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REGULATION OF HEDGE FUNDS

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

THE INCREASED SCRUTINY OF THESE LIGHTLY-REGULATED FUNDS AND THE LACK OF REPORTING REQUIREMENTS, AUDITS, AND INSPECTIONS

TUESDAY, JULY 25, 2006

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C O N T E N T S

TUESDAY, JULY 25, 2006

WITNESSES

REGULATION OF HEDGE FUNDS

TUESDAY, JULY 25, 2006

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:11 a.m., in Room 538, Dirksen Senate Office Building, Hon. Richard C. Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN SHELBY

Chairman SHELBY. The Committee will come to order.

Today the Committee will examine the operation and the regulation of hedge funds. This hearing is particularly timely, given last month's Federal Appeals Court decision invalidating the Securities and Exchange Commission's rule requiring that certain hedge funds advisers register with the agency.

As the Senate panel with exclusive jurisdiction of hedge funds, the Banking Committee intends to continue its active role in overseeing the industry's activities and regulatory structure.

Hedge funds are flourishing. Just 15 years ago the industry managed only $50 billion in assets. That number now exceeds $1 trillion. Wealthy investors and large institutions, including pension funds and universities, have increasingly sought the portfolio diversification and returns in both bull and bear markets that hedge funds have been able to provide.

This dramatic growth has attracted the attention of financial regulators including the SEC. In late 2004, the Commission adopted its Hedge Fund Rule on the three to two vote. The agency based its rulemaking on the industry's rapid growth, the perceived exposure of average investors to hedge funds, and an increase in enforcement actions brought against hedge funds.

Now that the rule has been vacated, it is appropriate to once again consider whether there is a prudent basis for increased regulation of a dynamic industry that has delivered considerable returns for its investors and important liquidity benefits to the markets and has avoided a comprehensive regulatory scheme on the theory that its sophisticated investor base can fend for itself.

We must conduct this review in a manner that is mindful of the context in which hedge funds currently operate in order to accurately assess the costs and benefits associated with the choices that we make.

There is a common misperception that hedge funds are completely unregulated and absolutely secretive investment vehicles. It is important to note that hedge funds are currently subject to the market manipulation and anti-fraud provision of the Federal securities laws. On this point, I want to note the crucial importance of these laws. They are fundamental to the operation of the marketplace. It is absolutely essential for the SEC to uniformly apply these rules to every individual participating in the capital markets, without exception.

While we are discussing the integrity of the marketplace generally, I would like to take a moment and digress from the topic of hedge funds to express my concern to Chairman Cox recording the manner in which stock options have been granted at some companies. I intend to explore these troubling revelations here further during the question and answer period.

Returning to hedge funds, I would also add that thousands of funds are currently registered with the SEC and the Commodity Futures Trading Commission, and thus subject to oversight and inspections. Moreover, Government regulators have access to information relating to hedge funds.

I look forward to hearing our witnesses discuss these issues in more detail.

This morning we will hear testimony from the Honorable Christopher Cox, Chairman, the Securities and Exchange Commission; the Honorable Reuben Jeffery, III, Chairman, Commodity Futures Trading Commission; and the Honorable Randal K. Quarles, Under Secretary of the Treasury for Domestic Finance, U.S. Department of the Treasury.

Senator Sarbanes.

STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Chairman Shelby.

I want to commend Chairman Shelby for convening today's hearings to examine the hedge funds. Actually, in recent years this Committee has held several oversight hearings that focus on hedge funds or at which hedge funds issues were discussed and I think it is important to underscore that this is an important area of the Committee's jurisdiction.

The hedge fund industry, as the Chairman has referenced, is a significant component of the Nation's financial landscape. It has grown rapidly in recent years. It has an estimated $1.2 trillion of assets under management. Hedge funds have brought improved liquidity and price efficiency to financial markets. Millions of Americans are invested in hedge funds, either directly or more relevantly indirectly through retirement plans or fund the funds.

Public interest in hedge funds has been growing. Recently, in a speech to the Federal Home Loan Bank of Atlanta, Chairman Bernanke of the Federal Reserve noted and I quote him "The debate about hedge funds and their effects on financial markets has now resumed with vigor, spurred no doubt by the creation of many new funds, large reported in-flow to funds, and a broadening investor base."

As investment in hedge funds have grown, public concern has also grown. This recent article in the Washington Post, which read Hedge Funds Near Day of Reckoning—I am not quite sure what the reckoning was to being, but in any event—and a July 20th column in the Wall Street Journal by its Deputy Washington Bureau

Chief David Wessel said, "How would hedge funds behave in a crisis? If there is a financial earthquake, will these new mechanisms turn it into a tsunami? Will we have fewer crises but bigger ones, that sort that jar whole economies, not just shake up a few leveraged investors? It is a good time for such questions."

Witnesses who previously have testified before this Committee and other observers have also voiced concerns about whether there is excessive leverage, the valuation and transparency of hedge funds assets, whether the standards for an accredited investor are too low, whether they need to be adjusted, a potential conflicts of interest involving managers of hedge funds and mutual funds, and the impact of hedge fund trading particularly short selling and its potential for market manipulation on the securities markets.

I join the Chairman in welcoming Chairman Cox, Chairman Jeffery and Treasury Under Secretary Quarles to the Committee. We look forward to their testimony about these issues.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Senator Allard.

STATEMENT OF SENATOR ALLARD

Senator ALLARD. Mr. Chairman, I would also like to thank you for holding this important hearing. Other committees have some oversight on this, but from my point of view this is the primary Committee that has oversight as far as hedge funds are concerned. And so I think this is an important hearing.

Historically, hedge funds provide an investment vehicle for financially sophisticated investors with sizable capital to invest. The funds seek to profit in all kinds of markets through leveraging and other speculative investment practices that may increase the risk of investment loss. Not all mutual funds are required to register with the SEC and are not required to provide the same level of disclosure.

However, as investors look for ways to maximize returns, more are turning to hedge funds. But do these investors, particularly those investing in the registered funds of hedge funds, adequately understand the risks involved? How does less regulation of hedge funds translate into the capital markets?

This hearing will be a good opportunity to explore these and other matters. We have an excellent lineup of witnesses that will be able to provide helpful insight, Mr. Chairman. I thank them for being here today and look forward to their testimony.

Thank you for holding this hearing.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR HAGEL

Senator HAGEL. Mr. Chairman, thank you. And to our witnesses, good morning and thank you for your appearance this morning.

I, like all members of the Committee, Mr. Chairman, will be interested in hearing what our witnesses have to say. Markets have, over the years, provided important liquidity for our economy. We have generally and overwhelmingly benefited from that liquidity, as we have enhanced our productivity and our competitive position in the world. There have been spikes of volatility, bubbles, excesses. We appreciate that.

One of the issues that I know our witnesses will get into this morning, and it is an area that I would like to ask some questions on, is do our witnesses believe that hedge funds now are contributing to an unacceptable amount of volatility in our markets? What are your projections for the next couple of years? If we stay where we are, essentially with a very limited regulatory scheme, is that good? Do we risk continued volatility or deeper or wider volatility that may, in fact, impact on our economy and our competitive position in the world, our future investment opportunities?

Those are the general areas I think, Mr. Chairman, that we are going to want to hear about today. And I will reserve further comments and questions until I have an opportunity to ask the questions.

Thank you.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

There have been some major developments since the hearing on hedge funds in May. As the Chairman mentioned, the SEC rule requiring hedge funds advisers to register was thrown out by the D.C. Circuit. So I think it is appropriate to have another hearing.

The biggest cause for concern about hedge funds is that we do not know a lot about them. Due to that lack of information, we cannot be sure how much risk they pose to our financial systems. I think we need to know more and hopefully we will get some good answers in this hearing.

A lot of money is invested in hedge funds, some estimate as high as $1 trillion worldwide. In addition to being a popular investment option for the wealthy, hedge funds have also become popular for university endowments and pension funds. A lot of money and a lot of people's futures are riding on them, and that raises a lot of questions and concerns.

Not only do hedge funds affect people who are directly invested in them, but because of their size and speed, they can affect the entire market when they move. We can all agree that it is important to take reasonable steps to protect investors.

But even more importantly, we must be sure that we are keeping a close eye on threats to the stability of our financial markets. That is why we need to know more about what hedge funds are doing and what they are not doing. It is not our job to stop investors from taking any risk. But we need to address risk to our financial markets and the overall economic well-being of our country. I hope we can get a better picture of what is going on and what needs to be done.

I look forward to the hearing, what the SEC has learned in the brief registration period, and what the agency's plans are now that the courts have acted. Hopefully, this hearing will help us to see where we need to go from here.

Thank you very much.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman.

I, too, join with everyone who has thanked you for holding this hearing. It is a very critical and important issue.

It is no secret that I have been a strong critic of the SEC's Hedge Fund Rule, and it is going to be interesting to me today to hear from the SEC as to what their intentions are in terms of moving forward.

I am not going to repeat the kinds of comments that have already been made by my colleagues here. I share the concerns that they have raised and the interest that they show.

I do have an additional concern that in this arena, as well as in many others, I hope that we are going to be able to create an environment and to find that balance where we create an environment where business can thrive in the United States and where we do not get caught up in over regulating business to the point that we send it overseas. I think that all too often today we see kind of an overreaction to the need to assure that we have safety and soundness in our markets, which I think is a proper objective and which is the line we want to achieve.

What we are, in my opinion, seeing a dangerous trend in terms of creating a situation in which the United States is not necessarily the most favorable climate in which to conduct business these days.

And so I am going to be looking to see if the incredible increase in popularity and use of hedge funds has resulted in a changing dynamic in the marketplace such that it will require us to extend further regulatory controls and establish new regulatory regimes in order to assure the safety and soundness of our markets, or whether we are already at that point where we have the right balance in place and we simply need to see the kind of regulatory structure that currently exists properly and effectively enforced.

It is those kinds of questions that are most interesting to me, because I believe we have not only the safety and soundness of our markets at stake here but the issue of whether our markets will stay our markets if we do not manage and regulate them properly.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you. Senator Sununu.

STATEMENT OF SENATOR SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

I think as we begin the hearing and prepare to hear from our witnesses, it is important to be clear about why we are here. We are here because the D.C. Circuit invalidated a very significant portion of the hedge fund regulations that the SEC promulgated in 2004. The D.C. Circuit invalidated this regulation because this regulation, like several others put forward by the SEC in the 2002 to 2004 timeframe, was not designed to address any specific problems that we were seeing in this area, the financial services industry. And no empirical evidence was ever provided to argue how, in fact, the proposed regulations might improve the performance, oversight and security of this part of the financial services industry, hedge funds.

And in the absence of any clear definition of a problem that the regulatory infrastructure is trying to address, and in the absence of any empirical evidence purporting to demonstrate how this regulation will improve the efficiency of the markets, no one should be surprised that a court decides that the way in which the regulations were put forward was arbitrary or unfair.

I think the lesson here is that in this case the hedge fund regulation, but in all cases we want the SEC to be clear and professional and thorough in its recommendation of new regulations. And that means identifying a problem, being clear about what we are trying to address, solve or improve in the financial services industry, make sure that that is consistent with the SEC's very important mission of protecting average investors, and then at least make an effort to put together some empirical data that will suggest that this regulation might actually solve the problem.

I do not think that is too much to ask. I, and many other members of this Committee, asked for that very thing time and time again with regard to this regulation, with regard to other regulations that have also been struck down by the courts. And I think if we can make an effort, and I have full faith that Chairman Cox understands this and that he will make this effort. But if we can make that effort within the SEC, then I think we will be less and less likely to have hearings like this where we all get together and wonder exactly why courts are striking down regulations and how we proceed from here.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bennett.

STATEMENT OF SENATOR BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman.

My colleagues have covered the issues very well, so let me just focus on one very small item that is tied to the hedge fund thing, not suggesting that the other issues are not important.

By the way, I want to recognize and welcome a fellow Utahan, Secretary Quarles, to the Committee.

Hedge funds have been in the public eye because of their involvement in short selling. The whole short selling issue is a subsidiary issue, I think, of the question of regulation of hedge funds.

I have engaged in short selling. It has never been profitable for me. And since I have been in the Senate I have discovered that there are some who find it profitable because they never have to cover, and the whole question of naked short selling has come out.

And I think, in the pursuit of the practice of naked short selling, we have created an atmosphere where hedge funds may have been unfairly targeted and that the whole question of short selling has been attacked as an improper kind of activity. It is not an improper activity. It is part of the way the markets work.

But I want to congratulate Chairman Cox on the SEC's vigilance in going after the naked short selling activity that has been going on. It was called to my attention by a Utah company, and frankly not the one that has been in the headlines, where the organizers of the company had identified every single share of the stock and had locked it up in such a fashion that it was not available to be borrowed and there were still short sales going on. And they said how is this possible that people are shorting our stock when we are not making any stock available for that purpose? And that was before the SEC got involved in chasing this issue.

I may not be able to stay for the whole hearing. I have, unfortunately, two other conflicts today. But I wanted to use my opening statement as an opportunity to thank Chairman Cox for the work the SEC has been doing here, encourage him to continue to do it, and make it clear that my concern about this is not an attack on hedge funds as an industry who engage in short selling because I think, as an industry, there is a place for them to do that and we need to separate these two issues.

With that, Mr. Chairman, I look forward to the hearing and the information we will get from our witnesses.

Chairman SHELBY. Thank you. Senator Reed.

Senator REED. Mr. Chairman, I simply want to welcome the witnesses and look forward to their testimony.

Thank you.

Chairman SHELBY. All of your written testimony will be made part of the record in its entirety. Chairman Cox, we will start with you. Welcome.

STATEMENT OF CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you, Mr. Chairman, ranking member Sarbanes, members of the Committee. It is a pleasure to be here this morning. Thank you for inviting me to testify about the regulation of hedge funds.

It is an especially welcome opportunity to be here with Secretary Quarles and Chairman Jeffery as representatives of the President's Working Group on Financial Markets.

As you have recognized, each of us has responsibility for different but crucial aspects of the world in which hedge funds operate. That is why the Securities and Exchange Commission is working closely and cooperatively as a member of the President's Working Group on the questions of systemic market risk posed by hedge fund activity, and also the investor protection issues that stem from the increasing exposure of retail investors to opportunities for hedge fund investment.

Senator SARBANES. Mr. Chairman, I think if you would pull the mic a little closer it would be helpful.

Chairman SHELBY. Pull the mic just a little closer.

Mr. COX. I should emphasize at the outset, Mr. Chairman, that my testimony today reflects my views as Chairman of the Securities and Exchange Commission and does not represent the views of the five-member Commission. The views I am expressing this morning are solely my own.

