information based on reasonable inquiry and to the best of their belief, and based on their consistently applied internal procedures for each question that does not provide an alternative methodology.³² The certification should be designed to subject a filer to sanctions if it had knowledge of material inaccuracies.

I. Reporting Information About Funds

The proposal sets out different requirements for reporting information about a private fund: (i) managers would aggregate information about funds that are part of a master-feeder structure, even if they did not aggregate the information for purposes of Form ADV; (ii) managers would report information about parallel funds separately; and (iii) managers would aggregate information about parallel managed accounts with the largest applicable private fund. We recommend that the Commissions instead provide managers with flexibility to provide information about private funds in a manner that best represents the activities of their funds and is consistent with their internal reporting procedures, while providing complete information to regulators.

In assessing the impact of hedge funds on systemic risk, an important consideration is the legal separation of different funds managed by the same adviser. These legally distinct funds often have different investors, and any losses at one fund are borne exclusively by the investors in and counterparties to that fund, and do not subject other funds managed by the same adviser directly to losses. Further, unlike other structures in the financial services industry, the different funds managed by a common adviser do not typically have the kind of intercompany loans or transactions that can create intraconnectedness (a firm's relationships within a structure of related businesses) and tie the risks associated with one company to other companies in the same ownership structure.

³¹ See e.g., Proposed Form PF Questions 28, 35, 36. See Section V *infra* for additional discussion.

³² In addition to the certification, the information submitted on the Form will be subject to existing anti-fraud prohibitions.

For a variety of reasons, including to meet investor demand and for tax or regulatory purposes, managers may operate funds in a master-feeder structure, or may operate separate funds and accounts in parallel according to the same investment strategy. While these funds and accounts are legally distinct as described above, for reasons of efficiency and consistency, some managers may treat these arrangements as a single entity for internal purposes, and some managers may treat these arrangements as separate entities. The treatment of separate funds and accounts for internal purposes has no legal significance, but rather is simply designed to better enable fund managers to more effectively manage the funds and oversee their activities.

We believe that the best approach for reporting information about such funds and accounts is for managers to have discretion as to how to report the information. Managers that treat funds or accounts as a single entity for internal purposes may determine that it is efficient to report information in the same manner on Form PF. Other managers that treat funds or accounts separately for most purposes may prefer to report information on an individual basis. To be clear, under this approach managers would continue to aggregate assets of funds and accounts for purposes of determining whether they exceed the “qualifying fund” threshold, and would report all information for each qualifying fund such that regulators would receive the same information about each fund and account that is currently proposed. This method of reporting, however, would relieve managers from having to implement new reporting procedures, and provide regulators with more comprehensive, useful information. It would also better ensure that reported information is consistent with a manager’s books and records, audited financials and reports to investors, which would better facilitate the SEC’s compliance inspections and examinations of these firms.

J. De Minimis Reporting Level

Form PF would require managers to complete Section 1 of the Form for each hedge fund they advise. While the Form would require less information for funds below the \$500 million threshold, the proposed rules would nevertheless require managers in many cases to submit dozens of individual filings for small funds that would not enhance the Council’s assessment of systemic risk. A *de minimis* reporting threshold for small funds with net asset values of less than \$250 million and that are less than 5% of a manager’s assets under management would enhance the usefulness of the Form. We recognize, however, that a *de minimis* threshold would need to be applied along with aggregation requirements to address concerns that managers could seek to avoid reporting, and we therefore would only recommend such a *de minimis* threshold if regulators determine not to adopt the recommendation set out above in Section I.

As described above, Form PF should be designed to provide Council members with the most relevant information for assessing individual funds and the industry, and should avoid excessive information that is not related to systemic risk. A *de minimis* level for reporting on Section 1 would enhance the Form by eliminating numerous separate filings of the smallest private funds, the activities of which are not likely to affect systemic risk. For example, absent a *de minimis* reporting exemption, managers would need to continue providing information on Form PF about funds they are winding down but which have not yet been fully liquidated, a process which can take several years. Information about these types of funds is highly unlikely to be relevant to the Council’s efforts to assess systemic risk.

If a *de minimis* provision were included, the SEC and Council members would have complete access to information about these funds through their authority to request additional information, and we would expect that the upcoming recordkeeping rules would apply to these funds. The Form should also include aggregation requirements for determining whether a fund exceeds the threshold similar to the requirements for determining whether a fund is a qualifying fund so that managers could not establish master-feeder funds or parallel funds or accounts below the threshold to avoid reporting. The assets of these small funds would also continue to be included in the calculation of a manager's hedge fund assets under management, and therefore would count for purposes of determining whether a manager was in excess of the large manager threshold.

V. Comments to Selected Form PF Questions

A. Reporting Information on Form PF

We appreciate the thoughtful approach the Commissions have taken in preparing Form PF, including consulting with the FSA and other foreign regulators, adopting a two-tier structure of enhanced reporting for large private fund managers, and providing detailed instructions and definitions. We recognize that preparing an entirely new reporting framework of this type is a complicated task, and we expect that managers will confront a similar challenge interpreting the Form and applying it to their businesses.

In general, we encourage the Commissions to consider the different types of data that managers will use to determine their responses. For some questions, managers will provide responses based on detailed, quantitative data from widely available sources, such as prices of equity securities that are actively traded on an exchange. For other questions, such as valuations of illiquid assets, managers will rely on a combination of quantitative and qualitative information, data from third party sources, and internal models. While managers will perform rigorous valuations, they will be less precise than other types of information. The Form should provide for these varying cases by requiring managers to respond with an appropriate level of precision, such as to the nearest one percent for information reported as a percentage.

In addition, the Form should take into account the extent to which managers will need to interpret the instructions and definitions. While the Commissions' guidance will assist managers, applying a general reporting form to a diverse industry with a wide range of business models and investment strategies will inevitably create questions and uncertainty. The Form takes a more prescriptive approach than the FSA hedge fund survey, which directs managers in many cases to make their own determination of what constitutes a fair representation. We recognize that a prescriptive approach can enhance certainty for managers and regulators; however, it is important that regulators also provide clear, simple instructions, or, for information that may not be subject to clear definitions, indicate that managers should calculate information based on their own internal methodologies.

