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

May 13, 2010

**Via Electronic Mail:**

The Honorable Christopher J. Dodd
Chairman
Committee on Banking,
Housing, & Urban Affairs
U.S. Senate
448 Russell Senate Office Building
Washington, D.C. 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking,
Housing, & Urban Affairs
U.S. Senate
304 Russell Senate Office Building
Washington, D.C. 20510

**Managed Funds Association Comments on the "*Restoring American Financial Stability Act of 2010*"**

Dear Chairman Dodd and Ranking Member Shelby:

Managed Funds Association[1] would like to provide comments with respect to the "Restoring American Financial Stability Act of 2010" (the "Bill"). We strongly support the goals of the Bill – promoting greater transparency in the financial system; establishing a systemic risk regulator to address potential systemic risks before they arise; instituting a framework for prudential regulation of systemically significant firms with specialized unwind authority; requiring registration of investment advisers to private funds; enhancing investor protections; and establishing a comprehensive system for the regulation of the over-the-counter ("OTC") derivatives markets. We believe that overall the Bill will achieve these goals and help protect the U.S. financial system from future economic crises; however, we have remaining concerns with respect to certain of the various regulatory provisions applicable to hedge funds and hedge fund advisers, which we discuss below.

Before doing so, I believe it is important to underscore the comprehensive and robust nature of the regulatory framework that will apply to hedge funds and their advisers under this Bill. Hedge fund advisers will be required to register with the SEC under the Investment Advisers Act of 1940. The responsibilities that will be imposed on hedge fund advisers by the Investment Advisers Act of 1940 entail significant disclosure and compliance requirements, including: publicly available disclosure to the SEC regarding the adviser's business; extensive systemic risk reporting to the SEC; detailed disclosure to clients; policies and procedures to prevent insider trading; maintaining extensive books and records; and periodic inspections and examinations by SEC staff.

[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 $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

The Bill establishes a heightened, prudential regulatory framework for systemically relevant banks and non-bank financial firms. The systemic risk regulator will have access to industry data through the SEC and directly as part of its mandate to monitor market activity.

The Bill also creates a comprehensive regulatory system for OTC derivatives markets, including strong, prudential regulation of major swap participants (including non-banks), enhanced disclosure and transparency requirements and mandatory central clearing of many OTC derivatives products.

Each of these areas of regulatory reform will significantly increase oversight and regulation of hedge funds and hedge fund advisers, and will require industry participants to allocate significant time and resources, at a meaningful cost, to legal and regulatory compliance. Regulators, in turn, will have access and authority to review, regulate, and if necessary, intervene in the business activities of these firms. As an industry, we have been supportive of these enhanced steps.

We believe that many of the provisions in the Bill take an "intelligent" approach to regulatory reform. We have concerns, however, with respect to certain of the various regulatory provisions as they apply to hedge funds and hedge fund advisers, which are set out below.

**Key Concerns**

**Definition of Major Swap Participant**. We support the basic structure of the Bill, which would create a broad regulatory framework for the OTC derivatives markets, similar to that of other financial markets. This framework includes the regulation of dealers, exchanges, and clearing houses and regulation of the markets, including the establishment of margin rules and general rules of conduct to protect less sophisticated participants. Nonetheless, we are concerned about a provision of the Bill that would subject certain non-dealer market participants to special regulation as major swap participants ("MSPs"). We believe this provision is overly broad. We support the regulation of non-dealer market participants without a federal financial regulator (such as AIG) whose OTC derivatives positions would expose both their counterparties and the broader financial system to substantial risk in the event of default. However, we believe that the current definition of MSP would include market participants, such as private funds, that do not pose such "AIG-like" risks to their counterparties or the marketplace, because they already secure their OTC derivatives contracts with margin. We believe that the goals underlying the regulation of MSPs will be accomplished with respect to non-dealer market participants that are already federally regulated and, therefore, we do not believe that this additional layer of regulation is necessary. We are also concerned about adding substantial reporting requirements that could overwhelm the regulatory agencies with information that obscures, rather than helps identify, potential systemic risks in the OTC derivatives markets.