It has been 8 years since Long Term Capital Management collapsed. This spectacular hedge fund collapse left in its wake serious questions about the threat to our capital markets as a whole from such significant funds pursuing high risk strategies with what might be generally, not just in that case, excessive leverage. In the months that followed, President Clinton established the President's Working Group on Financial Markets, with the SEC as a member, to coordinate regulatory oversight of these issues, as well as other questions that broadly impact the national securities markets.

Since then the President's Working Group has focused intently on the concern that the failure of one of more significant and highly leveraged investment pools, such as the Long Term Capital Management hedge fund, could threaten the stability of financial markets. We are more certain now than ever before that preventing future market instabilities will require a coordinated effort by all financial securities regulators.

But given the recent invalidation of the SEC's Hedge Fund Rule by the United States Court of Appeals, we have been forced back to the drawing board. Now we have got to devise a new way to acquire even basic census data that would be necessary to monitor hedge fund activity in a way that could mitigate systemic risk.

The current lack of such basic data requires me to hedge when I say that the SEC's best estimate is that there are now approximately 8,800 hedge funds, with approximately $1.2 trillion in assets. If this estimate is accurate, it implies a remarkable growth in hedge fund assets of almost 3,000 percent in the last 16 years.

Last year we believe an estimated 2,000 new hedge funds opened for business. And although even now hedge funds represent just 5 percent of all U.S. assets under management, they account for about 30 percent of all U.S. equity trading volume. They are particularly active in the convertible bond market and the credit derivatives market. We are also seeing hedge funds become more active in such varied activities as the market for corporate control, private lending, and the trade of crude petroleum.

It is undeniable that in addition to raising questions, such as systemic risk and investor protection, hedge funds also provide investors and our national securities markets with tangible benefits. They contribute substantially to capital formation, market efficiency, price discovery, and liquidity. Some hedge funds provide a way for institutional investors to reduce their exposure to downside risk.

But given the general lack of disclosure about the way hedge funds operate, the lack of standards for measuring a fund's valuation and its performance, the possibilities for undisclosed conflicts of interest, the unusually high fees, and the higher risk that accompanies a hedge funds' expected higher returns, these are not investments for mom and pop. They are generally risky ventures that simply do not make sense for most retail investors.

While some refer to an alleged growing trend toward the retailization of hedge funds, the Commission staff are not aware of significant numbers of truly retail investors in the United States investing directly in hedge funds. In my view, such a development, were it to occur, should be viewed with alarm.

Indeed, in the wake of the Court of Appeals decision in the Goldstein case, I intend to recommend to the full Commission that the SEC take further steps to further limit the marketing and availability of hedge funds to unsophisticated retail investors.

The concerns about hedge funds that the SEC enunciated when we adopted our Hedge Fund Rule in December 2004 remain the same today. The remarkable pace of hedge fund growth, which we noted at the time, has continued unabated. The potential for retail investors to be harmed by hedge fund risk remains as serious a concern now as then. And the growth in hedge fund fraud that we have seen accompany the growth in hedge funds implicates the very basic responsibility of the SEC to protect investors from fraud, unfair dealing and market manipulation.

And on that point, let me be very clear that notwithstanding the Goldstein decision hedge funds today remain subject to SEC regulations and enforcement under the antifraud, civil liability and other provisions of the Federal securities laws. We will continue to vigorously enforce the Federal securities laws against hedge funds and hedge fund advisers who violate those laws.

Hedge funds are not, should not be, and will not be unregulated. The challenge for the Securities and Exchange Commission and the President's Working Group going forward is rather to what extent to add new regulations, particularly in light of the recent Court of Appeals ruling.

The Securities Act, the Exchange Act, and the Advisers Act each provides the Commission with separate authorities to regulate fraud and unfair dealing by hedge funds. Using this still valid authority in recent years, the Commission has brought dozens of enforcement cases against hedge fund managers who have engaged in fraud or who have violated their fiduciary obligations.

The number of enforcement cases against hedge fund advisers has grown from just four in 2001 to more than 90 since then. I have provided several recent examples of significant hedge fund cases brought by the Commission in my written testimony.

But while our ability to bring enforcement actions against hedge funds and their managers remains intact following the Goldstein decision, the same cannot be said for the Commission's ability to require hedge fund advisers to register and submit to inspections. The Commission stated, when we adopted the Hedge Fund Rule in 2004, that its then-current program of hedge fund regulation was inadequate. With the rejection of the Hedge Fund Rule by the Court of Appeals, I believe that is once again the case. We must move quickly to address the gaping hole that the Goldstein decision has left.

Immediately following the Goldstein ruling, I instructed the SEC's professional staff to promptly evaluate the Court's decision, and to provide me with a set of alternatives that the SEC could pursue without legislation. That evaluation is still underway, but I have already decided upon several urgent courses of action which I can report to this Committee today.

Specifically, I intend to recommend to the full Commission the following emergency rulemakings and Commission actions: First, I will recommend that the SEC promulgate a new anti-fraud rule under the Investment Advisers Act that would have the effect of looking through a hedge fund to its investors. This would reverse the effect of the D.C. Circuit's opinion that the antifraud provisions of Sections 206(1) and 206(2) of the Act apply only to clients as the Court interpreted that term, and not to investors in the hedge fund. I believe that such a rule is possible because the Court itself noted that another antifraud provision, Section 206(4), is not limited to fraud against clients.

The result would be a rule that could withstand judicial scrutiny and which would clearly state that hedge fund advisers owe a fiduciary obligation to investors in the hedge funds. The staff is currently analyzing the Commission's authority to adopt such a rule to ensure that this interpretation is correct.

Second, I am directing the SEC staff to take emergency action to ensure that the transitional and exemptive rules contained in the 2004 Hedge Fund Rule are restored to their full legal effect. This is necessary to ensure that hedge fund advisers who were relying on the now invalidated rule are not suddenly in violation of our regulatory requirements when the Court issues its final mandate in mid-August.

Likewise, I am directing emergency action to restore to newly registered hedge fund advisers their qualified exemption from the recordkeeping requirement for performance data prior to their registration. They would still be required to maintain all records they have to substantiate their prior performance. Without this emergency action prior to mid-August, newly registered hedge fund advisers that remain registered, but that did not create records for the periods prior to their registration, will lose their ability to use their performance track record. Rather perversely, this would discourage hedge fund advisers from voluntarily remaining registered.

Yet another emergency action I am directing will restore the extension of time that was given to advisers for funds of hedge funds to provide their audited financial statements. The underlying hedge funds do not typically supply their audited financials to the fund of funds manager until the 120 day deadline, so the fund of funds managers need extra time to complete their audit work and send out the reports. The Hedge Fund Rule gave it to them, but the Goldstein decision invalidated that relief. I intend for the Commission to restore the extension of time from 120 to 180 days.

Similar action is needed to undo yet another effect of the Goldstein decision, which is to undo the Commission's 2004 Hedge Fund Rule insofar as it applied to offshore advisers to offshore hedge funds. Those advisers had to register under the new rule, assuming their funds had more than 14 U.S. investors. But they would have been subject to different treatment under the Advisers Act because they could treat the offshore fund as their client for all other purposes.

The Court's ruling, however, eliminated this aspect of the rulemaking. And by creating doubt whether registered offshore advisors will be subject to all of the provisions of the Act with respect to their offshore hedge funds, the ruling has created a disincentive for offshore advisers to remain voluntarily registered.

I have directed the Commission staff to prepare legal guidance that might remove this disincentive to registration.

Finally, to address my concerns with respect to the retailization of hedge funds, I have asked the staff to analyze and report to the Commission on the possibility of amending the current definitions of accredited investor for purposes of retail investment in hedge funds without registration. I am concerned that the current definitions, which are decades old, are not only out of date, but wholly inadequate to protect unsophisticated investors from the complex risks of investment in most hedge funds.

The Commission's Hedge Fund Rule would have had the effect of increasing the suitability threshold to $1.5 million of net worth rather than $1 million for any hedge fund that charges a performance fee. This was an important change and I would like to see it restored.

In California, the median home price is well over $500,000. So post-Goldstein, with barely more than $200,000 apiece in other assets, a California couple could qualify to buy a hedge fund in an unregistered offering even though that relatively small amount of assets might represent their entire life savings in the form of a teacher's or firefighter's retirement fund.

Beyond these emergency rulemakings and other actions to restore as much of the pre-Goldstein rule as possible, I have directed the SEC staff to continue to conduct compliance examinations of investment advisers who remain registered with us or who register in the future. All registered hedge fund advisers are subject to SEC regulation and the SEC will continue to conduct risk-based examinations of hedge fund advisers that are registered with the SEC.

While some number of hedge fund advisers will certainly deregister as a result of the Court's decision, our experience since Goldstein is that more hedge fund advisers have become newly registered than have deregistered. In other words, we have actually experienced a net increase in hedge fund adviser registrations since the Goldstein decision.

Mr. Chairman, hedge funds are a significant and a growing part of our financial markets that yield not only risks but also many benefits for our economic system. Each of us at this table, as members of the President's Working Group, has an interest and responsibility to continue working collaboratively to evaluate both the systemic market risks and retail investment issues associated with hedge funds in order to maintain these overall benefits. I and the SEC, for our part, are committed to doing so.

Thank you for inviting me to testify on this important subject and I am happy, after the panel concludes, to answer any questions that you might have.

Chairman SHELBY. Thank you, Chairman Cox.

Chairman Jeffery.

STATEMENT OF REUBEN JEFFERY, III, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. JEFFERY. Chairman Shelby, Senator Sarbanes, members of the Committee, I am pleased to have the opportunity to testify today on behalf of the CFTC at today's hearing on hedge funds regulations.

I will concentrate my remarks on how hedge funds intersect with two of the CFTC's core statutory responsibilities under the Commodity Exchange Act. They are: promoting market integrity and protecting the public from fraud in the sale of futures and commodity options.

The trading in futures and options on commodities, including those based on physical commodities such as energy products, has grown at an astonishing pace. The growth in the trading of these contracts demonstrates that futures markets function as important risk management tools to an ever growing number of U.S. investors and businesses.

Hedge funds, no less than other market participants, are covered by CFTC and exchange market surveillance programs to the extent that they participate actively in the regulated futures markets. The CFTC conducts market surveillance to preserve the important functions of risk management and price discovery that the futures markets perform in our economy.

The backbone of the Commission's market surveillance program is its so-called large trader reporting system, with which many of you are familiar. This serves as an effective tool for detecting the types of concentrated and coordinated positions required by a trader or group of traders attempting to manipulate a market in a particular commodity or financial product.

In addition, each futures exchange is required, under the Commodity Exchange Act to affirmatively and effectively monitor trading, prices and positions on its exchange.

Separately, the CFTC's disclosure-oriented customer protection regime is key to protecting investors from fraud involving commodity pools and hedge funds. I should emphasize that the CFTC does not regulate hedge funds, per se. Rather, if a hedge fund trades futures or commodity options, the fund is a so-called "commodity pool," as defined in our Act, and its operator and adviser may be required to register with the CFTC unless covered by a registration exemption based on, for example, the sophistication of its participants or the de minimis amount of commodity interest traded in the fund.

The CFTC has a simplified regulatory framework for registered commodity pool operators and trading advisers who operate or advise pools with participants meeting certain criteria. The day-to-day oversight of commodity pools and commodity trading advisers is carried out by the National Futures Association, the futures industry analog to the NASD in the securities world.

As part of its self-regulatory responsibilities, the NFA conducts onsite examinations of pool operators and trading advisers on a routine, periodic, and exception basis. Whether registered or unregistered, pool operators and trading advisers remain subject to the CFTC's anti-fraud authority. Over the past six fiscal years, the CFTC has brought some 49 enforcement actions involving commodity pools, hedge funds and CPOs. These enforcement actions typically involve fraudulent sales solicitations and/or misappropriation of investor or customer funds. In many instances, the CFTC works cooperatively with the NFA, state regulators, criminal authorities and the SEC in bringing such proceedings.

In closing, the CFTC's mission under the Commodity Exchange Act involves ensuring market integrity and customer protection. Hedge funds that trade futures and commodity options implicate both of those functions. The CFTC will remain vigilant in utilizing the tools provided in the Act—market surveillance, disclosure and reporting, and the full force of its enforcement authority where necessary—to fulfill its statutory responsibilities as hedge fund participation in the futures markets continues to expand.

This concludes my remarks and I look forward to your questions. Thank you.

Chairman SHELBY. Secretary Quarles.

STATEMENT OF RANDAL K. QUARLES, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. QUARLES. Thank you. Thank you, Chairman Shelby, Senator Sarbanes, and members of the Committee for having me here today on this panel to contribute to the discussion of a topic that is of significance for our financial markets, which is the regulation of hedge funds.

In considering the regulation of any area of financial activity, an important threshold matter is an understanding of the role that that activity plays in our financial markets. In May, before a Subcommittee of this panel I presented testimony regarding the role that hedge funds play, what hedge funds do in and for our financial markets. As I said then, if Government addresses the question of regulation of any financial institution or activity without a clear understanding of the place that it plays in our financial system, then we run the risk of imposing unnecessary or excessive or inappropriate regulation.

Some of the facts about the hedge fund industry are well known. They have been referred to today. They are flexible investment vehicles. They are able to sell short, leverage their investments, use derivatives in a wide variety of markets. They have an incentive compensation structure that provides generous rewards for strong performance. They restrict their investor base to high net work and institutional investors. And the industry has grown rapidly, as has already been remarked this morning, in the last decade to about 9,000 funds globally, managing well over $1 trillion in assets.

What has been less discussed, although this panel has certainly been active in focusing on this issue, but what has been less discussed in Washington are the benefits that these funds bring to our financial markets as their role is evolved over the years.

First and foremost is liquidity. Because of the varying and flexible strategies that these funds follow, they are often the willing buyers and sellers that add significantly to marketplace liquidity. That is particularly true in some of the less traditional markets such as the distressed debt and convertible bond markets where hedge funds represent the overwhelming majority of trading volume.

Second is price efficiency. Many hedge funds seek to create returns by targeting discrepancies between two or more markets with wide bid/ask spreads. That has the unsurprising effect of narrowing them. And so this private profit-making activity produces the public good of better price discovery and more efficient markets.

Third is risk distribution. Concentration of risk is one of the greatest threats to a smoothly functioning marketplace and hedge funds help to reduce that concentration through their willingness to be the counterparties in derivatives transactions through which financial institutions lay off some of the large risks that are inherent in their normal activities.

Without market participants that are willing to trade these derivatives in significant volumes, which hedge funds have the flexibility to do, large complex financial institutions that have clear systemic significance would have to retain more risk.

