MANAGED FUNDS ASSOCIATION

VIA ELECTRONIC MAIL: rule-comments@sec.gov

September 15, 2004

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Registration Under the Advisers Act of Certain Hedge Fund Advisers ─ File No. S7-30-04

Dear Mr. Katz:

Managed Funds Association ("MFA") is pleased to submit this letter in response to the request of the Securities and Exchange Commission (the "SEC") contained in the Federal Register on July 28, 2004, Release No. IA-2266[1] (the "Release") for comments on the proposed rule and rule amendments to require registration of certain hedge fund advisers under the Investment Advisers Act of 1940 (the "SEC Proposal").

Introduction

MFA's membership includes over 800 professionals in the global alternative investment industry, including hedge funds, fund of funds and managed futures funds, that manage a substantial portion of the nearly $1 trillion invested in these investment vehicles. Our members include representatives of 34 of the 50 largest hedge fund groups in the world. Accordingly, as the leading trade association representing the hedge fund industry, MFA recognizes that with the growth and evolution of the hedge fund industry comes new responsibilities. MFA supports the SEC in its efforts to re-examine the regulatory framework under which an evolving industry, such as the hedge fund industry, operates to ensure that the framework remains suitable. MFA believes certain of the objectives sought to be achieved by the SEC Proposal can and should be addressed. However, it remains MFA's position that the imposition on hedge fund advisers of the proposed regulatory regime contemplated by the SEC Proposal will not

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1 Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Rel. No. IA-2266, 69 Fed. Reg. 45172 (July 28, 2004).

work to benefit investors or the global financial markets, and that other, more efficacious means may be employed to achieve the ends desired.

In sum, MFA believes that the success and growth of the hedge fund industry testify to the fact that the regulatory framework under which the hedge fund industry currently operates continues to work well. MFA also maintains that significant information about the hedge fund industry is available to the regulatory agencies that directly or indirectly oversee hedge fund activities[2] and that the coordination and sharing of such information would serve to achieve the SEC's objectives without great cost to the hedge fund industry and our capital markets. In contrast, direct regulation of hedge fund advisers under the Investment Advisers Act of 1940 (the "Advisers Act"), as contemplated by the SEC Proposal, would entail significant costs and unintended consequences for the hedge fund industry, investors and the U.S. capital markets and is not warranted by the three reasons cited in the Release – growth of the industry, incidence of fraud and retailization.

In this letter, MFA sets forth the basis for the existing regulatory framework and explains why the new regulatory regime contemplated by the SEC Proposal is not warranted. MFA also seeks to identify the costs and consequences associated with the SEC Proposal and questions the SEC's authority to implement the SEC Proposal given existing legal precedent and historical interpretation of the related regulations and legislation by both Congress and the SEC. In response to the request for alternative proposals in the dissent of Commissioners Atkins and Glassman, MFA is formally calling upon the President's Working Group on Financial Markets (the "PWG"), comprised of the Secretary of the U.S Department of Treasury (the "Treasury Department") and the Chairpersons of the SEC, the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the Commodity Futures Trading Commission (the "CFTC"), to identify available sources of information about the hedge fund industry and to implement memoranda of understanding or other information sharing arrangements that will ensure that the appropriate regulatory agencies will have access to this information as necessary to carry out their regulatory responsibilities. We believe this undertaking will likely yield an approach that more directly and efficiently

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2 *See* Annex A hereto (containing a detailed list of the regulatory filings (excluding tax-related and state "blue sky" filings) that hedge fund managers may be required to make in the United States depending on either their trading activity or their status as a regulated entity) and Annex B hereto (containing a detailed list of statutory authority of federal regulatory agencies which receive information about hedge funds through examinations and inspections of hedge fund brokers, dealers, lenders and counterparties).

achieves the SEC's objectives without the attendant costs of the SEC Proposal discussed later in this letter.

MFA is submitting these comments at this time in order to comply with the deadline established in the Release; however, given the considerable time required on the part of affected industry participants to assess the full potential impact of the SEC Proposal and to explore and develop meaningful alternatives, MFA reiterates its request and expresses its support for the requests made by numerous other trade associations that the current deadline for comments on the SEC Proposal be extended until at least October 28, 2004.[3] Such an extension would allow industry participants to fully assess the impact of the SEC Proposal and provide the time necessary to gather additional data, particularly with respect to the costs of the SEC Proposal, to prepare a more meaningful response to the issues and questions raised by the SEC in the Release and to explore in greater detail alternative proposals.

Summary of MFA's Position

In determining whether additional regulation of unregistered hedge fund advisers is necessary, the core objectives of the federal securities laws — protecting retail investors and assuring that markets are efficient — should be borne in mind. In light of these objectives, the federal securities laws have always recognized that private transactions between sophisticated parties should not be subject to the full panoply of regulations applicable to transactions involving retail investors. Accordingly, while MFA acknowledges the SEC's objectives, MFA believes that the SEC Proposal is inconsistent with these core objectives and is neither necessary nor beneficial to investors or the U.S. capital markets.

Appropriate Regulatory Framework Already Exists. As the SEC recognizes in the Release, hedge fund advisers that are not registered under the Advisers Act are nevertheless subject to the anti-fraud and anti-manipulation provisions of the Advisers Act, the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), as well as to prohibitions on insider trading

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3 *See* Letter of MFA; Chamber of Commerce of the United States, Washington, DC; The Alternative Investment Management Association Limited (AIMA), London, England; International Swaps and Derivatives Association, Inc. (ISDA), New York, New York; and Futures Industry Association (FIA), Washington, DC, August 13, 2004 (requesting an extension of the comment period). *See also* Letter of the Association of the Bar of the City of New York, August 17, 2004 (requesting an extension of the comment period) and Letter of the National Venture Capital Association, August 27, 2004 (requesting an extension of the comment period).

under the U.S. securities laws. In addition, there are safeguards covering the activities of hedge funds to the extent that they interact with regulated third parties such as registered broker-dealers and banks and, to the extent that they engage in futures trading, with futures commission merchants. As more fully discussed below, these existing rules and regulations reflect a well-established understanding of the fact that sophisticated investors do not need additional regulatory protections.

These rules and regulations also provide the SEC and other federal regulatory agencies with substantial information about the hedge fund industry. As noted above, MFA maintains that this existing information should be evaluated by the PWG in the belief that, through the coordination and sharing of this information, the federal regulatory agencies that directly and indirectly oversee hedge fund activities will be able to address the SEC's objectives without great cost to the industry and U.S. capital markets.

SEC Proposal Goes Far Beyond "Mere Registration." While certain of the SEC Commissioners and staff have stated that the SEC Proposal would merely require registration, MFA submits that it goes well beyond registration to impose a new regulatory regime that is incompatible with the core objectives underlying the federal securities laws. Registration under the Advisers Act would impose a number of burdensome and costly requirements on hedge fund advisers, including extensive books and recordkeeping requirements, the submission to time-consuming and costly periodic examinations and the hiring of chief compliance officers.

Impact on Investors and Capital Markets. The imposition of the new regulatory regime contemplated by the SEC Proposal will hurt hedge fund investors and the U.S. capital markets. The regulatory burdens that the SEC proposes to impose have the potential to impede entrepreneurial efforts and inhibit an industry that until now has been characterized by its diversity and innovation, the end result of which may be to limit the quality and quantity of available investment opportunities. The SEC Proposal would also divert precious SEC resources from the areas of the securities markets that traditionally have been the focus of the SEC's efforts -- the retail markets -- at a time when it seems the SEC resources are already grossly over-taxed.

Meaningful Consensus Should Be Reached Prior to Further SEC Action. The SEC Proposal is highly controversial and lacks meaningful consensus as to its merits. First, there is division within the SEC itself as evidenced by the unprecedented written dissent filed by two of its five Commissioners, Mr. Atkins and Ms. Glassman. Second, the other members of the PWG do not support the SEC Proposal. Most notably, Alan Greenspan, Chairman of the Federal Reserve, has on numerous occasions publicly expressed grave concerns about the impact of such regulation on financial institutions and capital markets as a whole.[4] Third, the fact that the industry itself opposes the SEC Proposal should not be overlooked.[5] Fourth, many investors have voluntarily chosen to invest with unregistered investment advisers, thereby evidencing that these investors do not consider mandatory registration essential. [6]

This lack of consensus threatens the efficacy and success of the SEC Proposal. Although there has been widespread participation in gathering information about the industry since the SEC staff commenced an examination of the hedge fund industry in 2002, it is also critical to have widespread participation in crafting a solution that meets the SEC's objectives. Moreover, since the SEC has identified this as only a "first step",[7] it is essential to identify the likely scope of future regulation at the outset so as not to create a specter of uncertainty that could have a chilling effect on the market.

Alternative Proposals. Given the short time in which to respond to the SEC Release, MFA has not had an opportunity to explore alternate proposals to the extent it believes is appropriate, but would welcome the opportunity to work with the SEC in crafting the specific terms of an alternative proposal. As discussed in more detail later in this letter, MFA concurs with Commissioners Atkins and Glassman that there

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4 *See, e.g., The Federal Reserve's Second Monetary Policy Report to Congress for 2004,* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (July 20, 2004); *Nomination of Alan Greenspan,* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (June 15, 2004); *The Federal Reserve's First Monetary Policy Report to Congress for 2004,* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (February 12, 2004); *Private-sector Refinancing of the Large Hedge Fund, Long-Term Capital Management*, Hearing Before Committee on Banking and Financial Services, U.S. House of Representatives, 105th Congress (October 1, 1998).

5 This industry opposition has been echoed in many of the top nationally recognized publications. S*ee, e.g.,* "Hands off Hedge Funds*," The Washington Post*, Editorial (July 18, 2004); "Too Stern a Hand-Hedge Funds," *The Economist*, Editorial (July 17, 2004); "The SEC's Expanding Empire," *The Wall Street Journal*, Editorial (July 13, 2004); "Reforming Hedge Funds," *The New York Times*, Editorial (June 27, 2004); "Mr. Donaldson's Hedge," *The Wall Street Journal*, Editorial (March 31, 2004); "Mr. Donaldson's Hedge Funds," *The Wall Street Journal*, Editorial (October 10, 2003).

6 *See* "2004 Alternative Investment Survey – Hedge Funds: Full Speed Ahead," *Deutsche Bank Equity Prime Services Report* (February 2004) at 16 (stating that only 15% of investors surveyed require that their hedge fund investments be managed by registered investment advisers).

7 Testimony of William H. Donaldson, Chairman of the SEC, *Regulation of the Hedge Fund Industry,* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (July 15, 2004).

should be further study before any action is taken and, in addition, the PWG should have the opportunity to identify and implement means of sharing available information about the hedge fund industry to the extent a regulatory agency seeking such information demonstrates appropriate need. This approach would address the SEC perception about lack of available information without the costs and burdens associated with the SEC Proposal.

