MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

RICHARD H. BAKER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing
Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 13, 2011

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION

Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight
September 13, 2011

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises' hearing, "Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight," held on September 13, 2011. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $2 trillion invested in absolute return strategies around the world.

MFA's members are among the most sophisticated institutional investors and play an important role in our financial system. They are active participants in the commodity, securities and over-the-counter derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. The growth and diversification of investment funds have strengthened U.S. capital markets and provided investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, MFA members 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.

MFA members favor smart, effective regulation of securities markets generally, and have a strong interest in thoughtful and efficient regulation of hedge fund managers. MFA provided its views to policy makers during the deliberations leading to enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), and MFA is actively engaged in working with regulators as they undertake rulemakings to implement the Act. MFA supports many of the regulatory reforms in the Dodd-Frank Act that are designed to enhance oversight of private fund managers and strengthen our capital markets, including the mandatory registration of unregistered managers of private pools of capital, a framework for the oversight of systemic risk that includes reporting of information to regulators by market participants, and reducing systemic risk and enhancing transparency by transitioning eligible over-the-counter derivatives ("OTC") markets to central clearing.

MFA strongly supports the approach taken in the Dodd-Frank Act to subject managers of private pools of capital to oversight by the SEC as investment advisers under

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

the Investment Advisers Act of 1940 (the "Advisers Act"). A significant proportion of our members are already registered as investment advisers with the SEC, and we anticipate that most of our members will be registered with the SEC as of March 30, 2012, the effective date of registration. We offer these comments on the future oversight of the private fund manager industry in light of our extensive experience with the regulatory framework for investment advisers and the SEC inspection and examination process.

Section 914 of the Dodd-Frank Act requires the SEC to study its examination program for investment advisers and the extent to which the establishment of a self-regulatory organization ("SRO") would improve the frequency of investment adviser examinations. The SEC staff report under Section 914, "Study on Enhancing Investment Adviser Examinations (the "Study")," assesses its examination program and recommends, among other things, that Congress consider authorizing one or more SROs to examine SEC-registered investment advisers. We appreciate the thoughtful and balanced approach taken in the Study in evaluating the SEC's examination program and the potential consequences of an SRO for investment advisers, and we have carefully considered its recommendations.

Based on our experience, we strongly believe that the existing framework of SEC regulation of private fund managers, as enhanced in a number of respects by the Dodd-Frank Act and regulatory implementation of the Act, is effective in fulfilling the SEC's mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. As further described in our comments below, an SRO would lack experience in regulating private fund managers, create inconsistent regulation, face difficult conflicts of interest, and ultimately diminish the quality of regulatory oversight of the private fund industry. For these reasons, during the deliberations prior to the enactment of the Dodd-Frank Act, policy makers did not consider, and industry participants did not suggest, that an SRO would be a reasonable alternative to private fund manager registration with, and regulation by, the SEC.

MFA members are private fund managers that provide investment advice to pooled vehicles that are limited to investments from sophisticated individuals and institutional investors. Our comments relate only to the regulation of private fund managers, and do not address the need for, costs of, or benefits from a potential SRO for other types of investment advisers. Below are our views on what we believe are the key considerations of the appropriate regulatory framework for private fund managers.

THE SEC HAS EXTENSIVE AUTHORITY OVER PRIVATE FUND MANAGERS

Private fund managers are subject to comprehensive, long-standing federal securities laws and regulatory oversight by the SEC. The SEC regulates private fund managers as investors, like other market participants, under the Securities Act of 1933

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), and as investment advisers managing assets of client under the Advisers Act. In broad terms, this statutory framework, as enhanced by the Dodd-Frank Act and regulatory implementation of the Act, subjects private fund managers to oversight with respect to their trading and investment activities, their effects on markets and financial stability, and their management of client assets. In its entirety, this framework applies to all areas of a private fund manager's business, and leaves no gaps in oversight.

The Dodd-Frank Act has substantially enhanced the SEC's authority in many of these areas, and as a result the SEC will have extensive knowledge of the private fund industry, and will continue to be responsible for implementing and enforcing rules across all aspects of managers' businesses. We believe this framework for regulating hedge fund managers is effective and should be maintained.

Securities and Derivatives Trading Activities

Private fund managers, like other investors, are subject to extensive rules governing trading activities that involve securities. Such rules include, for example, prohibitions on insider trading, restrictions on short selling, disclosure requirements, and limitations on the purchase and sale of unregistered securities. More generally, the SEC has broad authority to investigate and punish any type of manipulative trading activity involving securities. Pursuant to Rule 10b-5 under the Exchange Act, market participants are prohibited from using any device or scheme to defraud, from making any untrue statement of a material fact, or from engaging in any fraudulent act, practice, or course of business. The SEC regularly enforces the prohibitions in Rule 10b-5 against investors of all types that engage in inappropriate conduct, including private fund managers.

