MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

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MANAGED FUNDS ASSOCIATION

For the Hearing on

Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

OCTOBER 6, 2009

TESTIMONY OF MANAGED FUNDS ASSOCIATION

Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office
October 6, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Financial Services' hearing, "Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office" held on October 6, 2009. 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 appreciates the opportunity to express its views on financial regulatory reform, including the important subjects of investor protection and regulation for managers of private pools of capital, including hedge fund managers. In our view, any revised regulatory framework should address identified risks, while ensuring that private pools of capital are still able to perform their important market functions. It is critical, however, that consideration of a regulatory framework not be based on misconceptions or inaccurate assumptions.

Hedge funds are among the most sophisticated institutional investors and play an important role in our financial system. They provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or improve their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. Hedge funds engage in a variety of investment strategies across many different asset classes. The growth and diversification of hedge funds have strengthened U.S. capital markets and provided their investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, hedge funds help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

To perform these important market functions, hedge funds require sound counterparties with which to trade and stable market structures in which to operate. The recent turmoil in our markets has significantly limited the ability of hedge funds to conduct their businesses and trade in the stable environment we all seek. As such, hedge funds have an aligned interest with other market participants, including retail investors and policy makers, in reestablishing a sound financial system. We support efforts to protect investors, manage systemic risk responsibly, and ensure stable counterparties and properly functioning, orderly markets.

Hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were, and remain, substantially less leveraged than banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance despite the fact that our industry, and our investors, have suffered mightily as a result of the instability in our financial system and the broader economic downturn. The losses suffered by hedge funds and their investors did not pose a threat to our capital markets or the financial system.

Although hedge funds are important to capital markets and the financial system, the relative size and scope of the hedge fund industry in the context of the wider financial system helps explain why hedge funds did not pose systemic risks despite their losses. With an estimated $1.5 trillion under management, the hedge fund industry is significantly smaller than the U.S. mutual fund industry, with an estimated $9.4 trillion in assets under management, or the U.S. banking industry, with an estimated $13.8 trillion in assets. According to a report released by the Financial Research Corp., the combined assets under management of the three largest mutual fund families are at $1.9 trillion, which exceeds the total assets of the hedge fund industry. Moreover, because many hedge funds use little or no leverage, their losses did not pose the same systemic risk concerns that losses at more highly leveraged institutions, such as brokers and investment banks, did. A study by PerTrac Financial Solutions released in December 2008 found that 26.9% of hedge fund managers reported using no leverage. Similarly, a March 2009 report by Lord Adair Turner, Chairman of the U.K. Financial Services Authority (the "FSA"), found that the leverage of hedge funds was, on average, two or three-to-one, significantly below the average leverage of banks.

Though hedge funds did not cause the problems in our markets, we believe that the public and private sectors (including hedge funds) share the responsibility of restoring stability to our markets, strengthening financial institutions, and ultimately, restoring investor confidence. Hedge funds remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to our capital markets. We are committed to working with the Administration and Congress with respect to efforts that will restore investor confidence in and stabilize our financial markets and strengthen our nation's economy.

I. A "SMART" APPROACH TO FINANCIAL REGULATORY REFORM

MFA supports a smart approach to regulation, which includes appropriate, effective, and efficient regulation and industry best practices that (i) promote efficient capital markets, market integrity, and investor protection; and (ii) better monitor and reduce systemic risk. Smart regulation will likely mean increasing regulatory requirements in some areas, modernizing and updating antiquated financial regulations in other areas, and working to reduce redundant, overlapping, or inefficient responsibilities, where identified.

The first step in creating a smart regulatory framework is identifying the risks or intended objectives of regulation with the goal of strengthening investor protection and market integrity and monitoring systemic risk. Identifying the underlying objectives of proposed regulation will help ensure that proposals are considered in the appropriate context relative to addressing the identified risks or achieving the intended objectives. Regulation that addresses the key objectives of efficient capital markets, market integrity and investor protection is more likely to improve the functioning of our financial system, while regulation that does not address these key issues can cause more harm than good. We saw an example of the latter with the significant, adverse consequences that resulted from the SEC's bans on short selling last year.