In our view, the Bill should not provide a blanket exemption based on firm type or the nature of a firm's activities from the requirements on MSPs. Such an exemption could result in the accumulation of inappropriate levels of risk in the financial system from the next AIG. We also believe that the Bill needs to take into account other regulatory requirements that it would impose on market participants. For that reason, we believe that the definition of MSP should focus on market participants without a primary federal financial regulator: (1) that have substantial net positions, exposing their counterparties to risk of loss; and (2) whose default on those positions would pose systemic risk to the broader market. Accordingly, we believe that private funds, given the new,

extensive SEC regulatory authority, should not fall within the definition of MSP as long as they post the margin required by the OTC regulators for their OTC derivatives positions.

Additionally, we believe that regulators should have explicit authority to tailor their prudential regulations in light of the risks and nature of the diverse non-bank firms being regulated. For example, the Bill currently requires regulators to impose capital restrictions on MSPs. Capital requirements, which are appropriate for banks and other depository institutions, protect counterparties and the system from risk of loss in the event of a bank or depository institution's failure. In contrast, non-bank entities such as private funds currently post margin with their counterparties at levels that reflect each fund's credit risk. It would be duplicative and unnecessary for regulators to impose both capital and margin requirements on private funds. Accordingly, we believe that legislation imposing bank-like capital requirements on these funds (or their advisers) would be inappropriate and misplaced.

**Confidentiality of Systemic Risk Reports**. We support systemic risk reporting by private funds to the Systemic Risk Council and the Office of Financial Research. However, given the sensitivity of the information to be provided and the potential for serious harm to a financial company if that information were to be disclosed, we believe that proprietary information reported under Title I should be subject to strong confidentiality protections. We are concerned that the Bill fails to provide adequate protection of proprietary information provided to the Systemic Risk Council and the Office of Financial Research under Title I. We believe that proprietary information reported to these entities should have the same protections as proprietary information provided to the SEC in systemic risk reports under Title IV of the Bill. We also are concerned with language in Title I that would subject reported information to FOIA, as this could subject regulated firms to having their proprietary information publicly exposed to competitors. The failure to equalize the legal standards of the two titles could substantially complicate regulators' ability to obtain and share information and would expose private sector firms unnecessarily to varying levels of protection.

**Application of Bank-like Regulation to Funds and Advisers**. We support enhanced regulation of systemically relevant, non-bank financial companies and believe that regulators should have both the authority and flexibility to tailor regulations to these participants. As such, mandatory, bank-like regulation of investment funds and advisers, such as capital requirements, advance notice requirements to be able to acquire securities, and restrictive credit concentration limits, are misplaced when applied to investment firms. They fail to take into account the nature of these firms' businesses (which acquire securities as a core function, for example) and could effectively preclude them from operating. We believe that regulators should have the discretion and flexibility to tailor regulatory requirements so that they are appropriate for different business models.

**Definition of Client**. The Bill provides the SEC with broad authority to define the term "client", except for certain anti-fraud provisions of the Advisers Act. For advisers to private funds, the adviser-client relationship is between the adviser and the fund, not between the adviser and specific investors in any fund. This relationship is a key characteristic of pooled vehicles, as distinguished from individual advisory relationships. We recognize and strongly support the fiduciary obligations that investment advisers owe their clients. However, we have concerns about expanding the definition of client to include investors in private funds, as advisers would be subject to irresolvable conflicts if they were required to manage a pooled investment in the interests of individual investors. We are concerned that the Bill's narrow limitation on the definition of client does not adequately address this issue. Defining "client" to include investors for other purposes of the Advisers Act would still subject

advisers to irresolvable conflicts of interest, particularly with respect to state law and common law requirements, which the Advisers Act definitions may trigger.

**Consumer Financial Protection Bureau (the "CFPB").** The Bill clearly intends to establish the CFPB to regulate retail consumer products (*e.g.*, credit cards, mortgages) and provides that entities regulated by the SEC or the CFTC will be outside of the scope of the CFPB. As drafted, however, only entities that are registered with the SEC qualify for this exemption. As a result, registered investment advisers and registered investment companies are outside of the scope of the CFPB, while private funds remain within the scope of the Bureau, despite the fact that private funds are not, and legally may not be, marketed or sold to retail customers. Given the stated intent of the CFPB, we believe that private funds should be excluded from the scope of the CFPB.