For example, we suggest that the Form more clearly indicate that a manager should use its own methodologies in determining the effect of specified changes in market factors, such as increases or decreases of equity prices, interest rates, currency rates and default rates, on a fund's

portfolio.³³ There is no standard methodology for these types of calculations, and managers would need to determine these values based on their own internal models and assumptions about their portfolio and market conditions. Other examples where we suggest similar indications are providing estimates of the liquidity of a fund's portfolio and calculations of a fund's value at risk.³⁴ While we recognize that such estimated information may be useful, it is important that managers have clear instructions in providing their responses.

B. Comments to Specific Questions

Attached as Appendix A are recommendations related to specific questions and instructions that we believe will provide increased certainty to managers and more useful information to the Council in assessing systemic risk.

* * * * *

MFA appreciates the opportunity to provide comments to the Commissions in response to their proposal. If you have any questions regarding any of these comments, or if we can provide further information, please do not hesitate to contact Stuart J. Kaswell or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

cc: The Hon. Mary Schapiro, SEC Chairman
The Hon. Kathleen L. Casey, SEC Commissioner
The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner

The Hon. Gary Gensler, CFTC Chairman
The Hon. Michael Dunn, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner

³³ Proposed Form PF Question 36.

³⁴ Proposed Form PF Questions 28 and 35.

MFA Comments to Selected Questions on Proposed Form PFInstruction 5

The Form should clarify how a manager should respond if under the terms of its management agreement it does not have access to all investment information related to managed accounts over which it has investment discretion.

Instruction 7

Funds of funds typically invest some portion of their assets in direct investments, including derivative hedges and cash equivalents. We recommend that a “fund of funds” instead be defined as any private fund that invests principally in other private funds, excluding cash. Under the current definition, regulators would receive duplicate information with respect to many funds of funds and underlying funds. The definition should also be moved from Instruction 7 to the glossary for ease of reference.

Instructions as to value generally

The Form uses the term “value” repeatedly. In general, “value” means market value in the context of cash instruments and notional value in the context of derivatives. In some questions, however, the two constructs are seemingly mixed together. For example, in Section 2a, question 25 (geographical breakdown), the adviser must indicate the percentage of aggregate gross asset value (seemingly a market value concept) represented by assets in each geographical region by adding the notional values of derivative products to the market values of cash products and then dividing them by aggregate gross asset value. These calculations would not appear to generate meaningful information. Similarly, in Question 38 (derivatives and collateral), the notional value of derivative positions is to be compared against the market value of collateral posted in respect thereof. Please consider making the measures used in numerators and denominators consistent. Additionally, perhaps in some cases, such as Question 38, it would make sense to request both the market value and the notional value of derivative positions.

Instructions as to positions and netting generally

The Form generally indicates that positions should not be netted. However, the meaning of “position” is not entirely clear. In the context of derivatives, for example, a position may be comprised of two or more partially offsetting legs with the same counterparty. One could confirm both legs in a single confirmation; however, to preserve operational efficiency and liquidity, each leg is often separately confirmed. Summing the notional values of these legs does not generally give an accurate representation of risk. For example, if a fund buys a ten-year option and sells a five-year option otherwise having the same terms with the same counterparty under the same master agreement to create a forward starting option in respect of years 6 through 10, it would seem that for risk assessment purposes, this should be thought of as one position. The same would also seem to be true of spread trades, where the legs are all with the same counterparty under the same master agreement and in respect of the same underlying risk, and the only difference is strike price. We suggest that the Commissions consider permitting netting to the extent that the legs are offsetting (determined without regard to the expected benefits of correlation), provided that the legs are executed with the same counterparty under the same master agreement. We note that this is the approach taken in Question 24 in calculating the turnover rate.

Question 3

As described in a separate letter, we recommend that the SEC define “regulatory assets under management” as a manager’s net assets under management.³⁵ There is no generally accepted definition of how to calculate the amount of borrowing and leverage that many private funds regularly use, and managers do not have easy access to “any outstanding indebtedness or other accrued but unpaid liabilities.”

If regulators seek a calculation of assets under management that includes leverage in Form PF, it is important that the Form provide a simple, easy to apply description of how an adviser should calculate its indebtedness and other liabilities. The calculation should only include assets of private funds or parallel managed accounts.

We note that in Form CPO-PQR, the CFTC would define "net asset value" as calculated in accordance with GAAP. We recommend that the SEC and CFTC use a similar approach for the definitions of assets under management in Form PF. GAAP information is regularly reported across the industry and is a data point that most managers track in the ordinary course, so applying a GAAP standard would be less burdensome for managers than creating a new definition. This approach would also lend consistency to the forms and make it easier for the regulators to compare data across the forms.

Question 4

The Form should clarify what is meant by “other private funds,” and explain which types of accounts should be listed in the categories of “other private funds” and “funds and accounts other than private funds.”

Question 5

We support providing space for managers to describe any assumptions they make in responding to a question.

Question 7

The Form should provide a clear definition of a fund’s gross asset value to enable managers to make this calculation in a consistent manner. As noted above, there is no generally accepted definition of how to calculate the amount of borrowing and leverage that many private funds regularly use.

Question 10

The dollar amount that a fund owes to a creditor should be based on net borrowings, rather than aggregate borrowings. Net borrowings would be more useful in assessing systemic risk by taking into account any amounts that are owed to the fund by a creditor. The question should also provide clarification with regard to treatment of collateral taken in from counterparties.

³⁵ MFA Implementing Letter.

Question 12

We recommend that the Form request a range of record owners of a fund, rather than the number of beneficial owners. Managers have easier access to information about record owners, and a range would ease the filing burden on managers while still providing regulators with important information.

Question 14

The Form requires managers to determine performance information by deducting “fees and expenses” (including fixed advisory fees and operating, trading, and investment expenses), and to provide the performance information with and without deducting “performance fees.” Managers typically do not report this information, but instead report gross performance and performance net of all fees. We recommend the Form be revised to request (i) gross performance and (ii) performance net of all fees. Alternatively, advisers should be able to calculate gross or net performance using their standard methodologies, as applied for reporting to investors.

Consistent with our comments above, we recommend that managers provide this information as of the end of the reporting period, rather than monthly.

If there is more than one “inception class” of a particular fund, the manager should be permitted to make a good-faith determination regarding which inception class is most representative and should be reported. Please also clarify if side pockets should be included if they are part of a different share class.

