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

May 31, 2011

Via Electronic Mail: rule-comments@sec.gov

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

Re: Managed Funds Association Comments on Incentive-Based Compensation Arrangements; File No. S7-12-11

Dear Ms. Murphy:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the joint proposed rules, "Incentive-Based Compensation Arrangements" (the "Proposed Rules"), issued by the Securities Exchange Commission (the "SEC") and other federal regulatory agencies (together the "Joint Agencies").[2] We recognize that Congress in enacting Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") directed the Joint Agencies to issue rules or guidelines to limit incentive-based compensation arrangements that could pose systemic risks or that could threaten the safety and soundness of covered financial institutions. We encourage the SEC to adopt rules or guidelines that are designed to achieve these objectives while avoiding the potential for adverse unintended consequences from overly broad or overly prescriptive rules.

[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] The other agencies include the: Office of the Comptroller of the Currency; Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); National Credit Union Administration (NCUA); and Federal Housing Finance Agency (FHFA).

Overview

Section 956 of the Dodd-Frank Act was intended to address incentive-compensation arrangements that could have serious adverse effects on economic conditions or financial stability or that could threaten the safety and soundness of a financial institution. In considering the concern about how incentive-based compensation may affect the safety and soundness of financial institutions, policy makers recognized that financial institutions and their employees are required to take risks and that the provisions of Section 956 are not intended to prevent risk taking activities. Policy makers expressed a narrower concern regarding incentive-based compensation arrangements that reward upside performance with no risk of loss for an employee if the financial institution suffered losses (the so-called "heads I win, tails I break even" situation).

As discussed in more detail below, we believe the structure of hedge fund advisers and the compensation structure for adviser employees are well designed to promote sound risk management and avoid the concerns that Congress sought to address in enacting Section 956 of the Dodd-Frank Act. Further, we believe that hedge funds comprising the industry as it stands today do not pose systemic risk, although regulators should and will consider this issue and revisit it periodically over time.

We are concerned that the Proposed Rules go beyond the scope of entities and compensation arrangements that Congress sought to include under Section 956 of the Dodd-Frank Act. We are also concerned that the overly broad scope of the Proposed Rules could unintentionally create disincentives for advisers to maintain current practices that promote sound risk management and align the interests of advisers, adviser employees and fund investors, a result that would be contrary to the policy goals underlying the Proposed Rules. Accordingly, we encourage the SEC to consider amending the Proposed Rules as discussed below, which we believe would better address Congress's intent in enacting Section 956 while avoiding the potential adverse consequences that could result from certain of the provisions in the Proposed Rules.

Background Discussion on Hedge Fund Industry

Structure of hedge fund adviser compensation

Unlike many banks and other large financial institutions, hedge fund advisers are typically privately owned and, therefore, do not have public shareholders. Moreover, the principals who own the hedge fund adviser are also typically senior management of the adviser with primary responsibility for the portfolio management activities and oversight of other employees of the adviser. Unlike financial institutions with public shareholders, therefore, management and ownership of hedge fund advisers are integrated, not separated. This integration of ownership and management ensures an alignment of interest, which provides strong incentives to appropriately manage risks.

The revenue model for hedge fund advisers also is distinct from that of many other financial institutions. Hedge fund advisers do not generate revenue by trading their own assets; they generate profits by receiving management and performance fees for successfully managing client assets. The incentive-based compensation earned by senior employees of hedge fund advisers is tied to the performance fees generated by the adviser and those fees are fully disclosed to investors in the funds. Further, because the principals of the hedge fund adviser typically have significant amounts of their own capital invested in the funds they advise, and because the performance fees earned by the adviser typically are subject to high-water marks,[3] the fee structure for advisers is designed to encourage generating long-term risk-adjusted returns and to discourage excessive short-term risk taking.

Hedge funds do not currently pose systemic risk

The Financial Stability Oversight Council (the "Council") has issued proposed rules that create six categories the Council will consider in determining whether a financial institution should be designated as systemically significant -- 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.[4] For the reasons discussed below, in considering these six categories as regards the hedge fund industry, we believe it is unlikely that the failure of any hedge fund or hedge fund manager would have systemic implications.

- Small firm and industry size: 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.
- Plenty of substitutes as asset managers in market: 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. Moreover, because hedge funds are one of many different types of asset management structures, other investment managers are available to replace the services of failed hedge funds
- Low financial leverage: Hedge funds generally do not employ a significant amount of leverage and typically post collateral in connection

[3] High-water marks are part of the performance fee structure and prevent a hedge fund adviser from collecting a performance fee unless the investors in the fund have recouped prior losses. They ensure that an adviser collects a performance fee only when it has generated net, long-term profits for its investors.

[4] Notice of Proposed Rulemaking Regarding Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies 76 Federal Register 4555 (January 26, 2011).

with any leverage employed (whether it be via borrowing arrangements or derivatives contracts), thereby substantially reducing the risk to their counterparties.

- Low interconnectedness: Hedge funds generally do not have financial relationships with large numbers of counterparties throughout the market, concentrating their trading positions with a relatively small number of firms that are likely to themselves be regulated as systemically significant. The government, by regulating such firms, will effectively be able to control hedge fund risk to the broader financial markets indirectly.
- "Stickiness" of capital sources prevents liquidity risk and maturity mismatches: Equity capital invested in hedge funds is subject to limited redemption rights, which ensures a stable equity base and prevents redemption-forced liquidations of investment portfolios. Debt capital provided to hedge funds by prime brokers is overcollateralized by assets under the control of the lending parties, giving them economic comfort that will further assist in preventing forced liquidations.
- Enhanced regulation post Dodd-Frank: The greater supervision and more intensive 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.