A smart regulatory framework should include comprehensive and robust industry best practices designed to achieve the shared goals of monitoring and reducing systemic risk and promoting efficient capital markets, market integrity, and investor protection. Since 2000, MFA, working with its members, has been the leader in developing, enhancing and promoting standards of excellence through its document, *Sound Practices for Hedge Fund Managers ("Sound Practices")*.[1] As part of its commitment to ensuring that *Sound Practices* remains at the forefront of setting standards of excellence for the industry, MFA has updated and revised *Sound Practices* to incorporate the recommendations from the best practices report issued by the President's Working Group on Financial Markets' Asset Managers' Committee. MFA and other industry groups have also created global, unified principles of best practices for hedge fund managers.

Because of the complexity of our financial system, an ongoing dialogue among market participants and policy makers is a critical part of the process of developing smart, effective regulation. MFA and its members are committed to being active, constructive participants in the dialogue regarding the various regulatory reform topics.

Regulation is also not a panacea for the structural market breakdowns that currently exist in our financial system. One such structural breakdown is the lack of certainty regarding major public financial institutions (*e.g.*, banks, broker dealers, insurance companies) and their financial condition. Investors' lack of confidence in the financial health of these institutions has been, and continues to be, an impediment to investors' willingness to put capital at risk in the market or to engage in transactions with these firms, which, in turn, are impediments to market stability. The comprehensive stress tests earlier this year on the 19 largest bank holding companies were designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. While those stress tests appear to have helped develop greater certainty, we believe that it is also important for policy makers and regulators to ensure that accounting and disclosure rules are designed to promote the appropriate valuation of assets and liabilities and consistent disclosure of those valuations.

Though regulation cannot solve all of the problems in our financial system, careful, well thought out financial regulatory reform can play an important role in restoring financial market stability and investor confidence. The goal in developing regulatory reform proposals should not be to throw every possible proposal into the regulatory system. Such an outcome will only overwhelm regulators with information and added responsibilities that do little to enhance their ability to effectively fulfill their agency's missions. The goal should be developing an "intelligent" system of financial regulation, as former Fed Chairman Paul Volcker has characterized it.

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1 MFA's *Sound Practices* is available at:
http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf

We believe that regulatory reform objectives generally fall into three key categories. Those categories are: investor protection, market integrity and regulation, including registration of advisers to private pools of capital; systemic risk regulation; and regulation of market-wide issues, such as short selling. In light of the focus of today's hearing, I will address the first key category -- investor protection, market integrity and regulation, including registration of advisers to private pools of capital.

II. Registration of Advisers to Private Pools of Capital

In adopting a smart and effective approach to the regulation of unregistered managers of private pools of capital, it is important to recognize that many, if not all, of these regulatory issues will be relevant to all such managers, including firms that manage hedge funds, private equity funds, venture capital funds, commodity pools and real estate funds. The Obama Administration, in its release *Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation* (the "Administration Report"),[2] is supportive of this approach, calling for the registration of advisers of hedge funds and other private pools of capital with the SEC. MFA supports the registration of currently unregistered investment advisers to all private pools of capital, subject to a limited exemption for the smallest investment advisers with a *de minimis* amount of assets under management.

MFA has publicly supported this comprehensive approach to adviser registration over the past several months, even when the Administration called for a narrower registration requirement only for advisers to the largest and most systemically relevant private pools of capital. We strongly encourage policy makers also to consider the issue of registration in the context of all private pools of capital and the unregistered managers of those pools. Likewise, we strongly encourage regulators to consider regulations that apply to all private investment firms and not just hedge fund managers. This approach will both promote better regulation as well support the many benefits private investment firms provide to the US markets.

MFA and its members recognize that mandatory SEC registration for advisers of private pools of capital is one of the key regulatory reform proposals being considered by policy makers. We believe that the general approach set out in the Administration Proposal of requiring the registration of currently unregistered investment advisers, including advisers to private pools of capital, under the Investment Advisers Act of 1940 (the "Advisers Act") is a smart approach in considering this issue. I note that more than half of MFA member firms already are registered with the Securities and Exchange Commission (the "SEC") as investment advisers. Applying the registration requirement to currently unregistered investment advisers to all private pools of capital, instead of focusing solely on hedge fund managers is also consistent with the objective of a "smart" approach to this type of reform. We believe that removing the current exemption from registration for advisers with fewer than fifteen clients would be an effective way to achieve this result.[3] The form and nature of registration and regulation of investment advisers to private

2 Available at: http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

3 We note that this approach is consistent with the approach taken by H.R. 711 and S. 1276.

pools of capital should be evaluated in the context of how to best promote investor protection, market integrity and systemic risk monitoring, each of which may be best achieved by different types of regulation.

