TESTIMONY BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE:

“HEDGE FUNDS AND SYSTEMIC RISK IN THE FINANCIAL MARKETS”

MARCH 13, 2007
I. INTRODUCTION

Mr. Chairman, thank you for the opportunity to testify here today on behalf of Managed Funds Association (“MFA”), which I serve as one of its Directors. I founded and serve as the Chief Investment Officer of Clinton Group, an investment adviser for a diverse group of institutional and high net income individual investors with over $1 billion under management. MFA is the only U.S.-based global membership organization dedicated to serving the needs of those professionals throughout the world who specialize in the alternative investment sector of the capital markets, including hedge funds, funds of funds and managed futures funds. MFA represents the hedge fund industry before the Congress, the Executive Branch and independent agencies, and works closely with the Committee. MFA submitted testimony for the record to this Committee in 2003 and testified before its predecessor committee in 1999.1

As this Committee is well aware, the hedge fund industry has experienced significant growth in recent years, with assets under management estimated at over $1.4 trillion.2 This growth reflects in large part, the needs of institutional investors for investment vehicles that offer a diversity of investment styles and help them meet their future funding obligations and other investment objectives.

As recently recognized by the President’s Working Group on Financial Markets (“PWG”), Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, private pools of capital “bring significant benefits to the financial markets.” Such pools are “an essential part of what keeps the U.S. capital markets the most competitive in the world.”3

With the growth of hedge funds have come important benefits to the markets as a whole – including increased liquidity, improved price discovery due to arbitrage, and overall enhanced functioning of markets and lower risks for market participants. Treasury Secretary Henry Paulson has observed that hedge funds have “made our capital markets more efficient, facilitating the dispersion of risk.”

Recognizing the critical market benefits generated by hedge funds and other private pools of capital, the PWG has recently defined the principles under which the public and private sectors should discharge their “shared responsibility” for the vitality,
stability and integrity of our capital markets by addressing the public policy issues associated with such funds. MFA fully supports the PWG’s assessment and its charge to market participants to maintain market discipline — which represents the primary means of addressing risk in a market-based economy. The hedge fund industry and policy makers currently face an important challenge, namely, to preserve the benefits offered by hedge funds while addressing legitimate systemic risk, investor protection and market integrity issues presented by the growth in hedge fund investments. MFA and its members are committed to meeting these challenges.

**MFA’s Mission.** As background, MFA, founded in 1991, is the U.S.-based global membership organization dedicated to serving the needs of the professionals who specialize in the alternative investment industry. The mission of MFA is to enhance the understanding of the hedge fund industry, to further constructive dialogue with regulators, and to foster communications and training of the Association’s members. As an example, MFA has an ongoing and regular program to promote implementation of sound industry practices. MFA activities include educational outreach to and representation before the U.S. Congress, the Securities and Exchange Commission (“SEC”), Commodity Futures Trading Commission (“CFTC”), Federal Reserve Board, U.S. Department of the Treasury, state legislatures and international regulatory agencies.

MFA’s over 1,300 members include professionals in hedge funds, funds of hedge funds, and managed futures funds. MFA members manage a substantial portion of the over $1.4 trillion invested in these investment vehicles. Members include representatives of a majority of the 100 largest hedge funds groups in the world. These larger hedge fund managers represented within MFA’s membership collectively manage in excess of $530 billion in assets, pursue a wide range of investment strategies and most are investment advisers registered with the Securities and Exchange Commission.

**Highlights of MFA’s Testimony.** In our testimony, we highlight the beneficial role of hedge funds in the economy and make the following points:

- MFA supports the *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital* and the path it sets forth. We accept the PWG role of being ever-vigilant.
- In the spirit of the *Principles and Guidelines*, MFA continues its vigilance in promoting the development of industry sound practices for hedge fund managers.
- MFA representatives have devoted significant resources to working with the Fed 18 in the development and implementation of targets for improving market practices for derivative products in order to reduce systemic risk concerns, particularly with respect to credit derivatives.
- MFA supports of the SEC’s efforts to increase financial sophistication standards for investors in hedge funds.
- We have suggested in the past that the SEC implement a proposal to collect census data on hedge fund managers.
MFA endorses efforts to increase understanding of hedge funds among pension plan fiduciaries and trustees, and is committed to helping promote investor financial literacy through the development of due diligence materials.

Finally, MFA is committed to promoting fair and competitive markets in which the inappropriate use of material non-public information is not tolerated.

These points are developed more fully in this testimony. We are pleased to provide Congress with our views on the hedge fund industry.