If, following further study and the above-referenced undertaking by the PWG, the SEC is able to demonstrate that certain of its objectives remain valid and unsatisfied, alternative proposals could be explored.[8] For example, as discussed in more detail later in this letter, hedge fund advisers taking advantage of the exemptions from registration under the Advisers Act could be required, as a condition of the exemption, to submit to the SEC a notification containing information that the SEC demonstrates to be necessary or appropriate (taking into account information already available and any information-sharing arrangements implemented as part of the proposed PWG undertaking). This information could be made available, as appropriate, to investors, as well as state and federal regulators, in a central depository. In addition a hedge fund adviser relying on a registration exemption could be required to agree to provide, upon special call by the SEC under limited circumstances, certain information related to its business that the SEC may determine appropriate to enforce the anti-fraud and anti-manipulation provisions of the U.S. securities laws. The SEC could also require hedge fund advisers to provide a certification as to, for example, its compliance with certain qualification standards specified in Form ADV or its intent to comply substantially with the custody rules applicable to registered investment advisers (with appropriate disclosure and investor consent to any variations deemed desirable for the business model of the adviser). Each hedge fund adviser could also be required to undertake not to represent itself as registered with or regulated by the SEC.

These alternatives, together with those alternatives presented by other affected industry participants and the other suggestions raised throughout this letter, should be carefully considered before action is taken with respect to the SEC Proposal.

Background to MFA's Response

Evolution of Industry Examination. In 2002, the SEC requested that its staff examine the activities of hedge funds and hedge fund advisers in light of the growth

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8 MFA notes that a number of alternatives have been recommended by other affected industry participants.

in the number and size of hedge funds, the number of enforcement cases in which hedge fund advisers defrauded investors and the possibility that hedge funds were being marketed to retail investors.[9] The SEC staff's examination included a Hedge Fund Roundtable in May 2003 and a large number of submissions from industry participants, which culminated in the publication of the SEC staff report entitled *Implications of the Growth of Hedge Funds* (the "Staff Report") in September 2003. Based on the Staff Report and additional information gathering, the SEC staff developed the proposed rule and rule amendments set forth in the Release, which was proposed by the SEC in a split decision in July 2004.

MFA's Participation in the Industry Examination. MFA has been consistently involved in working with Congress, the SEC and other regulatory agencies to address issues raised in connection with the industry examination by participating in the Hedge Fund Roundtable, providing a response to the Staff Report and, most recently, testifying before the U.S. Senate Committee on Banking, Housing, and Urban Affairs in July 2004.[10] In particular, MFA has been and continues to be committed to promoting sound practices in the hedge fund industry. MFA has undertaken to foster sound compliance practices among both registered and unregistered investment advisers by publishing and promoting through periodic seminars its *2003 Sound Practices for Hedge Fund Managers* ("2003 Sound Practices"), which contains recommendations that are intended to promote sound business and compliance practices in the hedge fund industry

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9 *See* Speech by former SEC Chairman Harvey L. Pitt, "Remarks Before the Investment Company Institute 2002 General Membership Meeting," (May 24, 2002) (available at http://www.sec.gov/news/speech/spch562.htm).

10 *See, e.g.,* Statement of Adam C. Cooper, Chairman of MFA, before the Greenwich Roundtable (August 19, 2004); Testimony of Adam C. Cooper, Chairman of MFA, and Written Statement of MFA, *Regulation of the Hedge Fund Industry*, Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (July 15, 2004) (including written responses to Chairman Shelby's questions submitted on August 20, 2004); *MFA's Response to the Staff Report*, submitted to the SEC on November 21, 2003; MFA's *2003 Sound Practices for Hedge Fund Managers,* submitted to the SEC on August 6, 2003; MFA's *White Paper on Registration of Hedge Fund Advisers Under the Investment Advisers Act of 1940,* submitted to the SEC on July 7, 2003; MFA's *White Paper on Increasing Financial Eligibility Standards for Investors In Hedge Funds,* submitted to the SEC on July 7, 2003; *Written Statement of MFA, The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk*, Hearing Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, 108th Congress (May 22, 2003); *Comments of Managed Funds Association for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds May 14-15, 2003,* submitted to the SEC on May 6, 2003 and ongoing dialogue, meetings and correspondence with members of Congress and the PWG. All of these materials can be found at www.mfainfo.org.

and, in doing so, enhance investor protection while contributing to market soundness. These include recommendations regarding fulfilling responsibilities to investors and compliance with applicable rules and regulations. MFA developed these recommendations in the belief that "the most effective form of oversight is self-evaluation combined with self-discipline and self-policing."[11] As the Staff Report itself observes, "[t]he use of best practices can be an effective means of addressing issues that arise in the hedge fund industry."[12] Although the SEC did not reiterate this position with respect to best practices in the Release, the promotion of and reliance on sound practices should be given greater weight as an alternative to expending SEC staff resources.

History of the Relevant Exemptions and Exclusions from Registration

Investment Company Act. Under the Investment Company Act of 1940 (the "Investment Company Act"), any company that is engaged primarily in investing in securities must register as an investment company, unless an exemption or exclusion is available. To be excluded from this registration requirement, hedge funds rely on one of two exceptions from the definition of investment company. Section 3(c)(1) of the Investment Company Act excepts funds with no more than 100 U.S. beneficial owners that have not made and do not propose to make a public offering. Section 3(c)(7) of the Investment Company Act excepts funds whose securities are owned exclusively by "qualified purchasers" and that have not made and do not propose to make a public offering.

Congress adopted the exclusions set forth in Section 3(c)(7) of the Investment Company Act in response to a 1992 report of the SEC's Division of Investment Management (the "Division") that recommended the adoption of a new exception for private funds that are sold exclusively to "qualified purchasers," whether or not they have more than 100 U.S. investors. The Division reasoned that "[f]or issuers whose securities are owned exclusively by sophisticated investors, the * * * 100 investor limit [is] not supported by sufficient public policy concerns. The new exception would be premised on the theory that 'qualified purchasers' do not need the Act's protections because they are able to monitor such matters as management fees, transactions with affiliates, corporate governance, and leverage."[13]

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[11] 2003 Sound Pratices at 2.

[12] Staff Report at 102.

[13] SEC, Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation*, 104-05 (1992).

In 1996, Congress enacted the National Securities Markets Improvement Act ("NSMIA"),[14] which included the new exception for qualified purchaser funds. As the Senate report on the legislation explained:

> The qualified purchaser pool reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.[15]

The SEC Proposal runs counter to this well-established understanding that sophisticated investors can and should evaluate for themselves the structures and risks of the investments they undertake.

Advisers Act. The adviser of a hedge fund generally will come within the definition of an "investment adviser" under the Advisers Act. While some hedge fund advisers voluntarily register as investment advisers based on the structure and business model they adopt, other hedge fund advisers elect to rely on the exemption from registration that currently exists under Section 203(b)(3) of the Advisers Act for advisers

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14 P. L. No. 104-290, 110 Stat. 3416, 3432-33 (1996).

15 S. Rep. No. 104-293, at 10 (1996). *See also* H. R. Rep. No. 104-622, at 18 (1996):

> The legislation also provides a new exception from the definition of "investment company" to permit investment pools that sell their securities only to "qualified purchasers" who are deemed to be sophisticated investors to sell to an unlimited number of these investors. These pools, which include not only hedge funds but also financing vehicles such as venture capital funds that provide capital directly to start-up companies or businesses, currently operate pursuant to an exception in the Investment Company Act that limits the number of investors that can invest in these pools. Although there is no exact accounting of the total number and size of these private investment partnerships, estimates indicate that the total number may be as high as 3,000, with assets estimated between $75 and $160 billion. The Committee recognizes the important role that these pools can play in facilitating capital formation for U.S. companies. The Committee expects that the legislation will significantly reduce regulatory restrictions that have affected these pools, and will remove incentives that have caused some Americans to invest in unregulated offshore markets.

that have fewer than 15 advisory clients (counting each fund, and not each investor therein, as a client), do not hold themselves out to the public as investment advisers, and do not act as advisers to any registered investment companies. By interpreting "client" as referring to a fund as a single client, this exemption is consistent with the operational reality of private funds: a private fund adviser invests a fund's assets consistent with the investment guidelines applicable to the particular fund, rather than the financial objectives of individual fund investors. This interpretation of the Advisers Act also has been recognized implicitly and approved by Congress, in amendments to the Investment Company Act and the Advisers Act.

The SEC has consistently, since its enactment in 1940, acknowledged that, for client counting purposes, a fund, and not its equity owners, is an adviser's client by exempting any investment adviser who had fewer than 15 clients and did not hold itself out to the public as an adviser, even if the adviser was an adviser to a registered investment company. In a 1966 report entitled *Public Policy Implications of Investment Company Growth*, the SEC recommended that the law be changed to eliminate the exemption from registration for investment advisers that had registered investment companies as clients.[16] This recommendation evidences the fact that the meaning of client was never intended to include investors in the investment company, as that would have rendered the exception meaningless. Moreover, in making such recommendation to Congress to amend the Advisers Act, it is notable that the SEC did not suggest any amendment to the definition of client, thereby acknowledging that the well-established statutory meaning of client did not contain a "look through" provision to underlying investors as the SEC now suggests.

Since that time, the SEC has continued to recognize that where an adviser tailors its advice to the investment objectives of a fund, it is the fund itself and not its investors that should be deemed its client. As part of the Small Business Investment Incentive Act of 1980, Congress took the same approach toward business development companies, amending the Advisers Act to make clear that a business development company, rather than its individual investors, would count as the adviser's client. In 1985, the SEC proposed and adopted Rule 203(b)(3)-1, which codified these positions for funds organized as limited partnerships. As discussed above, in 1996 Congress enacted NSMIA, which included the exception under Section 3(c)(7) of the Investment Company Act to facilitate unregistered hedge funds offering to sophisticated persons, in recognition of the fact that these sophisticated persons do not need the additional protections of the

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[16] H.R. Rep. No. 87-2339 (1966).

Investment Company Act. As part of its effort to implement provisions of NSMIA in 1997, the SEC amended Rule 203(b)(3)-1 in order to broaden its scope and apply its client counting standard to other forms of business organizations, including corporations, general partnerships, limited liability companies, and trusts. In so doing, the SEC confirmed that its interpretation of client has not changed.[17]

In sum, Congress and the SEC have recognized that private investment funds and their advisers need not be required to register under the Securities Act, the Investment Company Act, and the Advisers Act. Given this history, it would be without proper authority and wholly inconsistent with past interpretation for the SEC to adopt the SEC Proposal on client counting to compel private fund advisers to register under the Advisers Act.