**Regulation D Offerings**. We support the goal of ensuring appropriate regulatory oversight over private offerings and believe that goal is best achieved by focusing the SEC's resources on larger offerings and authorizing the SEC to delegate oversight over smaller offerings to state regulators. We believe this approach is consistent with the approach taken in the National Securities Markets Improvement Act of 1996. We are concerned about provisions in the Bill that would subject large, private offerings that are national in scope to regulation on an ongoing basis by numerous state regulators, even if the SEC subsequently conducts its oversight responsibility after the initial time period specified in the Bill. We believe the Bill should focus on ensuring appropriate SEC oversight of private offerings, and should not subject market participants that have fulfilled their filing obligations to the unfair consequence of having to comply on an ongoing basis with myriad state requirements because of a delay in federal regulatory attention.

**Swap-Dealer Fiduciary Duty**. We support ensuring that financial institutions meet appropriate standards of conduct in conducting their businesses. We are concerned, however, with provisions in Sections 731 and 764 of the Bill, which would impose fiduciary obligations on a swap dealer entering into a swap with a pension plan, endowment or retirement plan (collectively, "Plans"). As drafted, these provisions could effectively preclude Plans from entering into swaps to hedge their risks, because of legal restrictions on a Plan entering into transactions with fiduciaries to the Plan. We are also concerned that the broad language in the Bill could have the unintended consequence of effectively precluding pooled investment vehicles, such as private funds, that have Plan investors from entering into swap agreements with swap dealers. We believe the provisions should specify that the standard of conduct being applied to swap dealers should not be interpreted as precluding a Plan from entering into a swap contract with a swap dealer. We also believe the provisions should be amended to clarify that they would not apply to a swap contract entered into between a swap dealer and a pooled investment vehicle, such as a private fund, even if the pooled investment vehicle has Plan investors, so long as the pooled investment vehicle is not deemed to be plan assets for purposes of ERISA.

## Market Concerns

We wish to offer comments on two other portions of the Bill that would affect the orderly functioning of the capital markets and might diminish the Bill's potential to reduce systemic risk posed by systemically significant firms. These items do not affect the regulation of private funds in particular, but as market participants and creditors and counterparties to these major institutions, we hope our views will be helpful as policy makers consider the Bill.

**Disparate Treatment of Similarly Situated Creditors**. As stated above, we support a resolution authority that unwinds failing firms that pose a threat to the system. We are concerned, however, with provisions in Title II of the Bill, which enable the Federal Deposit Insurance Corporation to treat similarly situated creditors differently. Although we note that recent changes to the Bill provide greater clarity with respect to the use of this authority and improve the transparency and oversight with respect to any determination by the FDIC to treat similarly situated creditors differently, we remain concerned that these provisions will create significant uncertainty for investors in the debt of these institutions and other creditors. This uncertainty likely will inhibit investors from investing in, providing capital to, or otherwise doing business with, financially weak or weakening firms. The heightened uncertainty and potential for politically-based decisions will chill investments and raise costs. The follow-on effects on the market could be profound, with vulnerable firms failing more rapidly and contagion spreading to others of questionable health. Removing predictability and longstanding principles upon which market participants rely would produce the opposite of the intended goals of reduced and contained risk. We therefore believe that similarly situated creditors should be treated equally.

**Trading Market for Debt of Failed Firms**. Because Title II of the Bill establishes a new resolution framework that intentionally creates new rules distinct from existing rules and practices under bankruptcy law, investors face a significant amount of uncertainty with respect to the implementation of this new framework, including with respect to the transferability of claims by creditors of a failed firm. Consistent with the above, we believe it is important to clarify in the Bill that the provisions in Title II are not intended to restrict the free transferability or assignability by creditors (both unsecured and secured) of their claims after receivership occurs. This is important to enable creditors that cannot wait to pursue their claims to liquidate their positions and redeploy capital. We are also concerned with a provision in Title II that would limit the ability of certain transferees that acquire outstanding debt of a failed financial to exercise their right to set off any amounts owed to them by the failed firm with respect to any amounts the transferee owes to the failed firm. If investors are not able to continue trading their positions in failed firms, they are more likely to sell their positions at financially weak or weakening firms, further accelerating failure of those firms and spreading systemic risk.

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MFA appreciates the opportunity to provide comments on the Bill, whose overall principles we strongly support. We believe that, in many respects, the Bill provides an "intelligent" approach to accomplishing those goals. As discussed above, we do, however, have some remaining concerns about certain provisions that could impede legitimate market activity. We would be happy to discuss any of our comments with you or your staff, or answer any questions that you may have on our concerns. Please do not hesitate to contact me, Lou Costantino, or David Landers, at (202) 367-1140 should you wish to discuss any of the matters discussed in this letter.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO