



MANAGED FUNDS ASSOCIATION

COMMENTS OF MANAGED FUNDS ASSOCIATION

FOR THE

U.S. SECURITIES AND EXCHANGE COMMISSION

ROUNDTABLE ON HEDGE FUNDS

May 14 - 15, 2003

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INTRODUCTION

Managed Funds Association (MFA) is pleased to provide the following comments in anticipation of the Commission’s Roundtable on Hedge Funds to be held May 14-15, 2003 (the “Roundtable”).

Today’s Challenge for the Hedge Fund Industry. MFA believes that the hedge fund industry together with the Commission and other public policy makers currently face an important challenge: preserving the recognized benefits that hedge funds bring to the global financial markets and the investment community as a whole while addressing the legitimate investor protection issues presented by the increasing interest of a broader range of investors in hedge fund investments. With these comments, MFA identifies the principal issues that it believes must be adequately considered in formulating a response to this challenge. These comments will also address related concerns that have been raised recently in regard to hedge funds and explore how they may be addressed as part of this response.

About MFA. MFA has more than 600 members who manage a significant portion of the estimated \$600 billion invested in hedge fund products globally. Since its inception in 1991, MFA has provided leadership to the hedge fund and managed funds industries in government relations, communications, media relations and education for members and investors. For example, MFA recently published *Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs* (2002) in response to the enactment of the USA PATRIOT Act.¹ MFA also maintains a library of hedge fund industry materials, many of which are accessible on its web site at www.mfainfo.org. These materials include government reports on hedge funds, Congressional testimony and speeches by

¹ For a comprehensive view of MFA and its activities, please see the “Government Affairs” section of MFA’s web site at www.mfainfo.org.

regulators regarding hedge funds, legislation and rules relevant to hedge funds, as well as academic and industry papers and reports on hedge funds.

UNDERSTANDING HEDGE FUNDS

Hedge Funds Defined. Recognizing that there is no statutory or legal definition of a hedge fund, the President’s Working Group on Financial Markets broadly defined a hedge fund as follows:

“any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.”²

Given the broad scope of the definition, it is not surprising that the term “hedge fund” captures “a wide range of investment vehicles, which can vary substantially in terms of size, strategy, business model and organizational structure, among other characteristics.”³ Although the word “hedge” refers to a hedge fund’s ability to hedge the value of the assets it holds (e.g., through the use of options or the simultaneous use of long and short positions), some hedge funds engage only in simple “buy and hold” equity strategies or other strategies that do not involve hedging or arbitrage. In fact, the term “hedge fund” is used to refer to private funds engaging in over 25 different types of investment strategies, as discussed below.

Although hedge funds, like mutual funds, are pooled investment vehicles managed by professional managers, hedge funds are distinguishable from mutual funds in many ways. For example, hedge funds and their managers tend to be small relative to mutual funds and their associated financial institutions. The President’s Working Group observed that “most hedge funds are relatively small, with the vast majority controlling less than \$100 million in invested capital.”⁴ In contrast, the largest mutual funds “have almost \$100 billion in assets,

² President’s Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management*, April 1999 (“PWG Report”), at 1.

³ *Sound Practices for Hedge Fund Managers*, February 2000 (“Sound Practices”), at 3 (available on MFA’s web site in the “Hedge Fund Materials” section at www.mfainfo.org).

⁴ PWG Report at 2.

and there are many [mutual] funds with assets over \$10 billion.”⁵ In addition, as discussed further below, hedge funds restrict their shares to limited groups of sophisticated investors and, as a result, are not subject to the investment limitations of mutual funds. MFA believes these distinctions are important and should be preserved, for reasons discussed in greater detail below.

Hedge Funds Misunderstood. A number of commentators have observed that “little is understood about hedge funds and what they do.”⁶ MFA believes that many misconceptions about hedge funds and their activities may be attributed to the following:

- The absence of a legal or widely accepted definition of a hedge fund.
- The broad universe of investment strategies encompassed by the use of term “hedge fund”.
- Legal restrictions on hedge funds’ ability to engage in publicity or public solicitation. This prohibition on publicity may account for some of the “mystique” attributed to hedge funds and the limited public understanding of hedge fund investments.
- The focus of popular press coverage on rare instances of hedge fund failure or allegations of fraud by hedge fund managers rather than on the industry as a whole.
- Restrictions on participation by the general investing public in hedge funds, which means that the public has limited exposure to or need to understand hedge funds.

MFA is hopeful that the Roundtable and other undertakings by the Commission will contribute to a greater understanding of the hedge fund industry and serve to dispel misconceptions about hedge funds among regulators, legislators and the general public.

Regulatory Profile of Hedge Funds. Hedge funds restrict their shares to a limited group of qualified investors (as explained further under “Retailization of Hedge Funds”) and do not engage in public offerings. By so doing, hedge funds are not required to register with the

⁵ Robert A. Jaeger, *All About Hedge Funds*, at 57 (2003).

⁶ Stephen J. Brown & William N. Goetzmann, “Hedge Funds with Style”, *The Journal of Portfolio Management*, Winter 2003, at 101-102.

Commission and are therefore not subject to the investment and other limitations imposed upon registered investment companies. The fact that hedge funds are not registered does not mean, however, 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. See Annex B for a list of some of the reporting requirements and other regulations applicable to hedge funds and their activities in the United States.

A DIVERSITY OF STRATEGIES IN PURSUIT OF ABSOLUTE RETURNS

Broad Array of Investment Strategies. As noted above, the hedge fund industry represents a widely varied universe of investment styles and strategies.⁷ The variety in investment approaches may be attributed to the fact that hedge funds are not subject to the types of legal investment restrictions placed on mutual funds (such as limitations on leverage and strategies such as short-selling) and are typically granted flexibility in their investment mandate by investors.

Principal Strategies. The major hedge fund investment strategy classifications include the following:

- 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.

⁷ A list of over 25 investment strategies and their definitions can be found at the web site for Hedge Fund Research, Inc. (www.hedgefundresearch.com).

- 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.
- 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).

These alternative investment strategies can present a more complex risk/reward ratio than those of traditional stock and bonds, which is one of the reasons why access to hedge fund investments is generally restricted to “accredited investors” or, in many cases, “qualified purchasers”.⁸

Pursuit of “Absolute Returns”. Many hedge fund 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 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. This approach is distinguishable from that of most mutual funds, which typically seek to realize “relative” returns, or returns based upon the performance (whether it be positive or negative) of a certain market or relative to a market benchmark (like the S&P 500 stock index).⁹ The fact that hedge fund strategies differ from those of mutual funds and other investment vehicles in this way allows hedge funds to provide investors with a valuable means of portfolio diversification, as discussed below.

⁸ The qualifications for accredited investors and qualified purchasers are discussed further below in connection with the 3(c)(1) and 3(c)(7) exclusions from the Investment Company Act of 1940.