MFA's Response to SEC Proposal

Industry Developments

The Release concludes that further regulation of the hedge fund industry is necessary for three reasons: (i) growth of the industry, (ii) incidence of fraud in the industry and (iii) retailization of the industry. MFA responds to each of these concerns below in order to demonstrate that they are supported neither by the empirical data cited by the SEC nor by logic.[18]

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17 *See* MFA's *White Paper on Registration of Hedge Fund Advisers Under the Investment Advisers Act of 1940,* submitted to the SEC on July 7, 2003.

18 In the wake of the near-collapse of Long Term Capital Management, Inc., the PWG considered the issue of systemic risk raised by exposure of counterparties to highly-leveraged hedge funds and correctly concluded that direct regulation of hedge fund advisers was not an appropriate solution. The Report of the PWG concluded direct hedge fund regulation would "present formidable challenges in terms of cost and effectiveness" and that indirect measures "would best address concerns relating to systemic risk without the potential attendant costs of direct regulation of hedge funds." *See Report of the President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (April 1, 1999) at 26 and 42. As a result of the examination, counterparties under the supervision of banking regulators and the SEC subsequently changed their practices and procedures to manage and oversee the risk. No member of the PWG, which is the appropriate body to address market-wide systemic risk, has raised systemic risk as a concern with respect to hedge funds. Perhaps this is a recognition that the risks posed by hedge funds are no different than the risks posed by any large pool of private capital in the market and mere growth in private capital has not and should not give rise to a reason to regulate.

Growth of the Industry

Prosperity Benefits Investors and Capital Markets. Robust market growth does not justify the imposition of the regulatory regime contemplated by the SEC Proposal. The hedge fund industry has prospered under the existing legal framework to the benefit of investors and the U.S. capital markets. This success and growth testify to the fact that the current regulatory framework works well. It is important to bear in mind that it was the industry's substantial growth and success — and not a major crisis, scandal or structural flaw in the industry — that led the SEC to begin a sweeping examination of the industry in 2002.

Increased investment in hedge funds is a direct result of the growing demand from institutional and other sophisticated investors for investment vehicles that deliver true diversity and help them meet their future funding obligations and other investment objectives. It is therefore difficult to understand how the industry's growth in and of itself could serve as a basis for imposing a new regulatory regime that is not independently warranted by other factors.

Many hedge funds provide attractive mechanisms for portfolio diversification because their returns have little or no correlation to those of more traditional stock and bond investments.[19] As a result, many hedge fund categories tend to outperform stock and bond investments when the latter perform poorly. Furthermore, it is typical for hedge fund advisers to have a substantial amount of their own capital invested in the funds they manage, and a significant portion of their compensation is based upon the absolute, or positive, performance they achieve for their investors. As New York Attorney General Eliot Spitzer observed, the interests of hedge fund advisers and their investors tend to be "aligned", largely due to this combination of the advisers' commitment of capital to their funds and the performance-based compensation structure.[20]

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19 *See, e.g.,* Annex A to the *Comments of Managed Funds Association for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds May 14-15, 2003,* submitted to the SEC on May 6, 2003 (containing a bibliography of academic and other research regarding the attributes and benefits of hedge fund investments).

20 Testimony of Elliot Spitzer, Attorney General of the State of New York, *Strategic Planning, Resource Allocation and Crisis Management - Is the SEC Ready?* Hearing Before the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, U.S. House of Representatives, 108th Congress (April 20, 2004).

The role of hedge funds as highly active market participants allows them to trade and change their investment positions as circumstances warrant, and move quickly and flexibly to respond to changes in market conditions. The active and informed participation of hedge funds in financial markets allows them to perform a number of important roles in the global financial market place, including contributing to a decrease in overall market volatility, acting as "shock absorbers" by standing ready to put capital at risk in volatile markets when other investors choose to remain on the sidelines, providing markets with price information, which translates into pricing efficiencies, identifying pricing inefficiencies or trouble spots in current markets and introducing state-of-the-art trading and risk management techniques that foster financial innovation and risk sophistication among the market participants with which they deal.

Existing Framework is Appropriate. The existing statutory and regulatory framework is consistent with regulatory frameworks governing other institutional marketplaces, such as the markets for private placements, private equity, venture capital and OTC derivatives. This framework reflects a long-standing recognition by Congress and regulators that government resources should be devoted to protecting retail investors that require protection, rather than those that can look out for themselves. Material change to the regulatory framework governing this institutional marketplace, including a decision to apply different standards to the hedge fund industry as a whole, deserves careful scrutiny and further consideration as to whether the proposal will in fact achieve the desired objectives without unnecessary burdens and costs and unintended, harmful consequences.

There is a common misapprehension that hedge funds and their advisers operate "in the shadows," below the radar of federal and state regulators. However, unregistered hedge fund advisers are subject to a variety of rules and regulations. For example, hedge fund advisers, regardless of whether they are registered with the SEC as an investment adviser, are subject to the following:

- **Anti-Fraud Provisions and Insider Trading Prohibitions under the U.S. Securities Laws**. All hedge funds and their advisers are subject to the broad anti-fraud and anti-manipulation provisions of the Securities Act, the Exchange Act and the Advisers Act, which prohibit fraud in connection with the offer, sale and purchase of securities and in connection with the advisory relationship. In addition, hedge fund advisers are subject to the U.S. securities laws' prohibitions on insider trading. These provisions and the related rules and regulations create the need for all hedge fund advisers, whether or not they are registered as investment advisers with the SEC, to have explicit trading and valuation policies and procedures to avoid liability.

- **CFTC Regulation.** A substantial majority of the large hedge fund advisers that are not registered with the SEC are registered with the CFTC as commodity trading advisors ("CTAs") and/or commodity pool operators ("CPOs") and are therefore subject to the CFTC's registration, reporting and recordkeeping requirements, as well as periodic on-site audits by the National Futures Association ("NFA") for purposes of determining their general compliance with applicable CFTC and NFA rules. Although the CFTC has recently adopted rules that may provide exemptions from registration as CTAs or CPOs, to date there is no evidence that, nor does MFA anticipate that, many of the hedge fund advisers will withdraw their CFTC registration. Accordingly, the SEC Proposal would be particularly burdensome for those hedge fund advisers registered with the CFTC, as many of the recordkeeping requirements and examination procedures imposed by the Advisers Act could result in potentially duplicative compliance costs.

- **NASD Regulation ("NASD-R")**. A number of hedge fund advisers have affiliates or funds that are registered as broker-dealers and regulated by NASD-R, which administers a comprehensive compliance regime. In addition, broker-dealers that sell interests in hedge funds are subject to the requirements of NASD rules. NASD requires broker-dealers to comply with suitability requirements that, among other things, require the broker-dealer to have both a reasonable basis for believing that the product is suitable for any investor and to determine that its recommendation to invest in a hedge fund is suitable for the particular investor.

- **Reporting Requirements.** As with other market participants, hedge funds are required to comply with certain reporting requirements designed to increase market transparency, including various SEC equity ownership and portfolio reporting requirements, large position and other reporting requirements of the Treasury Department and the Federal Reserve in connection with government securities and foreign exchange transactions, and the CFTC large trader reporting system.

- **Anti-Money Laundering Regulations.** U.S. hedge funds (and hedge funds with a U.S. nexus) will be required by the Treasury Department to file notices containing specified information to comply with certain key provisions of the USA PATRIOT Act once final rules are promulgated with respect to hedge funds. MFA has published *Preliminary Guidance*, as well as an *Update* to this document, on developing anti-money laundering programs in order to prepare hedge funds for complying with these requirements.[21]

Concerns cited regarding the lack of information available about hedge funds and their investment advisers are not justified as they fail to properly account for the extent of information already available to federal and state regulators with respect to the hedge fund industry. As detailed above, hedge fund advisers are already subject to a wide array of regulations and reporting requirements through which regulators are able to gather a significant amount of information about hedge funds and their trading activities.[22] Moreover, the SEC generally has access to records of trading on behalf of hedge funds through the books and records maintained by the brokers and lenders that hedge fund advisers use. In addition, all hedge funds are subject to significant indirect regulation through their relationships with these broker dealers, as well as U.S. banks and futures commission merchants.[23] As a result, the SEC should evaluate the information it already has and consult with other regulatory agencies about the body of available information prior to imposing a new regulatory regime on hedge fund advisers. As noted and discussed further below, MFA believes that members of the PWG should evaluate the information available to them to determine how this information can be shared among agencies and made available to investors in order to achieve the objectives of the SEC Proposal without unnecessary burdens on hedge fund advisers.

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21 *See* Proposed Rule: Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 60617 (Sept. 26, 2002). MFA's *Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs* (March 2002) and MFA's *USA PATRIOT Act Update* (February 2003) are available at www.mfainfo.org.

22 *See* Annex A hereto.

23 *See* Annex B hereto.

Incidence of Fraud

Empirical Data. The incidence of fraud cited in the Release does not justify the regulatory regime contemplated by the SEC Proposal. The SEC Staff Report stated that there is "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."[24] Even SEC Chairman Donaldson has acknowledged that he has "no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else."[25]

In the Release, the SEC indicates that its concern with fraud by hedge funds stems in part from the mutual fund late trading and market timing that has been uncovered since the publication of the SEC Staff Report and in part from an increase (in absolute terms) in the number of enforcement cases brought by the SEC with respect to hedge funds.[26] However, as SEC Commissioners Atkins and Glassman pointed out in their dissent, the new regulatory regime proposed by the SEC would not address the types of frauds observed. The large majority of the cases cited by the SEC involved advisers that were either too small to be captured by the SEC Proposal or were registered already.[27] Moreover, the number of enforcement cases brought by the SEC against hedge funds in the last five years remains relatively small, less than 2% of the total cases.

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24 Staff Report at 73.

25 Testimony of William H. Donaldson, Chairman of the SEC, *Recent Developments in Hedge Funds*, Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (April 10, 2003).

26 Late trading and market timing occurred despite the fact that both mutual funds and broker-dealers are already subject to comprehensive examination. Therefore, it is difficult to see how expanding examination to the hedge fund industry would have led to a different result.

27 Commissioners Atkins and Glassman indicate in their dissent that:

> Eight of these 46 cases [mentioned in the Release] involve hedge fund advisers who were already registered with the Commission. In five of the 46 cases, the fund should have been registered under the Investment Company Act, so their advisers already should have been registered under current rules. In 20 of the 46 cases, the hedge funds were too small to be covered by the proposed rulemaking. In two cases, the fraud involved a principal of a registered broker-dealer or investment adviser, over whom we already had full regulatory oversight. Three of the 46 cases were garden-variety fraud designed to swindle investors, regardless of whether the vehicles were called hedge funds, venture capital funds, limited partnerships or prime banks. Registration might have deterred them from using the term "hedge fund," but would not have deterred the fraud itself (July 28, 2004) (available at www.sec.gov/rules/proposed/ia-2266.htm#dissent).

