MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

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MANAGED FUNDS ASSOCIATION

For the Hearing on

"Perspectives on Systemic Risk"

BEFORE THE

U.S. HOUSE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

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TESTIMONY OF MANAGED FUNDS ASSOCIATION

"Perspectives on Systemic Risk"
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Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises' hearing, "Perspectives on Systemic Risk" held on March 5, 2009. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies around the world.

MFA appreciates the opportunity to express its views on the important subject of systemic risk regulation and the systemic relevance of the hedge fund industry. In considering the issue of systemic relevance, we believe that it is important to focus not just on potential risks to our financial system, but also on ensuring that systemically important institutions are able to perform their important market functions.

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

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

Hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were substantially less leveraged than banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance despite the fact that our industry, and our investors, have

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suffered mightily as a result of the instability in our financial system and the broader economic downturn. We believe that the public and private sectors share the responsibility of restoring stability to our markets, strengthening financial institutions, and ultimately, restoring investor confidence. Hedge funds remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to our capital markets. The value of hedge funds (and other private pools of capital) as private investors has been recognized by Treasury Secretary Geithner in his proposals for a public/private investment fund and implementation of the Term Asset-Backed Securities Loan Facility, each of which is dependent on private investor participation to be successful. In addition to providing liquidity, managers of private pools of capital have significant trading and investing experience and knowledge that can assist policy makers as they continue to contemplate the best way to implement the Administration's Financial Stability Plan.

Regulatory reform will be an important part of stabilizing markets and restoring investor confidence, but it will not, in and of itself, be sufficient to do so. The lack of certainty regarding major financial institutions (*e.g.*, banks, broker dealers, insurance companies) and their financial condition has limited the effectiveness of government intervention efforts to date. Investors' lack of confidence in the financial health of these institutions is an impediment to those investors' willingness to put capital at risk in the market or to engage in transactions with these firms, which, in turn, are impediments to market stability. The Treasury Department's plan to conduct comprehensive stress tests on the 19 largest bank holding companies is designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. Treasury's announcement that it plans to involve private asset managers in helping to value illiquid assets held by banks as part of the public/private investment fund recognizes the beneficial role that private asset managers can play in helping provide that certainty.

While "smart" regulation cannot, in and of itself, restore financial stability and properly functioning markets, it is a necessary component of any plan to achieve those ends. "Smart" regulation would include appropriate, effective, and efficient regulation and industry best practices that better monitor and reduce systemic risk and promote efficient capital markets, market integrity, and investor protection. Regulation that addresses these key issues is more likely to improve the functioning of our financial system, while regulation that does not address these key issues can cause more harm than good. We saw an example of the latter with the significant, adverse consequences that resulted from the SEC's bans on short selling last year.

A smart regulatory framework should also include comprehensive and robust industry best practices designed to achieve the shared goals of monitoring and reducing systemic risk and promoting efficient capital markets, market integrity, and investor protection. Since 2000, MFA has been the leader in developing, enhancing and promoting standards of excellence through its document, *Sound Practices for Hedge Fund Managers ("Sound Practices")*. As part of its commitment to ensuring that *Sound Practices* remains at the forefront of setting standards of excellence for the industry, MFA has updated and revised *Sound Practices* to incorporate the recommendations from

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the best practices report issued by the President's Working Group on Financial Markets' Asset Managers' Committee.

Because of the complexity of our financial system, an ongoing dialogue between market participants and policy makers is a critical part of the process of developing smart, effective regulation. MFA and its members are committed to being active, constructive participants in the dialogue regarding the various regulatory reform topics, including the primary topic of today's hearing, systemic risk regulation.

The first step in developing a systemic risk regulatory regime is to determine those entities that should be within the scope of such a regulatory regime. There are a number of factors that policy makers are considering as they seek to establish the process by which a systemic risk regulator should identify, at any point in time, which entities should be considered to be of systemic relevance. Those factors include the amount of assets of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants.