Aggregating parallel managed accounts with private funds for purposes of this section may produce blended performance results, especially if the various accounts have different cash flows, fee structures and/or different performance over a given period. We recommend that the Commissions consider whether parallel managed accounts should not be aggregated with funds for this question.

Question 17

We recommend that the Form include additional categories of typical hedge fund investment strategies, such as those in the FSA survey, so that managers are able to more easily identify the appropriate categories (*e.g.*, “Statistical Arbitrage – Equity,” “Other Quantitative Strategies”).

We also recommend that managers provide estimates as of the end of the reporting period, rather than during the reporting period. To the extent that strategy allocations change during the reporting period, it would be difficult to attempt to calculate strategies at multiple times during the period.

Managers should also have the option of presenting strategy exposure in terms of risk capital allocation rather than as percentage of NAV, provided that the underlying assumptions are disclosed. We believe this approach, which is often used by risk management professionals, could allow for a more meaningful comparison of exposures across differing assets classes and strategies within a single portfolio or fund.

Question 18

We recommend that the Commissions remove this question from the Form. Fund managers frequently use computer-driven trading algorithms for both quantitative and fundamental strategies and reporting the amount of such trading would not be useful to assessing systemic risk.

Question 19

We recommend that the Form clarify whether managers should exclude any credit exposures they have to futures commission merchants (“FCMs”), direct clearing members (“DCMs”), or prime brokers, including any over-the-counter related amounts which are margined in a prime broker account. Clause (iii) should be clarified to refer to loans or loan commitments by the fund to the trading counterparty. We also recommend that managers not be required to net out unsettled transactions, since this would be complicated and burdensome. The Form should also clarify that the calculations should be made as of the end of the reporting period.

The directions state that affiliated entities should be treated as a single group. Please clarify the following: (i) whether the exposure of one affiliate should be netted against offsetting exposure with another affiliate or parent, (ii) the treatment if the fund has exposure to one affiliate, but has a net liability to another affiliate, and (iii) whether the answer should depend on the existence or absence of set-off provisions.

Please indicate whether assets held in tri-party collateral accounts (that is, accounts with a third-party securities intermediary held in the name of the fund in which the dealer has a security interest) should be considered when determining exposure to the dealer counterparty.

Question 21

We recommend this question be clarified to include both long and short positions. The definition of “market value” should be the net amount paid or received, since this requirement is related to trades during the period, and not the position held at the period end. We recommend aggregating asset-backed securities together with other debt securities. It would be more efficient and in line with market practice to group asset-backed securities and debt securities together instead of segregating them.

We recommend that traded and cleared derivatives be classified by contract type (*e.g.*, swap contracts, futures contracts, foreign currency contracts, options, etc.) instead of by the derivative underlie. Collection of the data as proposed would require additional resources and expense on an ongoing basis, including manual aggregation of data points. Please also provide clarification if options should be delta adjusted.

The Form should clarify that the definition of “notional value of derivatives” is intended to be the notional amount, not the notional amount net of mark-to-market. Using “notional amount” would be in line with current market practice and less burdensome for managers to calculate.

Question 23

The level of detail required in this question is generally more expansive than what is required for reporting in financial statements under U.S. GAAP, and in many cases fund managers do not track asset classes using the detail or categories described in this question. This question would

require a new, parallel method of tracking asset classes in addition to the methods fund managers currently use to comply with U.S. GAAP. We recommend using standard U.S. GAAP categories in this question rather than those proposed.

We recommend that managers report the net notional value of derivatives exposure, rather than gross notional. We recommend that the Commissions consider aggregating long and short positions.

It is difficult and burdensome to provide duration for each instrument type. We recommend that managers provide LMV and SMV by maturity buckets (*e.g.*, < 1 year, < 2 years, 2-10years, 10+ years). There should also be a separate category for short-term interest rate products.

Alternatively, we suggest that managers be permitted to provide LMV/SMV in 10-year equivalents using accepted methodology for doing so with appropriate additional disclosure, which will provide a more meaningful disclosure for positions with widely disparate durations. Managers should also be permitted to substitute DV01 or CR01 measures instead of calculating duration.

The question should clarify whether a rating refers to issues or issuers, and include a section for “non-rated” issues.

Cash and cash equivalents should be broader and include U.S. T-bills and short term high quality corporate debt. It should also allow for netting, otherwise the unencumbered cash calculation in Question 29 would be more useful.

Foreign exchange derivatives should exclude any positions which explicitly hedge foreign exchange risk in non-U.S. dollar denominated assets, which would be consistent with the FSA survey. Please indicate whether cross currency swaps be included under interest rate swaps or foreign exchange derivatives.

Question 24

We recommend that the Form request turnover by asset class. As proposed, certain assets, such as interest rate derivatives, could significantly outweigh other assets. The question should also exclude instruments that are used for cash management purposes such as U.S. T-bills and short term, high-quality corporate debt.

We propose using a 60 day average turnover rate where: $\text{Turnover rate} = (\text{traded GMV on day } t) / (\text{portfolio end of day GMV on day } t-1 \text{ plus portfolio end of day GMV on day } t)$.

Question 25

Clarification is needed for each asset class if the jurisdiction of organization of the issuer or counterparty should be used. We recommend using the jurisdiction of organization of the issuer because it would be more meaningful than the jurisdiction of organization of a counterparty. For example, while foreign exchange derivatives are categorized by reference to the underlying currency (or one of the underlying currencies if there is more than one), other derivatives are categorized by reference to the issuer’s or counterparty’s jurisdiction, as applicable. Is it intended that, for example, an interest rate swap in respect of an Asian rate curve executed with a European bank would be allocated to Europe, while a currency option in respect of any Asian currency, executed with the

same bank, would be allocated to Asia? In the alternative, managers should be permitted to report according to any internal methodologies to ensure that the results are meaningful.

Alternatively, we recommend that the geographic allocation is either presented as a percentage of capital allocated or permitted to be calculated separately by asset class, since, for example, interest rate derivatives would likely skew the geographic allocation and make the report less meaningful.

We recommend the following categories, based on Bloomberg's country of risk methodology: North America, UK, Europe ex UK, Japan, Pacific Rim, Asia ex Japan, Latin America, EMEA, and Offshore.

Question 27

We recommend that the Form include repos with borrowings. Given that repos are financing transactions, including them separately would result in double counting asset exposures.