But hedge funds do not just continue to a more efficient marketplace. They can also directly benefit investors. Their increasing number, the diversity of strategies that they can follow gives investors more choice. That allows greater diversification. And their nimble structures can also create the possibility of seeking to outperform traditional benchmarks. That is often referred to as generating alpha or excess returns. That is a clear benefit, obviously, for the investor of a successful fund.

But while hedge funds provide important benefits to our financial markets and market players, there are some open questions about how they might affect the financial systems' response to stress. Leverage can magnify losses in the financial system. And while the fund's balance sheet leverage seems contained, it is harder to measure the degree of so-called embedded leverage that is involved in many of the complex structured instruments in which some hedge funds trade.

So well, overconcentrated positions can strain liquidity. Valuation models that hedge funds use can be vulnerable to mischief. Some trading practices can present operational challenges to clearing and settlement systems.

So we face a familiar conundrum: what is the proper response of Government to a significant marketplace development that brings clear and important benefits but raises some questions as it involves?

The lens through which we examine the evolution of any institution's role in the financial markets often shapes our view of what, if anything, is the right response. And so it is important that that lens be as clear and as polished as possible.

So to that end, the Treasury Department is beginning a series of meetings to review comprehensively the issues surrounding the role of hedge funds in our financial system. These meetings involve the regulatory and oversight community, fraud outreach to the financial committee including prime brokers, transaction counterparties, the funds themselves. And as part of this comprehensive review, we will be working with the SEC and other PWG members as Chairman Cox and the Commission consider alternative courses of action following the D.C. Circuit Court's recent decision.

At the moment, it is too soon to say what, if any, initiatives will come from this focus. But we intend for it to be a cooperative and collegial effort with the private sector with the end being a clear understanding of a rapidly changing industry.

Thank you and I look forward to your questions.

Chairman SHELBY. Thank you, Mr. Secretary.

Chairman Cox, in your testimony you outline some recommended parameters for any hedge fund regulatory regime. You assert that there should be no Governmental interference with the hedge funds' investment strategies or operations, including its use of derivatives, trading, leverage, and short selling. In addition, you state there should be no disclosure requirements related to portfolio, composition or trading strategies. Finally, you caution that policymakers should pay careful attention to the cost of any such regulation.

Chairman Cox, why is the avoidance of unnecessary regulations so important to the continued success of hedge funds?

Mr. COX. Mr. Chairman, as you have heard from each of the members of this panel, we believe, and the President's Working

Group believes, that hedge funds, while posing risks particularly to retail investors, also provide benefits. They provide benefits in terms of liquidity, in terms of risk management, in terms of diversification. And all of these things are worth preserving.

As a result, when we regulate the capital markets, we want to be sure that we are achieving the benefits that are necessary for investor protection or, in the case of other agencies, to deal with these concerns of systemic financial risk.

In terms of the SEC, we have an interest directly in maintaining the integrity and the orderliness of the markets. But while we are achieving these objectives, we want to make sure that we do not interfere with the operations of the market itself.

I should also point out that that list, that desiderata that comprises a portion of my written testimony, were norms outlined by Commissioner Goldschmidt in a speech that he made after the adoption of the Hedge Fund Rule. I think there is broad agreement among all of the Commissioners—although I cannot speak, as I said, for others who are not here—on those general principles.

Chairman SHELBY. Chairman Cox, risk and liquidity are what make markets are they not, in a sense? You cannot have a market without risk and some liquidity to propel it, can you?

Mr. COX. That is exactly right and maintaining pools of liquidity, maintaining overall the function of our capital markets as deep and liquid, is vitally important.

Chairman SHELBY. In your testimony, you also mentioned it was important for the SEC to have basic census data relating to hedge funds. What information is currently available to the Commission? And what additional information is important for the Commission's investor protection agenda?

Mr. COX. A fundamental aim of the Hedge Fund Rule that was invalidated by the Court of Appeals was to identify hedge fund advisers operating in the United States and hedge funds operating in the United States. The truth is that before the rule and now post-Goldstein neither we nor any Government agency has good data on hedge funds.

As I indicated in my oral presentation just now, for that reason I have to hedge when I give you statistics. I believe these numbers to be approximately correct, but the truth is nobody knows.

Chairman SHELBY. Does the SEC currently have the requisite statutory authority to address the questionable activities that hedge funds may engage in?

Mr. COX. I am not prepared to say yes or no to that question today because, Mr. Chairman, as I indicated, our review of our authorities, different authorities than we have relied upon thus far, is still ongoing.

I have already been able to identify, as I presented, several actions that I believe—although this is somewhat tentative—but I believe that we can take these steps. And we will have to see collectively what all of the remedial measures amount to and whether or not we think they are sufficient.

But whether or not legislation is necessary or advisable is always within the prerogative of the Congress, of course.

Chairman SHELBY. Thank you.

Secretary Quarles, what is your latest thinking on the systemic market risk posed by hedge funds? What is the principal risk involved? And are there new risks on the horizon that you have identified? And please comment, if you can, on the steps taken by the President's Working Group to address these dangers, if you see them out there.

Mr. QUARLES. Certainly. I think there is reason to believe that there is less risk that is posed by the hedge fund industry than may have been posed in the past, say around the time of LTCM. You do not have any individual fund that is nearly as large as LTCM, that has that many assets. You have a greater diversity of strategies. You have a larger number of funds.

So at least on the face of it there are a number of factors that would suggest that this is a more stable industry than it might have been five or 6 years ago.

On the other side, I think an issue is the question of embedded leverage. So while balance sheet leverage to hedge funds in the aggregate is less than it was some years ago, the leverage of some of these complex instruments is much harder to measure. I think that is something we need to look at and we are looking at that in the President's Working Group.

Chairman SHELBY. Chairman Cox, a lot of us have been troubled by the recent revelations relating to the backdating of stock options. There appears to be some confusion on this practice.

Could you explain to the Committee today whether backdating is legal under certain circumstances, and when it is illegal, and so forth.

In other words, this seems to be a big thing going on with a lot of companies that does not look very good.

Mr. COX. You are absolutely right, Mr. Chairman, and this is, for that reason, an area of special interest both from a policymaking standpoint and from an enforcement standpoint at the Securities and Exchange Commission.

Undisclosed backdating, which is one of the ways in which backdating can be illegal, is a serious potential problem under the Federal securities laws. It implicates both our accounting rules and our disclosure rules.

When not properly accounted for, backdated options can significantly overstate a company's earnings and conceal its true financial conditions. That potential impact exists both under the old accounting rule that most companies followed, which required companies to expense them in the money portion of option grants, and under the new accounting rules, FAS 123(R).

The Commission's contested civil fraud action against former executives of Brocade Communications Systems, which you may be aware of, we announced it last week, is an example of the serious accounting implications.

In that case we allege that fraudulent option grants went on for more than 4 years. Brocade restated and revised its financial statements for 6 years, from 1999 through 2004, and it resulted in inflation of Brocade's net income by as much as $1 billion in 2004 alone.

Chairman SHELBY. Does that not undermine the integrity of the marketplace? In other words, the integrity of the marketplace, confidence in the marketplace, securities market, are of the utmost importance to all of us, are they not, as investors?

Mr. COX. Indeed, Mr. Chairman. And for that reason I believe that illegal backdating goes to the heart of investor confidence. And it is one of the reasons that the SEC will be vigilant in proceeding against it.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

On May 17th, the Washington Post reported, and I quote "Some regulators and analysts worry that some sort of market shock might prompt many investors to withdraw money from hedge funds at the same time, causing a run on the bank that would not leave the hedge funds enough cash to refund investors or make good on their financial contracts."

I am interested in how each of you would respond to these concerns about the destabilization that could occur if this sequence of events were to take place. How much are you concerned about it? Why don't we start with you, Secretary Quarles, and we will go across in the other direction.

Mr. QUARLES. I think that it is something that, in the President's Working Group, we are focused on, is ensuring we understand how the financial system would respond to various shocks. For the reasons that I described, there are prima facie some reasons to think that the hedge fund industry is better situated today than it might have been in the past, both to respond to shocks and for problems in the hedge fund industry not to metastasize into general problems in the financial sector.

One of the main reasons is the emphasis that has been placed since LTCM on counterparty risk management, so that the regulated counterparties of the hedge funds, the prime brokers and the depository institutions that provide financing for the hedge funds, are more focused than they have been in the past and have more information than they have had in the past about overall exposures and about the quality of that credit.

So both because of the increasing number and diversity of strategies, which in general ought to result in less correlation, although I think there are some reasons to look at that and ensure whether there really is significant diversity on some of these facially diverse strategies, as well as the emphasis that is placed on counterparty risk management, there is reason to believe the hedge fund industry is in better shape for a financial shock than it has been the past.

But we are continuing to look at that question in the President's Working Group. We are not complacent.

Senator SARBANES. Anyone want to add to that?

Mr. COX. Mr. Chairman, I would just echo what Secretary Quarles said concerning some of the changes that have taken place in the industry and in the market since the collapse of Long Term Capital Management in 1998.

Broker dealers have become much more sophisticated in managing their exposure to hedge funds, we believe, through secured financing transactions, for example. Prime brokers active in financing positions for hedge funds have, as a group, dramatically improved their capacity to monitor the value of collateral and liquidate positions quickly. And that, in turn, reduces their risk of loss.

I would note that many of these enhancements are implementations of the recommendations of the reports issued by the Counterparty Risk Management Group in 1999 and 2005.

But having said that, if there were, as is posited in the newspaper article from which you quoted, a systemic downturn, I am absolutely certain it would heighten the risk of fraud by hedge fund advisers because some managers would be tempted in those circumstances to hide losses and to falsify their returns in order to avoid losing their investors. And that, I think, places a premium on at least the aims of the approach that the Commission had taken in our Hedge Fund Rule because for the hedge fund advisers that are registered, and this will be true even post-Goldstein for those that remain registered, the oversight that we exercise through our examination program will potentially deter some fraud and expose other fraud before it can seriously harm investors.

The same is true to the extent that all registered advisers have to implement compliance policies and procedures and designate a chief compliance officer. These are all important aspects of our approach that I think we look in other ways to maintain.

Senator SARBANES. The AFL–CIO, Richard Trumka, the Secretary-Treasurer, has written to the Chairman and me, as the ranking member, about their concern about the pension funds, worker pension assets, that are then placed in hedge funds. And they note that in the pension bill that is being considered in the Congress now there is a move afoot to allow substantially more pension assets to be invested in hedge funds that will not be subject to ERISA coverage.

I am interested to know your view on this possibility of weakening ERISA protection over hedge fund assets and its implications for worker pension funds?

Mr. QUARLES. I can address that.

With respect to the proposal, as I understand it, in the pension bill, obviously the Department of Labor has the lead with respect to that issue. But as I understand the proposal, what is at issue is not really whether pension funds, an individual pension fund, would have the capacity to increase its exposure to hedge funds but whether a hedge fund could have pension funds in the aggregate. You could have, in theory, 1,000 pension funds, each investing $12.73. The question is what is the aggregate pension asset investment in the hedge fund?

And the plan assets rules that are in question have never really dealt with the question of whether an individual pension fund was overconcentrated in a particular type of asset. There are other rules to deal with that.

So when you look at the question that way, I think there is some scope for more flexibility in the aggregate amount of pension assets that a hedge fund could take given, as I outlined in my testimony, that again these diversity of strategies and the diversity of investments that allowing a pension fund to invest in hedge funds can bring that can be a benefit to the pension fund.

I think there is some scope for some more flexibility there. My understanding is that with some refinements the Department of Labor is also open to that modification.

Senator SARBANES. Anyone want to add to that?

Mr. Chairman, thank you.

Chairman SHELBY. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I would like to direct a question to all of you as to how hedge funds play with offshore entities. We all know that FASB is trying to bring some convergence together on the accounting standards in recognition of some of these global markets, and hedge funds are certainly an example of a global market where we have domestic as well as offshore hedge funds.

In what ways is the United States working with other countries to develop some joint regulation as far as hedge funds are concerned? And what kind of competitive environment are we in when we get into the international offshore funds? And what are the dynamics that are being played out there?

Chairman Cox, maybe you would like to start with that?

Mr. COX. First, I should say that we are working very closely with the FSA and the United Kingdom on the question of hedge fund activity or monitoring of hedge fund risk and our regulatory approaches to hedge funds and their advisers. That is especially important because together the United States and the U.K. account for the vast majority of hedge fund activity and prime brokerage activity.

With respect to accounting standards convergence, I would like to just remind all of us of some of the recent milestones that have taken place regarding IFRS since I last appeared before this Committee. Last year IOSCO announced plans to create a data base for cataloging interpretations and decisions in order to improve cross-border enforcement of the application of these standards. That data base is expected to be launched later this year.

In February of this year, the FASB and the IASB announced a memorandum of understanding which provides a road map for the next 3 years for standard setting to converge the provisions of U.S. GAAP and IFRS. And I am completely committed to this road map.

The SEC staff has recently begun reviewing the 2005 IFRS financial statements and the accompanying U.S. GAAP reconciliations that have been filed by about 300 foreign registrants. And that work, I think, is going to help us better understand how international financial reporting standards are applied in practice.

Mr. JEFFERY. Senator, from our perspective at the CFTC we, like the SEC, work closely with our fellow regulators, the FSA being one, elsewhere in the world, as well as through international forums such as IOSCO and CESR—in discussing issues related to hedge fund monitoring, evaluation, regulation, et cetera.

One thing that comes up repeatedly in the world of the CFTC as it relates to hedge funds is the importance we place on making sure the things that we do at the agency—with respect to executing our core mission of maintaining, preserving and protecting open, competitive and financially sound markets—are done in a way that will continue to be attractive to financial institutions, hedge funds and other market participants.

Other regulators certainly have that same view in mind as they look at their markets. And therefore, when trying to reach accommodations with regulators where we have differences of opinion, we tend to be respectful of their views, they of ours, given that we have a common objective of maintaining investor protections and market integrity but also making sure from a U.S. perspective that we maintain our lead as the leading, most liquid, robust capital markets in the world.

Senator ALLARD. Mr. Secretary, do you have anything to add?

Mr. QUARLES. I think the only thing that I would add is that this is also a topic that is discussed in the Financial Stability Forum, the U.S. delegation there chaired by the Treasury. It also involves the SEC and the Fed. And international regulators and finance ministers and central banks come together twice a year and the Financial Stability Forum where, among other things, hedge funds and their contribution to financial stability are a frequent topic of review.

Senator ALLARD. Chairman Cox, is there any interest or anything in the EU? As you mentioned in your statement, we do most of it with the British Commonwealth countries. But anything out of the EU that is emerging in this area?

Mr. COX. Indeed, I think that all of our counterpart regulators in Europe and around the world are interested at a minimum in acquiring basic census data to the degree that that is possible.