We believe that the Advisers Act provides a meaningful regulatory regime for registered investment advisers. The responsibilities imposed by Advisers Act registration and regulation are not taken lightly and entail significant disclosure and compliance requirements, including:

- Providing publicly available disclosure to the SEC regarding, among other things, the adviser's business, its clients, its financial industry affiliations, and its control persons;
- Providing detailed disclosure to clients regarding, among other things, investment strategies and products, education and business background for adviser personnel that determine investment advice for clients, and compensation arrangements;
- Maintaining of books and records relevant to the adviser's business;[4]
- Being subject to periodic inspections and examinations by SEC staff;
- Adopting and implementing written compliance policies and procedures and appointing a chief compliance officer who has responsibility for administering those policies and procedures;
- Adopting and implementing a written code of ethics that is designed to prevent insider trading, sets standards of conduct for employees reflecting the adviser's fiduciary obligations to its clients, imposes certain personal trading limitations and personal trading reports for certain key employees of the adviser; and
- Adopting and implementing written proxy voting policies.

In addition to registration and regulation of advisers through the Advisers Act, the hedge fund industry is subject to other, meaningful regulatory oversight. Hedge funds, like other market participants, are subject to existing, extensive trading rules and reporting requirements under the U.S. securities laws and regulations.[5] Increasing investor confidence and promoting market integrity are carried about by the SEC and other regulators through these regulatory requirements.

With a comprehensive registration framework comes additional burdens on federal regulators. A registration framework that overwhelms the resources, technology and capabilities of regulators will not achieve the intended objective, and will greatly impair the ability of regulators to fulfill their existing responsibilities, as well as their new responsibilities. Regulators must have adequate resources, including the ability to hire and retain staff with

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[4] Section 204 of the Advisers Act and rule 204-2 under that Act set out the required books and records that must be maintained by registered investment advisers. MFA can provide copies of the relevant rule upon request.

[5] We are also supportive of providing regulatory authorities, on a confidential basis, with information regarding trading/investment activities to promote better monitoring of systemic risk.

sufficient experience and ability, and improve the training of that staff, to properly oversee the market participants for whom they have oversight responsibility. The SEC, which is the existing regulator with oversight of investment advisers, has acknowledged that its examination and enforcement resources are already seriously constrained.[6] This raises the question whether the SEC would have the resources or capability to be an effective regulator when advisers to private pools of capital are required to register under an expanded registration framework. We strongly encourage policy makers, as part of their regulatory reform efforts, to ensure that the SEC has the resources and regulatory capabilities it needs to effectively meet its expanded regulatory mandate. Failing to do so will likely ensure that any regulatory reform effort will fail to achieve its intended objectives(s).

In addition to questions regarding the resources and capabilities of the SEC to regulate advisers to private pools of capital, consideration must also be given to the organization of the SEC, and whether changes to the current regulatory structure would lead to a more effective regulatory outcome. We applaud Chairwoman Schapiro, who has announced efforts to review such issues to make the SEC a more effective regulator. MFA has previously met with SEC staff to offer suggestions on ways to make SEC oversight of investment advisers more effective.

In considering the appropriate adviser registration framework, and in light of concerns about resources, capabilities and regulatory structure, we believe that it is important for there to be an exemption from registration for the smallest investment advisers that have a *de minimis* amount of assets under management. This exemption should be narrowly, though appropriately, tailored so as not to create a broad, unintended loophole from registration. We are supportive of a comprehensive adviser registration regime, however, we recognize that registration carries with it significant costs that can overwhelm smaller advisers and force them out of business. We believe that the amount of any *de minimis* exemption should appropriately balance the goal of a comprehensive registration framework with the economic realities of small investment advisers. As mentioned above, regulatory resources, capabilities and structure should also be considered as policy makers determine an appropriate *de minimis* threshold.[7] We are not proposing a specific *de minimis* amount, however, we encourage policy makers to determine an amount that is not so high as to create a significant loophole that undermines a comprehensive registration regime, and also not so low that the smallest investment advisers are unable to survive because of regulatory costs.