BENEFITS OF HEDGE FUNDS

Public and private sector experts have recognized that hedge funds provide significant benefits to their investors as well as the financial markets more generally.

Benefits to Investors. Many hedge funds provide attractive mechanisms for portfolio diversification because their returns have little or no correlation to those of more traditional stock and bond investments. As a result, many hedge fund categories tend to outperform stock and bond investments when the latter perform poorly. Much of the growth in hedge funds since the 1980s can be attributed to the increasing recognition by institutional investors, confirmed by a growing body of academic research,¹⁰ that hedge funds are an attractive alternative asset class that can help diversify returns and, in doing so, reduce the overall risk of an investment portfolio. As one academic paper summarized,

“hedge funds offer the opportunity to:

- 1) reduce portfolio volatility risk,
- 2) enhance portfolio returns in economic environments in which traditional stock and bond investments offer limited opportunities, and
- 3) participate in a wide variety of new financial products and markets not available in traditional investor products.”¹¹

In addition, hedge fund managers typically have a substantial amount of their own capital invested in the funds they manage, and a significant portion of their compensation is based upon the absolute, or positive, performance they achieve for their investors. As New York Attorney General Eliot Spitzer observed recently, the interests of hedge fund managers and

⁹ For example, a mutual fund that seeks to track the S&P 500 would be considered successful if its annual performance were -15% in a year when the S&P 500 declined by 20%.

¹⁰ See [Annex A](#) for a bibliography of academic and other research regarding the attributes and benefits of hedge fund investments cited herein.

¹¹ Thomas Schneeweis & Georgi Georgiev, *The Benefits of Hedge Funds*, Working Paper, Center for International Securities and Derivatives Markets, June 19, 2002. Dr. Schneeweis is a member of MFA’s Board of Directors.

their investors tend to be “aligned”¹², largely due to this combination of the managers’ commitment of capital to their funds and the performance-based compensation structure.

Benefits to the Global Financial Marketplace. Because many hedge funds are highly active participants in the markets they trade and can change their investment positions as circumstances warrant, they can move quickly and flexibly to respond to changes in market conditions. The active and informed participation of hedge funds in financial markets allows them to perform a number of important roles in the global financial market place, including the following:

- *Many hedge funds can act as “shock absorbers”.* By standing ready to put capital at risk in volatile markets when other investors choose to remain on the sidelines, hedge funds employing investment strategies that rely on arbitrage, hedging or contrarian approaches help to absorb market shocks and act as a buffer for other market participants.¹³ In doing so, hedge funds can inject needed liquidity into markets irrespective of market direction and “can be stabilizing influences”¹⁴, reducing the severity of price fluctuations in severe market conditions.
- *Hedge funds enhance market liquidity and provide “depth”.* As active trading participants in international capital markets, hedge funds provide systemic benefits by adding “depth and liquidity to financial markets”.¹⁵

¹² Dina Temple-Raston, “Spitzer Offers Assurance to Hedge Fund Leaders”, *New York Sun*, March 4, 2003.

¹³ Sound Practices at 3.

¹⁴ Statement of Treasury Deputy Assistant Secretary (Government Financial Policy) Lee Sachs Before the Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives (page 1) (1999).

¹⁵ Statement of John P. LaWare, Member, Board of Governors of the Federal Reserve System Before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives (1994).

“...many of the things which [hedge funds] do ... tend to refine the pricing system in the United States and elsewhere, and it is that really exceptionally and increasingly sophisticated pricing system which is one of the reasons why the use of capital in this country is so efficient ... there is an economic value here which we should not merely dismiss...I do think it is important to remember that [hedge funds] – by what they do – they do make a contribution to this country.” – Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, testifying before the Committee on Banking and Financial Services, U.S. House of Representatives regarding the collapse of Long Term Capital Management. October 1, 1998.

- *Hedge funds help to refine the pricing system, contributing to efficiencies in pricing and market stability.* By trading based on sophisticated and extensive market research, hedge funds provide markets with price information, which translates into pricing efficiencies. “Without Hedge Fund Managers’ research and commitment of capital, the markets would have potentially wider price spreads, pricing inefficiencies and illiquidity.”¹⁶ In targeting temporary pricing inefficiencies and market dislocations, hedge funds effectively help to minimize market distortions and eliminate these dislocations.
- *Many hedge funds act as a counterbalance to “herding”.* Many hedge fund investment strategies can serve as a valuable counterbalance to “herd” buying behavior, where market participants take positions similar to those of other market participants without reasonable justification. “Herding behavior can create price ‘bubbles’, meaning that the price of a stock may at that time be more reflective of a temporary order imbalance or transitory excess demand for that stock, than a useful representation of demand based on the fundamentals of the underlying asset.”¹⁷ Many hedge fund managers that perceive this imbalance will assume market positions that tend to restore unnaturally inflated prices to their true level. This is particularly important given that many market participants, such as mutual funds, are long-biased, meaning they tend to hold long positions in the assets in which they invest. The speculative bubble of the late 1990s would have been even more significant without the willingness of market participants such as hedge funds to take a bearish position.

¹⁶ Sound Practices at 3.

¹⁷ Judith Chase, “The State of Hedge Funds”, *SIA Research Reports*, March 10, 2003 (Securities Industry Association).

“Our activities are trend bucking rather than trend following. We try to catch new trends early and in later stages we try to catch trend reversals. Therefore, we tend to stabilize rather than destabilize the market. We are not doing this as a public service. It is our style of making money.” Statement of George Soros, Soros Fund Management, Before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, April 13, 1994.

- *Hedge funds provide a critical source of liquidity to illiquid markets.* Unlike mutual funds, hedge funds often require investors to maintain their investments in a fund for a certain minimum “lock-up” period, which can extend for a year or more depending on the type of fund concerned. In addition hedge fund investors must typically provide advance notice of redemptions and may only redeem shares at certain specified times (month-end, quarterly). Given the longer redemption horizon and the more stable asset base, hedge funds have the ability to invest in relatively illiquid markets and structured investments, such as the mortgage derivatives, distressed securities and risk arbitrage markets, which depend upon access to stable pools of investment capital.
- *Many hedge funds are less likely to engage in “momentum trading”.* “The predictability of purchases and redemptions by small retail investors in mutual funds depending on market conditions makes their managers particularly prone to “momentum trading”, that is, buying into a rising market and selling into a falling market, increasing market volatility.”¹⁸ Because hedge funds impose longer redemption horizons on their investors, hedge funds have fewer incentives to engage in momentum trading.
- *Through short-selling, hedge funds indirectly act as “whistle blowers”.* In certain recent cases hedge funds have been among the first market participants “to spot trouble” with certain issuers, and their trading activity effectively presaged the discovery of major issuer frauds.¹⁹ For example, short interest in Enron ballooned from 13.8 million shares in mid-September 2001 to 31.1 million shares as of November 15, 2001, weeks before Enron filed for bankruptcy. As one research firm recommended,

¹⁸ See *Hedge Funds and Financial Market Dynamics, Occasional Paper 166*, International Monetary Fund (May 1998) at 29; see also Brandon Becker and Colleen Doherty-Minicozzi, *Hedge Funds in Global Financial Markets* (February 2000) at 90-93, for a discussion of other reasons why hedge funds are viewed as being “a more stabilizing influence than other market participants.”

¹⁹ See Statement of James S. Chanos, Kynikos Associates, Ltd., Before the Committee on Energy and Commerce, Developments Relating to Enron Corp., U.S. House of Representatives, February 6, 2002; see also “Don’t Shoot the Messenger - Why short-selling should be encouraged,” *The Economist*, March 1, 2003.

“Investors should absolutely look at short interest because short sellers do better homework than buyers of stock.”²⁰

- *Certain hedge funds act as market and risk management innovators.* The employment of state-of-the-art trading and risk management techniques by certain leading hedge funds fosters financial innovation and risk sophistication among the market participants with which they deal.

“Hedge funds can and do provide positive benefits to financial markets. Their trading can increase market efficiency, in that positions taken to profit from temporary price discrepancies can reduce such gaps. Indeed, the risk-taking engaged in by hedge funds and major market participants can serve to correct incongruities in market valuations. I believe that attempts to eliminate or stifle this market activity will result in less efficiency and liquidity in the marketplace.” Statement of CFTC Commissioner (now Chairman) James E. Newsome before the Committee on Agriculture, Nutrition and Forestry, United States Senate, December 16, 1998.

“RETAILIZATION” OF HEDGE FUNDS

As noted above, one of the reasons for growth in the hedge fund industry in recent years has been an increasing recognition by investors that hedge funds are an attractive alternative asset class that can diversify returns while reducing the overall risk of an investment portfolio. Other reasons that account for increased interest in hedge funds include recent declines in mutual fund returns and the movement of talented investment professionals to trading on behalf of hedge funds.

The growing investor interest in hedge funds has led to concerns regarding the “retailization” of hedge fund investments, that is, the potential for increased availability of hedge fund investments to less sophisticated investors. MFA believes that the key question presented by the potential retailization of hedge funds is whether the existing regulatory structure for the offer and sale to the general public of registered investment companies that invest in hedge funds is appropriate.

²⁰ Paul R. LaMonica, “Enron: Could your stock be next?”, *CNNMoney*, November 30, 2001.

Existing Investor Requirements for Hedge Funds. Hedge funds are required by law to limit their U.S. investors to those that satisfy special qualifications under the U.S. securities laws. The specific investor qualifications with which a hedge fund must comply depend upon the exclusion from the Investment Company Act of 1940 (the “1940 Act”) that is applicable to the hedge fund. The principal exclusions and their associated investor qualifications are summarized below.

- *Section 3(c)(1).* This exclusion provides that an investment fund will not be required to register as an investment company under the 1940 Act 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 Regulation D of the U.S. Securities Act of 1933. 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 in excess of \$300,000.²¹
- *Section 3(c)(7).* This exclusion provides that an investment pool will not be required to register under the 1940 Act if each investor in the pool is a “qualified purchaser” and the pool does not undertake a public offering. The term qualified purchaser includes: 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; certain qualifying trusts; and institutional investors.

MFA believes that the existing regulatory structure as applied to hedge funds – which bars retail investors from directly investing in hedge funds and prohibits hedge funds from advertising or engaging in general solicitation of the public – has worked well and continues to be sound. This structure appropriately seeks to achieve investor protection by limiting hedge funds to investors who have been deemed sufficiently sophisticated and capable of determining for themselves whether the risk-reward profile presented by hedge fund investments is appropriate to their investment needs. To the extent that the Commission believes it appropriate to revisit existing investor qualifications as they apply to hedge funds,

²¹ For a detailed discussion of the requirements applicable to 3(c)(1) funds as well as Regulation D, see Barry P. Barbash & Emanuel D. Strauss, *Navigating Among Icebergs: The U.S. Regulatory Scheme Involved in Organizing and Operating Private Investment Funds*, presented as part of the International Conference on Private Investment Funds, February 24-26, 2002.

MFA would be pleased to participate in any such undertaking and to explore ways in which these qualifications may be modified in order to achieve legitimate investor protection goals.

Funds of Hedge Funds. In response to growing investor demand for hedge fund investments, certain regulated entities have begun offering their clients shares in registered investment companies that invest in hedge funds, or “funds of hedge funds” that are registered with the Commission. As Chairman Donaldson stated in his recent testimony before the Senate Banking committee, the first of these products was registered with the Commission less than a year ago; since that time, an additional 17 have been approved for public offering. Because these funds were registered under the U.S. Securities Act of 1933 and the Investment Company Act of 1940, their shares could be offered publicly to investors that meet lower financial net worth and sophistication standards than those required of direct hedge fund investors. Despite the potential ability to offer shares more broadly, the sponsors of these funds to date have voluntarily restricted these products to accredited investors or investors that are “qualified clients”²² and generally have imposed minimum investment requirements of between \$25,000 and \$100,000 (and in some cases \$1 million); as a result, retail investors have not had access to these products to date. However, there is no legal requirement to impose investor eligibility standards or investment minimums, and “it is possible that funds might seek to lower this requirement making these types of funds available to a greater number of investors with even less capital.”²³

MFA recognizes that the offering of these new registered fund products more widely raises legitimate federal interests. Although a broader class of investors may have legitimate interests in diversifying their investment portfolios to include hedge fund strategies and returns, it is important that these investors be capable of assessing and understanding the risks associated with such investments. Consequently, MFA believes it is appropriate for the

²² As defined in 205-3 of the Investment Company Act of 1940, which generally requires that the net worth of an investor (together with spouse) exceed \$1.5 million or that the investor be a “qualified purchaser,” owning at least \$5 million in investments.

²³ Statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission Before the Committee on Banking, Housing and Urban Affairs, United States Senate, “Investor Protection Implications of Hedge Funds,” (April 10, 2003) (“Donaldson Statement”), at 17.

Commission to consider the types of investments being made by registered investment companies and to monitor the offer and sale of these new products to ensure that they are suitable for their investors. In particular, MFA supports the undertakings of the Commission and the National Association of Securities Dealers to ensure that regulated broker-dealers are complying with applicable securities laws and regulations in offering these investments to their clients.²⁴ MFA is confident that, through the fund registration process as well as the regulation of entities offering these registered fund products, the Commission has adequate authority to supervise and regulate the development and offering of these products.