As I mentioned, one of the emergency actions I have directed our staff to take relates directly to our ability to gain census data about offshore hedge funds and hedge fund advisers in order to undo one of the effects of the Goldstein decision.

We have got to make sure that we do not deter the offshore advisers from remaining voluntarily registered. If we can have continued voluntary registration, we will be able, to that extent, to gain this kind of census information.

Senator ALLARD. Thank you, Mr. Chairman. I see my time has expired.

Chairman SHELBY. Thank you.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Thank you, gentlemen, for your testimony.

Chairman Cox, since the Court of Appeals decision only a few hedge fund advisers have deregistered; is that accurate?

Mr. COX. In fact, the number is 10. And I am advised by the staff that the vast majority of those are for stated reasons having nothing to do with the Goldstein decision, such as they have run out of assets or are going out of business.

Senator REED. Has anyone registered since the decision?

Mr. COX. Yes, and indeed the net new registrants as against deregistration is positive. That means we have more people registered post-Goldstein.

Senator REED. So despite the decision, you still have a significant number of advisers registered with the SEC and subject to your jurisdiction; is that correct?

Mr. COX. For the moment that is true. We will have to see how that plays out over time. But there is no question that is the case today.

Senator REED. You point out in your testimony, Chairman Cox, that the threat of retailization is one that you are concerned about. It would seem to me that is one I would be concerned about too, since the basic logic of the hands-off approach is that sophisticated investors can handle their own calculation of risk, but the retail market has to be protected vigorously.

Can you outline, and I know you mentioned this in your testimony, how you are going to monitor the situation for us to see if it reaches a critical level? And what steps do you think you will pursue?

Mr. COX. At this point we are already beyond monitoring. I think we know what the situation is. Our suitability rules have not been changed since 1982. If we adjusted them for inflation, instead of the $1 million net worth test, for example, we would be at $1.8 million today. The Hedge Fund Rule, effectively, would have raised that figure to $1.5 million. So I think we have got to do what we can.

But what I have asked the staff to do is to tell us what exactly that might be and under what authorities we might accomplish this objective.

As you might imagine, in the wake of the Court of Appeals decision invalidating our rule, this has happened for other reasons in other cases, we are going to be particularly punctilious about acting on the basis of solid legal authority.

Senator REED. But you anticipate a very deliberate rulemaking process going forward as fast as possible?

Mr. COX. I do, but I have to add this caution. I am testifying here today, very clearly, in my own capacity as Chairman and as one of five Commissioners. We have not had the opportunity, because we are trying to give you the latest information of where we are, this is a work in progress, to get Commission consensus on some of the recommendations that I am making. So I am, to that degree, a little bit out ahead.

Senator REED. Thank you very much, Mr. Chairman.

Chairman Jeffery, the Commodity Futures Trading Commission does monitor some hedge fund activity under your surveillance program. Can you give me a rough idea of the percentage of hedge funds that you are looking at?

Mr. JEFFERY. I would have to come back to you with specific answers, as to the percentage of hedge fund activity in our markets. But it is a very significant part of the exchange traded commodity and futures markets.

In order to provide data on the extent of hedge fund participation in U.S. futures markets, we reviewed market surveillance information collected on a daily basis by the Commission's large trader reporting system. While hedge funds are not a separate reporting category, the positions of hedge funds along with other managed money traders, such as, traders registered as Commodity Pool Operators (CPO) and Commodity Trading Advisors (CTA) are reported to the CFTC. A hedge fund that trades commodity futures may be a commodity pool, and a CPO is a registered entity that operates a commodity pool. CTAs direct the trading of clients, including hedge funds and commodity pools.

The Commission recently reviewed managed money positions on May 9, 2006. On that date, managed money traders held on average about 19 percent of the open interest in the 21 largest commodity futures markets, and about 30 percent of the open interest in the 20 largest financial futures markets.

Managed money positions are not all on one side of the market. CFTC data for May 9, for instance, indicates that in commodity futures markets, managed money traders held on average about 23 and 16 percent of the long and short open interest, respectively. In financial futures markets, they held on average about 36 and 24 percent of the long and short open interest, respectively.

Trading volume and open interest are measures of market activity. Volume is the total number of contracts traded for the day. Open interest is the total number of contracts entered into and not yet offset during the life of the contract. For instance, if during the first trading day of any futures contract A sells 1 contract to B and B buys the 1 contract from A then sells 1 contract to C, then the volume of trading for the day is two contracts, and the open interest is one contract. A is short 1 and C is long 1. B is no longer in the market.

The CFTC's Large Trader Reporting System tracks open positions of large traders in all actively traded futures markets to identify potential market disruptions or manipulations. For instance, at the close of trading in the NYMEX Crude Oil contract on May 9 there were 1,090,810 open contracts, each one representing an obligation to buy 1,000 barrels of crude oil by long traders and sell 1,000 barrels of oil by short traders on certain future dates. The notional value of a 1,000 barrel contract of crude oil was $70,690 on May 9 and is approximately the same value today.

Of these open contracts 200,949 to buy were held by 114 non-commercial traders each of whom owned at least 25 contracts. That is, large non-commercial traders such as hedge funds, other managed money traders and a small number of others held 18.4% of the long side of the market. Seventy-four large non-commercial traders held 10.5% of the short positions and 22.2% of the open contracts were held by 117 large non-commercial traders with spread positions, that is, long in one delivery month and short in another. Summaries of this information are published every week by the CFTC as the Commitments of Traders Report on the Commission's website, *www.cftc.gov.*

Mr. JEFFERY. But again, let me stress something I tried to make clear in my testimony, and is that hedge funds are treated exactly like other market participants under the broad architecture of our statutory mandate. We provide vigorous market oversight, working with the exchanges, on the exchange traded markets of hedge funds and other financial institution and commercial users of those markets.

We also oversee, importantly with the exchanges, the clearing and settlement function, which is really the backbone—the financial backbone—of the integrity of the futures and options trading system in the United States. It was one of the reasons, frankly, why the futures exchanges in the U.S. have been so robust and so successful in the recent past, and hopefully will continue to be so.

And finally, on the enforcement side, we will look at hedge funds just like anybody else. When we see evidence of bad behavior, particularly with all the attention today on the activity in physical commodities markets, energy in particular, you can be sure that the vigilance of our market surveillance people and our enforcement attorneys in looking for possible attempts at manipulation, false reporting or actual manipulation are very vigorous and very robust.

Again, hedge funds are treated just like every other market participants. But we are very mindful of their presence, substantial presence, in the marketplace.

Senator REED. On a constant basis you are over watching the markets. Is there any cause for concern about trends or concentration of manipulation that you are seeing?

Mr. JEFFERY. Not to the best of our knowledge. Occasionally we will find evidence of bad behavior by this or that entity, hedge fund or otherwise. But no evidence of systemic manipulation or attempts to influence market prices in a perverse or unfair way. No, sir.

Senator REED. Thank you very much.

My time has expired, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

Senator HAGEL. Thank you, Mr. Chairman.

This is a question for Chairman Cox but I would be interested in receiving the responses of you, Chairman Jeffery, as well as you, Secretary Quarles.

Chairman Cox, you note in your testimony, and I will read a very brief part of this on page five, "As you consider the possibility of legislation" and then you say some other things and then you get to the point, "I would counsel that, to the maximum extent possible, our actions should be nonintrusive. There should be no interference with the investment strategies or operations of hedge funds, including their use of derivatives trading, leverage, or short selling. Nor should the Federal Government trample upon their creativity, their liquidity, or their flexibility."

In your mind, what kind of legislation should this committee be considering?

Mr. COX. I thought at first you wanted me to justify the desiderata that were set forth in the testimony, which I find much easier to do than to answer the harder question which you actually put, which is what kind of legislation——

Senator HAGEL. If I could help you a little bit, since you have mentioned it. Since you have talked about the possibility of legislation, what kind of legislation should there be? I assume then you believe we should pass legislation?

Mr. COX. That is not what I mean in my formal testimony, nor what I mean to say to you just now. What I mean to state very quickly is that, particularly as a former Member of Congress, I recognize that it is the prerogative of the legislative branch in addressing questions such as this, to pass legislation if you see fit.

I also observe that that effort is already underway in this body and the other body. Whether that amounts to anything remains to be seen. But what I did offer in my formal testimony is the good offices of the Securities and Exchange Commission and our professional staff in providing any advice and technical expertise that you might request or require.

But I am instead, as Chairman, in the meanwhile, focused on exercising to the maximum extent possible, our existing statutory authorities so that we can report more fully and robustly to you very soon on what we have been able to accomplish and where the gaps remain.

Senator HAGEL. Let me ask you this question.

Mr. COX. There are very big gaps, post-Goldstein, no question, that have to be filled.

Senator HAGEL. Mr. Chairman, recognizing what you said, your experience on both sides of the table, in light of your new responsibilities over the last year, what your colleagues have said this morning and what you have said, do you believe, in fact, the SEC has the adequate authority to deal with this issue and future issues that may arise?

We have talked this morning about volatility, destabilization possibilities, derivatives, all of the dynamics that are part of the fabric of what we are talking about. Do you believe you have the authority? If you do not, then I assume you believe that you need additional authority through legislation? Is that correct? Not correct? Where are you on that?

Mr. COX. We are right in the middle of that river. We have swum halfway across and we are rapidly paddling to the other side.

As I mentioned earlier, we have already got underway emergency measures, some rulemakings, some perhaps no action letters, perhaps legal advice that we might provide that will restore to some degree greater or less what was there pre-Goldstein.

I have also asked other divisions beyond the Investment Management Division to help us examine what legal authorities we might have. I do not have all of those answers yet. But I think very soon we will be able to fill out the rest of this picture so not only we but you can assess whether or not what we have got is adequate.

But I can state categorically right now that the regulatory regime implemented by the Securities and Exchange Commission vis-à-vis hedge funds and their advisers is inadequate and we are working very quickly to fill that gap.

Senator HAGEL. And so it is still an open question whether you need additional authority to through legislation. Is that fair?

Mr. COX. That is correct.

Senator HAGEL. Gentleman, any additional comments you would like to offer on this issue of legislation and what would be required? Additional law or authority? Chairman Jeffery.

Mr. JEFFERY. Yes, Senator, thank you.

As it relates to the futures world, the exchange-traded futures world and the Commodity Exchange Act, we have said on a number of cases that we believe the CFTC has the tools it needs that are necessary to supervise the markets we regulate. Again, hedge funds and all market participants.

When one engages in a discussion like today's and other dialogs on hedge funds, the two recurring concerns one has, among others, is one of investor protection. And the other is a concern related to systemic risk.

In the futures world, under the Commodity Exchange Act, the investor protection concerns, the way we get at those is through a disclosure-based regime, which is described in greater detail in the written submission for today, related to so-called commodity pool operators and commodity trading advisers.

In terms of the more profound concern related to systemic risks where the Act and those of us involved with the Commodity Futures Trading Commission are active, is on these important areas of market and exchange oversight and that of clearing organization oversight. We feel that we have the tools necessary to effectively carry out our mission in that regard with respect to actual businesses that are engaged in markets for physical commodities and hedging transactions, and other market participants of a financial nature, hedge funds included.

That does not mean that we cannot always find and look for ways to do our jobs better. Every day we try to do that.

Senator HAGEL. Thank you. Secretary Quarles.

Mr. QUARLES. Simply that I do think it would be premature for us to recommend any legislation, whether there is any need for legislation, until we have completed this comprehensive review that I have described. I think that is a necessary predicate.

Senator HAGEL. What is the timeline on the completion of the review?

Mr. QUARLES. We have not set a deadline but we are proceeding promptly with the various relevant groups to ensure we brought them together.

Senator HAGEL. End of the year?

Mr. QUARLES. As I said, we have not set a timeline but we are not considering that this is an extremely long process either.

Senator HAGEL. Thank you. Mr. Chairman, thank you.

Senator SARBANES. Is this the President's Working Group on Financial Markets that is doing this review?

Mr. QUARLES. At the moment it involves the members of the President's Working Group, but also other relevant regulars as well, such as the New York Fed and some of the other regulators.

So technically it would say we are not viewing this as necessarily under the aegis of the President's Working Group but it is something the President's Working Group will be discussing.

Senator SARBANES. I appreciate Chairman Cox talking about the prerogatives of the legislative branch, but let us set that to one side for the moment and proceed on the premise that we look to the regulators who have, after all, a high degree of professionalism in dealing with these issues and staff that focus on this and not much beyond this for counsel and advice on how we ought to proceed.

So I am anxious to pinpoint the responsibility. Who is the responsible person for informing the Congress on what you think needs to be done to cover any gaps with respect to inadequacy and how we deal with the hedge funds?

So if something goes wrong down the road, we can say you know, we looked to you to tell us and you did not tell us. Are you in charge of this effort, Secretary Quarles?

Mr. QUARLES. Well, when you put it that way——

[Laughter.]

Mr. QUARLES. The Treasury Department is being active in convening the regulators and others to form a view. Obviously, there are important areas of responsibility of each of the President's Working Group.

So until you have asked your question, we have not viewed this as a sort of we are standing up and saying if you do not hear from us, you have not heard the last word. But we are being very active in attempting to form the view that you have requested.

Senator SARBANES. The SEC, as I understand it, is moving ahead in terms of following up on this court's decision.

Mr. COX. We are, indeed, and I see no reason for diffidence in answering the question as you put it. Our requirement that hedge fund advisers register, which went into effect in February but was then invalidated, rather unequivocally established the Commission as the primary national regulator of hedge fund advisers. That registration would have preempted most State law. It would have preempted the CFTC, or supplanted the CFTC, which had recently adopted exemptive rules, effectively vacating the space.

It would have permitted the Commission to maintain a uniform national regime. And that would benefit not only investors, I think, but also the hedge fund industry and it would permit the SEC to work with foreign national regulators as a single U.S. regulator.

So it is in the wake of the dismantling of that approach that we meet here today. And we are working as quickly as we can to try and, if not put Humpty Dumpty back together again, then to erect something more sturdy that will accomplish some of the same objectives.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Chairman Cox, yesterday you may have seen the Financial Times article.

Mr. COX. I read it every day.

Chairman SHELBY. The CFA Center for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics published a report focusing on the issuer, analysts, institutional investor, asset manager, and hedge fund manager communities. The report called for corporate leaders to end the practice of providing quarterly earnings guidance. This was the lead story.

What is your reaction to this recommendation? There has been a lot of stuff written, a lot of pressure put upon executives to meet their quarterly earnings estimates, they made guidance market, rather than the long-term health of the company.

Mr. COX. Yes. I think that these are, in the main, healthy recommendations because concerns with short-termism have been with us for some time and there are many attendant pathologies.

Obviously, the problems that we have seen with manipulating earnings, managing earnings, smoothing earnings and so on are derivative of that kind of short-termism.