We would like to share with you today some initial thoughts on some of the key principles that we believe should be considered by Congress, the Administration and other policy makers as you consider the appropriate regulatory framework. Those principles are:

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[6] Speech by SEC Chairman Mary L. Schapiro: Address to the Council of Institutional Investors (April 6, 2009), available at: http://www.sec.gov/news/speech/2009/spch040609mls.htm.

[7] We believe that Congress should ensure that any approach in this regard is consistent with state regulation of smaller investment advisers and avoids duplication.

- The goal of any reform efforts should be to develop a more intelligent and effective regulatory framework, which makes our financial system stronger for the benefit of consumers, businesses and investors.

- Regulation should address identified risks or potential risks, and should be appropriately tailored to those risks because without clear goals, there will be no way to measure success.

- Regulation should not impose limitations on the investment strategies of private pools of capital. As such, regulatory rules on capital requirements, use of leverage, and similar types of restrictions on the funds should not be considered as part of a regulatory framework for private pools of capital.

- Regulators should engage in ongoing dialogue with market participants. Any rulemaking should be transparent and provide for public notice and comment by affected market participants, as well as a reasonable period of time to implement any new or modified regulatory requirements. This public-private dialogue can help lead to more effective regulation and avoid unintended consequences, market uncertainty and increased market volatility.

- Reporting requirements should provide regulators with information that allow them to fulfill their oversight responsibilities as well as to prevent, detect and punish fraud and manipulative conduct. Overly broad reporting requirements can limit the effectiveness of a reporting regime as regulators may be unable to effectively review and analyze data, while duplicative reporting requirements can be costly to market participants without providing additional benefit to regulators. It is critical that regulators keep confidential any sensitive, proprietary information that market participants report. Public disclosure of such information can be harmful to members of the public that may act on incomplete data, increase risk to the financial system, and harm the ability of market participants to establish and exit from investment positions in an economically viable manner.[8] Regulations should not force market participants publicly to reveal information that would be tantamount to revealing their trade secrets to competitors.

- We believe that the regulatory construct should distinguish, as appropriate, between different types of market participants and different types of investors or customers to whom services or products are marketed. While we recognize that investor protection concerns are not limited to retail investors, we believe that a "one-size fits all" approach will likely not be as effective as a more tailored

8 MFA also believes that regulators should also ensure that they share information with foreign regulators only under circumstances that protect the confidentiality of that information. For example, the SEC has adopted Rule 24c-1 under the Exchange Act (17 CFR §24c-1), which allows the SEC in its discretion to share nonpublic information with a foreign financial authority if the authority receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate. MFA believe that US regulators should employ this type of approach when sharing information with foreign regulators.

approach. One such relevant distinction is that between private sales of hedge funds to sophisticated investors under the SEC's private placement regulatory regime and publicly offered sales to retail investors. This private/public, sophisticated/retail distinction has been in existence in the United States for over 75 years and has generally proven to be a successful framework for financial regulation. We do not believe this distinction should be lost, and we strongly believe that regulation that is appropriate for products sold publicly to retail investors is not necessarily appropriate for products sold privately to only sophisticated investors.

- Regulation regarding market issues that is applicable to a broad range of market participants, such as market manipulation and insider trading, should be addressed in the broader context of all market participants. Market issues are not specific to the hedge fund industry and, therefore, regulatory reform regarding these issues should be considered in the broader context and not in the context of hedge fund regulation.

- Lastly, we believe that industry best practices and robust investor diligence should be encouraged and recognized as an important complement to regulation. Regulators will tell you that their oversight is no substitute for a financial firm's own strong business practices and investors' robust diligence if we are to promote market integrity and investor protection concerns.