The Form should clarify whether netting applies to non-U.S. currency holdings (*e.g.*, netting long/short euro balances in two accounts a given entity has with a broker, or netting long/short balances in a given currency held with two different brokers). In our view, the information would be less useful without information about a fund's non-U.S. dollar positions. Regulators would get a better sense for currency exposure from the sensitivity analyses requested later in the Form. Cash is not a particularly useful metric, unless it is viewed in conjunction with positional exposures, including foreign exchange forwards.

We recommend that the instructions clarify that managers may calculate responses to this question based on their own internal valuation methods, provided they are calculated in good faith and consistently across funds.

Question 28

The Form should indicate whether managers should define "portfolio" in terms of gross market value or capital. We recommend that the Form use the same liquidity periods as the FSA survey.

Question 29

Please clarify if overnight repos used for liquidity management should be included in unencumbered cash. We believe they should be included.

Question 30

We recommend that the definition of a "position" be further clarified. We also recommend this question be revised to include a threshold of 1% of the net asset value of the fund. As proposed, a large number of immaterial positions may be reported, which would obscure the actual diversification (or lack thereof) of the reporting fund. Please clarify whether foreign exchange positions should be netted.

Question 31

We note that the proposed numerator and denominator are different (*e.g.*, numerator would consider derivatives at notional value, and net asset value would incorporate them at balance sheet value). We recommend using gross market value as the denominator. Please also clarify whether options should be delta adjusted.

Also, the directions state that two or more positions in securities (or derivatives based on securities) of a single issuer should be treated as a single position. While this is appropriate for derivatives that are security-based derivatives, it is unclear as to how to handle derivatives based on broader measures, such as interest rates. For example should two positions that allow for receiving a fixed rate in U.S. dollars be aggregated, or only if the fixed rates and maturity dates are the same?

Questions 32 and 33

As you know, variation margin may be negative. The Form should focus on the equity exposure a fund has to each counterparty. The gross exposure under master agreements is not relevant because the structure of the master agreement is designed to codify the netting down of exposures.

The part of the question requesting the percentage of initial margin and independent amounts that the reporting fund has rehypothecated should be revised, since typically a hedge fund would not have rehypothecated initial margin. Also, managers generally are not able to calculate the percentage of variation margin that the reporting fund has rehypothecated since collateral is fungible.

The drop-down list should offer an “other” category for counterparties.

Please indicate whether repos and reverse repos be netted across counterparties or only within the same counterparty. In terms of repos, for initial margin and independent amounts, please clarify whether this is a haircut.

Question 34

Managers may not have easy access to the data requested by this question. For example, FCMs and DCMs typically stand between funds and central clearing counterparties (“CCPs”), and do not always provide a breakdown of the amount of fund assets held by the CCP. Generally fund managers look to the FCM or DCM as the firm to which the fund has the credit exposure. We recommend the Commissions consider removing or modifying this question.

Question 35

Many managers track risk exposure using metrics other than value at risk (“VaR”). We recommend this question be revised to ask simply if the manager tracks risk exposure, and if so, to choose the primary metric they use and answer questions similar to those provided with respect to VaR. For managers that do not use VaR to track risk but use another metric, the implications of answering “no” to this question are potentially misleading.

Question 36

Regulators should consider whether this question should request information in the aggregate.

The default rate category is not necessary, since the credit spread sensitivity should include that risk. If the default rate category is not removed, please indicate whether convertible bonds should be included in the “Default rates (corporate bonds)” section. Please also clarify whether CDS or CDX should be included in the default rate category.

Question 37

The Form should clarify whether borrowing includes short borrowing and synthetic borrowing. We note that the use of repos and reverse repo are in reference to the counterparty, rather than the fund. Please clarify the treatment of repos and reverse repos, and indicate the category for equity swaps.

This format is not practical for reporting of exposures in prime broker accounts. In many cases the manager cannot look at the straight borrowing amount after backing out derivatives positions that are in the prime broker accounts, and it will be very difficult for funds to segregate out physical and synthetic positions. We recommend that managers be permitted to look at the entirety of the fund's prime brokerage relationship when responding to the question. It would be more practical to report the amount borrowed as determined by the prime broker based on the entirety of transactions which reside in the prime broker account.

Additionally, the Form should allow managers to report the value of all collateral posted to the prime broker as a single number instead of differentiating types of collateral into three subcategories. Investment managers generally would not be able to determine the requested figures due to rehypothecation, the complexity of such calculations, and the lack of transparency of such calculations from prime brokers.

Question 38

We refer to Question 32 for our comment about rehypothecation. Please clarify if interest rate options and futures should be included in this section.

Additionally, the absolute value of notional values cannot meaningfully be compared to variation margin amounts. Variation margin is net across all positions (long and short) transacted under a master agreement and is based on fair market value. Perhaps both the notional values and net market values of derivative positions should be reported so that the evaluation of the initial and variation margin amounts, respectively, is more meaningful.

Finally, it is unclear how to report if a fund is a net receiver of collateral. Please indicate if collateral received should be positive and collateral posted negative.

Question 39

Uncommitted lines of credit may not be provided by the lender when requested by the borrower, and should not be included in this calculation.

Question 40

We recommend that this question be clarified to not include parallel funds or parallel managed accounts, as such funds or accounts may have different liquidity terms or gates than the reporting fund. Also, please clarify that this question should only apply to the largest class or most representative class of the reporting fund, as different classes may have different liquidity terms or gates. Attempting to aggregate different classes' liquidity terms for the purpose of this question would lead to varying reporting standards by different managers.

With respect to part (a), please explain whether “is subject to a ‘side pocket’ arrangement” refers to assets currently in a side pocket, or to the maximum percentage of assets a fund could place into a side pocket.

Question 41

We recommend revising this question to reflect expected investor liquidity assuming that 100% of the fund is subject to redemption. Otherwise, in order to provide the information requested, the calculations would require significant judgment and assumptions both among funds and reporting managers. If the question is maintained, we recommend altering the reporting categories to track those included in the FSA survey for consistency.

Question 55

This question does not appear to be applicable to liquidity funds, which invest in a portfolio of short-term obligations. Calculating estimates would be time-consuming and burdensome with limited benefit.