Notwithstanding the foregoing, MFA shares the SEC's contempt for fraud in the money management industry and supports the efforts of the SEC and other regulators and law enforcement authorities to investigate and prosecute fraudulent conduct. MFA's concern with the SEC's Proposal is that the means proposed will not accomplish the ends desired. Instead the SEC should seek to maximize its enforcement resources through coordination and consultation with other enforcement authorities and experts. MFA, therefore, supports the recommendation by Commissioners Atkins and Glassman in their dissent that the SEC "revisit [its] oversight methods rather than looking for more entities to inspect." This is appropriate not only in light of the relatively low incidence of hedge fund fraud in the industry, but also in light of the increased examination procedures recently undertaken by the SEC to address, among other things, the late trading and market timing scandal in the mutual fund industry, and which are likely to overburden the SEC's limited resources.

Deterring Effect. The Staff Report and Release argue that SEC examination permits compliance problems to be identified at an early stage and serves as a deterrent to fraud and other unlawful conduct. Recent findings suggest otherwise, however. Richard J. Hillman, Director of Financial Markets and Community Investment of the General Accounting Office, testifying as to the reasons why the SEC did not detect abusive practices involving mutual funds, stated that, "according to SEC staff, many of the cases involved fraud and collusion among personnel and such activity is very hard to detect in a routine examination."[28] Alan Greenspan echoed this concern by indicating that the SEC Proposal "seeks to deter fraud and market manipulation but is unlikely to accomplish those objectives. The information reported to the SEC by registered advisers is very limited and would be of little value for these purposes. Nor are examinations of advisers likely to uncover much fraud. Our experience with bank examinations indicates that examiners have great difficulty uncovering fraud."[29]

Success in discovering fraud has also proved elusive with respect to other types of entities, such as registered broker-dealers and investment companies, which are

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[28] Testimony of Richard J. Hillman, Director, Financial Markets and Community Investment, United States General Accounting Office, *SEC Operations, Oversight of Mutual Fund Industry Presents Management Challenges*, Hearing Before the Subcommittee on Efficiency and Financial Management, Committee on Government Reform, U.S. House of Representatives, 108th Congress (April 20, 2004).

[29] *The Federal Reserve's Second Monetary Policy Report to Congress for 2004,* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (July 20, 2004) (written response of Alan Greenspan, Chairman of the Federal Reserve, to question from Senator Crapo).

subject to regulatory audits. It is clear that those audits have neither deterred nor prevented fraudulent activities.

The premise that the absence of direct regulation increases the likelihood of fraud is without foundation, and the SEC has failed to demonstrate that the SEC Proposal will serve as a deterrent to fraud or enable the SEC to detect fraud in a meaningful way. Furthermore, MFA maintains that the regulatory framework currently in place is adequate to enable the Enforcement Division at the SEC and state regulators to investigate and prosecute hedge fund fraud cases to the fullest extent under the securities laws (including criminal referrals). Therefore, given the relatively low incidence of fraud in the hedge fund industry, MFA believes it would be preferable for the SEC to focus its efforts on those market participants providing true retail-level services to investors that are not able to fend for themselves.

Growth in Retailization

The SEC expresses concern about growth in the exposure of retail investors and public and private pension funds, directly or indirectly, to hedge fund investments. However, concerns regarding retailization do not justify, and would not be addressed by, the imposition of the regulatory regime contemplated by the SEC Proposal. Moreover, as described below, the current regulatory framework provides the SEC the tools necessary to ensure the protection of retail investors, and reliance on this framework is a more efficient, less intrusive, means than adopting new rules.

Funds of Hedge Funds. Publicly offered funds of hedge funds ("FOHFs") are subject to the full panoply of protections afforded by SEC registration and regulation because they are registered with the SEC as investment companies and sold in registered public offerings.[30] In addition, advisers of these FOHFs are registered under the Advisers Act. The SEC should therefore exercise its existing authority and judgment to address investor protection issues that may be presented by these registrants. To the extent the

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[30] MFA notes the statement of Paul Roye, Director of the SEC's Division of Investment Management, in *The Wall Street Journal* that "hedge fund investment is moving downstream." Aaron Lucchetti, "Little Guy Finds 'New' Investment," *The Wall Street Journal* (September 15, 2004) at C1. As Mr. Roye and the SEC are well aware, the only way that hedge funds can become "full-blown retail" products is if they are subject to the full panoply of existing SEC regulations. MFA believes that to suggest otherwise is merely a thinly veiled attempt by the SEC to confuse the issue of FOHFs in order to gain unjustified support for its claim of retailization.

SEC believes additional action is necessary, it has full authority to require the registration of advisers to the underlying funds.[31]

Pension Plan Investment. MFA does not believe that investment by pension plans in hedge funds is an adequate rationale for imposing the regulatory regime contemplated by the SEC Proposal.[32] Hedge funds represent the smallest percentage of "alternative investments" in which pension funds invested in 2003, approximately 1% of their total assets, as compared to real estate and private equity, in which pension funds invested 3.4% and 3% of their total assets, respectively.[33] Furthermore, as a result of the existing statutory framework applicable to private pension funds, a large majority of pension funds invest with hedge funds managed by advisers that are voluntarily registered with the SEC. Moreover, investors are represented by professional money managers who act as fiduciaries to the plans and are subject to comprehensive regulation under the Department of Labor's Employee Retirement Income Security Act of 1974 ("ERISA"). The operation of ERISA has built in incentives for plan fiduciaries to invest with registered advisers by generally limiting such fiduciaries' liabilities under ERISA for misconduct by registered hedge fund advisers.[34]

Investor Qualification. Concerns regarding investor qualification and lowering of hedge fund investment minimums should be addressed directly by raising accredited investor standards,[35] not indirectly through mandatory investment adviser

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31 *See also* the dissent of Commissioners Atkins and Glassman stating that "if the [SEC] can demonstrate that publicly-offered funds of hedge funds pose real undisclosed risks to retail investors, the [SEC] could consider whether the problem can be addressed by reversing past regulatory actions that have permitted these funds of hedge funds to be publicly offered" (July 28, 2004) (available at www.sec.gov/rules/proposed/ia-2266.htm#dissent).

32 William H. Donaldson, Chairman of the SEC, *Testimony Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry,"* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (April 20, 2004) at 20 (initially raising issue of protection of pensioners vis à vis hedge fund investments).

33 Greenwich Associates, *Alternative Investments May Disappoint Dabblers* (January 21, 2004) (available at http://www.greenwich.com/).

34 *See* Richard K. Matta, "ERISA for Securities Professionals," *The Journal of Investment Compliance*, (Summer 2004) (Vol. 5, No. 1) at 69.

35 Rule 501 of Regulation D defines an "accredited investor" to include certain institutional investors as well as any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000 or who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. Regulation D is based on the recognition that there are situations in which there may be no need

registration. The Staff Report expressed concern that the rise in investor wealth and incomes has allowed a large number of investors to meet the "accredited investor" standard which could ultimately result in "retail investors investing directly in hedge funds relying on Section 3(c)(1) of the Investment Company Act."[36]

Although this concern was not re-addressed in the Release, MFA believes that the SEC staff's concern regarding the increase in the number of persons qualifying as accredited investors is valid. However, it is not one that is appropriately, or even adequately, remedied by requiring hedge fund advisers to register as investment advisers. Instead, the SEC should address this increase directly by raising the accredited investor standard so that the monetary thresholds reflect the inflation in wealth and incomes since 1982[37] or by imposing a similar enhanced accredited investor standard under the Advisers Act for hedge fund investors.

Impact on Market and Investors

The SEC is proposing to reverse course with respect to a regulatory framework that has served the industry, its investors and the U.S. capital markets well. As discussed above, the hedge fund industry is a thriving one and the imposition of the new regulatory regime contemplated by the SEC Proposal would entail substantial costs to this industry, its investors and the U.S. capital markets without providing corresponding benefits.

Future Restrictions. The SEC Proposal raises the specter of potential future restrictions on hedge fund advisers and creates business uncertainty for the hedge fund industry. This uncertainty has the potential to do substantial harm because industry participants are unable to predict parameters and costs in structuring business opportunities. Of particular concern is Chairman Donaldson and the SEC staff's indication that this proposal is a "modest first step".[38] As Commissioners Atkins and

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(footnote continued from previous page)

for the registration provision of the Securities Act or in which the public benefits of registration may be too remote to require expensive and time consuming compliance.

36 Staff Report at 95.

37 *See* MFA's *White Paper on Increasing Financial Eligibility Standards For Investors In Hedge Funds,* submitted to the SEC on July 7, 2003.

38 Testimony of William H. Donaldson, Chairman of the SEC, *Regulation of the Hedge Fund Industry,* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (July 15, 2004).

Glassman point out in their dissent, "this begs the question of what this is a first step towards." Indeed, it is this potential for future, more substantive regulation that is likely to stifle hedge funds' innovation and ability to carry out business. It is therefore MFA's belief that any material change to the regulatory framework governing this institutional marketplace deserves careful consideration and scrutiny and should establish a clear framework for future regulatory action at the outset.

Chairman Greenspan shares MFA's concern about the drawbacks of an uncertain regulatory environment. He suggested that "should registration fail to achieve the intended objectives, pressure may well become irresistible to expand the SEC's regulatory reach from hedge fund advisers to hedge funds themselves. The application of the Investment Company Act to hedge funds would greatly impede their important contributions to the flexibility and resiliency of our financial system."[39]

Opportunity and Actual Costs of SEC Proposal. The business uncertainty and potential losses and costs referred to by Chairman Greenspan and Commissioners Atkins and Glassman will be borne not only by the hedge fund advisers themselves, but also by investors. The costs associated with investment adviser regulation, in terms of management time and resources, infrastructure and professional advisors necessary to handle examinations and document requests as well as maintaining on-going compliance programs consistent with books, recordkeeping and other requirements imposed by the Advisers Act, are continuing obligations, not one-time costs, that are far greater than the SEC acknowledges. The fact that the costs of regulation are far greater than the SEC acknowledges provides further support to MFA's position that further action should not be taken on the SEC Proposal until the costs are better understood and substantiated.