As an Association, we are currently engaged in an active dialogue with our members to better understand how these factors, among others, may relate to the systemic relevance of all financial market participants – including our industry and its members. MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework. We are committed to being constructive participants in the dialogue regarding the creation of that framework.

There are four primary components of a systemic risk regulatory framework that I will discuss today. Those components are: a central systemic risk regulator; confidential reporting of information to a systemic risk regulator; establishing a clear regulatory mandate to protect the financial system; and the scope of authority of the systemic risk regulator.

CENTRAL SYSTEMIC RISK REGULATOR

Under our current regulatory structure, systemic risk oversight is the responsibility of multiple regulatory entities, or worse, no one's responsibility. For systemic risk oversight to be effective, there must be oversight over the key elements of the entire financial system, across all relevant structures, classes of institutions and products, and an assessment of the financial system on a holistic basis. We believe that a single central systemic risk regulator should be considered to accomplish this goal. This central regulator should be responsible for oversight of the structure, classes of institutions and products of all financial system participants. MFA is engaged in discussions with its members with respect to which regulatory entity, whether new or existing, would be best suited for this role.

We believe that having multiple regulators with responsibility for overseeing systemic risk likely would not be an effective framework. Jurisdictional conflicts,

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unintended gaps in regulatory authority, and inefficient and costly overlapping authorities likely would inhibit the effectiveness of such a regulatory framework. Moreover, in a framework with multiple systemic risk regulators, no one regulator would be able to assess potential systemic risks from a holistic perspective, as no regulator would oversee the entire system.

CONFIDENTIAL REPORTING TO REGULATOR

MFA and its members recognize that for a systemic risk regulator to be able to adequately assess potential risks to our financial system, that regulator needs access to information. We support a systemic risk regulator having the authority to request and receive, on a confidential basis, from those entities that it determines (at any point in time) to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system.

In considering the appropriate scope of this authority, we believe that it is important for the systemic risk regulator to have sufficient authority and flexibility to adapt to changing conditions and take a forward-looking view toward risk regulation. Attempting to pre-determine what information a regulator would need would not provide sufficient flexibility and likely would be ineffective as a tool to address potential future risks. We believe that granting the systemic risk regulator broad authority with respect to information gathering, along with ensuring that it has the appropriate resources and capabilities to effectively analyze that information, would be a more effective framework.

While we support a systemic risk regulator having access to whatever information it deems necessary or advisable to assess potential systemic risks, we believe that it is critical for such information to be kept confidentially and granted full protection from public disclosure. We recognize the benefit of a regulator having access to all important data, even potentially sensitive or proprietary information from systemically relevant entities. A systemic risk regulator can fulfill its mandate to protect the financial system without publicly disclosing all the proprietary information of financial institutions. We do not believe that there is a public benefit to such information being publicly disclosed.

Moreover, public disclosure of such information could be misleading, as it would likely be incomplete data that would be viewed by the public outside of the proper context. Public investors may be inclined to take action based on this data without fully understanding the information, which could lead to adverse consequences for those investors, for the investors in systemically relevant entities, and for the stability of the financial system as a whole. Public disclosure of proprietary information also harms the ability of market participants to establish and exit from investment positions in an economically viable manner. Such disclosure also could lead to systemically relevant entities being placed at an unfair competitive disadvantage compared to non-systemically relevant entities, as sensitive and proprietary information of only the systemically relevant entities would be publicly available.

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MANDATE TO PROTECT THE FINANCIAL SYSTEM

Setting a clear and specific mandate is important for any regulator to be effective. This is particularly true in a regulatory framework that has multiple regulatory entities, as a lack of clarity in the mandates of regulators can lead to gaps in oversight, or costly and inefficient overlapping regulation. We believe that the systemic risk regulator's mandate should be the protection of the financial system. Investor protection and market integrity should not be part of its mandate, but should instead be addressed by other regulatory entities. Congress should be clear in stating that the risk regulator should collect information only for its mandate to protect the financial system, and should not use that authority for other purposes.