MFA Views on Administration's Proposed "Registration of Advisers to Private Funds" (the "Administration Proposal") and the Proposed "Private Fund Investment Advisers Registration Act of 2009" (the "Discussion Draft"

As mentioned above, MFA is supportive of the general approach taken in the Administration Proposal – a comprehensive registration regime under the Advisers Act designed to ensure that there is appropriate regulatory oversight over investment advisers to private pools of capital. We recognize and appreciate the Administration's objective of registering and regulating important market participants that have previously been exempt from registration. It is critical that this objective be done in a way that creates a "smart" regulatory framework, and we believe the removal of the so-called 'private adviser' exemption currently in the Advisers Act achieves that objective with respect to investment adviser registration. We have a concern, however, that the Discussion Draft would continue to leave a gap in the oversight of investment advisers by providing an exemption from registration and reporting requirements for advisers to private pools of capital that engage in certain investment strategies. Though we are generally supportive of the Administration Proposal, we do have concerns with respect to certain provisions in both the Proposal and the Discussion Draft, which are discussed in detail below.

➢ Ensuring that the registration framework is comprehensive is an important component of a "smart" regulatory framework; however, it is equally as important to ensure that any new regulatory framework does not impose unnecessary, duplicative and costly requirements on advisers to private pools of capital. Such action would have adverse consequences for markets and investors while providing little to no benefit with respect to enhancing investor protection and market integrity, promoting greater transparency to either markets or regulators, or monitoring systemic risk. In that regard, we believe that eliminating the current exemption from registration in section 203(b)(6) of the Advisers Act, for certain commodity trading advisors ("CTAs") which are registered with the Commodity Futures Trading Commission (the "CFTC") (*i.e.,* those whose business is not primarily acting as an investment adviser), would create unnecessary, duplicative and costly requirements for those CTAs.

Section 203(b)(6) of the Advisers Act provides a limited exemption from registration as an investment adviser with the SEC for CTAs that are registered with the CFTC and which do not primarily act as an investment adviser (as defined in the Advisers Act). This exemption does not create a regulatory gap, nor does it leave advisers to private funds outside of a registration framework. It ensures that CTAs to private funds, which are primarily engaged in the business of providing advice regarding futures[9] and are already subject to a comprehensive registration and regulatory framework, do not have to be subjected to a dual registration and regulatory framework. Requiring these CTAs to register with both the SEC and the CFTC would, at best, subject them to a duplicative regulatory framework and, at worst, subject them to potentially inconsistent regulatory requirements. We are not aware of any regulatory failure or other public policy justification to warrant this change.

➢ We appreciate the inclusion of confidentiality with respect to information reported to regulators under section 404 of the Administration Proposal and section 4(b)(8) of the Discussion Draft (both of which amend section 204(b) of the Advisers Act). Confidentiality of this sensitive information is critical. We believe that the Federal Reserve's protection of bank information received through their examination authority provides a good model for the type of protection that should be provided with respect to information provided under this section. It is also important that any final legislation make clear that confidential information shared with any agency (for example, under subparagraphs (5) and (7) of section 404 of the Administration Proposal and sections 4(b)(6) and (8) of the Discussion Draft) be protected by those agencies as well as the agency which originally receives the information.

➢ There is some uncertainty with respect to some of the reporting requirements in the Administration Proposal and the Discussion Draft. For example, it is unclear what type of information that the reporting of trading practices is intended to address. To the extent that legislation establishes new reporting or recordkeeping requirements, we believe that it is important for the legislation to define or otherwise clarify what information or records are being required.

➢ We recognize the importance of an adviser's fiduciary obligation to its clients. We also understand that following the United States D.C. Circuit Court of Appeals

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9 On September 25, 2009, MFA submitted a letter to the SEC and the CFTC suggesting a methodology by which the agencies could determine whether an adviser registered with the CFTC is primarily acting as an investment adviser pursuant to section 203(b)(6) of the Advisers Act. MFA's comment letter is available at http://www.managedfunds.org/downloads/MFA%20response%20to%20SEC.CFTC.9.25.09.pdf.

decision in *Goldstein v. SEC*, the agency had concerns regarding their authority appropriately to regulate advisers to private funds. Though we understand that concern, we believe that a broad delegation of authority to the SEC to define the term "client" in any manner for purposes of the Advisers Act raises concerns, specifically with respect to an adviser's fiduciary obligations to its clients.