II. BENEFICIAL ROLE OF HEDGE FUNDS IN CAPITAL MARKETS

Diversification and Non-Correlated Returns for Institutional Investors. Much of the growth in hedge funds since the 1980s can be attributed to the increasing recognition by sophisticated 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, until recently, has come from university endowments and foundations. The endowment community stands at the forefront of innovation and thought towards portfolio management. From 2005 to 2006, endowments increased their hedge fund allocations from 7.3% to 8.7% on average. Moreover, top endowments, which include America’s most prestigious universities, allocated an average of 22.4% of their portfolios to hedge fund strategies.

Corporate and public pension plan investments in hedge funds will also continue to grow, both through direct investments and through fund-of-hedge-funds vehicles. 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.

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 smaller than in publicly traded indices. Academic research recognizes that hedge fund investments can reduce the overall risk of investment portfolios for investors such as endowments and public and private pension plans.

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. … [T]he 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.”

Increase in Efficiency. By trading on the basis of 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 as follows:

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.

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.

III. 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, but it is used 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”). 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 returns, typically through investments and trading in publicly traded securities and other interests. Hedge funds are one category of the universe of “alternative investments”. Other categories include: venture capital, private equity, leveraged buyout, oil and gas, and real estate funds.

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 the industry consists of over 13,000 single hedge funds with approximately 4,900 distinct single hedge fund managers, with total assets under management of over $1.4 trillion. Approximately 240 of these single hedge fund managers are large organizations, each of
which manage at least $1 billion in assets under management. It is estimated that these 240 managers collectively manage over 80% of all hedge fund assets. At the other end of the hedge fund spectrum, there are thousands of small firms managing hedge fund assets under $50 million each, many of them relative newcomers to the industry.

**Broad Array of Investment Profiles and Strategies.** 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, unlike most mutual funds, their returns do not depend on, nor are they benchmarked against, the long-term return of the markets, such as the Dow Jones Industrial Average or S&P 500. Rather, hedge funds seek to achieve positive returns based on the skill or strategy of the manager rather than to 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.

The universe of hedge funds divides naturally into four main strategy groups: (1) equity hedge funds, (2) global asset allocators, (3) relative-value managers, and (4) event-driven managers. Within each of these four main categories lie a variety of more specialized sub-strategies. A hedge fund’s proprietary trading strategy is what makes it unique. In pursuit of their strategy, hedge funds utilize a broad range of investment tools such as stocks, bonds, options, futures and derivatives. Hedge funds stand at the forefront of financial innovation in pursuit of their strategies and are important sources of new investment products, particularly in the area of derivatives, as explained later in this testimony.

The significance of the 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 actually comprised of many sub-strategies, each 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. Policymakers should be mindful of the value of these different strategies to the global marketplace in considering any policy decisions impacting the hedge fund industry.

**IV. CURRENT ISSUES**

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 regulatory initiatives on which MFA is focusing.

**PWG’s Agreement on Principles and Guidelines Regarding Private Pools of Capital.** As noted above, on February 22, 2007, the PWG issued its Principles and
Guidelines Regarding Private Pools of Capital, intended to guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds. The Principles and Guidelines assert the PWG’s view that “[t]he vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors” and reaffirm their view that, “market discipline of risk-taking is the rule and government regulation is the exception.” The PWG agreed that “[m]arket discipline most effectively addresses systemic risks posed by private pools of capital” and investor protection concerns “can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.”

MFA fully endorses the PWG’s conclusion that it is the shared responsibility of the private and public sectors to protect our capital markets and address the potential systemic and investor protection risks that may be presented by private pools of capital. While we believe that the path laid out by the PWG in their agreement is the right path, we pledge to work with Congress and all financial regulators, to ensure that the PWG’s principles are carried out by all market participants. MFA is and will do its part in this process.

As the largest U.S.-based association representing hedge funds, MFA has taken a leadership role in ongoing industry initiatives to address potential systemic risks, investor protection issues and other regulatory concerns. As discussed more fully below, our current initiatives include:

- **Updating MFA’s Sound Practices for Hedge Fund Managers** — a detailed, comprehensive framework of internal policies, practices and controls for hedge fund managers.

- Participation in private and public sector initiatives to address rapid growth and resulting documentation concerns presented by the use of credit derivatives.

- Participation in the SEC’s ongoing review of investor eligibility standards for participation in hedge funds.

- Participation in a joint effort with 11 other trade associations on the “Statement Regarding the Communication and Use of Material Nonpublic Information” and related initiatives to protect against misuse of market information.