In addition to these long-standing rules governing transactions in securities, the Dodd-Frank Act creates a new, comprehensive regulatory regime for investing activities involving OTC derivatives. Prior to the Dodd-Frank Act, OTC derivatives were generally not subject to the type of direct regulatory oversight applicable to transactions in securities. Title VII of the Act establishes an extensive new framework for the regulation of OTC derivatives. The rules to be adopted by the SEC and CFTC under Title VII will, among other things: (i) require certain standardized transactions to be cleared and exchange-traded; (ii) require "swap dealers" and "major swap participants" to register with the SEC or CFTC, and subject them to specific obligations; (iii) impose initial and variation margin requirements on both cleared and uncleared transactions; and (iv) provide for substantial incremental transparency, including transaction reporting, to market participants and regulators. Many private fund managers, like other investors, transact in OTC derivatives as part of their investment strategy, and together these new rules will implement a broad framework of CFTC and SEC oversight of these activities.

Private Fund Manager Reporting to the SEC

As a result of the Dodd-Frank Act, the SEC will have the authority to collect even more extensive information about private funds. Notably, the SEC and CFTC have

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

proposed a reporting form for private fund managers, Form PF, that would be used by the Financial Stability Oversight Council (the "Council") for systemic risk assessment. The Form would require SEC-registered private fund managers to submit an extensive amount of highly sensitive, proprietary information about their businesses and the funds they manage, including information about their portfolios, use of leverage, counterparty relationships, and collateral practices. The SEC must keep such information confidential and only share the data outside of members of the Council in limited circumstances, so that as a result the SEC will serve as the primary repository of a significant amount of information about private fund managers.

The SEC has indicated that it will use this information to strengthen its inspection and examination functions and to inform its various rulemakings related to private fund managers. This extensive reporting framework, together with other provisions of the Dodd-Frank Act that extend the SEC's authority, will further enhance and expand SEC oversight of private fund managers.

Management of Client Assets and Investor Protection

Finally, private fund managers are subject to SEC regulation as investment advisers under the Advisers Act, which applies broadly to an advisory firm's investment activities and relationship with clients. The responsibilities imposed by Advisers Act registration and regulation 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 books and records relevant to the adviser's business;

- 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.

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

Significantly, the Dodd-Frank Act maintains the Advisers Act as the primary framework for the regulation of private fund managers. We strongly agree with this approach and believe that the Advisers Act, as enhanced by SEC staff interpretations and guidance, is an effective, comprehensive framework for regulating the advisory activities of private fund managers. As noted above, the Act not only continues to subject the private fund industry to SEC oversight under the Advisers Act, it expands the Adviser Act's application to private fund managers by requiring certain unregistered managers to register with the SEC.

In addition, the SEC has recently enhanced its oversight of private fund managers through its implementation of the Dodd-Frank Act and rulemakings under the Advisers Act by, among other things:

- Adopting requirements for private fund advisers to publicly disclose information about funds they manage on Part 1 of Form ADV, the investment adviser registration form, including: (i) organizational information and the fund's identification number; (ii) the exemption from the Investment Company Act of 1940 upon which the fund relies; (iii) the type of private fund; (iv) the gross asset value of the fund; (v) the minimum amount required to be invested, number of beneficial owners, and percentage of the fund owned by certain types of investors; (vi) information designed to identify any potential conflicts of interest; and (vii) information about the fund's auditors, prime brokers, custodians, administrators, and marketers.

- Adopting additional disclosure on Part 2 of Form ADV that requires a registered adviser to provide detailed, narrative information about its advisory business, including: (i) fees and other compensation; (ii) investment strategies and risks; (iii) disciplinary events involving the firm and its personnel; (iv) brokerage practices; and (v) the nature of any conflicts of interest and how it addresses such conflicts. Advisers must now publicly disclose this information.

- Adopting a rule under the Advisers Act that strengthens safeguards for the custody of assets by requiring a registered investment adviser to maintain client assets with a qualified custodian and providing for independent verification of such assets.

- Proposing Form PF, which would require private fund managers registered with the SEC to regularly report extensive information about their funds' operations and investment activities. Large hedge fund managers would report on Form PF detailed portfolio and other information, such as: (i) the market value of financial instruments held by the fund organized by asset class, on a short and long basis; (ii) the monthly turnover rate of the adviser's aggregate portfolios; (iii) a geographic breakdown of investments; (iv) collateral practices of significant counterparties; (v) exposure of the fund to central clearing counterparties; (vi) risk management calculations; (vii) financing information; and (viii) information

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

concerning investors and liquidity terms, including requirements for withdrawals and exemptions.