Chairman SHELBY. This could be a step in the right direction, could it not?

Mr. COX. Yes. And I think if it amounts to nothing more than a contribution to the general ethos in which we all operate, these kinds of norms being enunciated at high levels, that is a good thing.

Senator SARBANES. A long time distinguished State Attorney General recently said "Right now hedge funds are in a regulatory void without disclosure or accountability. States will fill the void."

I would be interested in your comments on this possibility and what its implications are.

Mr. COX. I believe you are referring to the comments of the Connecticut Attorney General. With respect to the Blue Sky authorities the SEC in this, as in virtually all securities regulatory instances, takes the view that we have got to exercise our authorities in a complementary way.

Obviously, if one level of government does nothing, that leaves the others to act in a vacuum and that may be the prospect to which that comment refers.

I think there is zero risk that that is going to be the future. Instead, I think you will see the SEC continue to operate in this sphere, as you will presumably see Connecticut and other States doing what they can.

At minimum, in the area of anti-fraud activity, we have got to put our resources together. And as I indicated, Goldstein notwithstanding, the SEC has been increasingly active in moving against hedge fund and hedge fund adviser fraud. We have gone from just four cases in 2001 to over 90 since then.

Senator SARBANES. Recently Bloomberg News and Newsweek reported that the Bush Administration's Task Force on Corporate Crime will discuss hedge fund fraud at its next meeting at the end of this month. The Deputy Attorney General, Paul McNulty, spoke in strong terms about this as an emerging threat.

Can you give us some idea where that task force is headed with regard to hedge funds?

Mr. COX. I will be in a much better position to tell you after the meeting takes place. I intend to attend that meeting.

Senator SARBANES. Anyone else have any information on it?

Will Treasury be at that meeting?

Mr. QUARLES. We will be, through our General Counsel's office.

Mr. JEFFERY. As will the CFTC.

Chairman SHELBY. We need to get you back after the meeting.

Senator SARBANES. Do you have enough resources? In other words, budget, manpower, and so forth, to do what has to be done in this area? Or are you in need?

Mr. COX. With respect to the SEC, that is an area where legislation would make a difference. There are some things that we can do with regulatory authority. There are other things that we cannot do.

Chairman SHELBY. Legislation or money?

Mr. COX. I do not mean to make the authorizer/appropriator distinction, although with you, Chairman Shelby, I do not have to.

Chairman SHELBY. We will talk about money in another committee with you.

Mr. COX. All right, I will subside.

Senator HAGEL. You recognize the Chairman is both.

Mr. COX. I do, indeed.

Chairman SHELBY. Chairman of the other Committee, Appropriations.

Senator SARBANES. How about the CFTC and the Treasury?

Mr. JEFFERY. Well, resource allocation is a constant challenge in every organization, but as our statute is currently structured and our mission defined, subject to the goodwill of Congress and continued budget appropriations along the lines that have been requested, we believe we have the resources sufficient to our job as currently constituted.

Senator SARBANES. Treasury?

Mr. QUARLES. With respect to the Treasury, I mean I never want to say we have enough resources. But with respect to this issue, for what our role is, I think we are covered.

Senator SARBANES. Mr. Chairman, I just want to close out by saying I think it is very important that you carry through with these work programs. You have this uneasy feeling of the whole area here that we do not really know very well. We do not fully understand.

And you constantly get—you know, Business Week had an article in May saying—and just listen to this, it may be a small thing but still. "Smaller colleges are moving aggressively in the hedge funds. They may be putting their endowments in jeopardy."

The article identified some small colleges that invested 60 or 80 percent of their endowments in hedge funds and was concerned that these institutions may lack financial sophistication to fully understand the risks.

Is that a legitimate concern, would you say? Would you dismiss this concern?

Mr. QUARLES. I would not dismiss the concern. I would certainly note that if you have a small institution that is unlikely to have in-house expertise, there are a variety of ways to outsource that expertise, to hire professional advisers, to invest through funds of funds in order to ensure that you are not taking on more risk than you ought.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

Chairman Cox, I wanted to ask a specific question, which you are well aware of the issue regarding the cases concerning Overstock and Biovale, where hedge funds are alleged to have paid securities analysts to issue misleading research to the marketplace.

Do you believe the SEC has the authority to deal with a critical component of not just the hedge funds, but the entire investment environment and universe in the market of independent research and analysis? Obviously, we have two specific cases here.

But as you are analyzing, as we have talked this morning, on future needs, if it comes to that through legislation, obviously this is a big part of it. If there is some question in the marketplace by investors about the independence, the actual independence of research and analysis, that obviously destabilizes everything. And it affects all decisions.

So what is the SEC doing to deal with this? I think this is as critical a component of this issue as any one thing, the legitimate independence of research and analysis.

The second part of that question is do you believe you have the authority to deal with it?

Mr. COX. Yes indeed, I believe we have both the resources and the authorities that we need to deal with this problem on a policy basis and on an enforcement basis. One of the ways that we are proceeding to attack this problem is through enforcement, as well as policymaking.

Senator HAGEL. What specifically can you tell us about these two cases?

Mr. COX. To the extent that they are ongoing, I cannot.

Senator HAGEL. What will you be recommending in the way of changes to not just deal with this but strengthen it? What can you tell us, aside from you think you have the authority?

Mr. COX. Well, we began from the premise that research is vitally important to the market, that there are pressures on independent research right now and that the SEC needs to examine its own rules to make sure that we are encouraging and not diminishing the provision of independent research.

Second, we have a rubric of law and rules that need to be examined for opportunities to strengthen the requirements of independence and the freedom of research providers from interference or manipulation themselves.

Senator HAGEL. Do you believe that as you are analyzing all of the dynamics of authorities and hedge funds in particular that this is going to be something that you will come to the Committee with, with additional information as to not just needs in the area of authority, statutory authority? But again this is as critical a component of this, at least in my opinion. I suspect the market, if they have no confidence in this or if there is a question of the confidence of the quality of that analysis and research, then it skews everything.

So how do you respondent then to that question? When will you—is this part of your overall analysis and review? When would you have been prepared?

Mr. COX. Well, with respect to enforcement actions and ongoing investigations, we can report the moment that those become public or that we take actions in a public venue, in court, before in ALJ, before the Commission.

With respect to the findings of our respective divisions and offices concerning this problem, we can report on an ongoing basis. And I would be more than pleased to do so.

Senator HAGEL. Thank you.

Secretary Quarles, a question for you. The issue of Long Term Capital Management has been raised. It was raised at the beginning of Chairman Cox's testimony this morning, referencing the Federal Reserve and Chairman Greenspan in particular, what Greenspan said about that issue and how it could have destabilized our markets for all of the reasons you understand if we had not interfered.

Using that Long Term Capital Management as an example, here is the question: obviously, the excessive leverage that we saw in that case, it posed a very real systemic risk for all our markets. And you three this morning have talked about systemic risk, which is not unimportant obviously in your roles as regulators. The markets are the markets, and we recognize that. We do not want to tie down a market to the point where we lose the point of a market.

But specifically, as you know, and the Treasury has been very deeply involved in the GSE issue. This issue has arisen, in particular with Fannie and Freddie, on their significant use of derivatives. And we have talked about this here.

With the LTCM issue as an example, here is the question. Do you think there are corollary lessons to be learned here as we review the specific environment of hedge funds and the larger universe of the market with excessive leverage in particular?

And in particular to that, derivatives where Fannie and Freddie use, to a great extent, and then the systemic risk associated with that?

Mr. QUARLES. I think absolutely. I think the lessons of LTCM are as you have noted. They are one, leverage. They are two, concentration of risk. And they are three, counterparty risk management, market discipline, if you will. The reason that you had the problems with LTCM is that you did not have adequate market discipline because counterparties did not have sufficient transparency in order to appropriately evaluate their risks. And so you had excessive leverage for an entity that turned out then to have systemic consequence.

I think you can walk through—right now when you look at the hedge fund industry, you are actually in a better situation than you were at that time on all three of those fronts. I do not want to say that there is no possibility of problem. Not at all. But you are in a better situation on leverage, on counterparty risk management, and on market discipline than you were at the time of LTCM.

For the GSEs, by contrast, you have the problem of lack of market discipline because of the perceived Government backstop, the misperception of Government backstop. You have lack of market discipline. You have lack of counterparty risk management, again because of the perception of the Government standing behind those companies.

As a consequence, you have the ability to buildup excessive leverage in a way that creates systemic risk. I think that is a concern. And that is the fundamental reason that we have been proposing what we have proposed for the GSEs.

Senator HAGEL. Thank you. Mr. Chairman, thank you.

Chairman SHELBY. Thank you, Senator Hagel.

I want to thank the panel for your participation today. We have a vote on the floor now.

The Committee is adjourned.

[Whereupon, at 11:50 a.m. the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman for scheduling this hearing today.

Although hedge funds have been around for a long time, they have certainly grabbed my attention in the last 5 years. In 2001, there were only 2,000 hedge funds and today, that number has grown more than 300%.

As we all know—there is simply too little known about the estimated 9,000 hedge funds and their investments totaling $2.4 trillion according to the SEC.

What concerns me even more is that pension funds, charities, and university endowments are investing in hedge funds despite the lack of information. The problem is that when something goes wrong, no one is able to obtain any information about the fund's assets or activities.

Unfortunately, in Michigan, we know about pension failures. The idea of creating more harm to working families who have contributed their own earnings to a pension plan is extremely concerning to me. We need to make sure that everyone understands what is at stake with hedge fund investments.

As a committee, I believe we should not be guessing about what would happen if something went wrong with a $2.4 trillion industry. We should do all we can to protect investors and those families who have worked hard to retire with a pension.

I look forward to hearing the panel's recommendations.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF CHRISTOPHER COX

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

JULY 25, 2006

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

Thank you for inviting me to testify today about the regulation of hedge funds. It is an especially welcome opportunity to appear on this panel with other members of the President's Working Group on Financial Markets, including the Department of the Treasury and the Commodity Futures Trading Commission.

As you have recognized, each of us has responsibility for different, but crucial aspects of the world in which hedge funds operate. That's why the Securities and Exchange Commission is working closely and cooperatively with the other members of the President's Working Group on the questions of the systemic market risks posed by hedge fund activity, and the investor protection issues that stem from the increasing exposure of retail investors to hedge fund investment opportunities.

I should emphasize at the outset, Mr. Chairman, that my testimony today reflects my views as Chairman of the SEC, and does not represent the position of the five-member Commission. The views I am expressing this morning are solely my own.

It has been eight years since Long Term Capital Management collapsed, after losing $4 billion in just five weeks. Then-Fed Chairman Alan Greenspan said at the time that, had the Federal Reserve Bank of New York not intervened to organize a $3.6 billion bailout by the fund's creditor banks, the bankruptcy of LTCM "could have potentially impaired the economies of many nations, including our own." LTCM was effectively liquidated by early 2000.

This spectacular hedge fund collapse left in its wake not only ruined investors, but also serious questions about the threat to our capital markets as a whole from such significant funds pursuing high risk strategies with excessive leverage. In the months that followed, President Clinton established the President's Working Group on Financial Markets, with the SEC as a member, to coordinate regulatory oversight of these issues as well as other questions that broadly impact the national securities markets.

Since then, the President's Working Group has focused intently on the concern that the failure of one or more significant and highly leveraged investment pools, such as the Long Term Capital Management hedge fund, could threaten the stability of financial markets. We are more certain now than ever before that preventing future market instabilities will require a coordinated effort by all financial securities regulators.

But given the recent invalidation of the SEC's hedge fund rule by the United States Court of Appeals, we have been forced back to the drawing board to devise a workable means of acquiring even basic census data that would be necessary to monitor hedge fund activity in a way that could mitigate systemic risk.

The current lack of such basic data requires me to hedge when I say that the SEC's best estimate is that there are now approximately 8,800 hedge funds, with approximately $1.2 trillion of assets. If this estimate is accurate, it implies a remarkable growth in hedge fund assets of almost 3,000% in the last 16 years. Much of this growth is attributable to increased investment by institutions. This includes not only investment companies and investment banks, but also private and public pension plans, endowments, and foundations.

Last year, we believe an estimated 2,000 new hedge funds opened for business. There were just over 2,500 hedge fund advisers registered with the Commission at the end of June 2006. Half of those registered following the Commission's hedge fund rule. The vast majority of the registered hedge fund advisers, 88% of them, are domiciled in the United States.

Although hedge funds represent just 5% of all U.S. assets under management, they account for about 30% of all U.S. equity trading volume. They are particularly active in the convertible bond market and the credit derivatives market. We are also seeing hedge funds becoming more active in such varied activities as the market for corporate control, private lending, and the trading of crude petroleum.

It is undeniable that in addition to raising questions such as systemic risk and investor protection, hedge funds also provide investors and our national securities markets with tangible benefits. They contribute substantially to capital formation, market efficiency, price discovery, and liquidity. By actively participating in derivatives markets, hedge funds can help counterparties reduce or manage their own risks. Some hedge funds provide a way for institutional investors to reduce their exposure to downside risk by allocating a portion of their portfolio to an investment with a low correlation to overall market activity.

But given the general lack of public disclosure about the way hedge funds operate, the lack of standards for measuring a fund's valuation and its performance, the possibilities for undisclosed conflicts of interest, the unusually high fees, and the higher risk that accompanies a hedge fund's expected higher returns, these are not investments for Mom and Pop. They are generally risky ventures that simply don't make sense for most retail investors.

While some refer to an alleged growing trend toward the "retailization" of hedge funds, the Commission's staff are not aware of significant numbers of truly retail investors investing directly in hedge funds. In my view, such a development, were it to occur, should be viewed with alarm. Indeed, in the wake of the Court of Appeals decision in the *Goldstein* case, I intend to recommend to the full Commission that the SEC take formal steps to further limit the marketing and availability of hedge funds to unsophisticated retail investors.

In addition to the threat of retailization, the increased investment in hedge funds by institutional investors with retail constituencies, such as public and private pension plans, fund of funds investments, universities, endowments, foundations and other charitable organizations, carries with it the potential for retail exposure to hedge fund risk. This trend, however, is still in its infancy. A recent industry report by Greenwich Associates indicates that 80% of public pension funds, and 82% of corporate funds, have little or no investment in hedge funds. Those corporate pensions that actively invest in hedge funds allocate on average only 5.3% of their assets to this entire investment class. Public pensions that actively invest in hedge funds allocate 5.1%.

The trend among endowments toward hedge fund investments is more pronounced. Nearly two-thirds of endowments invest in hedge funds, and those that do allocate an average of 18% to them. Whether or not this sort of institutional investment directly impacts retail investors, it surely is increasing the potential impact that hedge funds might have on our capital markets.