CONFLICTS

Certain mutual fund managers have begun managing hedge funds in addition to the mutual funds they have traditionally managed. Some observers have questioned whether managing a hedge fund alongside a mutual fund creates potential conflicts of interests for the mutual fund manager. For example, if the hedge fund's compensation structure pays the manager a share of trading profits as a performance fee, the investment adviser may be "tempted to favor its hedge fund clients over its registered investment company clients in allocating lucrative trades".²⁵

MFA supports the efforts of the Commission to ensure that mutual fund managers treat their investors fairly and equitably. MFA is confident that the Commission has the authority to supervise and regulate mutual fund managers and to address the potential conflicts of interest presented by offering mutual funds and hedge funds side by side.

VALUATION

While mutual funds are subject to regulations governing the valuation of the assets they hold, hedge funds are required to perform valuations consistent with their agreements with

²⁴ The NASD recently published a "Notice to Members" in February 2003 reminding its members of their suitability and other obligations when selling funds of hedge funds to their customers.

²⁵ Donaldson Statement at 13.

investors. For example, most hedge funds commit to perform valuations and maintain their accounts in accordance with U.S. generally accepted accounting principles, or GAAP, and to have their accounts audited annually by an internationally recognized audit firm. In addition, hedge fund valuation determinations, like those of mutual funds and other investment vehicles, are subject to the antifraud provisions of the federal securities laws.

As with mutual funds, sound valuation practices are critically important to hedge funds because these practices determine the price at which investors subscribe and redeem shares of the fund. A group of hedge fund managers stressed the importance of proper valuation procedures in *Sound Practices for Hedge Fund Managers*,²⁶ stating that “Senior Management should determine policies for the manner and frequency of computing [Net Asset Value] based upon applicable GAAP and disclose such policies to investors. Such policies should establish valuation methods that are consistent and fair to both buyers and sellers.” The *Sound Practices* report also recommended that valuations “be periodically validated by independent internal or external review, preferably on a monthly basis, but no less frequently than annually. The accuracy of [Net Asset Value] calculations should be verified by external auditors at least annually to assure compliance with GAAP.” The portions of *Sound Practices for Hedge Fund Managers* that address valuation are attached as [Annex C](#).

MFA strongly endorses the principles detailed in *Sound Practices for Hedge Fund Managers* with respect to valuation procedures. MFA believes that hedge fund investors are capable of demanding the disclosures they require to determine whether a hedge fund’s valuation and accounting policies and audit program are appropriate and adequate. The hedge fund manager’s response to those demands is subject to the anti-fraud provisions of the federal securities laws as well as their contractual obligations to investors. Consequently, MFA does not believe that new regulation is required to address valuation methods employed by hedge funds.

²⁶ Sound Practices at 10-12 and Appendix I, I-5 to I-8..

FRAUD

As the hedge fund industry has grown into an estimated \$600 billion industry with over 6,000 firms, the number of investigations undertaken by the Commission into allegations of fraud by hedge funds has also grown.²⁷ While the number of these investigations may have increased, MFA believes that there are relatively few instances of fraud relating to hedge funds in comparison to the size of the industry. Commission Chairman Donaldson recently acknowledged that he has “no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else.”²⁸

Certain recent cases involving hedge funds have involved fraudulent valuations by the hedge fund, or fraud by the hedge fund as issuer. As noted above under “Valuation”, a hedge fund’s obligations with respect to valuations are governed by their agreement with investors as well as by the anti-fraud provisions of the U.S. securities laws. To the extent a hedge fund engages in accounting fraud or fraud with respect to the valuation of its shares, the hedge fund, similar to any other issuer that engages in such forms of fraud, may be liable for violations of federal securities laws, as well as violations of its contractual obligations to investors.

With respect to fraud on the market more generally, it is important to recognize that, like other market participants, all hedge funds and their managers and advisors are subject to the broad anti-fraud and anti-manipulation provisions of the U.S. Securities Act of 1933, the U.S. Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 which prohibit fraud in connection with the offer, sale and purchase of securities and in connection with the advisory relationship.²⁹ Hedge fund managers are also subject to the U.S. securities laws’ prohibitions on insider trading. Hedge funds that engage in futures trading are also subject to the anti-fraud and anti-manipulation provisions of the U.S. commodities laws. In

²⁷ A list of recent Commission enforcement actions involving hedge funds may be found at <http://www.sec.gov/divisions/enforce/enforceactions.shtml>

²⁸ Donaldson Statement at 19.

²⁹ See [Annex B](#) for a detailed list of the anti-fraud and anti-manipulation provisions to which hedge funds are subject.

addition U.S. hedge funds (and hedge funds with a U.S. nexus) are expected to be required to comply with certain key anti-money laundering provisions of the *USA PATRIOT Act* once final rules are promulgated with respect to hedge funds.

MFA believes that there exists no basis for treating hedge funds differently from other issuers or market participants with respect to instances of fraud and that the regulatory framework currently in place is adequate to enable the Enforcement Division at the Commission to prosecute allegations of fraud under the federal securities laws.

“[T]he Commission has a solid record of uncovering hedge fund fraud and recovering a portion of the victims’ assets.” Stephen M. Cutler, Director of Commission Division of Enforcement, Sept. 2001.

SYSTEMIC RISK

The Lessons of Long-Term Capital Management. Although many public and private sector commentators have acknowledged that Long-Term Capital Management (“LTCM”) was unique in terms of both its size and the levels of leverage it employed, the market turbulence that followed the near-collapse of LTCM in 1998 led both the public and private sectors to focus renewed attention on ways to reduce systemic risk.³⁰

One notable public sector response was the report published by the President’s Working Group on Financial Markets (consisting of the Secretary of the Treasury and the Chairpersons of the Commission, the Federal Reserve and the Commodity Futures Trading Commission) entitled *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (the “PWG Report”). The PWG Report recommended a number of measures, both public and private, designed to enhance market discipline in constraining excessive leverage, recognizing that “[a]ny resort to government regulation should have a clear purpose and

³⁰ Charles Adams, Donald J. Mathieson, and Gary Schinasi, *World Economic and Financial Surveys: International Capital Markets – Developments, Prospects, and Key Policy Issues* (September 1999) at 152; see generally Brandon Becker and Colleen Doherty-Minicozzi, *Hedge Funds in Global Financial Markets* (February 2000).

should be carefully evaluated in order to avoid unintended outcomes.”³¹ Rather than propose any direct regulation of hedge funds, the PWG Report’s recommendations called for “indirect regulation” of unregulated market participants. One of the products of this recommendation was the publication of *Sound Practices for Hedge Fund Managers* by the hedge fund industry in response to the PWG Report.

