MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

March 30, 2011

Via Electronic Filing:

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: MFA comments on Notice of Proposed Rulemaking Regarding Definitions of "Predominantly Engaged in Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company; RIN 7100-AD64

Dear Ms. Johnson:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's (the "Board") proposed regulation, Definitions Of "Predominantly Engaged In Financial Activities" And "Significant" Nonbank Financial Company And Bank Holding Company (the "Proposed Rule"). As noted in the Proposed Rule, the two proposed definitions are used in certain provisions of Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We strongly support the goals of the Dodd-Frank Act in establishing a regulatory framework to address potential systemic risks before they arise, and mandating enhanced regulation of systemically significant financial companies.

Definition of "Predominantly Engaged in Financial Activities"

MFA supports the approach taken in the Proposed Rule to defining the term "predominantly engaged in financial activities." We believe that the proposed tests establish a reasonable framework to implement the relevant provisions of the Dodd-Frank Act.

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1 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

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Definition of "Significant Nonbank Financial Company"

MFA is generally supportive of the proposal to establish a clear threshold to determine which nonbank financial companies should be deemed "significant nonbank financial companies," and we believe that an asset threshold of $50 billion is reasonable. In determining the threshold, we believe it is important for the Board to clarify two key issues: the calculation of assets for asset managers and the investment funds they manage; and the need to adjust the threshold to account for the effects of inflation and the growth of capital markets over time. Finally, we believe it is important for the Board to maintain the privacy of any list of significant nonbank financial companies, to avoid unintended market effects on firms that meet the definition.

Consolidated Balance Sheet Test

The structure of investment advisers and the private investment funds they manage is fundamentally different from the holding company structure typical of other types of financial institutions. We are concerned, however, that the proposed consolidated balance sheet test does not appropriately account for these important differences and, thus, could be overly broad with respect to investment advisory firms. This is because Generally Accepted Accounting Principles and other accounting standards may, under certain circumstances, require the assets of client investment funds managed by an adviser to be consolidated onto the balance sheet of the adviser. However, this accounting treatment does not reflect the reality of where the at-risk assets are located and would provide a misleading view of the size and interconnectedness of investment advisory firms. Accordingly, we strongly urge the Board to clarify the rule to specifically exclude client assets under management from the consolidated balance sheet test for investment advisers, regardless of the accounting treatment with respect to such client assets.

A review of the basic structure of investment advisers to private investment funds illustrates the appropriateness of excluding client assets under management from an adviser's consolidated balance sheet. Advisers to private investment funds typically do not have substantial assets. Although the principals of the adviser often have personal capital invested the funds they manage, any losses to such capital do not affect the safety and soundness of the investment adviser entities. It is the funds that hold the financial assets, that transact with trading counterparties on a collateralized basis, and to which investors commit capital. Accordingly, the risks and rewards of the funds' investment portfolios are borne by a diverse group of underlying sophisticated investors, institutions or ultra-high net worth individuals, who typically invest in private investment funds as part of a diversified portfolio. (Private investment funds neither transact with retail investors nor do they take in investments or deposits from retail investors.[2]) The adviser entity is not liable for the obligations of the investment fund, nor does the investment

[2] The MFA has consistently urged Congress and the SEC to raise investment thresholds to address the effects of inflation and to prevent hedge funds from becoming accessible to retail investors.

fund have responsibility for the liabilities of the adviser entity. For all of these reasons, we believe it would be inappropriate and misleading to include fund assets under management when determining whether an investment adviser meets the $50 billion asset threshold.

If the nonbank financial company being considered for "significance" is the private investment fund(s) as opposed to the investment adviser, it is important to recognize the legal separation of different funds managed by the same adviser. These legally distinct funds, even when managed by the same adviser, typically have different investors and can engage in entirely distinct trading activities in different assets and markets. Because investment funds managed by the same adviser are legally independent and typically do not guarantee each other's liabilities, any losses at one fund are borne exclusively by the investors in, and counterparties to, that fund and do not subject other funds managed by the same adviser directly to losses. Further, unlike related entities in a holding company or other similar structures prevalent elsewhere in the financial services industry, the different funds managed by a common adviser do not typically have the kind of intercompany loans or transactions that can create intraconnectedness and tie the risks associated with one company to other companies in the same ownership structure. Unlike bank holding companies and other nonbank financial institutions such as insurance companies, private investment funds generally engage in one distinct business – namely, making investments for investors in that specific fund. For these reasons, analyzing private investment funds on a fund-by-fund basis provides a realistic view of the size and interconnectedness of those investment funds. It is this economic reality and not the accounting treatment of investment funds that should be the basis on which the Board considers whether an investment fund is "significant." Accordingly, we believe that the Board should clarify that separate investment funds managed by the same adviser should not be consolidated for purposes of the definition of "significant nonbank financial company" solely because the funds are managed by the same adviser, regardless of accounting treatment.

<u>Adjustment of $50 billion threshold</u>

As stated above, we believe that $50 billion in assets is a reasonable threshold for determining when a nonbank financial company should be deemed significant. We believe it is important that the threshold be adjusted over time to account for the effects of inflation and the growth of capital markets. Without appropriate adjustments over time, the threshold will become outdated and capture additional firms whose size relative to the size of capital markets has not increased. Accordingly, we encourage the Board to amend the Proposed Rule to include a requirement that the asset threshold be adjusted for inflation and the growth of capital markets.

<u>Privacy of Significant Financial Companies</u>

The Proposed Rule does not discuss whether the Board would disclose the identities of nonbank financial companies that meet the definition of "significant nonbank financial company." We encourage the Board not to publish such a list. While the

Proposed Rule makes clear that a company does not become subject to additional supervision or regulation solely because it meets this definition, we believe that market participants may misperceive the consequences to a firm that meets the definition. This could lead to unintended changes in market behavior with firms that meet the definition potentially being placed at an unfair competitive disadvantage compared to other firms that do not meet the definition.

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Conclusion

MFA appreciates the opportunity to comment on the Proposed Rule. We are generally supportive of defining "significant nonbank financial company" to include those firms with at least $50 billion in assets. We believe it is important, however, for the Board to clarify that, in applying the threshold to investment advisers, client assets under management should not be counted, regardless of the accounting treatment of such client assets.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other regulatory issues, please do not hesitate to contact Stuart J. Kaswell or me at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO