MANAGED FUNDS ASSOCIATION

TESTIMONY BEFORE THE

SUBCOMMITTEE ON SECURITIES AND INVESTMENT

OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,

UNITED STATES SENATE

"ROLE OF HEDGE FUNDS IN OUR CAPITAL MARKETS"

MAY 16, 2006

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I. INTRODUCTION

As the largest and most diverse U.S.-based association representing the hedge fund industry, Managed Funds Association ("MFA") is pleased to provide this testimony to the Senate Subcommittee on Securities and Investment regarding the Role of Hedge Funds in the Capital Markets.

The hedge fund industry has experienced significant growth in recent years, with assets under management estimated at $1.5 trillion.[1] MFA believes this is a direct result of the demand largely from institutional investors for investment vehicles that offer a diversity of investment styles and that help them meet their future funding obligations and other investment objectives. As former Federal Reserve Chairman Alan Greenspan has noted, hedge funds have "become increasingly valuable in our financial markets."[2] Hedge funds enhance market liquidity and contribute to pricing efficiency and market stability. Hedge funds also foster financial innovation and risk sophistication among the market participants with which they deal.

MFA recognizes that with the growth and evolution of the hedge fund industry have come new responsibilities and challenges. The hedge fund industry and policy makers currently face an important challenge, namely to preserve the benefits offered by hedge funds while addressing legitimate investor protection issues presented by the growth in hedge fund investments.

Background on MFA. Founded in 1991, MFA is the U.S.-based global membership organization dedicated to serving the needs of the professionals who specialize in the alternative investment industry. MFA's over 1,000 members include professionals in hedge funds, funds of funds, managed futures funds, and other financial and commodity-linked investments. They also include financial and commodity trading advisors, pool operators, and trading managers. MFA members manage a substantial portion of the estimated $1.5 trillion invested in these investment vehicles. Members include representatives of a majority of the 50 largest hedge funds groups in the world. MFA membership also includes the sponsors, investment managers and brokers for substantially all of the financial and commodity pools marketed on either a public or

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[1] Based on reported estimates by Hedge Fund Intelligence (London).
[2] Remarks by Chairman Alan Greenspan, "Risk Transfer and Financial Stability," to the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure, Chicago, Illinois, May 5, 2005.

private basis in the United States. The larger hedge fund managers represented within MFA collectively manage in excess of $500 billion in assets and pursue a wide range of investment strategies.

As further explained below, MFA's activities include educational outreach to and representation before the Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC"), Federal Reserve, Treasury Department, State and international regulatory agencies, and Congress. MFA also participates in a number of private sector initiatives, including development of industry sound practices, participation in Treasury-sponsored advisory committees, and work with the major dealers in improving credit derivative market practices.

II. OVERVIEW OF HEDGE FUNDS AND THEIR STRATEGIES

Definition of hedge fund. The term "hedge fund" is not a defined term under the Federal securities laws, except generally to connote a private investment fund that is not required to register as an investment company under the Investment Company Act of 1940 (the "Investment Company Act").[3] It is thus a term that is susceptible of different meanings to different people. In general, and for purposes of this testimony, MFA considers a "hedge fund" to be a privately offered investment company that is administered by a professional investment manager that seeks attractive absolute return.[4] In this regard they are similar to venture capital, private equity, leveraged buyout, oil and gas, and real estate funds, although MFA does not intend to capture them within its definition of "hedge fund."

Investment profiles. As noted above, hedge funds are more easily defined in relation to what they are not. They are investment companies that are not publicly offered. The hedge fund universe is characterized by a wide variety of strategies, with different risk characteristics and different return expectations. Many hedge funds managers engage in "absolute return" strategies, meaning that their returns do not depend on, nor are they benchmarked against, the long-term return of the markets or the assets in which they invest. In other words, hedge funds seek to achieve positive returns based on the skill or strategy of the manager rather than meet or exceed the performance of the underlying market or asset class. Many hedge fund strategies employ "enhanced active management," in which managers combine traditional active management with techniques such as short selling and leverage. Some hedge fund strategies may not be based on traditional techniques at all, such as risk arbitrage, convertible hedging, and distressed debt.