Registration under the Advisers Act requires compliance with a number of provisions. The Advisers Act requires the filing of a comprehensive registration statement providing information about the adviser, Form ADV, and requires the adviser to deliver this form to each prospective client. Each registered adviser must designate a chief compliance officer, adopt a code of ethics and prepare additional written policies and procedures. There are substantial requirements and costs relating to maintenance of books and records, including required retention policies relating to emails, employee trading records and advertising materials. There are advertising restrictions and custody

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39 *The Federal Reserve's Second Monetary Policy Report to Congress for 2004,* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (July 20, 2004) (written response of Alan Greenspan, Chairman of the Federal Reserve, to question from Senator Crapo).

requirements that include delivery of audited financial information. While the foregoing description is not an exhaustive list, MFA points out that these provisions impose tremendous costs to hedge fund advisers and believe that more data must be collected in order to fully understand the impact on the hedge fund industry of such requirements.

These requirements give rise to categories of expenses that we urge the SEC to further assess before proceeding with the SEC Proposal, including outside legal expenses, costs in establishing a compliance infrastructure and resources in handling examination. MFA members have estimated that they incurred outside legal and other expenses in excess of $300,000 in preparing for registration and establishing the compliance infrastructure required of a registered investment adviser. In particular, MFA estimates that the cost of hiring a chief compliance officer is likely to range from approximately $225,000 per year for smaller hedge funds to approximately $500,000 per year or more for larger hedge funds.

MFA members have also asserted that Form ADV is unduly time consuming because the form is not designed for use by hedge funds. One MFA member has indicated that dozens of hours of time were spent by its compliance officer in preparing a Form ADV filing and in coordinating with other departments to develop backup for filing, with internal costs in staff time estimated at over $75,000. In addition to initial registration, being subject to examination results in significant expense and tremendous use of internal resources that can be particularly burdensome and disruptive to operations of hedge fund advisers, particularly those with limited numbers of personnel. One MFA member stated that the SEC examination process was lengthy, with at least 160 hours of internal staff time dedicated to meeting the SEC examiner's requests over a ten-week period.

As discussed in more detail throughout this letter, there are less quantifiable costs that result from implementation of the SEC Proposal, such as the erection of a significant barrier to entry into the hedge fund business, which will tend to reduce the number of new funds that will form and reduce investor access to potential new money management talent. Moreover, the SEC Proposal will result in a limitation on choice by imposing registration. Sophisticated persons should be able to choose to invest their money with unregistered hedge fund advisers.[40] Likewise, hedge fund advisers should be able to choose to limit their potential marketability by remaining

[40] One survey suggested that only 15% of investors in hedge funds require their investments to be in funds that are registered investment advisers. *See* "2004 Alternative Investment Survey – Hedge Funds: Full Speed Ahead," *Deutsche Bank Equity Prime Services Report* (February 2004) at 16.

unregistered and forego the costs and burdens associated with investment adviser registration. Not only is the market able to support these distinct options, but limiting these choices for investors and hedge fund advisers will adversely affect the markets as a whole.

Chilling Effect. The unquantifiable costs and potential chilling effect of the SEC Proposal should be of tremendous concern. The chilling effect will cost not only our financial system in terms of flexibility and liquidity, but also the hedge fund industry's investors in terms of performance and the risk-return profile that they seek from hedge funds. Specifically, the regulatory regime contemplated by the SEC Proposal has the potential to undermine and inhibit hedge fund advisers' willingness to engage in complex and innovative investment strategies and to invest in illiquid markets, for fear that their intentions or objectives will be misunderstood or second-guessed in retrospect. The SEC Proposal has the potential to create inefficiency and instability in our capital markets by stifling the willingness of hedge funds to act as shock absorbers and provide risk capital in times of market instability at a time when the proper focus should be enhancing the efficiency of markets. Imposing the investment adviser regulatory regime on these advisers could unduly constrain their entrepreneurial efforts by imposing a one-size-fits-all regulatory structure.

In the words of Chairman Greenspan:

> If you start to inhibit [hedge funds] from taking the types of risks and supplying the liquidity, I'm fearful that we will remove some of the flexibility that we have in our overall system. And while I am certainly of the opinion that should hedge funds accept capital from retail investors, they should go under the same regulations as a mutual fund. But so long as their source of funds, equity funds, are professional or large investors with net worth say exceeding $1 million or more, I see no purpose in regulation and I see very significant potential loss in doing so.[41]

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[41] *Nomination of Alan Greenspan,* Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (June 15, 2004) (statement of Alan Greenspan, Chairman of the Federal Reserve, in response to a question from Senator Sununu).

Moreover, as discussed above, MFA believes that a reduction of systemic risk is an essential goal. However, this risk is properly being addressed without imposing new regulation. In fact, the imposition of regulation contemplated by the SEC Proposal threatens to cause inefficient and unstable markets, not to reduce systemic risk.

In addition to potentially stifling innovation and deterring certain money managers from entering the industry, MFA is concerned that the burdens associated with the SEC Proposal could lessen the ability of U.S hedge funds to compete with offshore hedge funds, result in offshore hedge funds no longer making offerings available to U.S. investors and thereby, in both cases, decreasing investment opportunities available to U.S. investors. Moreover, some have suggested that the SEC Proposal could encourage those that wish to retain the flexibility necessary to implement innovative investment strategies to move offshore and outside the SEC's jurisdiction.[42] As Chairman Greenspan put it:

> [M]ost hedge funds are only a short step from cyberspace. Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. The best we can do in my judgment is what we do today: regulate them indirectly through the regulation of the source of their funds. We are thus able to monitor far better hedge funds' activity, especially as they influence US financial markets. If the funds move abroad, our oversight will diminish.[43]

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42 *See, e.g.*, *Bank Lending to and Other Transactions with Hedge Funds,* Hearing Before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking & Financial Services, U.S. House of Representatives, 106th Congress (March 24, 1999) (statement of Laurence H. Meyer, Board of Governors, Federal Reserve).

43 *Private-sector Refinancing of the Large Hedge Fund, Long-Term Capital Management*, Hearing Before the Committee on Banking and Financial Services, U.S. House of Representatives, 105th Congress (October 1, 1998) (statement of Alan Greenspan, Chairman of the Federal Reserve). *See also* Statement by William J. McDonough as President of the Federal Reserve Bank of New York and Chairman of the Basel Committee on Banking Supervision, Hearing Before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking and Financial Services, U.S. House of Representatives, March 24, 1999) ("I do not believe that it would be easy to develop a workable approach to the direct oversight of hedge funds. The reality is that imposing direct regulation on hedge fund entities that are chartered in the major industrialized countries would likely result in the movement of all operations offshore. Direct regulation of hedge funds would require a high level of coordination involving the political, legislative, and judicial bodies of many countries").

This result would be counteproductive to the intent of the SEC Proposal, as it could lead to a decrease in the amount of information available to U.S. regulators to the extent that domestic hedge fund advisers are motivated to relocate offshore.

Mandatory Registration Could Mislead Investors. The SEC asserts in the Release that the SEC Proposal will legitimize the hedge fund industry and notes that "without appropriate regulatory oversight to check growing hedge fund fraud, investors' confidence in hedge fund advisers and the hedge fund industry could eventually erode."

MFA is concerned that SEC oversight of the hedge fund industry could create a "moral hazard" for the SEC by providing hedge fund investors with a false sense of enhanced investor protection. As Commissioner Glassman once put it, "I wouldn't want to mislead investors into thinking that SEC exams of hedge funds give them a good housekeeping seal of approval."[44] Mandatory registration of hedge fund advisers could create an expectation among investors and financial market participants that the SEC will be able to detect and protect them from difficulties or improper trading or valuation practices in the operations of hedge funds. In doing so, mandatory registration could harm investors and market counterparties that may rely on adviser registration as evidence of SEC supervision and approval and lead them to be less diligent in analyzing potential hedge fund investments or counterparties and less demanding in negotiating relationship terms.

Alternate Proposals

MFA reiterates that if the SEC were to take action to adopt the SEC Proposal it would be without statutory authority and would represent a hasty decision in light of the short period of time in which the industry and other affected market participants have been required to respond. In addition, the content of the Release and the information gathered by the SEC staff as part of its examination of the industry indicate that further study is required to determine what types of information are already available and whether that information could be used by the SEC rather than imposing a new regulatory regime. As Commissioner Glassman has stated:

> The plan before us is to register hedge fund advisers and then figure out what we should be doing. This strikes me as

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44 Speech by SEC Commissioner Cynthia A. Glassman, at the Eighth Annual Conference on The Practical Implications of SEC Regulation Outside the United States, (February 17, 2004) (London, England) (available at http://www.sec.gov/news/speech/spch021704cag.htm).

> putting the cart before the horse. My approach would be to decide what information is useful before we decide how best to get it. Lest this be mistaken for a delaying tactic, I would like to point out that I have been advocating this approach for months. What I have suggested is a more robust study that focuses on identifying the qualitative and quantitative information that would raise red flags and provide systematic data on hedge fund trends and practices. Our staff study, although it represents a lot of work and contains much descriptive information, is not sufficient for this purpose.[45]

MFA concurs with this recommendation for an additional study. In addition MFA has formally called upon the PWG to evaluate how available information about the hedge fund industry can be shared. The proposed undertaking by the PWG will likely demonstrate that the SEC's concerns can be addressed through making accessible the information that is already available to federal agencies.

Further study and examination of the SEC Proposal will also likely demonstrate that the costs to the hedge fund industry, investors and the SEC itself of the regulatory regime contemplated by the SEC Proposal far exceed what the SEC has acknowledged to date. Reliance on the existing regulatory framework would permit not only the information sharing among the members of the PWG proposed above but also the raising of accredited investor standards discussed earlier in this letter without the costs of the SEC Proposal. In addition, MFA recommends that the SEC consider relaxing existing solicitation standards as the SEC staff recommended in the Staff Report. An increase in information available through advertising and other marketing channels would also help to address the perceived concern about lack of available information relating to the hedge fund industry.

In the event that, after undertaking further study and the implementation of the information-sharing arrangements that have been recommended, the SEC validly demonstrates that certain of its objectives remain to be satisfied, alternative proposals should be explored. For example, the SEC should consider the alternative described below, which would achieve the SEC's objectives while simultaneously minimizing costs and recognizing that sophisticated investors do not need nor seek the same level of

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[45] Remarks of Commissioner Glassman, SEC Open Meeting, July 14, 2004.

protection as retail investors. As noted above, MFA would welcome the opportunity to work with the SEC on crafting the specific terms of any alternative proposal.