February 25, 2011

Via Electronic Filing:

The Honorable Timothy F. Geithner
Chairman
Financial Stability Oversight Council
1500 Pennsylvania, Ave., NW
Washington, DC 20220

Re: MFA Comments on Systemically Significant Institutions

Dear Secretary Geithner:

Managed Funds Association (“MFA”)¹ appreciates the opportunity to comment on the Financial Stability Oversight Council’s (the “Council”) notice of proposed rulemaking (the “Proposed Rule”) on the criteria that the Council should consider when determining whether to designate a nonbank financial company as systemically significant pursuant to section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).² We strongly support the goals of the Dodd-Frank Act in establishing the Council to address potential systemic risks before they arise, and mandating enhanced regulation of systemically significant financial companies. MFA also strongly supports efforts by regulators to gather data from different types of market participants, including investment advisers and the funds they manage, which is a critical component of effective systemic risk monitoring and regulation.

Overview

MFA believes that the Council should analyze financial institutions based on objective, quantitative data to determine which nonbank financial companies should be deemed systemically significant and, therefore, subject to supervision by the Board of

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.

² MFA also submitted a comment letter to the Council on November 5, 2010, in response to the Council’s Advance Notice of Proposed Rulemaking. A copy of MFA’s letter is available at: www.managedfunds.org.

Governors of the Federal Reserve System (the “Fed”). It is also critical that the Council’s determination process is transparent to the marketplace. Uncertainty regarding the criteria or designation of an overly broad set of firms could have profound unintended consequences for financial markets and the broader economy. Congress recognized the importance of avoiding an overly broad designation of systemically significant firms. The statutory text and legislative history of the Dodd-Frank Act clearly indicate Congress’s intention that the Council designate as systemically significant and regulate only those financial institutions that were previously considered “too big to fail,” *i.e.*, those companies that would threaten U.S. financial stability if they failed.³

In considering the potential systemic implications of hedge funds, we believe that it is important that the Council has a clear picture of the size, concentration, leverage and structure of hedge funds within the broader financial market. It is also vital that the Council consider the improvements made by hedge fund counterparties (banks and broker-dealers) over the last decade to risk management practices, as well as the new regulatory requirements mandated in Title IV and Title VII of the Dodd-Frank Act.

As discussed in greater detail in the sections below, hedge funds have the following characteristics, which should be considered by the Council in fulfilling its obligations under section 113 of the Dodd-Frank Act:

- The hedge fund industry – as well as individual firms and the funds they manage – are relatively small, in comparison to other financial market participants, the broader financial industry, and the financial markets in which hedge funds operate. Within the hedge fund industry, there is no significant concentration of assets under the management of any individual adviser or group of advisers.
- Hedge funds generally do not employ a significant amount of leverage and typically post collateral in connection with any leverage employed (whether it be via borrowing arrangements or derivatives contracts), thereby substantially reducing the risk to their counterparties.
- Capital invested in hedge funds is subject to limited redemption rights, which helps ensure a stable equity base and helps prevent runs on the fund’s cash/assets.

³ In a July 2007 report, the staff of the Federal Reserve Bank of New York offered a similar view of systemic risk, stating that a central element of systemic risk is “when financial shocks have the potential to lead to substantial, adverse effects on the *real* economy.” See, Kambhu, John, Schuermann, Til, and Stiroh, Kevin J., *Federal Reserve Bank of New York Staff Reports: Hedge Funds, Financial Intermediation, and Systemic Risk*, July 2007, page 10. Available at:

http://www.ny.frb.org/research/staff_reports/sr291.pdf.

- Hedge funds typically structure their borrowings to avoid a mismatch between their equity capital and investments on the one hand and their secured financing on the other hand.
- The enhanced regulation of hedge fund advisers and the markets in which they participate following the passage of the Dodd-Frank Act – including the substantially enhanced reporting requirements -- ensures that regulators will have a timely and complete picture of hedge funds and their activities.

Hedge Fund Industry Discussion

The Proposed Rule categorizes the statutory criteria set out in section 113 of the Dodd-Frank Act into six categories: size; lack of substitutes for the financial services and products the company provides; interconnectedness with other financial firms; leverage; liquidity risk and maturity mismatch; and existing regulatory scrutiny. Set out below is a discussion of key characteristics of hedge funds with respect to each of the categories proposed by the Council.

Size

Although the hedge fund industry is important to capital markets and the financial system, it is relatively small in size when considered in the context of the broader financial markets.⁴ For example, the hedge fund industry is significantly smaller than both the global mutual fund industry and the U.S. banking industry. The global mutual fund industry managed \$23.7 trillion in assets, as of September 30, 2010.⁵ The top 50 U.S. bank holding companies alone had \$14.4 trillion in assets, as of September 30, 2010.⁶ By comparison, the global hedge fund industry had an estimated \$1.9 trillion in assets under management, as of September 30, 2010.⁷

⁴ Our comments are intended only to provide perspective regarding the size and concentration of the hedge fund industry; we are not commenting on the systemic significance of other financial market participants or industries.

⁵ Source: Investment Company Institute, available at: http://www.ici.org/research/stats/worldwide/ww_06_10.

⁶ Source: Federal Financial Institutions Examination Council, available at: <http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx>.

⁷ Source: <http://www.marketwire.com/press-release/Combined-Assets-Billion-Dollar-Hedge-Funds-Nearly-Flat-First-Half-2010-AR-Magazine-Survey-1327660.htm>, citing *AR Magazine*, available at: <http://www.absolutereturn-alpha.com/>.

Lack of substitutes for the financial services and products the company provides

In addition to the relatively small size of the hedge fund industry as a whole, hedge fund assets are not heavily concentrated in any individual adviser or group of advisers, as illustrated by the fact that the largest hedge fund adviser manages assets equal to only approximately 3% of the entire hedge fund industry.⁸ Considering the fact that many advisers manage multiple funds, assets are even less concentrated when looking at asset concentration on a fund-level basis. The dispersion of assets among a broad group of advisers and funds significantly reduces the risk that the failure of any one fund or manager would create systemic risk due to a lack of substitutes. Indeed, each year, many hedge funds dissolve or fail for reasons as diverse as extended poor performance reducing their attractiveness to investors, the retirement or departure of senior personnel, or an investment strategy that no longer excels in a changed market environment. The fund's assets are sold, sometimes gradually over many months by the manager and sometimes suddenly in a "liquidation" mode by the prime brokers and exchanges with which the fund traded and that hold its collateral. This market discipline is a hallmark of the industry as funds and firms fail and other funds (existing or new) emerge.⁹ Moreover, because hedge funds are one of many different types of asset management structures, other investment managers also replace the services of failed hedge funds.