We have concerns with imposing fiduciary obligations on an adviser with respect to investors in pooled investment funds managed by that adviser. Imposing such an obligation on advisers to pooled investment vehicles raises several concerns. An adviser to a pooled investment fund likely would not have the information about the underlying investors in the fund necessary to be able to determine whether an individual investment made for a fund's portfolio would also be appropriate for an individual investor. Further, applying fiduciary obligations to the investor and the fund can create potential conflicts between an adviser's obligations to the fund and obligations to investors.[10] In light of this concern, we believe that the current language in the Administration Proposal and the Discussion Draft, which delegates broad authority to the SEC to define the term "client," is overly broad.

➢ We appreciate the importance of good disclosure to counterparties and creditors, but we have concerns about imposing such disclosure standards on private fund managers, which we believe do not apply to any other financial institutions. It is unclear how disclosure from a private fund adviser to its counterparties and creditors raises either investor protection or systemic risk concerns. Creditors and counterparties are not investors; they are sophisticated market participants capable of protecting their own interests in negotiating a transaction.

We also believe that there should be some limitations on the types of information that an investment adviser should be required to disclose to other market participants. For example, we would oppose a requirement that broadly forces an investment adviser to reveal its proprietary trading strategies or algorithms. In general, U.S. law respects the rights of businesses to protect trade secrets from other market participants. We believe that policy makers should design any required disclosures by investment advisers to other market participants to achieve the objective of enabling market participants to make informed decisions, while affording advisers the well-recognized right to protect their trade secrets and other proprietary information.

Likewise, systemic risk assessment does not seem to be a strong basis to require disclosure to counterparties. Counterparties are not responsible for assessing systemic risk, nor would disclosure from only an entity's clients provide the type of information necessary to adequately assess systemic risk concerns. To address concerns about the systemic risk posed by the connections between financial institutions, we believe that imposing standards on those who extend credit would be more effective than imposing disclosure obligations on institutions. If Congress were to impose such disclosure

[10] We note that this concern is also relevant to the Administration's proposed "*Investor Protection Act of 2009*",, which establishes a new and potentially different fiduciary standard for investment advisers than the fiduciary standard to which advisers are already subject.

standards, it would be equally important to require counterparties to provide disclosure to private fund advisers and we would recommend amending section 404(b)(6) of the Administration Proposal and section 4(b)(7) of the Discussion Draft to require disclosure from both parties, not just from private fund advisers.

➢ We believe it is important for there to be an appropriate transition period for implementation of the registration requirement to ensure market participants have an appropriate period of time to comply.

Investor Protection Recommendations

In addition to a comprehensive registration regime for investment advisers to private pools of capital, we encourage policy makers to make certain enhancements to the Advisers Act, which we believe would make the Advisers Act a "smarter" framework for the regulation of advisers to private pools of capital. Set out below are recommendations that we believe could be incorporated into both the Administration's and discussion draft of the "*Investor Protection Act of 2009*".

Congress or the SEC should increase the net worth requirement for investors in private funds to ensure that only experienced individuals with sufficient resources to put their money at risk are able to invest in hedge funds and other private funds. Current rules under the Advisers Act effectively require an investor to be a "qualified client" – a person who has a net worth, together with a spouse, of more than $1.5 million – to invest in most private funds managed by a registered adviser. We recommend that Congress or the SEC prospectively increase the net worth threshold to $2.5 million and automatically adjust the threshold for inflation (rounded up to the nearest $500,000) every five years.[11]

Policy makers should also enhance the existing framework for the protection of client assets to prevent an unscrupulous manager from misappropriating investor funds or securities. Many private fund managers currently engage independent public accountants to perform annual audits and to certify their private funds' financial statements. Providing annual audited financial statements to investors is a longstanding best practice in the hedge fund industry (as reflected in MFA's *Sound Practices*), but private fund managers are not required to do so. Congress or the SEC should require each SEC-registered private fund manager with custody of client funds or securities to arrange for each private fund it advises to: (1) be subject to an annual audit conducted by an independent public accountant registered with, and subject to inspection by, the Public Company Accounting Oversight Board; and (2) distribute audited financial statements to