Any unregistered hedge fund adviser (regardless of whether it has less than 30 million in assets under management) relying on and operating under the exemptions of Sections 3(c)(1) or 3(c)(7) of the Investment Company Act could be required to notify the SEC of its intention to operate as a hedge fund adviser in reliance on the relevant exemption. The notice could include certain basic census information about the hedge fund adviser determined to be necessary or appropriate (taking into account information already available and any information-sharing arrangements implemented as part of the proposed PWG undertaking) and identify a person designated to receive communications from the SEC. The notice could also include certifications that (i) no executive officer or member of the governing board of, or any holder of a 10 percent or greater equity interest in, the adviser is a person that would respond "yes" to one or more questions on Item 11 of Form ADV; (ii) the hedge fund adviser will comply with the conditions for the relevant exemption and will substantially comply with the custody rules applicable to registered investment advisers pursuant to Rule 206(4)-2 of the Advisers Act (with appropriate disclosure and investor consent to any variations thereto required for the business of the adviser); and (iii) the hedge fund adviser will notify the SEC of any material change in the information previously provided by the hedge fund adviser to the SEC pursuant to the notice requirement. This information could be made available in some type of central depository, as appropriate, to investors and federal and state regulators.

In addition, unregistered hedge fund advisers relying on exemptive relief from registration could agree that, upon special call by the SEC, they would provide to the SEC, in a form and manner and within the period specified in the special call, such information related to its business as an exempt hedge fund adviser, including information relating to transactions as the SEC may determine appropriate, in those limited circumstances where the SEC deems such information necessary to enforce the anti-fraud and anti-manipulation provisions of the U.S. securities laws. Finally, unregistered hedge fund advisers relying on exemptive relief could be required to agree not to represent to any person that it is registered with, or designated, recognized, licensed, or approved by the SEC.

Conclusion

MFA maintains that the existing regulatory framework under which the hedge fund industry operates works well and that the SEC already has access to important information regarding the hedge fund industry. The reasons cited by the Release do not warrant the imposition of the regulatory regime contemplated by the SEC Proposal and many of the SEC objectives can be met through less burdensome, more efficient means. MFA urges the SEC to support sound practices in the hedge fund industry and work with the existing regulatory framework and with information already available to federal agencies to accomplish its goals without the costs and burdens of the SEC Proposal and without an unwise circumscription of the statutory exemptions for private investment advisers and hedge funds.

[*signature page follows*]

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We appreciate this opportunity to comment on the SEC Proposal and we would be happy to discuss any questions the SEC or its staff may have with respect to this letter. Please feel free to reach me at 202.367.1140.

Very truly yours,

/s/ John G. Gaine

John G. Gaine
President

cc: Chairman William H. Donaldson
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Paul F. Roye, Director, Division of Investment Management
Cynthia M. Fornelli, Deputy Director, Division of Investment Management
Giovanni P. Prezioso, General Counsel
Alan L. Beller, Director, Division of Corporate Finance
Annette L. Nazareth, Director, Division of Market Regulation

Annex A

MANAGED FUNDS ASSOCIATION

2003 SOUND PRACTICES FOR HEDGE FUND MANAGERS

U.S. REGULATORY FILINGS BY HEDGE FUND MANAGERS[1]

Listed below are regulatory filings (excluding tax-related, broker-dealer and state "blue sky" filings) that Hedge Fund Managers may be required to make in the United States depending on either their trading activity or their status as a regulated entity. The filings made to regulators by individual Hedge Fund Managers will vary depending on the type and volume of trading in which they engage, their business model and the jurisdictions in which they operate. For example, like other market participants and institutional investors, Hedge Fund Managers are required to make certain filings in the United States if the size of the positions they hold in certain markets reaches "reportable" levels. In addition, some Hedge Fund Managers are regulated entities in the United States or are otherwise subject to a regulatory regime, and, like other similarly situated entities, are required to make certain filings in that capacity. This appendix lists filings required in the United States where the above circumstances apply to a Hedge Fund Manager. Hedge Fund Managers may also be subject to regulatory reporting and filing requirements in the foreign jurisdictions in which they conduct their business.

Federal Reserve

Treasury Securities Position and Foreign Exchange Transaction Reporting

1. *Large Position Reporting*	Report of positions in specific Treasury security issues that exceed the large position threshold specified by the U.S. Treasury Department (minimum $2 billion). Reports are filed in response to notices issued by the U.S. Department of the Treasury if such threshold is met. Reports are filed with the Federal Reserve Bank of New York and are not public.
2. *Form FC-1*	Report of weekly, consolidated data on the foreign exchange contracts and positions of major market participants. Reports to be filed throughout the calendar year by each foreign exchange market participant that had more than $50 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year. The report is filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of the Treasury and is

[1] The content of this Annex B reproduces Appendix II of MFA's 2003 Sound Practices for Hedge Fund Managers (August 2003). Capitalized terms have the meanings given to them in that document.

confidential.

3. *Form FC-2*

Report of monthly, consolidated data on the foreign exchange contracts and foreign currency denominated assets and liabilities of major market participants.

Reports to be filed throughout the calendar year by each foreign exchange market participant that had more than $50 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year.

The report is filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of the Treasury and is confidential.

4. *Form FC-3*

Report of quarterly, consolidated data on the foreign exchange contracts and foreign currency denominated assets and liabilities of major market participants.

Reports to be filed throughout the calendar year by each foreign exchange market participant which had more than $5 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year and which does not file Form FC-2.

The report is filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of the Treasury and is confidential.

Treasury Auction Filings

5. *Treasury Auction*	Treasury security reports filed as necessary. Confirmations must be filed by any customer who is awarded a par amount of$500 million or more in U.S. government securities in a Treasury auction. The confirmation must include its reportable net long position, if any. The confirmation is filed with the Federal Reserve Bank to which the bid was submitted and is not public.

Treasury International Capital Forms

6. *Forms CM, CQ-1* and *CQ-2*	Forms filed by U.S. persons who have claims on, or financial liabilities to unaffiliated foreigners, have balances on deposit with foreign banks (in the U.S. or abroad) or otherwise engage in transactions in securities or other financial assets with foreigners. Forms CQ-1 ("Financial Liabilities to, and Claims on, Unaffiliated Foreigners") and CQ-2 ("Commercial Liabilities to, and Claims on, Unaffiliated Foreigners") are quarterly reports, which collect data on financial and commercial liabilities to, and claims on, unaffiliated foreigners held by non-banking enterprises in the United States, which must be filed when the consolidated total of such liabilities are $10 million or more during that period. Form CM ("Dollar Deposit and Certificate of Deposit Claims on Banks Abroad") is a monthly report whereby non-banking enterprises in the U.S. report their total dollar deposit and certificate of deposit claims on foreign banks, which must be filed when the consolidated total of such claims are $10 million or more during that period. The forms are filed with the Federal Reserve Bank of New York are non-public except for aggregate information.
7. *Form S*	Form filed by any U.S. person who purchases or sells $2 million or more of long-term marketable domestic and foreign securities in a month in direct transactions with foreign persons. The form is filed with the Federal Reserve Bank of New York and is non-public except as to aggregate information.

Securities and Exchange Commission ("SEC")

Sale of Securities by an Issuer Exempt from Registration under Reg. D or 4(6)

8. *Form D*	Notice of sale filed after securities, such as interests in a private hedge fund, are sold in reliance on a Regulation D private placement exemption or a Section 4(6) exemption from the registration provisions of the 1933 Act. The form is filed with the SEC and relevant states and is publicly available.

Secondary Sale of Restricted and Control Securities Under Rule 144

9. *Form 144*	Form filed as notice of the proposed sale of restricted securities or securities held by an affiliate of the issuer in reliance on Rule 144 when the amount to be sold during any three month period exceeds 500 shares or units or has an aggregate sales price in excess of $10,000. The form is filed with the SEC and the principal national securities exchange, if any, on which such security is traded and is publicly available.

Ownership of Equity Securities Publicly Traded in the United States

10. *Schedule 13D*	Disclosure report for any investor, including a hedge fund and its fund manager, who is considered beneficially to own more than 5% of a class of equity securities publicly traded in the U.S. The report identifies the source and amount of the funds used for the acquisition and the purpose of the acquisition. This reporting requirement is triggered by direct or indirect acquisition of more than 5% of beneficial ownership of a class of equity securities publicly traded in the U.S. Amendments must be filed promptly for material ownership changes. Some investors may instead report on short-form Schedule 13G if they are eligible. See "11. Schedule 13G" The report is filed with the SEC and is publicly available.
11. *Schedule 13G*	Short form disclosure report for any passive investor, including a hedge fund and its fund manager, who would otherwise have to file a Schedule 13D but who owns less than 20% of the subject securities (or is in certain U.S. regulated investment businesses) and has not been purchased for the purpose of influencing control. This reporting requirement is triggered by direct or indirect acquisition of beneficial ownership of more than 5% of a class of equity securities publicly traded in the U.S. Amendments must be filed annually if there are any changes, and either monthly (for U.S. regulated investment businesses) or promptly (for other passive investors) if ownership changes by more than 5% of the class

The report is filed with the SEC and is publicly available.

12. *Forms 3, 4 and 5*

Every director, officer or owner of more than 10% of a class of equity securities of a domestic public company must file a statement of ownership. The initial filing is on Form 3 and changes are reported on Form 4. The Annual Statement of beneficial ownership of securities is on Form 5. The statements contain information on the reporting person's relationship to the company and on purchases and sales of the equity securities.

Form 3 reporting is triggered by acquisition of more than 10% of the equity securities of a domestic public company, the reporting person becoming a director or officer, or the equity securities becoming publicly traded, as the case may be. Form 4 reporting is triggered by any open market purchase, sale, or an exercise of options of those reporting under Form 3. Form 5 reporting is required annually for those insiders who have had exempt transactions and have not reported them previously on a Form 4.

The statements are filed with the SEC and are publicly available.

Registered and Unregistered Institutional Investment Managers

13. *Form 13F*

Quarterly position report for registered and unregistered institutional investment managers (*i.e.,* any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person) with investment discretion over $100 million or more in equity securities publicly traded in the U.S. Reports contain position information about the equity securities under the discretion of the fund manager, and the type of voting authority exercised by the fund manager.

The reporting requirement is triggered by an institutional investment manager holding equity securities having an aggregate fair market value of at least $100 million on the last trading day of a calendar year and require a report as of the end of that year and each of the next three quarters.

The reports are filed with the SEC and are publicly available.

Material Associated Persons of Registered Broker-Dealers

14. *Form 17-H*

Material Associated Persons (MAP) reports, filed by registered broker-dealers. Some Hedge Fund Managers are affiliated with registered broker-dealers. MAPs generally include material affiliates and parents and may therefore include an affiliated Hedge Fund Manager or the related hedge fund. Broker-dealers must report (1) organizational chart of the broker-dealer, (2) risk management policies of the broker-dealer, (3) material legal proceedings and (4) additional financial information including aggregate positions, borrowing and off-balance sheet risk for each MAP.