- Maintaining ongoing communication and dialogue with regulators, industry participants and investors to address emerging issues relevant to the hedge fund marketplace.

*Continued Development of MFA’s Sound Practices.* MFA has a longstanding, ongoing commitment to promoting sound practices in the hedge fund industry. *Sound Practices for Hedge Fund Managers* were first published in 2000 in response to a 1999
recommendation by the PWG 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, we published MFA’s 2005 Sound Practices for Hedge Fund Managers. The 2005 iteration of MFA’s Sound Practices was 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, providing specific commentary on recommended internal trading controls, responsibilities to investors, valuation, risk management, regulatory compliance, transactional practices, business continuity and disaster recovery, codes of ethics, best execution, soft dollar practices, and other matters.

Our document has been widely recognized by regulators and industry participants alike, such as the Counterparty Risk Management Policy Group II in their 2005 report, Toward Greater Financial Stability: A Private Sector Perspective (“CRMP Group II Report”). We continue to encourage hedge fund managers to incorporate MFA’s recommendations into their particular internal policies and procedures. MFA has underway a review and expansion of the 2005 Sound Practices to address new regulatory and marketplace developments and anticipates publishing this additional guidance within the next six months.

Credit Derivatives and Systemic Risk Issues. As mentioned above, hedge funds stand at the cutting edge of financial innovation in pursuit of a wide range of investment strategies. The clearest example of this is in the development of a relatively new investment product known as the credit default swap (“CDS”). A credit derivative, such as a CDS, is essentially a privately negotiated agreement that explicitly shifts credit risk from one party to the other. The growth in the use of these types 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 $700 billion at year-end 2001 to an estimated $26 trillion at mid-year 2006.

The rising use of credit derivatives has attracted the attention of regulators in the U.S. and overseas. In 2005, regulators raised particular concerns about 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 CRMP Group II Report. MFA members who are active participants 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.
As an outgrowth of the dialogue between the hedge fund and derivative dealer communities that occurred in late 2005, MFA has been in, and is continuing its, dialogue with representatives of the major dealers (now the “Fed 18”) and ISDA to provide significant input on the Fed 18’s proposed strategy for reducing confirmation backlogs in credit derivatives and other derivative products. Over the past 12 months, MFA representatives have devoted significant time and resources to working with the Fed 18 in the development and implementation of their stated targets for improving credit derivatives market practices. The Fed 18 dealers have shown commitment to working with hedge funds to develop and implement standard processing guidelines for credit derivatives in order to reduce the backlog of unexecuted confirmations and the development of automated solutions for the processing of standardized products. Because of the work in this area, significant reductions in backlogs – over 80%, were achieved last year. Our efforts illustrate that market participants can work together to achieve tangible improvements that benefit all market participants who trade derivative products.

Another tangible result is the release of an industry-wide electronic platform to warehouse credit derivative transactions. MFA continues to educate its members and keep 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. The systemic benefits of hedge funds have been widely recognized by regulators, as noted above. The “larger role played by a much-expanded number and more diverse mix of private fund managers,” along with improvements in risk management, enhanced risk transfer mechanisms and other developments “seem likely to have improved by the stability and resilience of the financial system.” The increased importance of leverage and leveraged funds in the capital markets has focused attention upon the potential impact of adverse market events, particularly “tail events,” upon hedge funds and leveraged institutions. Like the PWG, MFA believes that market discipline provides the most effective means of addressing systemic market risks of this nature. Industry leadership in developing specific standards to address these types of risks has already been demonstrated in the 2005 MFA Sound Practices guidance and the Counterparty Risk Management Policy Group Reports I and II. As the PWG has recently underscored, managers of private pools of capital, creditors, counterparties, investors and fiduciaries all have responsibilities to foster market discipline. We at MFA are committed to assuring that the hedge fund industry meets these responsibilities and works cooperatively with other stakeholders in addressing all relevant risks.

**Investor Protection Issues.** As discussed above, one of the reasons for growth in the hedge fund industry in recent years has been an increasing recognition that hedge funds are an attractive asset class that can diversify returns and reduce the overall risk of an investment portfolio. In recent years, regulators have voiced concern that hedge funds are becoming investment vehicles open to the retail public and, consequently, have raised investor protection issues. 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.