[11] Pursuant to Regulation D under the Securities Act of 1933, hedge funds and other private pools of capital are sold to "accredited investors". MFA also supports increasing the sophistication standards contained in Regulation D. In 2007, MFA submitted a comment letter to the SEC supporting an increase in the test to be an accredited investor. A copy of MFA's comment letter is available at http://www.managedfunds.org/downloads/MFA%20Regulation%20D%20Comment%20Letter.pdf.

each investor in the fund, except in cases where a manager does not have the authority to require an audit.[12]

In addition to accountants, other service providers play an important role in many components of a private fund manager's risk management system. The existing disclosure report for registered advisers under the Advisers Act, the SEC's Form ADV, should be enhanced to require that private fund managers disclose to investors their key service providers. Managers should disclose on Part II of Form ADV, the section that is delivered to investors, their accountants, principal prime brokers and custodians employed within the prior twelve-month period. Under existing law and regulation, hedge fund investors are sophisticated, experienced high net worth individuals and institutions. These investors request and receive a substantial amount of information from hedge fund managers prior to investing and during their investments, pursuant to agreements between the investors and the funds.[13] Although hedge fund investors already request and receive substantial amounts of information, we believe that a requirement that managers disclose their key service providers would enhance the existing disclosure framework and ensure that all investors have information necessary to make informed investment decisions.

Finally, we recommend that the SEC be given authority to prohibit individuals who engage in improper conduct while associated with a broker, dealer or investment adviser from being associated with any other securities industry participant, including a broker, dealer, investment adviser, municipal securities dealer transfer agent, or nationally recognized statistical rating organization. To further ensure that only appropriate individuals manage investor assets, the Advisers Act should also be amended to automatically bar a person who has engaged in criminal violations of the federal securities laws from associating with a registered investment adviser, subject to an appeal to the SEC.[14] An automatic bar would reduce the administrative costs caused by existing law requiring the SEC to issue an order to bar such persons from associating with a registered investment adviser.

(l) ADDITIONAL REGULATORY ISSUES

International Coordination

The International Organization of Securities Commissions ("IOSCO"), policy makers and regulators in the United States and the European Union, as well as policy makers and regulators in other countries are currently undergoing reviews of the regulation of financial entities,

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12 MFA recommended an independent audit requirement for private funds in its letter commenting on the SEC's proposed amendments to its custody rule under the Advisers Act. MFA's letter is available at http://www.managedfunds.org/downloads/MFA%20Comments%20to%20Custody%20Proposals.pdf.

13 MFA has published a model due diligence questionnaire that illustrates the types of information commonly requested by investors prior to investing. The questionnaire is available at http://www.managedfunds.org/downloads/Due%20Dilligence%20Questionnaire.pdf.

14 Section 9 of the Investment Company Act of 1940 contains an automatic bar prohibiting certain persons who engage in wrongful conduct from associating with a registered investment company.

including hedge funds, and financial markets. It is critical for policy makers and regulators to coordinate these regulatory reform efforts to eliminate, when possible, unnecessary duplication and inconsistency in regulation, and to avoid creating inappropriate barriers to participation within their respective jurisdictions, so that hedge funds can continue to provide benefits to markets and investors around the globe. We encourage policy makers and regulators in the United States, the European Union, Asia and elsewhere to continue to engage in an active dialogue on international financial regulation and to cooperate in their regulatory and enforcement efforts.[15] This approach is consistent with the Administration's approach to international coordination on regulatory reform.[16]

We believe that an example of the adverse consequences that can result from a lack of international coordination can be seen in the European Commission's Directive on Alternative Investment Fund Managers (the "Directive"). A number of the provisions in the Directive go far beyond the principles established by IOSCO and the G-20 and many of those provisions are inconsistent with a globally harmonized approach to the regulation of private pools of capital and their managers. We believe that these provisions in the Directive would have significant, adverse consequences for managers of private pools of capital, as well as their European investors. In particular, we are concerned about provisions in the Directive that would effectively ban U.S. fund managers from managing European-based private funds, or even having European investors in non-European based funds managed by U.S managers. MFA has produced a white paper analyzing key provisions of the Directive.[17]

Enhanced Protection of Customer and Client Assets

One of the lessons learned from the past year's crisis is that customer and client assets held by financial institutions need to be protected. A regulatory structure that fails to adequately protect customer and client assets not only harms investors, but can also increase systemic risk.