To fulfill its mandate to protect the financial system, we recognize that the regulator would need to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system. Absent such a concern about broad systemic consequences, however, the systemic risk regulator should not focus on preventing the failure of systemically relevant entities. Systemically relevant market participants do not necessarily pose the same risks or concerns as each other. There likely are entities that would be deemed systemically relevant for purposes of reporting information, but whose failure would not threaten the broader financial system. For this reason, we believe that the systemic risk regulator should focus on preventing failures of market participants only when there is concern about the consequences to the broader financial system, and should not focus on preventing the failure of all systemically relevant entities.

Consistent with this mandate, the systemic risk regulator should not equate systemically relevant entities with entities that are too big, or too interconnected, to fail. An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against its failure.

SCOPE OF REGULATORY AUTHORITY

The last topic that I would like to address in my testimony is the scope of authority that a systemic risk regulator should have to fulfill its mandate to protect our financial system. There are a number of suggestions that various people have made as to the type of authority a systemic risk regulator should have. We continue to discuss with our members what the appropriate scope of authority should be for such a regulator.

We believe that whatever authority the regulator has should ensure that the regulator has the ability to be forward-looking to prevent potential systemic risk problems, as well the authority to address systemic problems once they have arisen. The systemic risk regulator's authority must be sufficiently flexible to permit it to adapt to changing circumstances and address currently unknown issues. An attempt to

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specifically define the regulator's authority must avoid unintentionally creating gaps in authority that would prevent the systemic risk regulator from being able to fulfill its mandate to protect the financial system in the future.

We do believe that the systemic risk regulator needs the authority to ensure that a failing market participant does not pose a risk to the entire financial system. In the situation when a failing market participant does pose such a risk, the systemic risk regulator should have the authority to directly intervene to ensure an orderly dissolution or liquidation of the market participant. The significant adverse consequences that resulted from the failure of Lehman Brothers, Inc. this past fall is an example of what can happen when there is not an intervention to prevent a disorderly dissolution of such a market participant. The continuing market disruption caused by the failure of Lehman Brothers also demonstrates the importance of ensuring that there is a coordinated global effort with respect to such interventions.

Whatever the scope of authority that a systemic risk regulator has, its implementation of that authority will be critical to the effectiveness of any regulatory regime. We believe that the systemic risk regulator should implement its authority by focusing on all relevant parts of the financial system, including structure, classes of institutions and products. Because systemic risk concerns may arise from a combination of factors, rather than from the presence of any particular factor, a holistic approach is more likely to successfully identify and assess potential systemic risks.

Recent coordinated efforts between the Federal Reserve Bank of New York (the "New York Fed") and industry participants provide a good example of how a systemic risk regulator could address systemic risk concerns posed by structural issues in our markets. In recent years, the New York Fed, working with MFA and other industry participants through the Operations Management Group ("OMG") and other industry-led initiatives has made notable progress in addressing concerns related to the over-the-counter ("OTC") derivatives market. Some of the more recent market improvements and systemic risk mitigants have included: (1) the reduction by 80% of backlogs of outstanding credit default swap ("CDS") confirmations since 2005; (2) the establishment of electronic processes to approve and confirm CDS novations; (3) the establishment of a trade information repository to document and record confirmed CDS trades; (4) the establishment of a successful auction-based mechanism actively employed in 14 credit events including Fannie Mae, Freddie Mac and Lehman Brothers, allowing for cash settlement; and (5) the reduction of 74% of backlogs of outstanding equity derivative confirmations since 2006 and 53% of backlogs in interest rate derivative confirmations since 2006.

In addition to these efforts, MFA, its members and other industry participants have been working with the New York Fed to expedite the establishment of central clearing platforms covering a broad range of OTC derivative instruments. We believe a central clearing platform, if properly established, could provide a number of market benefits, including: (1) the mitigation of systemic risk; (2) the mitigation of counterparty risk and protection of customer collateral; (3) market transparency and operational

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efficiency; (4) greater liquidity; and (5) clear processes for the determination of a credit event (for CDS).

CONCLUSION

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

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

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