From all available information, hedge funds remain chiefly an investment vehicle
for institutional investors and high-net worth individuals. However, to address the
potential availability to retail investors of hedge fund investments without the
intermediation of an institutional investor, the SEC has proposed to create stricter
eligibility standards for individual investors in funds that are privately offered in reliance
on Regulation D to help ensure that such investors will be capable of evaluating and
bearing the risks of these investments.\textsuperscript{18} Currently, Regulation D, the safe harbor from
registration of securities that privately offered investment vehicles typically rely upon,
defines “accredited investors” to include natural persons with individual or joint net
worth of $1 million, 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. To address this development, the SEC’s proposed new category
of “accredited natural person” would require that a natural person own, individually or
jointly with the person’s spouse, not less than $2.5 million in investments in addition to
qualifying as an accredited investor under current net worth or income standards.

MFA agrees with the SEC’s conclusion that it is no longer appropriate for hedge
funds to be sold to natural persons who fall within today’s definition of Accredited
Investors. MFA has long endorsed raising the financial standards in Regulation D as a
means to address the SEC’s concerns about the “retailization” of hedge funds and the
effect of inflation on income and net worth standards as they relate to the “accredited
investor” definition.\textsuperscript{19} We have, however, some specific concerns about the proposed
new Accredited Natural Person Rule, including its high degree of complexity and the
potential for confusion on the part of investors, as well as added costs. MFA has
explored these issues fully in our comment letter, dated March 9, 2007, to the SEC on the
proposed rule. We ask Congress to consider ways to encourage greater consistency
among financial sophistication standards across all regulatory agencies over which it has
oversight for the benefit of investors and fund managers alike.

Regulators have also linked investor protection issues to regulations that require
investment adviser registration with the SEC. With respect to the registration of hedge
fund advisers, we believe the current statutory regime is sound. The vast majority of the
top 100 hedge funds in the world are managed by SEC-registered advisers. In the past,
mindful of the need of the SEC to gather data on the industry, we have proposed to the
SEC that unregistered hedge fund advisers could be required to notify the SEC of its
intention to operate as a hedge fund adviser in reliance on the relevant exemptions. Our
proposal provided for a notice that could include certain basic census information about
the hedge fund adviser determined to be necessary or appropriate. In the future,
regulators may wish to re-visit our proposal.

\textit{Pension Fund Investments in Hedge Funds}. In proposing to reduce the
availability of pooled investment vehicles to retail investors, the SEC acknowledged that
natural persons may have “indirect exposure” to private pools as a result of their participation in pension plans and certain other pooled vehicles that investment in private pools. However, the SEC distinguished these types of vehicles from the direct investments addressed by its proposed heightened eligibility standards: “[s]uch plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals,” protections not present in the case of natural persons who seek to invest in 3(c)(1) pools outside of the structure of such pension plans and pooled investment vehicles. For example, 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 Investment Advisers Act of 1940, 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.

The PWG also addressed concerns about less sophisticated investors being exposed to hedge funds through their participation as beneficiaries of pension funds. It concluded that such concerns “can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles. These fiduciaries have a duty under applicable law to act in the best interest of the beneficiaries.” The PWG recommended that such fiduciaries, in considering whether to invest in a private investment fund, should carefully evaluate the fund’s manager and conduct appropriate due diligence regarding the fund’s valuation methodology and risk profiles. Such fiduciaries should also consider whether the suitability and the size of an investment are consistent with their investment objectives and the principle of portfolio diversification. MFA agrees with the PWG that the focus of protection for the beneficiaries of pension funds should be on the plan fiduciaries and the skills and sophistication they apply in carrying out their responsibilities. MFA endorses efforts to increase understanding of hedge funds and hedge fund strategies among professional fiduciaries, and is committed to helping such fiduciaries continue to develop their skills in performing due diligence on hedge funds and fund managers. Specifically, MFA is committed to helping promote investor financial literacy through the development of due diligence materials.

While investments in hedge funds by public and private pension funds appear to be growing, such investments are 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. 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. As noted by the SEC, the beneficiaries of such plans have the benefit of professional fiduciaries and investment advisers and these vehicles thus do not present the “retail” investor issues addressed by the SEC in its proposed ”accredited natural person” definition.
Joint Statement Regarding the Communication and Use of Material Non-Public Information ("Joint Statement"). In December 2006, MFA together with 11 other trade associations, issued a Joint Statement reaffirming their commitment and that of their members, “to promote fair and competitive markets in which inappropriate use of material non-public information is not tolerated.” As set forth in the Joint Statement, the prohibition against “insider trading” and “insider dealing” – through the misuse of material non-public information in connection with transactions in securities or securities-related derivatives – is firmly established and integral to public confidence in, and the proper functioning of, our capital markets. The signatory associations reaffirmed their previously-issued guidance concerning the communication and use of material non-public information and pledged to “inform, educate and provide additional guidance to our members, non-members and other interested parties alike.”