Major hedge fund investment strategy classifications include the following:

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[3] More technically, a "hedge fund" is an investment company that is not required to register with the SEC by virtue of Section 3(c)(1) or 3(c)(7) of the Investment Company Act and that conducts only private offerings under the SEC's Regulation D.

[4] This is in keeping with the definition used by the President's Working Group on Financial Markets, of "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." President's Working Group on Financial Markets Report, "Hedge Funds, Leverage and the Lessons of Long-Term Capital Management," April 1999, at 1.

- Long/short strategies for trading in equities.

- "Macro" or global directional investment strategies, which take positions in domestic and international currency, interest rate and equity markets based on global economic conditions and opportunities perceived to be presented by them.

- "Market-neutral," "relative value," or arbitrage strategies, which take offsetting long and short positions or otherwise hedged positions to reduce market risk and utilize leverage to achieve desired returns.

- Event-driven strategies, which seek to profit from anticipated events or special situations, such as mergers, restructurings, distressed securities.

- Regional strategies, which concentrate on a particular geographic region (such as emerging markets).

- Sector strategies, which focus on a particular industry.

- Long only, or "buy and hold", equity strategies, similar to traditional equity mutual fund strategies, but which may also include active efforts to become involved in the management of holdings.

- Dedicated short sale equity strategies focusing on selling short securities that are deemed to be overvalued.

- Specific asset class strategies (such as currencies, commodities, interest rates).

The significance of these broad array of strategies should not be underestimated, as it reflects the increasing segmentation of the hedge fund industry, and with that the growing segmentation of risk. Today's hedge fund industry is thus actually comprised of many sub-industries, with separate and distinct pockets of risk. Each strategy can prudently withstand different levels of leverage, and each strategy has a different time horizon for investment and varying levels of volatility. The diversity of strategies employed by hedge funds also presents important considerations for policymakers seeking to accurately understand the scope of potential challenges as well as the efficacy of potential remedies.

Size. Because of the non-public nature of hedge funds, there is no universally accepted estimate on the size of the hedge fund universe; MFA believes it consists of 5,000 to 7,000 funds with total assets of approximately $1.5 trillion. A small number of these hedge funds are part of large organizations with assets over $1 billion and performance records extending 10 years or more. At the other end of the marketplace, there are thousands of small firms managing hedge fund assets under $50 million each.[5]

III. BENEFICIAL ROLE OF HEDGE FUNDS IN CAPITAL MARKETS

Diversification for institutional investor. Much of the growth in hedge funds since the 1980's can be attributed to the increasing recognition by institutional investors that hedge funds can help diversify returns and thereby reduce the overall risk of an investment portfolio. The majority of direct investment in hedge funds by institutional investors has come from endowments and foundations. From 2004 to 2005, endowments increased their hedge fund allocations from 7.3% to 8.7% on average.[6]

According to a study by the Bank of New York, "the hedge fund industry is midway through an important transition in its source of capital."

> Five years ago, hedge funds derived virtually all of their assets from wealthy individuals. Institutional interest was limited to a small number of endowments and foundations. Over the next five years, institutions (including pension funds) are likely to provide an additional $250 billion of hedge fund capital, accounting for 35 percent of net new flows in this period.[7]

Corporation and public pension plan investments in hedge funds continue to grow both through direct investments and through fund of hedge funds vehicles.[8] Former Federal Reserve Chairman Alan Greenspan has noted that these inflows may be attributed to institutional investors seeking alternatives to long-only investment strategies in the wake of the bursting of the equity bubble in 2001.[9]

These institutional investors understand that hedge funds provide attractive mechanisms for portfolio diversification because hedge funds' absolute returns tend to have little or no correlation to those of more traditional stock and bond investments. Many hedge fund categories may therefore outperform stock and bond investments when the latter perform poorly. Investment in hedge funds can thus help diversify risk in many institutional investment portfolios. Drawdowns in individual hedge funds – largest drop from peak value to trough value – are often less than in publicly traded indices. Academic research recognizes that hedge fund investments can reduce overall risk of