Interconnectedness with other financial firms

In considering the interconnectedness of financial institutions, we understand that Council members are looking at a firm's relationships within a structure of related businesses (sometimes referred to as "intraconnectedness") and the firm's relationships with third party institutions ("interconnectedness"). In considering the intraconnectedness of hedge funds, there are important structural factors to consider. The advisers (also frequently referred to as the managers) do not have substantial assets; though the principals of the adviser have personal capital invested in the funds they manage. It is the funds that hold the financial assets, that transact with trading counterparties on a collateralized basis, and to which investors commit capital. Accordingly, the risks and rewards of the funds' investment portfolios are borne by a diverse group of underlying sophisticated investors, institutions or ultra-high net worth individuals, who typically invest in hedge funds as part of a diversified portfolio. (Hedge funds neither transact with retail investors nor do they take in investments or deposits from retail investors.)¹⁰

⁸ Source: <http://www.finalalternatives.com/node/14018>, citing *AR* Magazine's Billion Dollar Club, available at: <http://www.absolutereturn-alpha.com/>.

⁹ According to a recent report from Hedge Fund Research, Inc., 945 hedge funds were formed in the most recent twelve-month period. Source: <http://www.reuters.com/article/2010/12/15/us-hedgefunds-launches-idUSTRE6BE48120101215>.

¹⁰ The MFA has consistently urged Congress and the SEC to raise investment thresholds to address the effects of inflation and to prevent hedge funds from becoming accessible to retail investors.

The adviser typically is not liable for the obligations of the fund, nor does the fund have responsibility for the liabilities of the adviser. This is one reason why, as recognized in the Dodd-Frank Act, the extent to which a financial institution manages assets owned by others rather than managing assets owned by the institution itself is a key consideration in whether a financial institution should be designated as systemically significant.

Another structural aspect of hedge funds is the legal separation of different funds managed by the same adviser. These legally distinct funds even when managed by the same adviser, often have different investors and can engage in entirely distinct trading activities in different assets and markets. Any losses at one fund are borne exclusively by the investors in and counterparties to that fund (though counterparty losses are typically limited for the reasons discussed below) and do not subject other funds managed by the same adviser directly to losses. Further, unlike related entities in a holding company or other similar structures prevalent elsewhere in the financial services industry, the different funds managed by a common adviser do not typically have the kind of intercompany loans or transactions that can create intraconnectedness and tie the risks associated with one company to other companies in the same ownership structure. Unlike bank holding companies and other nonbank financial institutions such as insurance companies, hedge funds engage in one distinct business – namely, making investments for investors in that specific fund, reducing the risk of contagion substantially.

The interconnectedness of hedge funds predominantly arises from the relationships between a hedge fund and its prime brokers or similar financial counterparties. It is through these relationships that hedge funds typically receive financing. Such financing is generally obtained from large, sophisticated financial counterparties, such as global banks or broker-dealers, that conduct substantial due diligence and engage in ongoing risk monitoring. 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.¹¹ In addition, this posting of collateral by hedge funds reduces the credit exposure of counterparty financial institutions to those funds. Consequently, hedge funds are substantially less likely to contribute to systemic risk by causing the failure of a systemically significant counterparty, such as a major bank. Given the limited leverage and the collateral posted by hedge funds, any losses that hedge funds incur are almost exclusively borne by their investors, not their creditors, counterparties, the general financial system, or taxpayers. Moreover, it is important to note that hedge funds often diversify their exposures across many counterparties, mitigating the risk that a fund poses to any one counterparty. For example, following the collapse of Lehman Brothers, many

¹¹ Various rules, for example, Regulations T, U and X with respect to securities, and regulations mandated under Title VII of the Dodd-Frank Act with respect to derivatives (discussed in more detail below), impose margin or collateral requirements, thereby restricting the amount of credit that a financial institution can extend to counterparties, including hedge funds.

large hedge funds increased the number of prime brokers they use, thus reducing their exposure to any individual prime broker.

Leverage

Though hedge funds are often mischaracterized as being highly leveraged financial institutions, the industry is, and has been, significantly less leveraged than other financial market participants. According to a recent Columbia University study, the leverage ratio of investment banks during the period from December 2004 to October 2009 was 14.2, with a peak of 40.7 for investment banks in 2009, and the leverage ratio of the entire financial sector during that period was 9.4.¹² By comparison, this study found that the leverage ratio for the hedge fund industry was 1.5 as of October 2009, with an average ratio of 2.1 from December 2004 to October 2009, and a high of 2.6.

The findings of the Columbia University study with respect to the leverage ratio of the hedge fund industry are consistent with other studies, which report leverage ratios below 3.0 for an extended period of time. The United Kingdom's Financial Services Authority (the "FSA") has conducted several studies on the hedge fund industry, most recently finding a leverage ratio of 272% [2.72], as of April, 2010 and a leverage ratio of 244% [2.44], as of October, 2009.¹³ A 2009 study by Lord Turner, then Chairman of the FSA, found that the leverage ratio of the hedge fund industry since 2000 has been two- or three-to one.¹⁴ A Bank of America Merrill Lynch study found the leverage ratio for the industry was 1.16 as of July, 2010.¹⁵ Each of these studies demonstrates that the hedge fund industry has consistently employed relatively low levels of leverage.

Liquidity risk and maturity mismatch

¹² Hedge Fund Leverage, available at:
<http://www2.gsb.columbia.edu/faculty/aang/papers/HFLeverage.pdf>.

¹³ FSA studies, Assessing possible sources of systemic risk from hedge funds, February 2010 and July 2010 (the "FSA Hedge Fund Studies"), available at:
<http://www.fsa.gov.uk/pages/search/index.shtml?cx=007702012814746907219%3An6pltugvaoc&cof=FO RID%3A9&ie=UTF-8&q=hedge+fund#1327>.

¹⁴ The Turner Review, A regulatory response to the global banking crisis, March 2009, available at:
http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

¹⁵ Available at: <http://www.reuters.com/article/idUSTRE67G28220100817>.

The above studies use different formulas for calculating leverage ratios, which explains the slight differences in leverage ratios determined by each study. Our purpose in this letter is not to endorse any particular formula, but to demonstrate that the leverage ratios for the hedge fund industry are significantly less than the ratios for many other types of financial institutions.