The concerns about hedge funds that the SEC enunciated when we adopted our hedge fund rule in December 2004 remain the same today. The remarkable pace of hedge fund growth, which we noted at the time, has continued unabated. The potential for retail investors to be harmed by hedge fund risk remains as serious a concern now as then. And the growth in hedge fund fraud that we have seen accompany the growth in hedge funds implicates the very basic responsibility of the SEC to protect investors from fraud, unfair dealing and market manipulation.

And on that point, let me make very clear that notwithstanding the *Goldstein* decision, hedge funds today remain subject to SEC regulations and enforcement under the antifraud, civil liability, and other provisions of the federal securities laws. We will continue to vigorously enforce the federal securities laws against hedge funds and hedge fund advisers who violate those laws. Hedge funds are not, should not be, and will not be unregulated. The challenge for the SEC and the President's Working Group going forward is, rather, to what extent to add new regulations, particularly in light of the recent Court of Appeals ruling.

The fact that hedge funds remain subject to the same prohibitions against fraud as other market participants, and their managers have the same fiduciary obligations as other investment advisers, directly addresses the Commission's concern with the growth in hedge fund fraud. The Securities Act, the Exchange Act, and the

Advisers Act each provides the Commission with separate authorities to regulate fraud and unfair dealing by hedge funds. Using this still valid authority over the past several years, the Commission has brought dozens of enforcement cases against hedge fund managers who have engaged in fraud or have violated their fiduciary obligations.

The number of enforcement cases against hedge funds has grown from just four in 2001 to more than 60 since then. These cases involve hedge fund managers who have misappropriated fund assets; engaged in insider trading; misrepresented portfolio performance; falsified their experience and credentials; and lied about past returns. We have brought cases for inaccurate disclosure of trading strategies; undisclosed preferential treatment of hedge fund clients at the expense of other clients; market manipulation; illegal short selling; and improper valuation of assets. In some cases we have worked side-by-side with criminal authorities who have brought criminal actions as well.

Recent examples of significant hedge fund cases brought by the Commission include:

- **SEC v. CMG-Capital Management Group Holding Company, LLC and Keith G. Gilabert,** *Litigation Release No. 19680 (May 1, 2006)*—In April 2006, the SEC filed an action in federal court charging a California hedge fund manager and his advisory firm with misappropriating more than $14 million in funds and misleading investors about the hedge fund's returns. The Commission is seeking permanent injunctions, disgorgement, and civil penalties against the defendants.
- **SEC v. Nelson J. Obus, Peter F. Black, Thomas Bradley Strickland, Wynnefield Partners Small Cap Value L.P., Wynnefield Partners Small Cap Value L.P. I, Wynnefield Partners Small Cap Value Offshore Fund, Ltd.,** *Litigation Release No. 19667 (Apr. 25, 2006)*—In April 2006, the SEC filed an insider trading case in federal court against a hedge fund manager and two others in connection with trading for three hedge funds in advance of the public announcement of a merger agreement, resulting in illicit gains of over $1.3 million. The Commission is seeking injunctions against the defendants, as well as disgorgement, civil penalties, and orders barring the hedge fund manager from acting as an officer or director of a public company.
- **SEC v. Kirk S. Wright, et al.,** *Litigation Release No. 19581 (Feb. 28, 2006)*—In February 2006, the Commission obtained a temporary restraining order and other emergency relief in federal court to halt an ongoing offering fraud involving the sale of investments in seven hedge funds by an Atlanta-based promoter and investment advisers controlled by him. The Commission alleged that the defendants raised as much as $185 million from up to 500 investors through the fraudulent investment scheme, and that the advisers provided investors with statements that misrepresented the amount of assets in the hedge funds and the returns earned by the funds. The Commission is seeking permanent injunctions against the defendants, an accounting and disgorgement of ill-gotten gains, and civil penalties.
- **SEC v. Deephaven Capital Management, LLC and Bruce Lieberman,** *Litigation Release 19683 (May 2, 2006) (also see Investment Advisers Act Release No. 2517 (May 26, 2006))*—In May 2006, the SEC charged hedge fund adviser Deephaven Capital Management, LLC and its former portfolio manager with insider trading based on information that 19 PIPE offerings were about to be publicly announced. Deephaven has agreed to disgorge $2.7 million in unlawful profits and to pay $343,000 in prejudgment interest and a $2.7 million civil penalty. The portfolio manager agreed to pay a $110,000 civil penalty and agreed to be barred from associating with an investment adviser for three years.

But while our ability to bring enforcement actions against hedge funds and their managers remains intact following the *Goldstein* decision, the same cannot be said for the Commission's ability to require hedge fund advisers to register and submit to inspections. The Commission stated, when we adopted the hedge fund rule in 2004, that its then-current program of hedge fund regulation was inadequate. With the rejection of the hedge fund rule by the Court of Appeals, I believe that is once again the case. We must move quickly to address the hole that the *Goldstein* decision has left. Some improvements will be possible through administrative action. Others, however, may well require legislation.

As you consider the possibility of legislation, which is of course the prerogative of the Congress, the SEC stands ready to assist you with technical advice and assistance should you request it. As a general principle, which I would apply both to the Commission's future regulatory actions in this area as well as to any potential legislation, I would counsel that to the maximum extent possible our actions should be non-intrusive. There should be no interference with the investment strategies or operations of hedge funds, including their use of derivatives trading, leverage, and short selling. Nor should the federal government trammel upon their creativity, their liquidity, or their flexibility. The costs of any regulation should be kept firmly in mind. Similarly, there should be no portfolio disclosure provisions. A hedge fund's ability to keep confidential its trading strategies and portfolio composition should be protected. And hedge funds should be able to continue to charge their clients performance fees, just as they do now.

Immediately following the *Goldstein* ruling, I instructed the SEC's professional staff to promptly evaluate the court's decision, and to provide me with a set of alternatives that the SEC could pursue without legislation. That evaluation is still underway, but I have already decided upon several urgent courses of action which I can report to this Committee today. Specifically, I intend to recommend to the full Commission the following emergency rulemakings and Commission actions:

First, I will recommend that the SEC promulgate a new anti-fraud rule under the Investment Advisers Act that would have the effect of "looking through" a hedge fund to its investors. This would reverse the side-effect of the *Goldstein* decision that the anti-fraud provisions of Sections 206(1) and 206(2) of the Act apply only to "clients" as the court interpreted that term, and not to investors in the hedge fund. I believe that such a rule is possible because the court itself noted that another anti-fraud provision, Section 206(4), is not limited to fraud against "clients." The result would be a rule that could withstand judicial scrutiny, and which would clearly state that hedge fund advisers owe serious obligations to investors in the hedge funds. The staff is currently analyzing what the contours of such a rule might be, given the Commission's authority to adopt such a rule under Section 206(4).

Second, I am directing the SEC staff to take emergency action to insure that the transitional and exemptive rules contained in the 2004 hedge fund rule are restored to their full legal effect. This is necessary to insure that hedge fund advisers who were relying on the now-invalidated rule are not suddenly in violation of our regulatory requirements when the court issues its final mandate in mid-August.

For example, among the provisions of the hedge fund rule that the court invalidated was a section governing the Advisers Act's restrictions on performance fees for hedge fund adviser contracts that were entered into before the hedge fund rule went into effect. This section of the hedge fund rule was designed to prevent a hedge fund adviser from having to renegotiate the terms of its existing advisory contracts, or from having to expel from the fund (including venture capital and private equity funds as well as hedge funds) pre-existing investors who are not "qualified clients."

Likewise, I am directing emergency action to restore to newly registered hedge fund advisers their qualified exemption from the recordkeeping requirement for performance data prior to their registration. (They would still be required to maintain all records they have to substantiate their prior performance.) Without this emergency action prior to mid-August, newly registered hedge fund advisers that remain registered, but that did not create records for the periods prior to their registration, will lose the ability to use their performance track record. Rather perversely, that would discourage hedge fund advisers from voluntarily remaining registered.

Yet another emergency action I am directing will restore the extension of time that was given to advisers for funds of hedge funds to provide their audited financial statements. The underlying hedge funds do not typically supply their audited financials to the fund of funds manager until the 120-day deadline, so the fund of funds managers need extra time to complete their audit work and send out the reports. The hedge fund rule gave it to them, but the *Goldstein* decision invalidated that relief. I intend for the Commission to restore the extension of time from 120 to 180 days.

Similar action is needed to undo yet another effect of the *Goldstein* decision, which is to undo the Commission's 2004 hedge fund rule insofar as it applied to off-shore advisers to off-shore hedge funds. Those advisers had to register under the new rule (assuming their funds had more than 14 U.S. investors), but they would have been subject to different treatment under the Advisers Act because they could treat the off-shore fund as their "client" for all other purposes. The Court's ruling, however, eliminated this aspect of the rulemaking; and by creating doubt whether registered offshore advisers will be subject to all of the provisions of the Act with respect to their offshore hedge funds, the ruling has created a disincentive for off-shore advisers to remain voluntarily registered. I have directed the Commission staff to address this disincentive to registration.

Finally, to address my concerns with respect to the retailization of hedge funds, I have asked the staff to analyze and report to the Commission on the possibility of amending the current definition of "accredited investor" as applied to retail investment in hedge funds without registration. I am concerned that the current definition, which is decades old, is not only out of date, but wholly inadequate to protect unsophisticated investors from the complex risks of investment in most hedge funds. Under the Commission's Regulation D, for example, one definition of an "accredited investor" is "Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000." This does not exclude one's residence. The Commission's hedge fund rule would have had the effect of increasing this suitability threshold to $1.5 million of net worth, rather than $1 million, for any hedge fund that charges a performance fee.

This was an important change, and I would like to see it restored. In California, the median home price is well over one-half million dollars. So post-*Goldstein,* with barely more than $200,000 apiece in other assets, a California couple could qualify to buy a hedge fund in an unregistered offering—even though that relatively small amount might represent their entire life savings in the form of a teacher's or fire fighter's retirement fund.

Beyond these emergency rulemakings and other actions to restore as much of the pre-*Goldstein* rule as possible, I have directed the SEC staff to continue to conduct compliance examinations of investment advisers who remain registered with us, or register with us in the future. All registered hedge fund advisers are subject to SEC regulation, and the SEC will continue to conduct risk-based examinations of hedge fund advisers that are registered with the SEC. The purpose of these exams will be to evaluate the hedge fund adviser compliance programs, and to detect violations of the securities laws.

Our continuing oversight of hedge fund advisers who remain registered with the SEC post-*Goldstein* will cover the majority of the over 2,500 of the hedge fund advisers of which we are aware. Because fully half of these advisers were registered with the SEC before the hedge fund rule required it, we anticipate that at least this number will voluntarily remain registered. And while some number of hedge fund advisers will certainly de-register as a result of the court's decision, our experience since *Goldstein* is that more hedge fund advisers have become newly registered than have de-registered. In other words, although these are early returns and may not be indicative of the final outcome, we have actually experienced a net increase in hedge fund registrations since the *Goldstein* decision.

We are also working with other regulators, including the CFTC and the other members of the President's Working Group, to coordinate our hedge fund oversight efforts. As I have noted, each member agency of the President's Working Group has a unique responsibility and provides a critical perspective when it comes to the efficient and effective functioning of our capital markets. In addition, we are working in close coordination with the Financial Services Authority in the United Kingdom, since together the U.S. and the U.K. account for the vast majority of the world's hedge fund activity, including prime brokerage.

As we move forward, it will be important that we view the whole picture as we work to evaluate both the systemic market risks and the retail investment issues associated with the growing presence of hedge funds in our capital markets. Hedge funds are a significant and growing part of our financial markets that yield not only risks but also many benefits for our economic system. Each of us at this table, as members of the President's Working Group, has an interest and responsibility to continue working collaboratively to evaluate both the systemic market risks and retail investment issues associated with hedge funds in order to maintain these overall benefits. I and the SEC are committed to doing so.

Thank you for inviting me to testify on this important subject. I am happy to answer any questions you may have.

PREPARED STATEMENT OF REUBEN JEFFERY, III

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

JULY 25, 2006

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am pleased to have an opportunity to testify on behalf of the CFTC on the regulation of hedge funds.

I will focus my remarks today on how hedge funds intersect with the CFTC's statutory responsibilities under its governing statute, the Commodity Exchange Act (the CEA). At the outset, I should emphasize that the CFTC does not regulate "hedge funds" *per se.* However, the CFTC encounters hedge funds as it performs two of its critical missions under the CEA: promoting market integrity and protecting the public from fraud in the sale of futures and commodity options. Hedge funds are on the CFTC's market surveillance radar when they trade in the regulated futures and commodity options markets. With respect to investor protection, if a collective investment vehicle, such as a hedge fund, trades futures or commodity options, the fund is a "commodity pool" and its operator and advisor may be required to register with the CFTC and meet certain disclosure, reporting, and recordkeeping requirements.

My testimony today will address four topics. First, I will share some observations regarding the participation of hedge funds in the regulated futures markets. Second, I will describe the CFTC's surveillance methods used to monitor large traders, including many hedge funds. Third, I will describe the CFTC's investor protection regime aimed at protecting investors from fraudulent practices in the sale of commodity pools, including hedge funds. Finally, I will comment on our recent enforcement activities involving commodity pools and hedge funds.

Participation of Hedge Funds in Futures Markets

Futures markets serve an important role in our economy by providing a means of transferring risk from those who do not want it to those willing to accept it for a price. Traders who are trying to reduce their exposure to price risks, that is, "hedgers," typically include those who have an underlying commercial interest in the commodity upon which the futures contract is based. For example, futures contracts allow a bank to transfer its risk exposure to rising interest rates, a grain merchant to hedge an expected purchase of corn, or an oil refiner to lock in the price of its heating oil and gasoline output. In order for these hedgers to reduce the risk they face in their day-to-day commercial activities, they need to trade with someone willing and able to accept the risk. Data from the CFTC's Large Trader Reporting System indicate that hedge funds, and other professionally managed funds, facilitate the needs of commercial hedgers to mitigate their price risks, and add to overall trading volume, which contributes to the formation of liquid and well-functioning markets.

CFTC large trader data also show that hedge funds and other professionally managed funds hold significant arbitrage positions between related markets. These arbitrage positions are structured to profit from temporary mispricing between related contracts (*e.g.,* prices for October delivery vs. prices for November delivery) and, when structured as such, are unrelated to the overall level of futures prices. These arbitrage trades play a vital role in keeping prices of related markets (and prices of related contracts within the same market complex) in proper alignment with one another.