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[5] See Robert Jaeger, *All About Hedge Funds*, McGraw-Hill (2003), at 57.
[6] 2005 NACUBO Endowment Study.
[7] Bank of New York and Casey, Quick & Acito, "Institutional Demand for Hedge Funds: New Opportunities and New Standards" (September 2004).
[8] A Morgan Stanley Prime Brokerage report suggests that corporate pension plans prefer direct allocations to hedge funds while public pension plans prefer indirect allocations.
[9] Remarks by Chairman Alan Greenspan, "Risk Transfer and Financial Stability," to the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure (May 5, 2005), at 6.

investment portfolios for investors such as endowments and public and private pension plans.[10]

Source of liquidity. As active trading participants in international capital markets, hedge funds add depth and liquidity to markets. This characteristic of hedge funds has been recognized by commentators including former Federal Reserve Chairman Alan Greenspan. He testified before the Senate Banking Committee in 2004, "it's so important that [hedge funds] are left free to supply the extent of liquidity that they are supplying to our financial markets. … the degree of flexibility in our economy has been instrumental in enabling us to absorb the shocks which have been so extraordinary in recent years. One of the most successful parts of our system is our ability to absorb financial shocks."[11]

Increase in efficiency. By trading based on sophisticated and extensive market research, hedge funds provide markets with price information that translates into pricing efficiency. In targeting temporary price inefficiencies and market dislocations, hedge funds effectively help to minimize market distortions and eliminate these dislocations. The President's Working Group described this function:

> Hedge funds and other investors with high tolerance for risk play an important supporting role in the financial system in which various risks have been distributed across a broad spectrum of tradable financial instruments. With financial intermediation increasingly taking place in the capital markets instead of banking markets, prices play a larger role in the allocation of capital and risk. In this world, investors such as hedge funds that undertake a combination of long and short positions across markets help maintain the relative prices of related financial instruments.[12]

Decrease in volatility. The increase in hedge fund growth has coincided with a decrease in overall market volatility. This may be due to the added liquidity that hedge funds provide to the market. This may also result from the fact that hedge funds generally eschew the "momentum trading" that many individual investors engage in. Because hedge fund investors generally have accepted longer redemption horizons, hedge funds have fewer incentives to engage in momentum trading. By contrast, more traditional investors, such as mutual funds, are more likely to buy into rising markets and sell into falling markets as a result of purchases and redemptions by individual retail investors, accentuating market volatility.[13]

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[10] See Written Statement of Managed Funds Association before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, U.S. House of Representatives, May 22, 2003, at Annex A.

[11] "Renomination of Alan Greenspan as Chairman of the Federal Reserve Board of Governors: Hearing before the Senate Banking, Housing and Urban Affairs Committee" (testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve) (June 15, 2004).

[12] President's Working Group Report at 2-3.

[13] "Hedge Funds and Financial Market Dynamics," Occasional paper 166, International Monetary Fund (May 1998), at 29.

IV. REGULATION OF HEDGE FUNDS

Under 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.

The first, Section 3(c)(1) of the Investment Company Act, was part of the Act as enacted in 1940. It provides that an investment fund will not be required to register as an investment company if: (a) it has no more than 100 investors, and (b) it does not offer its shares publicly. In order to comply with the latter requirement, a fund sponsor will effectively limit the offering of fund shares to "accredited investors," as defined in the SEC's Regulation D.[14] In addition to banks and other institutional investors, accredited investors include natural persons with individual or joint net worth of $1 million or individual income in each of the last two years in excess of $200,000, or joint income for the same period of $300,000.