The response advocated by the private sector was comparable to that of the PWG Report. For example, the Counterparty Risk Management Policy Group (“CRMPG”), a group of twelve major international investment and commercial banks, proposed a voluntary framework for enhanced counterparty credit risk management rather than endorse regulation of hedge fund counterparties.

MFA believes that the public and private sector measures implemented in the aftermath of LTCM, such as those described in the CRMPG framework and *Sound Practices for Hedge Fund Managers*, have successfully reduced the exposure of global financial markets to systemic risk. Consequently, MFA does not believe that new regulation to address this risk is necessary.

“Although I believe the LTCM debacle exposes serious and systemic problems in creditor monitoring of large institutional borrowers, I do not believe that it supplies any persuasive justification for direct regulation of hedge funds ... [T]he problem with direct regulation of hedge funds is two fold: (1) Investor protection – the traditional primary goal of SEC regulation – does not supply a coherent justification for regulation of hedge funds; and (2) Regulation is likely to drive hedge funds off shore.” John C. Coffee, Professor, Columbia University School of Law, testifying before the Banking Committee, U.S. House of Representatives, May 6, 1999.

³¹ PWG Report at 35.

SHORT-SELLING

In periods of bear markets, as in the present time, the topic of short selling becomes controversial, particularly among those who have an interest in seeing market prices rise. Critics of short selling practices often claim that short-sellers unfairly collude to drive down stock prices; however, academic research has been unable to link the most recent market declines to any single trading strategy.³²

"I am not saying anything critical of short selling. It has nearly always been an aspect of our marketplace that has been useful and beneficial. The people who first highlighted the problems at Enron were short sellers." Eliot Spitzer, New York Attorney General, March 3, 2003.

MFA believes that there is no demonstrated need to further restrict short-selling or to tilt the playing field further toward the long side by implementing additional restrictions on short-sellers akin to the "uptick rule." To the extent that the Commission believes that the impact of short-selling or other trading strategies on the market or certain issuers merit consideration, MFA would be pleased to cooperate with the Commission in such an undertaking. MFA, however, does not believe that the Roundtable is the appropriate forum for revisiting regulations applicable to short selling and that the Division of Market Regulation of the Commission would have to evaluate many factors and the potential impact on many market participants in evaluating the regulatory framework applicable to short selling before any meaningful conclusions could be drawn. Although many hedge funds may engage in investment strategies that involve short-selling, many other market participants do as well. Consequently, if a re-examination of short-selling is to be undertaken, MFA believes that it should be done in concert with the Division of Market Regulation of the Commission, the Federal Reserve, the Commodity Futures Trading Commission and the

³² See, e.g., Thomas Schneeweis and Richard Spurgin, "Market Crashes, Speculation and Hedge Funds", *AIMA Newsletter* (Sept. 2002) at 1.

Treasury, as well as representatives of the industries that would be impacted by increased regulation.

MFA believes that short selling is not only a legitimate investment activity, but one that plays an important role in improving market efficiency and price discovery. By allowing market participants to place short positions on particular securities that they believe to be over-valued, the existing regulatory scheme allows investors not only to protect their own investment portfolios, but also to reduce market volatility and help bring asset valuations back into line. As noted above, short-selling serves as an important counter balance to “bubble” markets and the long biases of other market participants. In several recent cases, hedge funds have acted indirectly as “whistle-blowers” by engaging in short-selling, the validity of which was later borne out by discoveries of fraud or other misconduct by the issuers concerned.³³ Commission Chairman Donaldson acknowledged in his recent statement before the Senate Banking committee that “[t]here is nothing inherently nefarious about hedge fund trading strategies, including short selling.”³⁴

“The evidence on subsequent stock returns suggests that in public battles between short sellers and firms, short sellers usually are vindicated by subsequent events. The evidence suggests that short sellers play an important role in detecting not just overpricing, but also fraud. Policy makers might want to consider making the institutional and legal environment less hostile to short sellers.” Owen A. Lamont, Associate Professor of Finance at the Graduate School of Business, University of Chicago commenting on the data in his study of battles between short sellers and firms entitled, “Go down fighting: Short sellers vs. firms”.³⁵

The prospect of additional regulation of short selling raises fundamental market issues that go far beyond those related to the trading activities of hedge funds. It potentially affects the efficiency and volatility of U.S. equity markets and the position of U.S. market participants in the world financial system. The adoption of additional short selling rules

³³ Owen A. Lamont, *Go down fighting: Short sellers vs. firms*, Working Paper, Graduate School of Business, University of Chicago and National Bureau of Economic Research (January 9, 2003) (“University of Chicago Study”).

³⁴ Donaldson Statement at 21.

³⁵ University of Chicago Study at 30-31.

could constitute a rash and harmful overreaction to isolated incidents of alleged impropriety that would be better addressed under the existing anti-fraud provisions of the U.S. securities laws.

CONCLUSION

MFA is pleased to offer these comments in anticipation of the Roundtable and hopes that they serve to properly frame the issues that participants may wish to address. MFA looks forward to working with the Commission on any efforts that it determines to undertake in the future that may be of relevance to the hedge fund industry.

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SOUND PRACTICES FOR HEDGE FUND MANAGERS

U.S. REGULATORY FILINGS BY HEDGE FUND MANAGERS³⁶

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

Federal Reserve

Treasury Securities Position and Foreign Exchange Transaction Reporting

1. *Large Position Reporting*

Report of positions in specific Treasury security issues that exceed the large position threshold specified by the U.S. Treasury Department (minimum \$2 billion).

Reports are filed in response to notices issued by the U.S. Department of the Treasury if such threshold is met.

Reports are filed with the Federal Reserve Bank of New York and are not public.

2. *Form FC-1*

Report of weekly, consolidated data on the foreign exchange contracts and positions of major market participants.

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

³⁶ The content of this Annex B reproduces Appendix II of *Sound Practices for Hedge Fund Managers* (February 2000). Capitalized terms have the meanings given to them in that document.

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

3. *Form FC-2*

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

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

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

4. *Form FC-3*

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

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

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

Treasury Auction Filings

5. *Treasury Auction*

Treasury security reports filed as necessary. Confirmations must be filed by any customer who is awarded more than \$500 million of U.S. government securities in a Treasury auction. The confirmation must include its reportable net long position, if any.

The confirmation is filed with the Federal Reserve Bank to which the bid was submitted and is not public.

Treasury International Capital Forms

6. *Forms CM, CQ-1 and CQ-2*

Forms filed by U.S. persons who have claims on, or financial liabilities to unaffiliated foreigners, have balances on deposit with foreign banks (in the U.S. or abroad) or otherwise engage in transactions in securities or other financial assets with foreigners. Forms CQ-1 (“Financial Liabilities to, and Claims on, Unaffiliated Foreigners”) and CQ-2 (“Commercial Liabilities to, and Claims on,

Unaffiliated Foreigners”) are quarterly reports, which collect data on financial and commercial liabilities to, and claims on, unaffiliated foreigners held by non-banking enterprises in the United States, which must be filed when the consolidated total of such liabilities are \$10 million or more during that period. Form CM (“Dollar Deposit and Certificate of Deposit Claims on Banks Abroad”) is a monthly report whereby non-banking enterprises in the U.S. report their total dollar deposit and certificate of deposit claims on foreign banks, which must be filed when the consolidated total of such claims are \$10 million or more during that period.