The case in point is the failure of Lehman Brothers. The losses resulting from the failure of Lehman Brothers are astronomical. Even with respect to customer and client assets that may eventually be recovered, the delays will be substantial, into the many years. Further, the process of recovery will undoubtedly generate numerous disputes over valuation and conflicting rights that seem likely to deplete a good portion of what otherwise might have been available for distribution to the directly injured parties.

15 MFA has submitted several letters to IOSCO, in response to that organization's requests for public comment on the following areas of regulatory reform: Direct Electronic Access, Hedge Funds Oversight, Regulation of Short Selling and Unregulated Financial Markets and Products. MFA's comment letters are available on its website, www.managedfunds.org.

16 See June 29, 2009 speech by Treasury Assistant Secretary for International Monetary and Financial Policy, Mark Sobel to the European Forum of Deposit Insurers at the Fédération Bancaire Francaise, available at http://www.ustreas.gov/press/releases/tg196.htm.

17 MFA's white paper is available at http://www.managedfunds.org/members/downloads/MFA%20White%20Paper%20on%20AIFMD.pdf

A large share of the money that was lost by the failure of Lehman Brothers was not that of Lehman Brothers' shareholders or even of its ordinary creditors who had made an investment decision to lend money to that firm. Rather, the money lost was that of Lehman Brothers customers, including its swaps customers, who had posted collateral with Lehman Brothers that was not segregated.[18] MFA believes that the financial markets cannot perform their purpose of capital formation if customers that are seeking safe custodial treatment of their assets are subject to the same risks, or even disproportionate risks, to the shareholders and creditors of a company. Custodial customers ought to be protected from the imposition of investment risk. For example, the initial margin posted by end-users on swaps is intended as a safeguard against failure; it ought not to be transformed by a swaps dealer into a disguised and forced investment by a customer into the assets of the swaps dealer.

We do not believe that it is sufficient merely to mandate that the custodian of the initial margin be a separate legal entity from the registered swap dealer. As we have seen since Lehman Brothers failed, entities that are under a common holding company are near to inextricably related. If one entity under the holding company fails, that failure is very likely to spread to the other members of the group. If a swap dealer fails, it is likely that so will its affiliated custodian. Nonetheless, we do not believe that it would be necessary to eliminate entirely the possibility that an affiliated custodian might hold initial margin pledged to a swap dealer. For example, where the custodian is an entity that is engaged solely in a trust or custody business, and so does not require any material amount of financing to operate from day to day, it may be able to continue operations at least long enough to return collateral it holds to the appropriate owners. While some amount of flexibility is appropriate, it is important for policy makers and regulators to consider ways in which client and customer assets can be better protected than was the case in the Lehman Brothers failure.

Engagement with Market Participants

As discussed above, we believe that a smart regulatory framework includes regular discussions among policy makers, regulators and market participants. MFA and its members have been active and constructive participants with regulators and policy makers regarding a variety of regulatory and market issues. Though the subject of my testimony today relates primarily to registration and regulation of advisers to private pools of capital, MFA and its members are committed to being constructive participants with respect to any of the other issues, including, among others, over-the-counter derivatives, short selling, systemic risk, and market issues that policy makers and regulators are considering as part of the ongoing regulatory reform initiative.

[18] We believe that there is in excess of $50,000,000,000 in customer assets still being held in Lehman Brothers International (Europe) ("LBIE"), which belongs to pension funds, endowments, hedge funds, and other large U.S. institutions whose beneficiaries are U.S. citizens. There is no timetable for when the assets will be returned. Congressman Gregory Meeks (D-NY) has offered a Concurrent Resolution seeking action to free the assets trapped at LBIE (See H. Con. Res. 184).

CONCLUSION

Hedge funds, as sophisticated institutional investors, have important market functions, in that they provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or turn around their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. MFA and its members acknowledge that smart regulation helps to ensure stable and orderly markets, which are necessary for hedge funds to conduct their businesses. We also acknowledge that active, constructive dialogue between policy makers and market participants is an important part of the process to develop smart regulation. We are committed to being constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets.

MFA appreciates the opportunity to testify before the Committee. I would be happy to answer any questions that you may have.