The second, Section 3(c)(7) of the Investment Company Act, was enacted as part of the National Securities Markets Improvement Act of 1996.[15] It excepts funds from registration as investment securities if each investor in the pool is a "qualified purchaser" and the pool does not undertake a public offering. The term qualified purchaser includes institutional investors; natural persons who have at least $5 million in investments; persons who, acting for themselves or the accounts of other qualified purchasers, in the aggregate own and invest on a discretionary basis not less than $25 million in investments; and certain qualifying trusts. The Senate report on the legislation provided the following rationale:

> 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.[16]

That hedge funds are not registered does not mean that their activities are unregulated. Hedge funds and their managers are subject to a variety of regulations and are required to furnish significant information and reports to regulators in connection with their trading activities.

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[14] The SEC staff has confirmed in a series of no-action letters that hedge funds and other private investment vehicles that conduct offerings pursuant to Regulation D can rely on Section 3(c)(1). Santa Barbara Securities, SEC No-Action Letter (Mar. 8, 1983).

[15] P.L. No. 104-290, 110 Stat. 3416, 3432-33 (1996). The legislation followed a 1992 report by the SEC's Division of Investment Management that recommended the adoption of a new exception for private funds sold exclusively to "qualified purchasers." SEC, Division of Investment Management, "Protecting Investors: A Half Century of Investment Company Regulation" (1992), at 104-05.

[16] S. Rep. No. 104-293, at 10 (1996).

SEC registration of hedge fund advisers. The SEC has recently implemented rule requiring registration of many hedge fund advisers that were not previously required to register. Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act") provides that an investment adviser may be exempt from SEC registration requirements if such adviser (i) had fewer than 15 "clients" during the preceding 12 months; (ii) does not hold itself out generally to the public as an investment adviser; and (iii) does not act as an adviser to any registered investment company.

The new hedge fund adviser rule requires a hedge fund adviser to count each "owner" of a "private fund"[17] it advises as a "client" for purposes of determining the adviser's eligibility for the private adviser exemption cited above. The term "private fund" was intended to capture advisers to hedge funds and not other private investment vehicles, such as private equity or venture capital funds. Under this new rule, hedge fund advisers are required to "look through" clients that are private funds and count the underlying investors to determine the number of clients to whom the adviser provides investment advisory services. If, after taking into account the aggregate number of investors in the private funds it advises, an adviser has 15 or more clients in the prior 12 months, and has in the aggregate at least $30 million in assets under management, then the adviser will be required to register with the SEC as an investment adviser. Hedge fund advisers that advise "private funds" were required to comply with this new rule by February 1, 2006.

CFTC regulation: Many hedge fund managers are also registered with the Commodity Futures Trading Commission as commodity pool operators ("CPOs"). Such registration is required under the Commodity Exchange Act for managers of hedge funds that trade futures and options contracts on a futures exchange. A hedge fund manager that provides advice to a hedge fund regarding such futures and options contracts may also become subject to regulation as a commodity trading advisor ("CTA"). CPOs and CTAs are subject to registration, recordkeeping, and reporting requirements and fraud prohibitions under the Commodity Exchange Act and the regulations of the CTFC and the National Futures Association. In 2004, 63 of the 100 largest hedge funds were registered with the CFTC and subject to its reporting and recordkeeping requirements. Hedge funds that are significant traders in the futures markets may also become subject to the CFTC's large trader reporting system, which requires the reporting of certain information on exchange-traded contracts to the CFTC for purposes of market surveillance.

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[17] Under Investment Adviser Act Rule 203(b)(3)-2, a "private fund" is defined as a company that: (i) would be an investment company under the Investment Company Act of 1940, as amended, but for an exception from the definition of "investment company" provided under either Section 3(c)(1) or 3(c)(7) thereunder; (ii) permits an investor to redeem its investment within two years of investment; and (iii) is offered based on its adviser's expertise. A pooled investment vehicle that does not meet any one of the above three elements is not a "private fund." Advisers to unregistered funds that are not "private funds" may continue to rely on the language of Rule 203(b)(3)-1 that permits an adviser to count these unregistered funds as a single client. This would include advisers to hedge funds that have redemption periods for their investors that are longer than two years.