The reporting requirement is triggered by status as broker or dealer registered under Section 15 of the Exchange Act.

This report is filed with the SEC quarterly and cumulatively at year-end and is not public.

There are also a variety of filings with the SEC and the securities self-regulatory organizations that must be made by registered broker-dealers and their employees who are associated persons.

Commodity Futures Trading Commission ("CFTC") and National Futures Association ("NFA")

Registered Commodity Trading Advisors ("CTAs") and Commodity Pool Operators ("CPOs")

15. *Commodity Pool Operator and Commodity Trading Advisor Registration*[2]

An individual or entity that operates or solicits funds for a commodity pool is generally required to register as a Commodity Pool Operator. As a result, a Hedge Fund Manager may be required to register as a Commodity Pool Operator if the Hedge Fund trades futures or options on futures and the Hedge Fund Manager operates the Fund.

An individual or entity that, for compensation or profit, advises others as to the value of or advisability of buying or selling futures contracts or options on futures must generally register as a Commodity Trading Advisor unless it has provided advice to 15 or fewer persons (including each person in an advised fund or pool) in the past 12 months and does not generally hold itself out to the public as a CTA. Providing advice indirectly includes exercising trading authority over a fund or account. A Hedge Fund Manager, therefore, may also be required to register as a CTA if the related hedge fund

[2] Since the publication of Sound Practices various exemptions from registration have been adopted. *See* Commodity Futures Trading Commission Rules 4.13(a)(4) and 4.14(a)(8)(i)(D).

	trades futures or options on futures.
	The documents required for registration as a Commodity Pool Operator or Commodity Trading Advisor are: a completed Form 7-R (which provides CPO or CTA information), a completed Form 8-R (which provides biographical data) and fingerprint card, for each principal (defined to include executive officers, directors and 10% owners), branch office manager and associated person (defined to include persons soliciting fund interests or accounts or supervising persons so engaged), and proof of passage of the "Series 3" exam for each associated person and proof of passage of the "Series 3" and futures branch office manager exams for each branch office manager.
	Applications for registration are filed with and approved by the NFA under authority granted to it by the CFTC and the registration documents are generally public except for fingerprint cards, although confidentiality may be requested for certain information relating to the principals.
16. *Form 3-R*	Form used to report any changes to information contained in the basic registration Form 7-R. The requirement to file this form is triggered by changes in the information provided in Form 7-R. The form is filed with the NFA and is public, though confidentiality may be requested for certain information relating to principals.
17. *Form 8-T Associated Person Termination*	Form that must be filed within 20 days of the termination of an Associated Person, principal or branch manager. The form is filed with the NFA and is generally public.
18. *Annual Report*	Annual report of a fund must be filed pursuant to Reg. §4.22(c) by that fund's CPO (unless the fund is exempt under §4.7). The Annual Report must contain certain information, such as actual performance information and fees, and must be distributed to each participant in the fund.
	The annual report must be filed by a registered CPO with the CFTC within 60 days of the fund's fiscal year-end and is generally publicly available; however, the CFTC is prohibited from disclosing information that would separately disclose the business transactions or market positions of any person or trade secrets or names of any investors.
19. *CPO/CTA Questionnaire*	Annual compliance questionnaire concerning its business activities for applicants registered as CPOs or CTAs. The questionnaire is filed with the NFA and is not public.
20. *NFA Self-Audits*	In order to satisfy their continuing supervisory

responsibilities, NFA members must review their operations on an annual basis using a self-examination checklist. The checklist focuses on a member's regulatory responsibilities and solicits information on whether the member's internal procedures are adequate for meeting those responsibilities.

Registered CPOs and CTAs as members of the NFA are required to conduct such self-audit annually. A written attestation affirming completion of the self-audit must be signed and dated by supervisory personnel. The attestation must be retained by the member for five years and provided to NFA upon request.

21. *Claims for exemption*	Filings made pursuant to Reg. §4.12(b)(3) (notice of claim for exemption from certain requirements by a CPO that complies with the Securities Act and manages a fund with limited trading in commodity futures and options), Reg. §4.7(d) (notice of claim for exemption by a CPO or CTA with "qualified eligible persons" as investors). Reg. §4.7 provides exemptions for qualifying CPOs and CTAs from most disclosure, recordkeeping and reporting requirements applicable to CPOs and CTAs. These statements are filed with the CFTC and NFA and are public.
22. *Disclosure Document*	CPOs and CTAs are generally required to prepare detailed Disclosure documents containing specified information. Such documents are filed with the CFTC and NFA and provided to investors but are not publicly available. CPOs and CTAs operating under Reg. §4.7, however, are exempt from the disclosure document requirement and are required only to provide all material disclosures (and include specified legends on their materials). In addition, under the exemption provided in Reg. §4.8, funds (which would otherwise be treated as commodity pools) with exemptions under Reg. §4.12(b) (compliance with the requirements of the Securities Act and certain limits on the trading of commodity futures and options) or which sell interests solely to "accredited investors" and rely on the safe harbor provisions of Rule 506 or 507 of Regulation D under the Securities Act may begin soliciting, accepting and receiving money upon providing the CFTC and the participants with disclosure documents for the fund, which requirement may be satisfied by a private placement memorandum.
23. *Year-End Financial Reports for §4.7 Funds*	Annual reports for §4.7 funds (*i.e.,* funds that are limited to qualified eligible persons and are exempt from the normal disclosure requirements applicable to commodity pools) must

contain a Statement of Financial Condition, a Statement of Income (Loss), appropriate footnote disclosure and other material information, as well as a legend as to any claim made for exemption. The Annual Report must be presented and computed in accordance with GAAP consistently applied and, if it is certified by an independent public accountant, it must be certified in accordance with Rule 1.16.

The annual report is filed with the CFTC, NFA and distributed to each investor, and the report is not public.

Position Reports

24. *Form 40*

"Statement of Reporting Trader" for persons who own or control reportable positions in futures. A hedge fund and/or Hedge Fund Manager will be required to file a Form 40 if it holds reportable positions [upon special call by the CFTC or its designee]. The form must be filed within ten business days following the day that a hedge fund's and/or its managers' position equals or exceeds specified levels. Such specified levels are set separately for each type of contract. For example, the reportable level for S&P 500 futures is 600 contracts. The Form 40 requires the disclosure of information about ownership and control of futures and option positions held by the reporting trader as well as the trader's use of the markets for hedging. Hedging exemptions from speculative position limits must be reported.

The form is filed with the CFTC and is not publicly available.

25. *Form 102*

Form filed by clearing members, futures commission merchants (FCMs), and foreign brokers, which identifies persons, including Hedge Funds, having financial interest in, or trading control of, special accounts in futures and options, informs the CFTC of the type of account that is being reported and gives preliminary information regarding whether positions and transactions are commercial or noncommercial in nature. The form must be filed when the account first becomes "reportable" (*i.e.* when it first contains reportable futures or options positions), and updated when information concerning financial interest in, or control of, the special account changes. In addition, the form is used by exchanges to identify accounts reported through their large trader reporting systems for both futures and options.

The form is filed with the CFTC and is non-public.

Selected Stock and Futures Exchange Reports

Application for Exemption from Speculative Position Limits

26. *Spec. Position Limit Exemption*

Application filed for exemption from speculative position limits. Exchanges generally have speculative position limits for physical commodities and stock index contracts, and the CFTC has speculative position limits for agricultural commodities. Exemptions from such limits are generally available for hedging transactions. Financial contracts, such as interest rate contracts, do not have such position limits.

For example, under Rule 543 of the Chicago Mercantile Exchange ("CME"), persons intending to exceed speculative position limits on S&P 500 contracts must either file the required exemption application and receive approval prior to exceeding such limits or receive verbal approval prior to exceeding such limits and, if approved, file the required application promptly thereafter. Generally, an application for any speculative position limit exemption must show that such position is a bona fide hedging, risk management, arbitrage or spread position.

The filing is made with the appropriate exchange in the case of physical commodities and stock index contracts and with the CFTC in the case of agricultural commodities.

Federal Trade Commission ("FTC")

Filings Made Prior to Mergers and Acquisitions

27. *Hart-Scott-Rodino Notice*

Notification filed prior to the consummation of certain mergers, acquisitions and joint ventures. After notification is filed there is a waiting period while the FTC and Department of Justice review the competitive effects of the transaction. The notification includes information about the transaction and the participants in the transaction.

As a general matter, both the acquiring person and the acquired person must file notifications when either the acquiring person or the acquired person is engaged in U.S. commerce or an activity affecting U.S. commerce, and either of the following tests is met:

(1) (A) one person has total assets or annual net sales of $100 million or more and the other person has total assets or annual net sales of $10 million or more, and (B) as a result of the transaction, the acquiring person will hold an aggregate total

amount of more than $50 million of the voting securities and assets of the acquired person, or

(2) as a result of the transaction, the acquiring person will hold an aggregate total amount of more than $200 million of the voting securities and assets of the acquired person, regardless of the sales or assets of the acquiring and acquired persons.

Acquisitions of voting securities are exempt from filing if they are made “solely for the purpose of investment” and if, as a result of the acquisition, the securities held do not exceed 10% of the outstanding voting securities of the issuer. Securities are acquired “solely for investment purposes” if the person acquiring the securities has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer.

The notice is filed with the FTC and the Department of Justice and is confidential.

Annex B

U.S. REGULATORY AUTHORITY TO RECEIVE INFORMATION ABOUT HEDGE FUNDS

INFORMATION AVAILABLE FROM HEDGE FUND BROKERS, DEALERS, LENDERS AND COUNTERPARTIES

The following lists the statutory authority of federal regulatory agencies to receive information about hedge funds through examinations and inspections of hedge fund brokers, dealers, lenders and counterparties. In all cases, to the extent the hedge fund has a relationship with a U.S. regulated entity, the authorities described below apply to the records of the regulated entity that involve hedge funds. As discussed below, broker-dealers regulated by the Securities and Exchange Commission (the "SEC") are included among the regulated entities that have extensive relationships with hedge funds. Hedge funds often utilize the services of broker-dealers to effect transactions in securities and to receive credit. In particular, many hedge funds receive services from prime brokers, which are broker-dealers that clear and finance customer trades executed by one or more executing brokers. Prime brokers also act as custodians for a hedge fund's securities activities. In addition, regulation of futures commission merchants ("FCMs") by the Commodity Futures Trading Commission is described below. FCMs execute orders for the purchase or sale of futures and commodity options and accept funds to guarantee or margin commodity transactions. Hedge funds are frequently customers of FCMs. Regulation of national banks by the Comptroller of the Currency and regulation of state banks by the Federal Reserve and the Federal Deposit Insurance Corporation is also described below. Banking relationships with hedge funds include lending, counterparty derivatives trading and investment advisory activities.