As a result of this regulatory framework, the SEC has been given an effective array of tools for regulating private fund managers. Given the breadth and depth of the SEC's regulatory and enforcement mission regarding private fund managers, we believe the SEC should remain as the regulator of private fund managers.

SEC Investment Adviser Examinations

The SEC continues to strengthen its inspection and examination program for investment advisers, including private fund managers. Recent changes to Form ADV, as described above, will allow the SEC to gather more detailed information from private fund managers. These enhancements to the reporting obligations of managers should significantly improve the ability of the SEC's Office of Compliance Inspections and Examinations ("OCIE") to gather information, and lead to a more effective risk-based assessment process. MFA has worked cooperatively with OCIE in recent years to provide education and other professional development opportunities to examination staff to enhance their knowledge of the industry and its practices. MFA also periodically updates sound practices for industry members and hosts educational events, often with regulators' participation, to promote best practices and robust compliance. These enhancements to OCIE's examination approach and capabilities will improve the quality and of examinations of registered investment advisers, including private fund managers.

In addition to improved quality of inspections and examinations, the Dodd-Frank Act will allow OCIE to conduct more frequent examinations of larger investment advisers by requiring smaller advisers, generally those with less than $100 million in assets under management, to de-register from the SEC and register instead with appropriate state regulators. The SEC staff estimates that the impact of the Dodd-Frank Act provisions will have a net effect of reducing the number of SEC-registered advisers from the current 11,500 to approximately 9,750 advisers, and only a minority of those remaining will be advisers to private funds. We note that by delegating certain examination functions to an association of investment advisers the "Investment Adviser Oversight Act of 2011" would likely enable the SEC to conduct more frequent examinations of other registered, non-retail investment advisers.

AN SRO WOULD LACK THE EXPERIENCE AND INDUSTRY PERSPECTIVE NECESSARY TO OVERSEE PRIVATE FUND MANAGERS

In addition to the concern that an SRO for private fund managers only would serve to carry out a function that is already being performed with increasing efficacy by the SEC, an SRO could diminish the quality of regulation of private fund managers.

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

An effective private fund industry SRO must have extensive knowledge of the industry, and experience in interpreting and applying the Advisers Act and its rules to private fund managers. We are not aware of any organization with these necessary competencies, and we are concerned that an SRO's lack of experience in overseeing private fund managers could lead to inconsistent regulation and uncertainty for managers in operating their businesses. In particular, the nature of the Advisers Act as a principles-based statute would present difficult challenges to a new SRO, or an SRO that instead has experience in administering a rules-based regulatory framework.

An SRO for private fund managers would have difficulty hiring experienced personnel to quickly acquire the necessary expertise. The private fund industry is small in comparison to other types of financial firms, and individual private fund managers typically rely on small staffs. As a result, the pool of personnel experienced with the operations and legal requirements of hedge fund managers is quite limited. Despite the small size of the industry, an SRO would need to be of sufficient size and scale to effectively oversee the industry, and we are concerned that an SRO would have difficulty establishing and maintaining such a staff.

An SRO Would Subject Investment Advisory Firms to Inconsistent Oversight

The investment advisory industry is made up of extremely diverse firms, including independent advisers, financial planners, traditional asset management firms, wealth managers, large financial institutions, small advisers, private fund managers, mutual fund advisers, pension consultants and others. Under the Advisers Act, each of these types of investment advisory firms is currently subject to consistent regulation by the SEC. Creating an SRO exclusively for one type of investment advisory firm, such as private fund managers, would seem to undermine the intent of the Advisers Act by creating separate, and potentially inconsistent, oversight of investment advisers.

Moreover, the creation of an SRO for private fund managers could subject a single advisory firm, such as a private fund manager or a traditional asset management firm that manages private funds in addition to other types of accounts, to two different regulatory frameworks. We are concerned that these results would create uncertainty, and could have the unintended consequence of leading to an uneven playing field among advisory firms.

An SRO Would Face Inherent Conflicts of Interest in Overseeing Private Fund Managers and other SRO Members

An SRO overseeing both private fund managers and other types of firms would face difficult conflicts of interest in overseeing all of its members fairly and equitably. Private fund managers are active participants throughout the securities markets, and interact with other financial firms in numerous capacities, including engaging them as service providers to funds they manage, entering into counterparty arrangements with them, and competing with them for investment opportunities. These natural and healthy

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

relationships would create challenges for an SRO to oversee private fund managers and other types of firms in an impartial manner.