One notable market development in recent years has been increased participation by hedge funds and other financial institutions in futures markets for physical commodities. These institutions view commodities as a distinct "asset class" and have allocated a portion of the portfolios they manage into futures contracts tied to commodity indexes. The total investment in commodity-linked index products by pension funds, hedge funds and other institutional investors has been estimated by industry observers to exceed $100 billion in assets. A significant portion of this amount finds it way into the regulated futures markets, either through direct participation by those whose commodity investments are benchmarked to a commodity index, or through participation by commodity index swap dealers who use futures markets to hedge the net risk associated with their dealing activities. Notably, although the percentage of participation by hedge funds has increased in recent years, commercial traders in these markets remain, by far, the largest segment of trading category.

Surveillance Methods Used by the CFTC to Monitor Large Traders—Including Hedge Funds

In the CFTC's world of regulated futures exchanges, market integrity is essential to preserving the important functions of risk management and price discovery that the futures markets perform in the U.S. economy. The CFTC relies on a program of market surveillance to ensure that markets under CFTC jurisdiction are operating in an open and competitive manner, free of manipulative influences or other price distortions. The backbone of the CFTC's market surveillance program is its Large Trader Reporting System. This system captures end-of-day position-level data for market participants meeting certain criteria. Positions captured in the Large Trader Reporting System typically make up 70 to 90 percent of all positions in a particular exchange-traded market. The Large Trader Reporting System is a powerful tool for detecting the types of concentrated and coordinated positions required by a trader or group of traders attempting to manipulate the market. For surveillance purposes, the large trader reporting requirements for hedge funds are the same as for any other large trader.

Using large trader reports, CFTC economists monitor futures market trading activity, looking for large positions that might be used to manipulate prices. Each day, for all active futures and option contracts traded on the regulated exchanges, surveillance staff members monitor the daily activities of large traders and key price relationships. In addition, CFTC market analysts maintain close awareness of supply and demand factors and other developments in the underlying cash markets through review of trade publications and government reports, and through industry and exchange contacts. Staff also closely tracks the net positions of managed money traders as a class to monitor for any market irregularities or trends. The CFTC's surveillance staff routinely reports to the Commission on surveillance activities at weekly surveillance meetings.

Market surveillance, however, is not conducted exclusively by the CFTC. Each futures exchange is required under the CEA to affirmatively and effectively supervise trading, prices, and positions. The CFTC examines the exchanges to ensure that they have devoted appropriate resources and attention to fulfilling this important responsibility. The CFTC staff's findings from these rule enforcement reviews are reported to the CFTC, and are publicly posted on the CFTC Website (*www.cftc.gov*). Furthermore, exchanges impose position limits, where appropriate, to guard against manipulation. For example, NYMEX imposes spot month speculative limits on its energy contracts.

When the CFTC's surveillance staff identifies a potentially problematic situation, the CFTC engages in an escalating series of communications with the largest long- and short-side traders—which may be hedge funds—to address the concern. Typically, the CFTC's staff consults and coordinates its activities with exchange staff. This targeted regulatory oversight by CFTC staff and the exchanges is quite effective in resolving most potential problems. However, hedge funds normally roll out of positions prior to the expiration month when manipulation is most likely to occur, because most do not have the capabilities to make or take delivery of the underlying commodity.

Given the CFTC's statutory role as an oversight regulator, and the exchanges' statutory responsibility to monitor trading to prevent manipulation, the law requires that the exchanges take the lead in resolving problems in their markets, either informally or through emergency action. If an exchange fails to take actions that the CFTC deems necessary, the CFTC has broad emergency powers to direct the exchange to take such action which, in the CFTC's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. Fortunately, most issues are resolved without the need for the CFTC's emergency powers, as the CFTC has had to take emergency action only four times in its history.

Just as the CFTC's market surveillance program monitors the activity of all large traders on the regulated futures exchanges to maintain an orderly operation of the markets, the system of financial safeguards in the futures industry is focused on ensuring that the financial distress of any single futures market participant, whether it be a hedge fund or any other participant, does not have a disproportionate effect on the overall market. This is primarily accomplished through a clearinghouse's financial safeguards. This includes the margin deposited by clearing member firms and guarantee funds. Futures clearinghouses perform periodic risk evaluations of clearing member firms in an attempt to detect potential weaknesses in financial condition or risk controls. In addition, each firm has its own financial and capital safeguards in place to protect itself from the financial distress of a customer—including a hedge fund customer.

CFTC's Oversight Authority With Respect to Operators and Advisors of Commodity Pools, Including Hedge Funds

Of no less importance is the CFTC's responsibility to protect investors who participate—whether directly or through participation in a professionally managed fund—in the futures markets through a diverse array of commodities products. To that end, the CFTC maintains a customer protection regime that, pursuant to the CEA, relies on full and timely disclosure to protect investors from abusive or overreaching sales practices. This encompasses participation in commodity pools, including hedge funds.

Registration is the cornerstone of the CFTC's customer protection scheme. As of June 30, 2006, there were approximately 1,600 Commodity Pool Operators (CPOs) and 2,600 Commodity Trading Advisors (CTAs) registered with the CFTC, operating and advising approximately 2,300 commodity pools. In annual reports filed for 2005, these CPOs reported total assets under management for commodity pools of approximately $700 billion, of which less than five percent represent direct investments in the futures markets.

The primary purposes of registration are to ensure a person's fitness to engage in business as a futures professional and to identify those persons whose activities are covered by the CEA. Generally speaking, those who operate or manage a commodity pool must register with the CFTC as CPOs, and those who make trading decisions on a pool's behalf must register as CTAs. Registration is not dependent on whether commodity interests are traded for speculative or hedging purposes, or on whether they are the predominant investment traded or advised. Notable exclusions or exemptions are available for operators of pools that are otherwise regulated; that have only sophisticated participants and de minimis commodity interest trading; and that have only the very highest level of sophisticated participants, regardless of the amount of commodity interests traded. Hedge fund operators frequently fall within one of the latter two exemptions from CPO registration.

Once registered, a CPO or CTA must comply with certain disclosure, reporting, and recordkeeping requirements designed to ensure that prospective and current participants in commodity pools receive all the information that is material to their decision to make, or maintain, an investment in the pool. For example, prospective participants must receive information regarding the pool's investment program, risk factors, conflicts of interests, and performance data and fees. Thereafter, a CPO must provide pool participants with an account statement at least quarterly, and an annual report containing specified financial statements which must be certified by an independent public accountant and presented in accordance with Generally Accepted Accounting Principles (GAAP).

The CFTC has established a simplified regulatory framework for registered CPOs and CTAs who operate or advise pools whose participants meet certain criteria. Relief from full compliance with the disclosure, reporting, and recordkeeping requirements is available where, for example, pool participants are CFTC or SEC registrants, "inside employees" of the CPO or CTA, or persons who earn $200,000 annually and who have assets worth at least $2 million. Many of the pools for which CPOs are exempt from disclosure, reporting, and recordkeeping regulations are likely to be hedge funds.

Having outlined what CFTC regulation involves, it is important to note the limits of that regulation. The CFTC's mandate under the CEA does not include imposing limits on the pool's market risk or leverage parameters, or the instruments that may be traded, or imposing capital requirements or risk assessment procedures.

Finally, day-to-day oversight functions of CPOs and CTAs are carried out by the National Futures Association (NFA), the futures industry analogue of the National Association of Securities Dealers. NFA's responsibilities include the registration processing function and review of CPO and CTA disclosure documents and pool financial statements. Consistent with the disclosure-based regulatory regime under the CEA, review of pool financial statements focuses on ensuring that they include all required information and conform to applicable accounting standards, but does not include an analysis of the pool's underlying transactions themselves. As part of its self-regulatory responsibilities, NFA conducts on-site examinations of CPOs and CTAs on a routine, periodic basis. NFA generally examines all CPOs and CTAs within two years of their becoming active, and every four years thereafter.

CFTC Enforcement Overview: Commodity Pools, Hedge Funds and CPOs

The CFTC takes its enforcement responsibilities with respect to CPOs, CTAs, and commodity pools very seriously. Whether registered or unregistered, exempt or not exempt, CPOs and CTAs remain subject to the CFTC's anti-fraud authority.

Over the past 6 fiscal years, the CFTC has brought 49 enforcement actions involving commodity pools, hedge funds and CPOs. These enforcement actions typically involve investments in commodity pools, including self-styled hedge funds, in which the investors' funds were misappropriated or misused, or where investors were victimized by solicitation fraud involving misrepresentations of assets under management and/or profitability. The CFTC's Division of Enforcement currently has 55 pending investigations of commodity pools, hedge funds and CPOs.

The majority of the CFTC's pool fraud cases have been brought against unregistered CPOs. These cases tend to involve ponzi schemes or outright misappropriation, as opposed to legitimate hedge fund operations. Sanctions in CFTC enforcement actions can include permanent injunctions, asset freezes, prohibitions on trading on CFTC-registered entities, disgorgement of ill-gotten gains, restitution to victims, revocation or suspension of registration, and civil monetary penalties.

The CFTC has taken enforcement action in several well-publicized recent hedge fund frauds. While the futures activities of these funds were not necessarily the primary cause of the problems, the CFTC took action against its registrants to punish their illegal conduct, deter future violations, and seek recovery of monies taken from innocent victimized investors. The following cases filed during the past year are illustrative:

On June 21, 2005, the CFTC filed an enforcement action against Philadelphia Alternative Asset Management Co., LLC (PAAM), a registered CPO, and Paul M. Eustace, a registered associated person and president of PAAM, alleging fraudulent solicitation and false reporting involving hedge funds and commodity pools. On the day that the complaint was filed, the CFTC froze approximately $70 million of the defendants' assets.

On September 29, 2005, the CFTC filed an enforcement action alleging misappropriation and fraud involving Connecticut hedge fund manager and registered CPO Bayou Management, LLC (Bayou Management), its principals Samuel Israel III (a registered associated person) and Daniel E. Marino, and Richmond Fairfield Associates, Certified Public Accountants. The complaint alleges that the defendants misappropriated customer funds, acquired funds through false pretenses, engaged in unauthorized trading, and misrepresented material facts to actual and prospective investors, including the rates of return the hedge funds earned, the value of assets under management, and the existence and identity of the accounting firms that had purportedly audited the hedge funds.

In many instances, the CFTC works cooperatively with NFA, state regulators, criminal authorities and/or the SEC in bringing such actions. In Bayou, for example, Israel and Marino, based upon the same conduct alleged by the CFTC, pleaded guilty to criminal charges brought by the U.S. Attorney's Office for the Southern District of New York. The CFTC also coordinated its Bayou investigation with the SEC, which filed a parallel enforcement action under the federal securities laws.

Conclusion

In closing, the CFTC's primary mission under the CEA includes ensuring market integrity and customer protection. Hedge funds that trade futures and commodity options on CFTC-regulated exchanges implicate both. Thus, the CFTC monitors participation by hedge funds in the regulated futures markets, as it does with other large traders, in order to ensure that these markets operate free of price distortions. The CFTC also administers a disclosure-based regime designed to ensure that investors participating in commodity pools receive all the information that is material to their decision to invest in pools; when problems are uncovered, the full force of the CFTC's enforcement authority is devoted to prosecuting those responsible. The CFTC will remain vigilant in utilizing the tools provided in the CEA—market surveillance, disclosure, reporting and recordkeeping, and enforcement authority—to fulfill its statutory responsibilities as hedge fund participation in the futures markets continues to expand.

This concludes my remarks. I look forward to your questions.

PREPARED STATEMENT OF RANDAL K. QUARLES

UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

JULY 25, 2006

Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, good morning, it is a pleasure to be here today. I would like to thank you for holding this hearing and allowing the Treasury Department to present its views. I am pleased to be here today to contribute to a discussion of a topic that is of critical importance to our financial markets, namely the regulation of hedge funds.

In May, before a subcommittee of this panel, I presented testimony regarding the role that hedge funds play; that is, what hedge funds do for and in our financial markets. As I said then, if government addresses the question of regulation of any financial institution or activity without a clear understanding of the place it plays in our financial system, we run the risk of imposing unnecessary, excessive, or inappropriate legislation.

As we consider the regulation of hedge funds, we should keep in mind that the role they fulfill in our financial markets is continuously evolving; and in recent years it has been evolving rapidly. Therefore, before I turn to the subject of today's hearing, I would like to reiterate some of the key points from the testimony I gave in May 2006, in which I discussed some of the characteristics of hedge funds and some of the potential benefits and risks that they can present.

Background

Despite the fact that hedge funds are today the subject of everyday discussion in the financial press and among policymakers, there is no universally accepted definition of a hedge fund. A recent report by the International Organization of Securities

Commissions (IOSCO) on the results of a survey of the regulatory approaches toward hedge funds of 20 IOSCO members revealed that none of the survey respondents had a formal definition of "hedge fund." In the late '90s, the President's Working Group on Financial Markets (PWG) defined a hedge fund as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." Though this was a useful working definition for the PWG's purposes, it is limited in how widely it can be applied, in large part because it does not distinguish hedge funds from other forms of unregistered capital pools that are generally recognized to have distinctive features, such as private equity funds and venture capital funds. In my May testimony I suggested that there are a number of features that can help to distinguish hedge funds from other capital pools, including: legal structure; investment objective and strategy; compensation scheme; investor base and capital commitment; and disclosure.

As I testified in May, hedge funds have experienced dramatic growth, especially in recent years. They have grown from an estimated $50 billion in assets in 1988 to about $300 billion in 1998 to over $1 trillion in assets today.[1] Current estimates suggest that there are about 9,000 hedge funds.

Hedge funds employ a variety of investment strategies that vary considerably depending on the goals and needs of the investors and the types of instruments in which the fund invests. Much, if not all, of this growth has been market driven, and, as a consequence, it has been subject to a significant amount of market discipline. As hedge funds have grown, their investor base has evolved, bringing increasing levels of professional analysis to the investor side of the relationship. Each new group of investors has imposed certain forms of discipline on hedge funds, resulting in the hedge fund market becoming much more "institutionalized" as it has developed. In addition, since the failure of Long Term Capital Management (LTCM) in 1998 hedge fund investors—and creditors—have recognized the need for more discipline regarding the use of leverage and collateral, and hedge fund investors now demand more transparency of their fund managers. Therefore, while the hedge fund market has grown dramatically in the past twenty years, there is at least some reason to believe this growth has been subject to reasonable private sector discipline.

Hedge funds clearly provide certain benefits to the financial markets. At the same time, they can also put stresses on it that need attention. In my May testimony, I discussed at length many of the benefits and potential risks that can arise from the activities of hedge funds. Hedge funds impart potential benefits both to the financial marketplace, in general, as well as to investors.