Securities and Exchange Commission ("SEC")

Registration of broker-dealers under the Exchange Act

1. *Section 15(a)*	Broker-dealers that engage in interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) must register with the SEC. Prime brokers and executing brokers are required to register as broker-dealers under Section 15(a).

SEC non-subpoena inspection and examination authority

2. *Section 17(a)*	Every registered broker-dealer must make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule prescribes as necessary or appropriate in the public interest.
3. *Section 17(b)*	All records of broker-dealers described in Section 17(a) are subject at any time, or from time to time, to such reasonable periodic, special or other examinations by representatives of

	the SEC or the appropriate regulatory agency for such broker-dealers.
	As further described below, examinations by the SEC may relate to records of a broker-dealer's hedge fund clients and counterparties.

Records required to be maintained by broker-dealers

4. *Rule 17a-3*	Broker-dealers are required to maintain blotters that itemize on a daily basis all receipts and delivery of securities and all receipts and disbursements of cash and other debits and credits. The blotters must show the identities of the parties involved in the transactions, the amount of securities purchased or sold, their purchase or sale prices and trade dates.
	Broker-dealers must maintain a record of each customer order. The record must identify, among other things, the account for which the order was entered, the terms of the order and the price of the execution.
	Broker-dealers must maintain copies of all confirmations of all purchases and sales of securities. A record showing the name and address of the beneficial owners of cash or margin accounts is also usually required.
5. *Rule 17a-4*	Broker-dealers must maintain specified records required by Rule 17a-3 for a period of six years. For the first two years, these records must be kept in an easily accessible place.
	Broker-dealers must furnish promptly to the SEC copies of required records upon request. This includes records pertaining to the broker-dealer's hedge fund clients and counterparties.

SEC investigatory authority for violations of securities laws

6. *Section 21(a)*	The SEC may make such investigations as it deems necessary to determine whether any person has violated, is violating or is about to violate the statutes under its jurisdiction.
	The SEC may conduct its investigation in a formal or informal manner. Such investigations may involve inspection of documents relating to hedge fund clients or counterparties.
7. *SECTION 21(B)*	FOR THE PURPOSE OF ANY INVESTIGATION, THE SEC MAY ADMINISTER OATHS AND AFFIRMATIONS, SUBPOENA WITNESSES AND

REQUIRE THE PRODUCTION OF ANY BOOKS, PAPERS, CORRESPONDENCE, MEMORANDA, OR OTHER RECORDS WHICH THE SEC DEEMS RELEVANT OR MATERIAL TO THE INQUIRY.

COMMODITY FUTURES TRADING COMMISSION ("CFTC")

RECORD KEEPING REQUIREMENTS AND INSPECTION OF FUTURES COMMISSION MERCHANTS ("FCMS") AND INTRODUCING BROKERS UNDER THE GENERAL REGULATIONS (THE "REGULATIONS") UNDER THE COMMODITY EXCHANGE ACT (THE "CEA")

8. *SECTION 4G (A) OF THE CEA*

EVERY REGISTERED FCM, INTRODUCING BROKER, FLOOR BROKER OR FLOOR TRADER MUST MAKE SUCH REPORTS AS ARE REQUIRED BY THE CFTC REGARDING THEIR TRANSACTIONS AND THE TRANSACTIONS AND POSITIONS OF THEIR CUSTOMERS, IN COMMODITIES FOR FUTURE DELIVERY ON ANY BOARD OF TRADE. BOOKS AND RECORDS PERTAINING TO SUCH TRANSACTIONS AND POSITIONS MUST BE KEPT IN SUCH FORM AND MANNER AND FOR SUCH TIME AS THE CFTC MAY REQUIRE AND MUST REMAIN OPEN TO INSPECTION BY ANY REPRESENTATIVE OF THE CFTC OR THE U.S. DEPARTMENT OF JUSTICE.

8. *SECTION 1.31 OF THE REGULATIONS*

ALL BOOKS AND RECORDS REQUIRED TO BE KEPT BY THE CEA OR THE REGULATIONS MUST BE KEPT FOR A PERIOD OF 5 YEARS AND BE MADE AVAILABLE FOR INSPECTION BY THE CFTC.

9. *SECTION 1.35 OF THE REGULATIONS*

FCMS AND INTRODUCING BROKERS MUST KEEP RECORDS OF ALL TRANSACTIONS RELATING TO THEIR BUSINESS OF DEALING IN COMMODITY FUTURES, COMMODITY OPTIONS AND CASH COMMODITIES. FCMS AND INTRODUCING BROKERS MUST ALSO PREPARE WRITTEN RECORDS OF EACH CUSTOMER ORDER, INCLUDING ACCOUNT INFORMATION. ADDITIONALLY, FCMS AND INTRODUCING BROKERS MUST MAINTAIN, FOR EACH CUSTOMER (INCLUDING HEDGE FUNDS), A FINANCIAL RECORD SHOWING ALL CHARGES AND CREDITS TO THE CUSTOMER'S ACCOUNT AND ALL COMMODITY FUTURES AND OPTIONS

TRANSACTIONS EXECUTED FOR EACH ACCOUNT.

10. *SECTION 1.36 OF REGULATIONS*

FCMS MUST MAINTAIN A RECORD OF ALL SECURITIES AND PROPERTY RECEIVED FROM CUSTOMERS (INCLUDING HEDGE FUNDS) TO MARGIN, PURCHASE, GUARANTEE, OR SECURE THE COMMODITY OR COMMODITY OPTION TRANSACTIONS OF SUCH CUSTOMERS.

11. *Section 1.37 of the Regulations*

FCMs and introducing brokers must maintain a record of the true name and address of all customers (including hedge funds) and the principal occupation or business of such person. For each commodity options account, the record must also indicate the person who has solicited and is responsible for the customer account.

CFTC investigatory and subpoena authority under the Regulations

12. *Section 11.2 of the Regulations*

The CFTC may conduct such investigations as it deems appropriate to determine whether any persons have violated, are violating or are about to violate the provisions of any statute under its jurisdiction.

13. *Section 11.4 of the Regulations*

In the course of a particular investigation, the CFTC may issue a subpoena directing the person named therein to appear before a designated person at a specified time and place to testify or to produce documentary evidence relating to any matter under investigation.

Federal Bank Agency Examination Authority of National and State Banks

The Comptroller of the Currency ("OCC") national bank examination authority under the Federal Reserve Act (the "Reserve Act") and OCC Regulations

14. *12 U.S.C. § 481*

The OCC may examine every national bank as often as it deems necessary. The examiner has the power to make a thorough examination of all affairs of the bank.

15. *12 C.F.R. § 4.6*

The OCC is required to conduct a full-scope, on-site examination of every national bank at least once during each 12-month period.

OCC recordkeeping requirements for customer securities transactions

16. *12 C.F.R § 12.3*

National banks effecting securities transactions for customers (including hedge fund customers) must maintain for at least three years an itemized daily record of each purchase and sale of securities, including the customer name, description of the securities and the name of the broker/dealer or other person from whom the securities were purchased or sold.

Federal Reserve authority to examine state member banks under the Federal Reserve Act and Federal Reserve Board Regulations.

17. *12 U.S.C. § 325*

As a condition of membership, state member banks are subject to examinations by the Federal Reserve.

18. *12 C.F.R § 208.64*

The Federal Reserve is required to conduct a full-scope, on-site examination of every insured member bank at least once during each 12-month period.

The Federal Deposit Insurance Corporation ("FDIC") examination authority of non-member state banks under the Federal Deposit Insurance Act.

19. *12 U.S.C. § 1820(b)*

The FDIC has the authority to examine any insured state non-member bank whenever the FDIC determines that an examination is necessary.

Content of federal bank agency examinations

Determination of the safety and soundness of the bank's activities

During examinations, the bank examiner's general role is to assess the safety and soundness of the bank's activities. As described in the Federal Reserve's *Commercial Bank Examination Manual*,[2] examiners may assess the level and direction of the bank's risk management processes and internal controls, including its management of credit, market, liquidity, operational, legal and reputational risk. In evaluating the bank's risk management, the examiners may assess how the bank measures and controls risk during the credit evaluation process and the bank's loan approval process. During this examination, the examiner may review the bank's hedge fund relationships and credit exposure to hedge funds as part of its regular assessment of risk exposure by the bank.[3] The examiner's review may involve the inspection of documents received by the bank from its hedge fund counterparties, including documents relating to a hedge fund's financial position or investment strategies.

Evaluating credit risk from bank derivatives trading activities

Pursuant to the Federal Reserve's *Trading and Capital Markets Activities Manual,*[4] examiners should pay increasing attention to a bank's policies, procedures and internal controls used to measure, assess and limit counterparty credit risks arising from trading and derivatives activities, *particularly with hedge funds.* Examiners should also ensure that banks conduct in-depth due-diligence reviews of a counterparty's internal risk controls, including obtaining supporting documentation for claims of fund managers, such as hedge fund managers. The Federal Reserve has further stated that examiners should ascertain whether the bank's assessment of hedge fund counterparties relies not only on simple balance sheet measures, but also takes into account off-balance sheet positions that may be a source of significant leverage for the hedge fund.[5]

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[2] The Board of Governors of the Federal Reserve, Commercial Bank Examination Manual, § 1000.1 (1994) (and Supplement 2002).

[3] See Report of the President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, (April 1, 1999).

[4] See Report of the President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (April 1, 1999).

[5] Board of Governors of the Federal Reserve System, Supervisory Guidance Regarding Counterparty Credit Risk Management, Supervisory Letter SR 99-3 (February 1, 1999).

The OCC has stated that national banks engaging in financial derivatives activities should have detailed policies and procedures to manage credit risk exposure to a particular counterparty, such as a hedge fund.[6] These policies and procedures should include the creation of credit risk exposure reports providing aggregate information about the bank's credit risk to a given counterparty. Additionally, the OCC recommends that examiners should ensure that a bank's credit approval process includes obtaining specific counterparty financial information such as on and off-balance sheet positions and current detail about the counterparty's business strategy and activities (including a quantitative assessment of leverage and risk concentrations).[7]

[6] Memo to Chief Executive Officers of National Banks from the Comptroller of the Currency regarding Risk Management of Financial Derivatives, BC-277 (October 27, 1993).

[7] Memo to Chief Executive Officers of National Banks from the Comptroller of the Currency regarding Risk Management of Financial Derivatives and Bank Trading Activity — Supplemental Guidance, OCC Bulletin 99-2 (January 25, 1999).