An example of the type of interactions that could give rise to potential conflicts of interest for an SRO is the relationships between private fund managers and broker-dealer firms. In implementing their investment strategies, hedge fund managers engage broker-dealer firms to serve as prime brokers and counterparties to funds. As prime brokers, broker-dealers provide a number of important services to hedge funds, including custody of assets, clearing of securities transactions, securities lending, financing and reporting. As counterparties, broker-dealers enter into arrangements with hedge funds in which they agree to make or receive payments to or from the fund based on certain market factors, such as the performance of an underlying asset.

While counterparty arrangements take various forms, depending on the type of financial transaction, each arrangement is an arm's length transaction between a fund manager and a broker-dealer in which the interests of the two parties are generally not aligned. The features of prime brokerage and counterparty arrangements are complex, and hedge fund managers and broker-dealers generally negotiate their terms. The overlapping and sometimes competing interests between managers and broker-dealers created by these arrangements would present challenges to an SRO responsible for overseeing these types of firms fairly and equitably. We appreciate that existing SROs seek to address these types of concerns through their governance process and other methods, however, we believe that oversight of private fund managers would lead to inherent structural difficulties in the operation of an SRO.

<u>An SRO Could Create Uncertainty for Managers and Reduce Accountability</u>

The current regulatory framework ensures that a single entity has authority for rulemaking, examinations and inspections, and enforcement with respect to private fund managers and other investment advisers. The creation of an SRO would upset this structure, and potentially create regulatory uncertainty and reduce accountability.

A structure in which an SRO was given authority to inspect and examine private fund managers, and the SEC retained policy making authority, for example, would add an extra layer of regulation for managers to comply with the Advisers Act. This dual regulatory structure would raise the risk of managers being confused as to how to comply with guidance from both entities, and could also lead to inconsistent policies. If instead, an SRO were provided with broad inspection and policy making authority over private fund managers, the SEC would no longer have direct oversight responsibility for private fund managers. We believe that to avoid either of these results, it is important for an independent, governmental agency to be accountable for such oversight.

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

STANDARD OF CONDUCT FOR INVESTMENT ADVISERS, BROKERS AND DEALERS TO RETAIL CUSTOMERS

Section 913 of the Dodd-Frank Act requires the SEC to study the effectiveness of existing legal or regulatory standards of care for providing personalized investment advice and recommendations about securities to retail customers. The SEC staff report under Section 913, "Study on Investment Advisers and Broker-Dealers," recommends that the SEC implement a uniform fiduciary standard of conduct for brokers, dealers and investment advisers when providing personalized investment advice about securities to retail customers that would require these entities to act in the best interest of the customer without regard to financial or other interests.

MFA members are private fund managers that provide investment advice to pooled vehicles that are limited to investments from sophisticated individuals and institutional investors. Accordingly, MFA members generally do not provide personalized investment advice to retail customers, and therefore would not be subject to the uniform fiduciary standard of conduct set out in Section 913 of the Act and recommended by the SEC staff.

Instead, private fund managers, as investment advisers, should continue to be subject to the longstanding, expansive fiduciary duty under the Advisers Act. Under federal law established by the U.S. Supreme Court, investment advisers have a fiduciary duty to their clients, and in meeting their duty, fiduciaries must act according to the highest standard of conduct. In its landmark interpretation of the Advisers Act, the U.S. Supreme Court confirmed that, as fiduciaries, investment advisers have a duty to "exercise the utmost good faith in dealings with clients."[1] The SEC has broadly interpreted the scope of an adviser's fiduciary duty under Section 206 to apply to all aspects of an adviser's management of client assets. We strongly support this heightened standard of conduct for investment advisers, and recommend that it remain the foundation of an adviser's obligations to its clients.

We believe that the uniform fiduciary standard of conduct in Section 913 is consistent with the existing fiduciary duty of investment advisers by requiring that brokers, dealers and investment advisers act in the best interest of customers when providing investment advice. We encourage the SEC in any rulemaking to implement such a uniform fiduciary standard of conduct to make clear that such a standard would be in keeping with the existing fiduciary duty standard, which has functioned effectively for many years, and is an integral part of how investment advisers conduct their business.

[1] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963).

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

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 are in favor of smart regulation that ensures market stability, protects investors, and facilitates capital formation. In our view, the existing framework of SEC regulation of private fund managers, as enhanced by the Dodd-Frank Act and regulatory implementation of the Act, is most effective in fulfilling the SEC's mission. We would be pleased to provide policy makers with any additional information that would be helpful about the private fund industry as they consider these important issues.

600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org