The forms are filed with the Federal Reserve Bank of New York are non-public except for aggregate information.

7. *Form S*

Form filed by any U.S. person who purchases or sells \$2 million or more of long-term marketable domestic and foreign securities in a month in direct transactions with foreign persons.

The form is filed with the Federal Reserve Bank of New York and is non-public except as to aggregate information.

Securities and Exchange Commission (“SEC”)

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

8. *Form D*

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

Secondary Sale of Restricted and Control Securities Under Rule 144

9. *Form 144*

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

Ownership of Equity Securities Publicly Traded in the United States

10. *Schedule 13D*

Disclosure report for any investor, including a hedge fund and its fund manager, who is considered beneficially to own more than 5% of a class of equity securities publicly traded in the U.S. The report identifies the source and amount of the funds used for the acquisition and the purpose of the acquisition.

This reporting requirement is triggered by direct or indirect acquisition of more than 5% of beneficial ownership of a class of equity securities publicly traded in the U.S. Amendments must be filed promptly for material ownership changes. Some investors may instead report on short-form Schedule 13G if they are eligible. See “11. Schedule 13G”

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

11. *Schedule 13G*

Short form disclosure report for any passive investor, including a hedge fund and its fund manager, who would otherwise have to file a Schedule 13D but who owns less than 20% of the subject securities (or is in certain U.S. regulated investment businesses) and has not been purchased for the purpose of influencing control.

This reporting requirement is triggered by direct or indirect acquisition of beneficial ownership of more than 5% of a class of equity securities publicly traded in the U.S. Amendments must be filed annually if there are any changes, and either monthly (for U.S. regulated investment businesses) or promptly (for other passive investors) if ownership changes by more than 5% of the class

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

12. *Forms 3, 4 and 5*

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

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

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

Registered and Unregistered Institutional Investment Managers

13. *Form 13F*

Quarterly position report for registered and unregistered institutional investment managers (*i.e.*, any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person) with investment

discretion over \$100 million or more in equity securities publicly traded in the U.S. Reports contain position information about the equity securities under the discretion of the fund manager, and the type of voting authority exercised by the fund manager.

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

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

Material Associated Persons of Registered Broker-Dealers

14. *Form 17-H*

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

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

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

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

Commodity Futures Trading Commission (“CFTC”) and National Futures Association (“NFA”)

Registered Commodity Trading Advisors (“CTAs”) and Commodity Pool Operators (“CPOs”)

15. *Commodity Pool Operator and Commodity Trading Advisor Registration*

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

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

The documents required for registration as a Commodity Pool Operator or Commodity Trading Advisor are: a completed Form 7-R (which provides CPO or CTA information), a completed Form 8-R (which provides biographical data) and fingerprint card, for each principal (defined to include executive officers, directors and 10% owners), branch office manager and associated person (defined to include persons soliciting fund interests or accounts or supervising persons so engaged), and proof of passage of the “Series 3” exam for each associated person and proof of passage of the “Series 3” and futures branch office manager exams for each branch office manager.

Applications for registration are filed with and approved by the NFA under authority granted to it by the CFTC and the registration documents are generally public except for fingerprint cards, although confidentiality may be requested for certain information relating to the principals.

16. *Form 3-R amend. 7-R*

Form used to report any changes to information contained in the basic registration Form 7-R.

The requirement to file this form is triggered by changes in the information provided in Form 7-R.

The form is filed with the NFA and is public, though confidentiality may be requested for certain information relating to the principals.

17. *Form 8-T Associated Person Termination*

Form that must be filed within 20 days of the termination of an Associated Person, principal or branch manager. The form is filed with the NFA and is generally public.

18. *Ethics Examination for all Registered Persons*

Ethics training is required under CFTC Reg. §3.34 for all associated persons and any individual registered as a CPO or CTA. In connection with the annual registration update, each NFA member will receive a report indicating ethics training due or overdue for its associated persons. The member is responsible for providing proof

of ethics training to the NFA, and the NFA will confirm this information to the public.

19. *Annual Report*

Annual report of a fund that must be filed pursuant to Reg. §4.22(c) by that fund's CPO. The Annual Report must contain certain information, such as actual performance information and fees, and must be distributed to each participant in the fund.

The annual report must be filed by a registered CPO with the CFTC within 60 days of the fund's fiscal year-end and is generally publicly available; however, the CFTC is prohibited from disclosing information that would separately disclose the business transactions or market positions of any person or trade secrets or names of any investors.

20. *CPO/CTA Questionnaire*

Annual compliance questionnaire concerning its business activities for applicants registered as CPOs or CTAs. The questionnaire is filed with the NFA and is not public.

21. *NFA self-audits*

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

Registered CPOs and CTAs as members of the NFA are required to conduct such self-audit annually.

A written attestation is then signed and dated by the supervisory personnel that they have reviewed the operations in light of the checklist. This attestation is retained by the member and not forwarded to the NFA and as such is not public.

22. *Claims for exemption*

Filings made pursuant to Reg. §4.12(b)(3) (notice of claim for exemption from certain requirements by a CPO that complies with the Securities Act and manages a fund with limited trading in commodity futures and options), Reg. §4.7(a)(3) (notice of claim for exemption by a CPO with "qualified eligible participants" as investors), and Reg. §4.7(b)(3) (notice of claim for exemption by a CTA advising "qualified eligible clients"). Reg. §4.7 provides exemptions for qualifying CPO/CTO applicants from most disclosure and other requirements of CPOs and CTAs.

These statements are filed with the CFTC and NFA and are public.

23. *Disclosure Document*

CPOs and CTAs are generally required to prepare detailed Disclosure documents containing specified information. Such documents are filed with the CFTC and NFA and provided to investors but are not publicly available.

CPOs and CTAs operating under Reg. §4.7, however, are exempt from the disclosure document requirement and are required only to provide all material disclosures. In addition, under the exemption provided in Reg. §4.8, funds (which would otherwise be treated as commodity pools) with exemptions under Reg. §4.12(b) (compliance with the requirements of the Securities Act and certain limits on the trading of commodity futures and options) or which sell interests solely to “accredited investors” and rely on the safe harbor provisions of Rule 506 or 507 of Regulation D under the Securities Act may begin soliciting, accepting and receiving money upon providing the CFTC and the participants with disclosure documents for the fund, which requirement may be satisfied by a private placement memorandum.