NASD regulation. Broker-dealers that sell interests in hedge funds are subject to NASD regulation. 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. These requirements include various SEC equity ownership and portfolio reporting requirements and large position and other reporting requirements of the Treasury Department and the Federal Reserve in connection with government securities and foreign exchange transactions. The Treasury Department requires weekly and monthly reports for certain large participants in the foreign exchange markets and imposes reporting requirements on entities, including hedge funds, that have large positions in recently-issued or to-be-issued Treasury securities.[18]

Antifraud and insider trading prohibitions. As the SEC has explained, hedge fund advisers, whether or not registered under the Advisers Act, are subject to the antifraud and anti-manipulation provisions of the Advisers Act, the Securities Act of 1933, and the Securities Exchange Act of 1934, as well as to prohibitions on insider trading 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. Hedge funds are also subject to State antifraud provisions, just as are other providers of financial services.

There is no fraud crisis with regard to private investment vehicles. The 2003 SEC staff report entitled “Implications of the Growth of Hedge Funds” stated there is “no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity.”[19] Former SEC Chairman William Donaldson testified that there is “no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else.”[20]

IV. CURRENT ISSUES REGARDING HEDGE FUNDS

Since its creation, MFA has been an advocate for the alternative investment industry on a number of important legislative, regulatory and private sector initiatives. Following is a summary of a few of the major initiatives on which MFA is focusing.

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[18] For further information on regulatory filings required of these hedge funds, please see MFA’s “2005 Sound Practices for Hedge Fund Managers” at Appendix II.
[19] Staff Report at 73.
[20] Testimony of William 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).

Compliance with hedge fund adviser registration rule. As described above, MFA's membership encompasses both registered investment advisers as well as those managers that are exempt from the SEC's hedge fund adviser registration rule. Prior to adoption of the rule, MFA raised concerns that the costs of the rule would outweigh its benefits.[21] However, since promulgation of the rule on October 26, 2004, MFA has worked with its members to prepare for implementation of the rule and has offered recommendations to the SEC staff to help develop internal agency training programs on hedge fund subject areas. This work is ongoing and MFA hopes to continue its positive interaction with the SEC staff.

Over the past 18 months, MFA has hosted six educational seminars to help its members prepare for the compliance with this new rule.[22] At each seminar held last year, an SEC Commissioner or senior staff member delivered the keynote address or served as moderator. MFA is continuing its dialogue with the SEC staff to address any issues that may arise now that the new hedge fund adviser registration rule has gone into effect. We discuss with our members how they are complying with the rule and their observations about SEC examinations.

Growth in credit derivatives and concerns of systemic risk. The growth in the use of derivatives products has been widely reported. According to the International Swaps & Derivatives Association ("ISDA"), the outstanding notional value of credit derivative contracts rose from an estimated $4 trillion at year-end 2003 to an estimated $17 trillion at year-end 2005. The International Monetary Fund devoted an entire chapter of a recent report to examining the influence of credit derivatives on financial stability.[23]

Last year, the rising use of credit derivatives attracted the attention of regulators in the U.S. and overseas.[24] Of particular concern was the growing trend of unconfirmed assignments of credit derivative transactions, known as "novations," and the threat that this would pose to systemic risk in the event of a large credit event. Regulators in the United Kingdom and in the U.S. feared that problems could emerge as a result of the high number of unsigned confirmations of novations transactions. These concerns were also expressed in the Counterparty Risk Management Policy Group II in their 2005 Report.[25]

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[21] See Letter to Jonathan Katz from John Gaine, "Registration Under the Advisers Act of Certain Hedge Fund Advisers," September 15, 2004.

[22] "Guidance on the SEC's New Regulatory Framework for Hedge Fund Advisers", held January 12, 2005 (New York, NY) & February 9, 2005 (Key Biscayne, FL); "Practical Guidance for Hedge Fund CCOs", held May 5, 2005; "The SEC's New Hedge Fund Rules & Implications for Managers in Europe", held July 12, 2005 (London); "*MFA's 2005 Sound Practices for Hedge Funds Managers* - A Practitioner's Guide to Strong Internal Controls in Today's Regulatory Environment", held September 29, 2005 (New York); and "A New Era Begins: Hedge Fund Advisers & Today's SEC Regulatory Environment," held February 7, 2006 (Key Biscayne, FL).