MFA is actively involved in carrying out the commitments set forth in the Joint Statement. MFA’s 2005 Sound Practices stress that hedge fund managers should establish written compliance procedures that address trading rules and restrictions, confidentiality restrictions, disclosure controls and policies designed to assure compliance with applicable securities and commodities laws, specifically including prohibitions on insider trading and other forms of market manipulation, measures to prevent flow of non-public information from one function to another, and personal trading policies. Specific recommended procedures are also provided. As I have noted, MFA has undertaken to revise and supplement its 2005 Sound Practices and the new version will include additional specific guidance to reaffirm the principles set forth in the Joint Statement and provide recommended procedures to reinforce these principles.

V. CONCLUSION

The growth of the hedge fund industry has provided enhanced liquidity to our capital markets, increased efficiency, decreased risks, and provided important diversification tools to institutional investors. However, with the growth and evolution of the hedge fund industry have come the new responsibilities and challenges discussed herein. On behalf of its members, MFA is committed to working with Congress, regulatory agencies and the private sector to ensure that these benefits continue while addressing systemic risk and investor protection concerns. MFA appreciates the opportunity to share its views with the Committee.
Source Materials


- Testimony of George E. Crapple, Chairman, Managed Funds Association, before the Committee on Banking and Financial Services, U.S. House of Representatives (May 6, 1999).


- PerTrac Financial Solutions, “2006 PerTrac Hedge Fund Database Study.”

- “Hedge Fund AUM Reaches $1.49 Trillion: Lipper TASS,” *HedgeWorld News* (February 27, 2007)


- Remarks of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, at the Distinguished Lecture 2006, sponsored by the Hong Kong Monetary Authority and Hong Kong Association of Banks, Hong Kong, September 15, 2006.


• Treasury Assistant Secretary for Financial Institutions Emil Henry, Remarks to the Federal Reserve Bank of Atlanta (April 18, 2006), (available at http://www.ustreas.gov/press/releases/js4187.htm)


• Casey, Quirk & Associates and Bank of New York, “Institutional Demand for Hedge Funds 2” (October 2006), at 6.


• “Renomination of Alan Greenspan as Chairman of the Federal Reserve Board of Governors: Hearing before the Senate Committee on Banking, Housing and Urban Affairs Committee” (testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve) (June 15, 2004).


• Robert Jaeger, All About Hedge Funds, McGraw-Hill (2003), at 57.


ISDA Press Release, “Industry Groups Urge Continued Focus on Credit Derivative Efforts; Confirmation Backlog Reduction Exceeds Target” (July 19, 2006).


2 Based on reported estimates by PerTrac Financial Solutions, “2006 PerTrac Hedge Fund Database Study.” See also, “Hedge Fund AUM Reaches $1.49 Trilli on: Lipper TASS,” HedgeWorld News (February 27, 2007) (citing Lipper TASS report asset inflow study).


5 Id. (includes only endowments of over $1 billion in assets under management).


7 “Renomination of Alan Greenspan as Chairman of the Federal Reserve Board of Governors: Hearing before the Senate Committee on Banking, Housing and Urban Affairs Committee” (testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve) (June 15, 2004).


9 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 or another exemption under the Securities Act of 1933. This can include long/short strategies for trading in equities; dedicated short sale equity strategies focusing on selling short securities that are deemed to be overvalued; regional strategies, which concentrate on a particular geographic region (such as emerging markets); sectoral strategies, which focus on a particular industry; or 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.

10 Also known as “global 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. This may include specific asset class strategies (such as currencies, commodities, interest rates).
Also called “market-neutral” 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.

A credit default swap is a credit derivative contract in which one party (protection buyer) pays a periodic fee to another party (protection seller) in return for compensation upon the default (or similar credit event) by a reference entity. The reference entity is not a party to the credit default swap. It is not necessary for the protection buyer to suffer an actual loss to be eligible for compensation if a credit event occurs. See ISDA Web site at www.isda.org (“Product Descriptions & FAQs”).


For example, on March 1, 2007, MFA, Fed 18 and DTCC representatives led a discussion for MFA members, “Update on Fed Targets, Derivatives Processing and the Role of DTCC & Trade Information Warehouse.”

T. Geithner, supra, note Error! Bookmark not defined.


SEC Release, at 404.

Id.