24. *Year-End Financial Reports for §4.7 Funds*

Annual Report requirements for §4.7 funds (*i.e.*, funds, which by having only qualified eligible participants, are exempt from the normal disclosure requirements applicable to commodity pools). The form must contain a Statement of Financial Condition, a Statement of Income (Loss), appropriate footnote disclosure and other material information and a legend as to any claim made for exemption.

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

Position Reports

25. *Form 40*

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

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

26. *Form 102*

Form filed by clearing members, futures commission merchants (FCMs), and foreign brokers, which identifies persons, including Hedge Funds, having financial interest in, or trading control of, special accounts in futures and options, informs the CFTC of the type of account that is being reported and gives preliminary information regarding whether positions and transactions are

commercial or noncommercial in nature. The form must be filed when the account first becomes “reportable” (i.e. when it first contains reportable futures or options positions), and updated when information concerning financial interest in, or control of, the special account changes. In addition, the form is used by exchanges to identify accounts reported through their large trader reporting systems for both futures and options.

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

Selected Stock and Futures Exchange Reports

Application for Exemption from Speculative Position Limits

27. *Spec. Position Limit Exemption*

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

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

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

Federal Trade Commission (“FTC”)

Filings Made Prior to Mergers and Acquisitions

28. *Hart-Scott-Rodino Notice*

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

The notice and waiting period requirement are generally triggered by the following tests: either the acquiring person or the acquired person must be engaged in U.S. commerce or an activity affecting U.S. commerce, a person with total assets or net sales of \$100 million or more is acquiring voting securities or assets of a person with total assets of \$10 million or more, and as a result of the transaction, the acquiring person will hold 15% or more of the voting securities or assets of the acquired person or an aggregate of \$15 million or more of assets and voting securities of the acquired person. A notice would generally have to be filed for an over \$15 million purchase by a hedge fund with \$100 million in assets if an exemption were not available. Acquisitions of voting securities are exempt from filing if they are made “solely for the purpose of investment” and if, as a result of the acquisition, the securities held do not exceed 10% of the outstanding voting securities of the issuer. Securities are acquired “solely for investment purposes” if the person acquiring the securities has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer.

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

SOUND PRACTICES FOR HEDGE FUND MANAGERS**RECOMMENDATIONS ON VALUATION**³⁷**Valuation**

Proper valuation is material both to Hedge Fund investors and to the risk monitoring process. Hedge Fund Managers should develop procedures for capturing and verifying prices for the instruments they trade and rely on external pricing sources where available. For Net Asset Value (NAV) purposes, Hedge Fund Managers generally should value instruments at market value, making adjustments to such values in accordance with generally accepted accounting principles (“GAAP”) only where market conditions mandate adjustments, recognizing that investors will both buy and sell shares of a Fund on the basis of NAV. In contrast, Hedge Fund Managers may determine that adjustments to market value are appropriate for risk monitoring purposes in order to enhance the accuracy of risk assessment. Policies for making such adjustments should be approved by Senior Management. The concepts related to valuation are explored in greater detail in Appendix I.

Hedge Fund Managers should have pricing policies and procedures for determining a Hedge Fund’s Net Asset Value (NAV) on a periodic basis and for determining the Hedge Fund’s value for risk monitoring purposes on a daily basis. The policies regarding NAV determination should be approved by a Hedge Fund’s Governing Authority and reviewed by external auditors for compliance with applicable accounting practices.

Hedge Fund Managers should develop procedures and/or systems for capturing pricing data for their positions from independent sources on a daily basis where possible. Procedures for periodically verifying the accuracy of pricing data should also be adopted, and material discrepancies between price sources should be investigated. Where an instrument is not traded actively or where obtaining price information requires significant effort, weekly (or less frequent) pricing may be appropriate depending on the nature and the size of the position.

³⁷ The content of this [Annex C](#) is excerpted from *Sound Practices for Hedge Fund Managers* (February 2000). Capitalized terms have the meanings given to them in that document.

Net Asset Value

Senior Management should determine policies for the manner and frequency of computing NAV based upon applicable GAAP and disclose such policies to investors. Such policies should establish valuation methods that are consistent and fair to both buyers and sellers.

Financial assets and liabilities should be valued at “fair value,” which is the price at which an item could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Consistent with GAAP, Senior Management should determine the valuation methods to be used where market prices are not available or are not indicative of fair value (*e.g.*, private equity investments may be valued at the lower of cost or market) and disclose such methods to a Hedge Fund’s Governing Authority.

For an instrument that is actively traded, Hedge Fund Managers should use price quotes available from reliable data vendors. The fair value of a position should be based upon the quoted price for a single trading unit in the most active market.

Where price quotes are not available from data vendors, Hedge Fund Managers should attempt to obtain quotes from independent sources.

For thinly traded instruments or those priced using models, Hedge Fund Managers should document the valuation methods used and periodically subject them to independent validation.

Dealer quotes and prices generated by models or other estimation methods should be regularly checked against realized prices to gauge their accuracy.

NAV valuations performed by third party administrators should be regularly reviewed to ensure compliance with valuation policies.

Valuations should be periodically validated by independent internal or external review, preferably on a monthly basis, but no less frequently than annually. The accuracy of NAV calculations should be verified by external auditors at least annually to assure compliance with GAAP.

Risk Monitoring Valuation

Senior Management should establish policies for determining when risk monitoring valuation methods may differ from NAV for operational or risk analysis reasons. Examples where valuations different from NAV may

be appropriate include situations such as those involving unusual position size, legal sale or transfer restrictions, illiquidity, control premiums or unusual hedging or transaction costs.

The following is an excerpt from Appendix I of *Sound Practices for Hedge Fund Managers*:

Valuation

As noted in the Recommendations, the valuation of positions serves two distinct purposes for the Hedge Fund Manager. In addition to providing the base input to the risk monitoring process, valuation of positions is required for the calculation of Net Asset Value (NAV), which is the basis for investor subscriptions and redemptions.

Hedge Fund Managers' valuation policies should be objective, fair, and consistent.

- Objectivity requires that Hedge Fund Managers either calculate or verify the accuracy of prices independent of the trading/risk selection function. To that end, Hedge Fund Managers should look to reliable price quotes from external sources wherever possible and cost effective to do so.
- Fairness recognizes that valuation for NAV purposes will determine the prices at which investors subscribe to or redeem from the Fund.
- Consistency can be achieved through the establishment of recognized procedures or practices. This section will provide more detail on valuation issues than was provided in the Recommendations, particularly with respect to valuation for risk monitoring purposes. After restating the principles of NAV valuation, Price Sources and Price Validation will be reviewed. Then, the discussion turns to valuation for risk monitoring purposes.