[23] IMF, *Global Financial Stability Report* (April 2006), Chapter II, pp. 51-84.

[24] See Speech by Timothy Geithner, Remarks at the Institute of International Finance, Inc.'s Annual Membership Meeting in Washington, D.C, September 25, 2005; and, Financial Services Authority, "Hedge Funds: A discussion of risk and regulatory engagement" (Discussion Paper 05/4).

[25] The Report of the Counterparty Risk Management Policy Group II, "Toward Greater Financial Stability: A Private Sector Perspective," July 27, 2005.

Last fall, MFA members who are active participants[26] in the credit derivatives markets took part in discussions with representatives of ISDA, the 14 major derivatives dealer firms (the "Fed 14"), and the Federal Reserve Bank of New York on the finalization of the ISDA 2005 Novation Protocol. These parties worked together to ensure that novations could be transacted successfully under the Protocol. Overall, that experience demonstrated that meaningful buy-side participation can be essential to ensuring the success of these industry-wide initiatives to curb operational or systemic risk. In this instance, focused and constructive dialogue among both buy-side and sell-side representatives led to a positive result.

As an outgrowth of the dialogue between the hedge fund and derivative dealer communities that occurred in late 2005, MFA continues its dialogue with representatives of the Fed 14 and ISDA. MFA continues its work with the Fed 14 representatives to share its views, along with those of other traditional asset managers, on the Fed 14's proposed strategy for reducing confirmation backlogs in credit derivatives.

MFA has pledged its support to work with the Fed 14 in the development and implementation of their targeted objectives for improving credit derivatives market practices. MFA appreciates the dealers' commitment to work with hedge funds and other buy-side representatives to develop and implement standard processing guidelines for credit derivatives. MFA has also expressed its support for improved transparency to reduce the backlog of unexecuted confirmations and the development of automated solutions for the processing of standardized products. Our statement made recommendations to the Fed 14 on how to achieve these goals and emphasized that, above all, meaningful buy-side input is essential for achieving improvements in these market practices.

MFA is now working on the development of industry-wide electronic platforms to warehouse credit derivative transactions, as well as on standards for transactions not eligible for electronic processing. MFA is committed to educating its members and keeping them informed regarding the latest operational developments in derivatives._As major participants in the credit derivatives markets, MFA's members have shown their willingness to work on private sector initiatives with their sell-side counterparties on steps to reduce systemic risk.

Investor eligibility standards or "retailization." In recent years, a concern has grown among regulators and others that hedge funds are becoming investment vehicles open to the retail public. This concern, coupled with the legally required non-public nature of hedge funds, has led regulators to inquire whether investors without the requisite financial means or sophistication were coming exposed to investments that might not be suitable for them.

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[26] Hedge funds make up only a small percentage of the credit derivatives market, approximately 7-16%, according to a September 2004 study released by the British Bankers' Association. See British Banker's Association Credit Derivatives Report 2003/2004 (available at http://www.bba.org.uk).

From all available information, hedge funds remain an investment vehicle for institutional investors and high-net worth individuals. The SEC in recent years has permitted the registration of investment companies that themselves invest in hedge funds. In these circumstances, the Investment Company Act, the Advisers Act, and all the investor protection mechanisms of the Federal securities laws come into play. These funds are subject to the rule range of protections afforded by SEC registration and oversight, as they are registered with the SEC and sold in registered public offerings. In addition, advisers of registered funds of hedge funds are required to be registered under the Advisers Act. The SEC therefore has authority to address any investor protection issues that may be presented.