Coordination with Tax Code

Rules changing the ways in which private fund advisers can compensate employees could have tax consequences for all of advisers, employees and investors in U.S. private funds. We encourage the SEC to coordinate with the Internal Revenue Service to avoid unintended adverse consequences that could result from the proposed rules.

Proposed changes to the Proposed Rule

Excluding Assets under Management

Section 956 of the Dodd-Frank Act exempts from the requirements of that Section covered financial institutions that have assets of less than $1 billion. We believe the Proposed Rules' approach of excluding client assets under management in calculating the assets of investment advisers is the appropriate method to implement the statutory exemption. The provision in the Proposed Rules that would measure an adviser's assets based on its consolidated balance sheet, however, would have the unintended consequence of effectively counting assets under management for certain advisers to private funds. As a result, we believe the proposed approach would include financial institutions that are statutorily exempt from the provisions of Section 956 of the Dodd-Frank Act. To better tailor the scope of entities subject to the rule, we urge the SEC to

clarify that assets managed on behalf of clients, including through pooled investment vehicles managed by the adviser, will not be included in the calculation of an adviser's assets, even if those client assets might be included on the adviser's consolidated balance sheet under certain accounting principles.

Calculation of Adviser Assets

We believe that the asset test should be based on the net assets of the adviser and not the adviser's gross assets, as an adviser's net assets are a better reflection of the true economic size of the adviser. To the extent the SEC does not use a net asset test, we believe that the SEC should exclude for purposes of the $1 billion threshold assets set aside for deferred compensation of employees that has been earned or accrued. We believe deferred compensation should be excluded from the asset test whether it is tied to the adviser or to a pooled investment fund managed by the adviser. Deferral of compensation can be a valuable risk management tool for advisers, which is one of the policy goals of the Proposed Rules. Further, we believe that assets invested in funds managed by the adviser should not be counted toward the threshold. These investments serve to align the interests of the adviser and investors, which encourages advisers to seek prudent long-term, risk-adjusted gains and avoid inappropriate short-term risk taking. Including assets set aside for deferred compensation or assets invested in funds managed by the adviser would create a disincentive for advisers to use these mechanisms, which seems contrary to the intended objectives of the rules.

Scope of Covered Persons

We believe that payments tied to a person's ownership stake in a hedge fund adviser should not be deemed incentive-based compensation under the Proposed Rules. Treatment of these types of payments as compensation would unfairly subject the owners of one type of business structure to restrictions on their ownership interests. We encourage the SEC to clarify in its final rule release that such payments are not subject to the provisions of the rules.

We also believe that the Proposed Rules should not apply to employees of a hedge fund adviser who have substantial ownership directly or indirectly in a fund managed by the adviser. An employee who has a substantial investment in a fund managed by the adviser faces downside risk with respect to losses on his or her investment, same as other investors in the fund. This alignment of interests between investors and adviser employees promotes sound risk management because such employees are rewarded for producing net, long-term, risk adjusted profits and suffer losses from negative performance. As such, the incentive-based compensation agreements with these employees do not create the "heads I win, tails I break even" situation that was a concern of policy makers.

Grandfathering Provision

In addition, we note that the Proposed Rules apply to incentive compensation arrangements "established or maintained" by a covered financial institution. We request that the SEC clarify that the requirements of proposed rule 205 will be applied prospectively, and not retroactively to compensation that has been previously awarded but not paid, or to compensation subject to existing employment agreements. If the SEC determines not to exclude compensation subject to all existing employment agreements, we believe it should at least exclude compensation awards or subject to existing employment agreements if the compensation is tied to the profitability or ownership of the adviser.

Timing of Calculation

We encourage the SEC to modify the Proposed Rules to base the asset test on an average of multiple dates in a calendar year, rather than a single snapshot. An average of multiple dates or an average over a period of time is likely to provide a better reflection of the adviser's financial position than a single snapshot.

Adjustment for Inflation

We believe it is important that the $1 billion and $50 billion thresholds be adjusted over time to account for the effects of inflation and the growth of capital markets. Without appropriate adjustments over time, the threshold will become outdated and capture additional firms whose size relative to the size of capital markets has not increased. Accordingly, we encourage the SEC to amend the Proposed Rules to include a requirement that the asset threshold be adjusted for inflation and the growth of capital markets.

Principles-Based Approach

In addition to consideration of the scope of entities subject to the incentive-compensation rules, we believe it is important for the SEC to consider issuing the rules as guidelines, as permitted by the statute, or to adopt a principles-based approach to implementation and enforcement of the rules. In light of the differences in business models and the risks associated with those businesses, we believe it would be difficult to adopt prescriptive rules that are appropriate for all types of covered financial institutions. Prescriptive rules are also more likely to cause unintended consequences, including the possibility of restricting or altering compensation structures of hedge fund advisers that promote sound risk management and alignment of interests with investors. Accordingly, we encourage the SEC to adopt a principles-based approach that is consistent with the statutory mandate.

Conclusion

MFA appreciates the opportunity to comment on the Proposed Rules. We are concerned that the Proposed Rules could have significant unintended consequences if adopted as proposed. We encourage the SEC to modify the Proposed Rules as discussed above, which we believe would address the policy concerns underlying Section 956 of the Dodd-Frank Act while minimizing the potential for unintended, adverse consequences.

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