Unlike many other financial market participants, hedge funds do not rely on unsecured, short term financing to support their investing activities. Instead, hedge funds rely on secured borrowings, which are designed to more closely match the term or expected liquidity of the asset and the financing which funds it. Without the benefit of a federal safety net, the industry has evolved carefully crafted practices to manage liquidity risk.¹⁶ The FSA Hedge Fund Studies confirm these practices, finding that the assets of the surveyed hedge funds could be liquidated in a shorter timeframe than the period after which their liabilities (to investors and finance providers) would become due.¹⁷

There are two sources of funds for a hedge fund: its investors and its bank/broker counterparties. As discussed above, the financing from counterparties is secured by collateral and inherently limited both by regulation and by the sophisticated counterparties' risk analysis. Most hedge funds build strong liquidity protections into their contractual relationships with investors who are subject to a variety of restrictions, including: limited periods of redemption (sometimes monthly, but more often quarterly, annual, or longer); significant advance notice requirements (often 30 to 90 days) prior to the requested withdrawal dates; the right of advisers to impose gates to manage outflows or even suspend redemptions (at the investor and/or the fund level), if deemed necessary; and side pocket vehicles for highly illiquid assets that allow redemptions only when realizations occur. These liquidity provisions help reduce the likelihood that redemptions of investor capital will be disruptive to a fund or to markets over extremely short periods of time, because they allow advisers to better match the assets and liabilities of the funds they manage and to manage orderly outflows of investor funds.

Moreover, the principals of hedge fund advisers also typically invest significant amounts of their own capital in the funds they advise, which provides an even greater capital cushion for the fund's business and promotes an alignment of interests between management and investors. The structure of performance incentives earned by hedge fund advisers, in which advisers earn a significant portion of their income by receiving a percentage of the gains of the funds they manage, also serves to align the interests of the adviser and the investors by encouraging the adviser to manage the funds with the objectives of generating attractive risk-adjusted returns over time and discouraging excessive short-term risk taking.

Existing regulatory scrutiny

The Dodd-Frank Act imposes a variety of regulations to ensure appropriate oversight of hedge funds and their advisers. Following passage of the Dodd-Frank Act,

¹⁶ See, MFA's Sound Practices for Hedge Fund Managers, available at: www.managedfunds.org; see, also, the President's Working Group on Financial Markets' Asset Managers' Committee report: Best Practices for Hedge Fund Managers, available at: <http://amaicmte.org/Public/AMC%20Report%20-%20Final.pdf>.

¹⁷ See, FSA Hedge Fund Studies.

all hedge fund advisers with at least \$150 million in assets under management will be required to register with the Securities and Exchange Commission (the “SEC”).¹⁸ Registered advisers are required to maintain books and records, make reports to the SEC, and are subject to examination by the agency. Congress specifically amended the Investment Advisers Act of 1940 to provide that the recordkeeping and reporting requirements for hedge fund advisers apply to the funds as well as the adviser.¹⁹ The Dodd-Frank Act also explicitly provides that data collected by the SEC for systemic risk purposes will be shared with the FSOC. The SEC and the Commodity Futures Trading Commission (the “CFTC”) recently proposed joint rules creating new Form PF to implement very detailed reporting requirements for private fund advisers and commodity pool operators.²⁰ As a consequence, the SEC, CFTC, and the Council will have comprehensive access to information about hedge fund advisers and the funds they manage.

The Dodd-Frank Act also creates a comprehensive regulatory regime for over-the-counter derivatives where none existed previously. These new regulations: (1) require certain standardized transactions to be cleared and exchange traded;²¹ (2) require “Swap Dealers” and “Major Swap Participants” to register with the SEC and CFTC, and subjects them to significant requirements; (3) impose initial and variation margin requirement on both cleared and uncleared transactions; and (4) provide for significant incremental transparency, including transaction reporting, to market participants and regulators. These rules will significantly reduce the potential for systemic risk involving the derivatives markets and their participants, such as hedge funds. For cleared swaps, central counterparties possess the ability to manage their risks by imposing margin requirements and other risk mechanisms that limit their exposure to potential losses from defaults by members and participants. The margin requirements must be sufficient to cover potential exposures in almost all market conditions. These provisions are well designed to ensure that central counterparties’ operations would not be disrupted and non-defaulting members would not be exposed to unexpected losses.

In addition, the Dodd-Frank Act mandates increased supervision of banks and broker-dealers, incorporating enhanced review of counterparty exposure and other risks associated with the prime brokerage and over-the-counter derivatives businesses. This provides regulators with critical information regarding an institution’s aggregate exposure to individual hedge funds as well as the hedge fund industry as a whole.

¹⁸ See sections 403 and 408 of the Dodd-Frank Act.

¹⁹ See section 404 of the Dodd-Frank Act, amending Section 204 of the Investment Advisers Act.

²⁰ Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, available at: <http://sec.gov/rules/proposed/2011/ia-3145.pdf>.

²¹ See *e.g.*, section 723 of the Dodd-Frank Act.

Changes in the Industry since 1998

The failure of Long Term Capital Management (“LTCM”) in 1998 is often cited as an example of a hedge fund that created a systemic risk to the financial system. First, it is important to note that the failure of LTCM did not result in any use of taxpayer funds. Regulators helped coordinate LTCM’s financial counterparties, who worked out a private sector resolution of the firm’s liabilities. But at no point were government funds offered or used. Lessons were learned, however, by both market participants and regulators, which have led to sounder practices. The resulting changes may be one of the reasons that hedge funds were not substantial contributors to the recent global financial crisis.

LTCM’s excessive position size and leverage, along with its counterparties’ inadequate risk management were the primary underlying causes of LTCM’s failure. The seminal analysis of the matter, conducted by the President’s Working Group on Financial Markets (the predecessor to the Council), found that LTCM, as of January 1, 1998, was leveraged more than 25-to-1,²² as compared to the 2.6-1 peak leverage ratio for the hedge fund industry during the period from December 2004 to October 2009.²³ Perhaps most importantly, the President’s Working Group found that LTCM was able to get such leverage because its counterparties did not require LTCM to post initial margin on its OTC derivatives trades.