To the extent that retail investors may be exposed to hedge fund investments without the intermediation of an institutional investor, Congress might want to inquire into the impact of inflation over the past quarter century on the SECs Regulation D. Regulation D defines "accredited investors" to include natural persons with individual or joint net worth of $1 million or individual income in each of the last two years in excess of $200,000, or joint income for the same period of $300,000. In the 25 years since the SEC last updated Regulation D, these dollar thresholds have come within the range of many middle class investors. The SEC might want to consider raising the Regulation D thresholds for investments in private funds.

MFA believes that concerns regarding investor qualification for participation in hedge funds should be addressed directly by raising the Regulation D standards. If the concern about the number of investors qualifying as "accredited investors" is valid, it is one the SEC should address through changes to Regulation D. MFA has expressed support for doubling the minimum net worth and minimum annual individual income standards from their current level, so that the monetary thresholds reflect the inflation in wealth and incomes since 1982.[27]

While investments in hedge funds by public and private pension funds appear to be growing, it is far from a level that would suggest undue risk to individual investors. In 2003, U.S., European, and Canadian pension funds reported that about 1% of their portfolio assets were invested in hedge funds.[28] By comparison, U.S. pension investments in real estate and private equity have been estimated at 3.4% and 3% of pension fund assets respectively.[29]

Publicly-offered funds of hedge funds are subject to the full range of protections afforded by SEC registration and oversight, as they are registered with the SEC as investment companies and sold in registered public offerings. In addition, advisers of funds of hedge funds are required to be registered under the Advisers Act. The SEC therefore has authority to address any investor protection issues that may be presented by these registered funds.

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[27] See MFA "White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds" (July 7, 2003).
[28] Greenwich Associates, "Alternative Investments May Disappoint Dabblers" (January 21, 2004).
[29] Greenwich Associates, "The Alternative Balancing Act" (December 32, 2003).

<u>*Continued development of MFA's Sound Practices*</u>. MFA has a longstanding and ongoing commitment to promoting sound practices in the hedge fund industry. "Sound Practices for Hedge Fund Managers" were first published by industry participants in 2000 in response to a 1999 recommendation by the President's Working Group on Financial Markets that hedge funds establish a set of sound practices for their risk management and internal controls. These sound practices were updated and expanded in 2003 by MFA as a response to industry developments.

Recognizing the valuable guidance provided by our 2003 guidance, on August 2, 2005 MFA published *MFA's 2005 Sound Practices for Hedge Fund Managers*. The 2005 iteration of MFA's Sound Practices were widely disseminated to policymakers on Capitol Hill and to U.S. and international regulators. The recommendations set forth in our 2005 Sound Practices provide a framework of internal policies, practices and controls for and by hedge fund managers. Our document provides relevant guidance on areas that are often of concern to regulators. These include hedge fund managers' internal trading controls, responsibilities to investors, valuation, risk management, regulatory compliance, transactional practices and business continuity and disaster recovery. New recommendations address guidance for developing compliance manuals, codes of ethics, and certain transactional practices including best execution and soft dollar practices.

Our document has been widely praised by regulators and industry participants alike, including in the Counterparty Risk Management Policy Group II Report. MFA continues to encourage hedge fund managers to incorporate its recommendations into their particular internal policies and procedures. As new industry practices develop, particularly under the new regulatory framework and with the rise of even more complex derivative instruments, MFA will update and expand its document within the next 12 to 18 months.

VI. CONCLUSION

The hedge fund industry has experienced significant growth in recent years. Much of this growth can be attributed to institutional investors seeking to diversify their returns and thereby reduce the overall risk of their investment portfolios. This growth has enabled hedge funds to serve as source of liquidity in global capital markets, increasing efficiency and decreasing risks.

With the growth and evolution of the hedge fund industry have come new responsibilities and challenges. On behalf of its members, MFA is committed to working with Congress, regulatory agencies, and on private sector initiatives to ensure an appropriate regulatory framework for the industry that allows the benefits to continue while addressing legitimate investor protection concerns. MFA appreciates the opportunity to share its views with the Subcommittee and will continue its work with both the SEC and its members to promote implementation of and compliance with the hedge fund adviser registration rule, as well as its efforts to reduce systemic risks and promote sound practices.