Net Asset Valuation

Fair Value. As described in the Recommendations, for NAV purposes, Hedge Fund Managers generally should value instruments according to generally accepted accounting principles (GAAP) for the appropriate jurisdiction, recognizing that investors will both buy and sell shares of a Fund on the basis of NAV and that its financial statements must reflect NAV. This generally requires the use of "fair value". For example, under FASB Statement of Financial Accounting Standards No. 107, the "fair value" of financial assets and liabilities under U.S. GAAP is the amount at which the item could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Calculation of NAV must take into account not only the value of the financial instruments in the portfolio (sometimes referred to as "trading P&L"), but also accruals of interest, dividends and other receivables and fees, expenses and other payables.

Prices. Where market prices exist and are indicative of fair value, they should generally be used to compute NAV. For instruments that are actively traded, the fair value should be the product of the number of trading units times the quoted price for a single trading unit in the most active market, even if placing an order to sell (or buy, if short) the holding might affect the price if a market's normal one-day volume might not be sufficient to absorb the quantity held.

For instruments traded in the over-the-counter market, Hedge Fund Managers should, to the extent possible, attempt to obtain multiple quotes from dealers active in that market. Where appropriate, the model parameters that the dealer used in determining its valuation should be obtained and analyzed.

Further considerations on price data are discussed below under “Price Sources”.

Senior Management should establish the valuation methods to be used for NAV purposes where market prices do not exist or are not indicative of fair value. These methods should be disclosed to a Hedge Fund’s Governing Authority. For investments in non-traded assets or assets that are extremely illiquid or otherwise difficult to value, Hedge Fund Managers should document the valuation methods used and periodically subject them to independent validation. For example, because there are no objective external price references for private equity investments, Hedge Fund Managers may determine they should be carried at historical cost.³⁸

Frequency. Senior Management should determine the frequency of computing NAV, which will be needed on each date for which balance sheets are prepared and each interim date on which NAV is disclosed to the Governing Authority or investors. Some Hedge Fund Managers calculate a daily NAV, while others calculate NAV less frequently.

If initial end-of-day values for portfolio instruments are obtained from the Hedge Fund Manager’s trader or other front-office staff, such values should be verified with a frequency determined by the materiality of the position. Significant differences between front- and back-office valuations should be investigated and reconciled. Alternatively, end-of-day valuation may be exclusively the role of back-office staff.

Portfolio values used to calculate NAV should also be used for risk monitoring valuation, except as expressly determined otherwise by Senior Management due to operational or risk analysis reasons as discussed below under “Valuation for Risk Monitoring”. However, valuation for risk monitoring purposes will be performed daily even though NAV may be calculated less frequently. Also, the daily expense accruals that must be reflected in NAV are generally not included in the portfolio valuation for Risk Monitoring purposes, which is instead based on the concept of trading P&L.

Price Sources

The appropriate source of price data depends on the position in question:

- Many of the positions held by Hedge Funds are securities or derivatives that are listed on organized exchanges or in over-the-counter markets for which reliable price

³⁸ Since illiquid instruments with long holding periods will generally not be included in the daily risk monitoring model, valuing these instruments on a daily basis for Risk Monitoring is not necessary.

quotes can be obtained from third-party data vendors. For those securities and derivatives, fair value can be based on the “closing” quotation or official closing price of an exchange or prices in the OTC market or other 24-hour markets as they appear on a data vendor screen (observed at the same time on each day).

- Data vendors may also provide quotations for less actively traded instruments based on a method known as “matrix pricing.” Matrix pricing uses market quotes for actively traded securities to approximate the value of a less actively traded security based on comparable characteristics, such as coupon, maturity, and risk. Matrix prices can be a useful source of third-party price information, but they should be recognized as modeled prices not transaction prices.
- Reliable quotes for certain over-the-counter derivative instruments and structured securities may not be available from data vendors, either because the transactions are “one of a kind” or not actively traded. In many cases the only “market” for these securities is with the original counterparty to the transaction. Such instruments can be valued either by obtaining a quote from the originating counterparty or from a pricing model. While a Hedge Fund Manager might be able to obtain quotes from other dealers not party to the original transaction (which would provide a more independent source of pricing information), such an approach may not be practical, for example because it would require disclosure of proprietary position data.

Price Validation

- Hedge Fund Managers should establish procedures for verifying the accuracy of prices obtained from data vendors, dealers, or other sources. For actively traded instruments, it may be sufficient to establish multiple feeds from data vendors in order to compare and verify their prices. In other cases, the Hedge Fund Manager should establish procedures for verifying the inputs to models and for validating modeled prices. Modeled prices could be validated by comparing them to prices observed in the market or to prices obtained from third parties where possible. As noted in the Recommendations, dealer quotes and prices generated by models or other estimation methods also should be regularly checked against realized prices to gauge their accuracy. Hedge Fund Managers may elect to use external auditors to verify aspects of their pricing and modeling, either as part of an annual audit or an independent review.

Valuation is typically independent of the trading function. However, for certain illiquid or hard to value investments, such as private equity investments, the valuation process may *begin* with a price obtained from those most familiar with a particular position, i.e., the trader or analyst. However, in such situations, the Hedge Fund Manager should take steps to independently (either internally or externally as appropriate) assess the reasonableness of that price.

Valuation for Risk Monitoring

The Risk Monitoring Function typically values positions consistent with the approach taken for the NAV calculation. However, the Risk Monitoring Function is not constrained by the requirements of GAAP. Consequently, in order to examine potential effects on the portfolio of changes in market conditions, the Risk Monitoring Function may use alternative values or may make adjustments to the position values calculated for NAV purposes. Senior Management should establish policies for determining when risk management valuation methods may differ from NAV for operational or risk analysis reasons. It would not be appropriate, however, to adjust a long position upward or a short position downward, from its fair value for Risk Monitoring purposes.

- Rather than using mid-market prices, bid prices could be used for long positions and ask prices used for short positions.
- Prices may be discounted to reflect the size of a position relative to the market, for example by using “exit values” rather than fair value. Exit value reflects the likely impact on the market price where the position must be liquidated quickly, such as where the position is significantly larger than historical trading volume during the assumed required exit period.
- For an actively traded security held in a large enough quantity and/or involving sufficient indicia of control that a Schedule 13D or similar public disclosure has been made of the position, and therefore where a sale of a portion could not be made anonymously, a downward adjustment from market value may be appropriate.
- For instruments subject to legal restrictions on sale or where the market is illiquid or has become disorderly, it may be appropriate to make a downward adjustment from the fair value.
- In volatile markets, prices may be discounted if the Risk Monitoring Function does not believe that quoted bids or offers are prices at which a trade could actually be done.
- For a less actively traded instrument representing only a small position, and where obtaining price information requires significant effort, weekly (or even less frequent) pricing may be appropriate.