Since the failure of LTCM, however, there have been significant changes in the market with respect to counterparty risk management. Counterparties now consistently limit the amount of leverage used by hedge funds by requiring the use of collateral to secure financing to hedge funds. Also, as a result of improvements to counterparty risk management best practices, financial institutions today conduct more in-depth due diligence on and have a much greater degree of transparency with respect to their hedge fund clients’ overall portfolios. Many of these changes have been brought about by the work done by the Counterparty Risk Management Policy Group.²⁴ In 2006, Federal Reserve Chairman Bernanke noted the improvements in the market place:

Since the LTCM crisis, ongoing improvements in counterparty risk management and the resultant strengthening of market discipline appear to have limited hedge fund leverage and improved the ability of banks and broker-dealers to monitor risk, despite the rapidly increasing size, diversity, and complexity of the hedge fund industry. Many hedge funds

²² Hedge Funds, Leverage and the Lessons of Long-Term Capital Management, Report of The President’s Working Group on Financial Markets, April 1999 available at: <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf>.

²³ See the discussion in the section above regarding the leverage of the industry.

²⁴ Copies of the reports are available at: <http://www.crmpolicygroup.org/index.html>.

have been liquidated, and investors have suffered losses, but creditors and counterparties have, for the most part, not taken losses.²⁵

In summary, MFA believes that, in considering hedge funds in light of the six categories set out in the Proposed Rule, it is unlikely that the failure of any hedge fund or hedge fund manager would have systemic implications. While we support the collection of information about hedge fund investment activity and the direct regulation of hedge fund advisors, we do not believe it would be appropriate to designate any hedge fund as a systemically significant nonbank financial company.

Process for public engagement with the Council

By grouping the statutory criteria into six categories, the Proposed Rule provides some clarity with respect to how the Council plans to analyze market participants. The Proposed Rule does not, however, discuss the risk metrics that will be used to analyze market participants or how the various criteria or categories will be weighed. We believe that both the risk metrics and weighting of the criteria are critical components of the Council's rules for implementing section 113 of the Dodd-Frank Act. As such, we believe that the metrics and weighting should be proposed by the Council for public review and comment. A public review and comment period will provide the Council with valuable feedback and, importantly, will help ensure that market participants understand how the Council will make a determination that a firm is systemically significant.

The Proposed Rule also sets out the formal process by which a market participant can request hearings with the Council and seek judicial review prior to being subject to supervision by the Fed as a systemically significant financial institution. We understand that the time periods for this formal process were set by the Dodd-Frank Act and provide limited flexibility for the Council in implementation. We encourage the Council to provide market participants the maximum amount of time permitted under the statute and the proposed rule to exercise their rights to hearings and judicial review. We further encourage the Council to provide firms that request hearings the opportunity to provide both written and oral testimony, if they so request.

We appreciate the Council's proposal to provide a mechanism for dialogue between the Council and market participants in advance of the formal designation process. As contemplated by the Proposed Rule, market participants would have 30 days to submit written materials to the Council prior to the Council beginning the formal designation process. In addition, we encourage the Council to engage in regular dialogue with market participants regarding relevant industry and market practices and, when

²⁵ Speech by Chairman Ben S. Bernanke, *Hedge Funds and Systemic Risk*, May 16, 2006. Available at: <http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm>.

appropriate, firm-specific practices. Such regular dialogue will better ensure that the Council has a full and complete understanding of markets and market participants. Regular dialogue with market participants may also help avoid the potential misperception and dampen rumors that any firm that engages with the Council is likely to be designated as systemically significant.

As the Council increases its understanding of industry segments and participants, we encourage the Council to provide guidance regarding specific metrics that it believes could make a firm or a fund systemically significant. Guidance, even if not a bright line test, would provide greater certainty to market participants and allow them to proactively manage their business risks.

Coordination among member agencies

We believe it is important for the Council to coordinate the designation process with existing and proposed data collection efforts to avoid unnecessary duplication of efforts and to ensure that Council members have comprehensive information about markets and financial institutions when they undertake their monitoring and designation responsibilities. As discussed above, the SEC and CFTC have proposed extensive systemic risk reporting to collect a significant amount of information from private fund advisers and the funds they manage. We have worked with them since the passage of the Dodd-Frank Act to develop these tools, and will be submitting detailed comments to help them refine the survey tool. We support the SEC's and CFTC's data collection efforts and believe that a coordinated approach with Council members (and the Office of Financial Research) will be the most effective and efficient method for the Council and Council members to gather and analyze information about private funds. Multiple data collection reports are not only a significant burden for the industry, but likely to create duplicative or inconsistent reports, which could make it more difficult for regulators to analyze information. While we recognize that there may be circumstances when it will be necessary for regulators to collect additional information, we encourage the Council and its members to coordinate to the greatest extent possible data collection efforts.

Additionally, as the Council begins its research, we stand ready to assist in providing information about the industry and convening educational sessions for Office of Financial Research staff or staff from Council member agencies to learn more about the hedge fund industry and delve into the issues we have discussed in greater detail. Given the potential for rumors about designation of any single firm to potentially harm such a firm, we encourage the Council to conduct its research through the MFA or other similar organizations to the extent possible, particularly in these early stages.

We are happy to work with the Council to expand upon the thoughts outlined above or to discuss further any of the criteria in the Dodd-Frank Act.

Conclusion

We believe that, in light of the structure of hedge funds and the market and regulatory changes regarding counterparty risk management, leverage and use of collateral, as described above, applying the criteria in section 113 and the six categories set out in the Proposed Rule to hedge funds should lead to the conclusion that it is highly unlikely that any hedge fund is systemically significant at this time. We recognize, however, that circumstances can change and that there is a possibility that a hedge fund may, in the future, become systemically significant.

We support robust reporting requirements to regulators (with appropriate confidentiality protections) to ensure that regulators have the information they need to assess all financial market participants, including hedge funds. Such periodic assessments, combined with oversight from the relevant regulators would help the Council assess whether circumstances have changed and that the Council should re-evaluate whether a hedge fund might have become systemically significant.

MFA appreciates the opportunity to comment on the Proposed Rule. We recognize that the Council has an ongoing responsibility to monitor and assess the systemic risk of market participants and we look forward to continuing the dialogue on this subject with the Council.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other regulatory issues, please do not hesitate to contact Stuart J. Kaswell or me at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

CC: The Honorable Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation
The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System
Edward J. DeMarco, Acting Director, Federal Housing Finance Agency
The Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission
The Honorable Debbie Matz, Chairman, National Credit Union Administration
The Honorable Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission
John Walsh, Acting Comptroller of the Currency