In the financial marketplace, hedge funds provide liquidity, price efficiency, and risk distribution, and contribute to the further global integration of markets. Because of the varying strategies employed by hedge funds, they are often the willing buyers or sellers that provide additional liquidity to financial markets. Hedge funds contribute even more significantly to marketplace liquidity in less traditional markets. Many hedge funds seek to create returns by targeting price inefficiencies, including wide bid/ask spreads. While this activity certainly benefits the hedge funds that are profiting from the trades, it has the salutary effect of creating narrower spreads and more efficient markets. Hedge funds can help mitigate market-wide concentrations of risk by transferring and distributing market risk through their willingness to be counterparties in derivatives trades. Today, there is no question that hedge funds are among the dominant participants in the re-distribution of market risk. In their search for the next profit opportunity, hedge funds often lead the way to identifying new and emerging markets. These markets often provide opportunities that no longer exist in more mature marketplaces. This, in turn, leads to further globalization of our marketplace which provides more choice for investors and greater efficiency of markets globally.

Hedge funds can have a direct positive impact on the investing community. Speaking broadly, hedge funds can provide investors with opportunities for diversification, "alpha" or excess returns, and capital protection in down markets. Hedge funds provide investors with more choices of both instruments and investment strategies. More choices allow investors the ability to diversify their investment portfolios, which is a common goal of many investors. In contrast to conventional investment vehicles employing traditional "go-long" strategies, the flexibility in the hedge fund structure enables strategies that attempt to produce positive returns in both bull and bear markets; that is, providing opportunities for generating "alpha" or excess returns, even in thriving years, and for capital protection (or better) in declining markets. It is worth noting that as the hedge fund industry grows and becomes

[1] The data about the hedge fund industry are not precise. Therefore, many of the figures noting the size and growth of the industry are estimates and Treasury has not independently verified them.

more mature and institutionalized, excess returns have become harder to find. In addition, a common technique employed by many hedge funds attempting to generate excess returns is employing leverage, which, of course, presents its own specific set of concerns.

While hedge funds can provide benefits to investors and the overall marketplace, they present some risk as well. There are risks that hedge funds' aggregate employment of large amounts of leverage or over-concentration of certain positions could have negative consequences for the marketplace. Certain valuation risks also are present in the hedge fund industry. Other risks involve operational challenges associated with the over-the-counter (OTC) clearance and settlement systems. Many of these risks, however, are not unique to hedge funds.

Leverage refers to the use of repurchase agreements, short positions, derivative contracts, loans, margin, and other forms of credit extension to amplify returns. With increased leverage, of course, comes increased risk. As discussed by the PWG in its report after the LTCM failure, excessive leverage can greatly magnify negative effects of market conditions. Linked closely with the issue of leverage and the potential for impaired liquidity in a period of market stress is the issue of concentration of market positions or "crowded trades." Sometimes referred to as "herding," crowded trades can arise to the extent that hedge fund managers are inclined to pursue the same or similar investment strategies. If numerous market participants establish large positions on the same side of a trade, especially in combination with a high degree of leverage, this concentration can contribute to a liquidity crisis if market conditions compel traders simultaneously to seek to unwind their positions. The risk, of course, is market disruption and illiquidity, possibly exacerbating the risk of a systemic financial market crisis.

As hedge funds become larger, their valuation policies and procedures become more important to the marketplace as a whole. Valuation is often dependent on complex proprietary models, but because of their proprietary nature, these models have not been subject to broad-based scrutiny and there is a concern that there could be unanticipated changes that might only present themselves in certain market conditions. Moreover, valuation concerns are exacerbated in the hedge fund industry because hedge fund adviser compensation is tied to period returns which, of course, requires periodic asset valuations. With respect to OTC settlement and clearance systems, hedge funds as a group do not pose a greater operational risk than any other group of market participants. However, operational risks can be posed by certain market conditions and certain technological conditions in certain *products*, particularly *new* products, where technological and legal infrastructures tend to lag product development and volume growth. These acute "growing pains" have developed most recently in the credit derivatives market across a wide spectrum of participants.

Thus, hedge funds, or any other group of participants, potentially could have a disruptive impact if there were concentrations of positions or attempted mass liquidation in illiquid markets. However, many of these issues and concerns have been or are actively being addressed—outside of a formal scheme of direct regulation of hedge funds—both by policymakers and by private sector groups.

In its report on LTCM, the PWG cautioned that problems can arise when financial institutions do not employ sufficient discipline in their credit practices with customers and counterparties. To this end, the PWG made several recommendations designed to help buttress the market-discipline approach to constraining leverage. Numerous public and private sector groups, such as Counterparty Risk Management Group II (also known as the Corrigan Group), also took up the cause of enhancing counterparty credit risk management, and many have continued to focus on emerging developments such as the growth of products containing embedded leverage. These efforts and others have had the positive effects that I alluded to earlier.

Valuations and correlations also can change rapidly in unexpected ways and these changes can have a ripple effect in the marketplace, especially if the instruments are concentrated and illiquid. In July 2005, the Corrigan Group issued a number of "guiding principles" and recommendations for all types of participants. It recommended that: (1) investment in risk management systems should continue, with full model testing and validation and independent verification; and (2) analytics should include stress testing, scenario analysis, and expert judgment, with special attention to the inputs and assumptions.

The Federal Reserve Bank of New York, Counterparty Risk Management Group II, Bank for International Settlements, International Swap and Derivatives Association, The Bond Market Association, and Depository Trust & Clearing Corporation all have made recommendations or undertaken efforts to strengthen the technological and legal aspects of the settlement and clearance systems for all market participants. The International Monetary Fund has also raised issues generally related to market concentrations and illiquidity and the potential for systemic risk in its recent "Global Financial Stability Report," and member countries and regulators continue to develop and coordinate policies and approaches to deal with these issues globally.

Treasury and the PWG can contribute significantly to these policy debates in the first instance by facilitating communication in the official sector and with industry participants and academics regarding credit risk management, concentration of risks, valuation techniques and models, and clearance and settlement systems. While the PWG continues to discuss these issues and formulate and coordinate actions and plans, we are encouraged by these positive developments noted above.

Regulation of Hedge Funds

The PWG's position on direct regulation of hedge funds

In its 1999 report on LTCM, the PWG was mainly concerned about the systemic risks posed by hedge funds and other highly leveraged institutions. Specifically, the PWG was concerned that excessive and unconstrained leverage could, in an episode of unusual market stress, lead to a general breakdown in the functioning of the financial markets. Accordingly, the PWG made a series of recommendations designed to encourage hedge funds, hedge funds' counterparties, and regulators to focus on enhancing market-wide practices for counterparty risk management. A number of the private sector initiatives I have already mentioned were initiated in direct response to the PWG's recommendations.

One recommendation the PWG did not make, however, was for the direct regulation of hedge funds. The PWG stated that, "if further evidence emerges that indirect regulation of currently unregulated market participants is not working effectively to constrain leverage," then direct regulation of hedge funds, among other measures, "could be given further consideration to address concerns about leverage." Even with that caveat, the PWG took care to emphasize that it believed its recommendations "would best address concerns related to systemic risk without the potential attendant costs of direct regulation of hedge funds." To date, the PWG has not observed evidence that "indirect" methods of constraining leverage are not working effectively.

SEC Hedge Fund Adviser Registration Rule

In late 2004, the Securities and Exchange Commission (SEC) issued a final rule that required hedge fund advisers to register with the Commission, mainly out of a perceived need to address increasing instances of hedge fund fraud and a concern that less sophisticated investors were becoming increasingly exposed to hedge fund investments, either directly or indirectly through their pension plans. The rule went into effect on February 1, 2006, prompting more than 1,100 previously unregistered hedge fund advisers to register with the SEC.

Neither Treasury nor the PWG ever took a formal position on the rule. We did work with the SEC, however, both bilaterally and through the PWG, to make sure we understood the SEC's rationale for their rule, and what their goals and expectations were regarding its implementation. Although we did not formally comment on the SEC's proposed rule, we did ask the SEC to work with the Commodity Futures Trading Commission (CFTC) to avoid potential duplicative registration requirements for CFTC-registered commodity pool operators and commodity trading advisers.

This past June, the U.S. Court of Appeals for the D.C. Circuit ruled that the SEC's hedge fund adviser registration rule was arbitrary in the way it redefined the term "client" so as to bring hedge fund advisers under the registration requirements of the Investment Advisers Act, and the court therefore vacated the rule. SEC Chairman Cox, in his statement on the Court's decision, expressed a very pragmatic approach to dealing with this decision. He noted that the SEC will continue to work with the PWG as it reevaluates its approach to hedge fund activity and as the SEC considers alternative courses of action. We look forward to working with Chairman Cox and the SEC staff on these issues.

Conclusion

Thank you again for allowing the Treasury Department to participate this afternoon. As I have mentioned, the question of the regulation of hedge funds must be carefully considered in light of the important role they play in our financial markets.

It is for that reason that Treasury is examining in detail the issues I have discussed this morning, with a view to evaluating whether the growth of hedge funds—as well as other phenomena such as derivatives and additional alternative investments and investment pools—hold the potential to change the overall level or nature of risk in our markets and financial institutions. This examination will involve bringing key government officials together to review their approaches to these financial market issues. The first such meeting was held last week, chaired by Assistant Secretary of the Treasury Emil Henry, and will be followed by further discussions in the future. We are also beginning a broad outreach to the financial community to help us examine these questions. As part of this comprehensive review chaired by the Treasury, we will be working with the SEC—both bilaterally and through the PWG—as Chairman Cox and the Commission consider alternative courses of action following the D.C. Circuit Court's recent decision.

Looking forward, we will be focused on seeking to understand in the most comprehensive way possible whether and how changes in the structure of the financial services industry—of which the rapid growth of new forms of capital accumulation, such as hedge funds, is just one example—have materially affected the efficiency with which markets intermediate risk, whether risk is pooled in different ways or in different places than it has been in the past—and if so, what appropriate policy responses might be. We will seek to be forward looking and to think about these changes not in a fragmented fashion, but in a comprehensive way. At the moment it is too soon to say what initiatives will result from this focus, but this is the lens through which we will filter the various ideas and efforts with which we will all be grappling over the next few years.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM CHRISTOPHER COX

Q.1. I read last week that at least 10 hedge fund managers have filed to de-register since the D.C. Circuit struck down the S.E.C.'s registration requirement. How many fund advisers have moved to deregister since the ruling last month, and did you get any valuable information from those who did register?

A.1. As of September 14, 106 investment advisers to hedge funds have withdrawn from SEC registration since the Court of Appeals for the District of Columbia Circuit issued the *Goldstein* opinion. Information filed by these investment advisers indicates that almost 40% of them withdrew for reasons unrelated to the Court's ruling. Some 1260 hedge fund advisers registered with the Commission because of the rulemaking, and we have no reliable way to estimate how many of them will eventually withdraw their SEC registrations, or for what reasons. We suspect that withdrawals will continue for the next several months as hedge fund advisers evaluate their options. Many hedge fund advisers and their attorneys have informed us that they plan to remain registered; some have changed their business model or accepted new clients so that they must remain registered, while some others are choosing to remain registered because their investors demand it. To smooth the transition, the Commission's staff provided no-action and interpretive responses to a letter from the American Bar Association that addressed many issues that arose from the Court's decision. The staffs response is available at *http://www.sec.gov/divisions/investment/noaction/aba081006.pdf.*

The Commission did get valuable information from the hedge fund advisers that registered. First, as the Commission pointed out in the adopting release, prior to the rule's adoption no government agency had any reliable data on basic census information on hedge fund managers. From the information hedge fund advisers filed with us, we were able to construct the most comprehensive picture to date of hedge fund advisers operating in the United States or managing money for U.S. investors. Data included the number of advisers, number of funds, hedge fund adviser disciplinary information, and the advisers' financial industry affiliations. The information that we have collected has also assisted the Commission's Office of Compliance Inspections and Examinations in carrying out its risk-based examination program, which has lead to several referrals to our Division of Enforcement for further review. We will continue to collect data from registered hedge fund advisers, but as some hedge fund advisers withdraw their registrations and some new hedge fund advisers choose not to register the data will be incomplete.

Q.2. As the hedge fund industry has evolved, even more people are getting in to hedge funds through different investment vehicles such as funds of funds. Without unified regulation, do people have an unfair advantage in the market by being able to choose an investment that is unregulated? And does the current system of regulation give the larger investor such as the university endowment fund an unfair advantage over a small individual investor?

A.2. In many cases, both Congress and the Commission have operated under a long-standing principle that wealthy or sophisticated investors have the ability to protect themselves (or hire experts to help them protect themselves) and therefore have access to certain investments that others may not have. I think this approach has served both retail and institutional investors well, and am uncertain of the benefits of alternative approaches that might need to either (i) treat all investors as institutional investors and thus eliminate important investor protections afforded to retail investors, or (ii) treat all investors as retail investors and deny institutional and similar investors access to useful investments such as hedge funds.

Q.3. I asked Mr. Quarles this question at the last hearing on hedge funds, so now I am going to ask Chairman Cox and Chairman Jeffery. In a regulated mutual fund industry, many questionable practices that were not in the best interest of the individual investor and the markets had to be regulated by government intervention. Why would we assume in a lightly regulated hedge fund industry that we wouldn't encounter similar indiscretions by managers? And do you think transparency requirements should be similar for mutual funds and hedge funds?

A.3. The Commission has not assumed that hedge fund managers would be less likely to participate in questionable or illegal practices. Indeed, one reason for the Commission's rulemaking was the growing number of enforcement actions we were bringing against hedge fund managers. We remain concerned about malfeasance in this area and are considering how to address it through further rulemaking. While there may be a need for some amount of greater transparency of hedge funds (such as that suggested by the President's Working Group on Financial Markets in 1999), I believe that requiring transparency similar to that required of mutual funds would be unwise. Disclosure of portfolio positions could undermine some of the types of investment strategies pursued by hedge funds.

Q.4. Have you seen evidence of market manipulation by hedge funds?

A.4. Yes. In fact, the Commission has brought enforcement cases against hedge fund managers that have involved either market manipulation or illegal short-selling.

The Commission has brought an action alleging that hedge fund advisers manipulated the market by creating the appearance of greater demand for two stocks than actually existed. *SEC v. Scott Sacane et al.* (Oct. 2005). The individual defendants in that case both pled guilty to related criminal charges and have been barred by the Commission from associating with an investment adviser. One defendant has settled the Commission's civil action, paying disgorgement and a civil penalty.

The Commission has also brought an enforcement action against a hedge fund manager for scalping. *SEC v. Berton M. Hochfeld* (Nov. 2005). The Commission alleged that the defendant, while employed as a research analyst with a broker-dealer, failed to disclose in research reports distributed to the broker's clients, that a hedge fund he controlled maintained positions in stocks that were the subjects of his research reports. On numerous occasions, he allegedly directed trades in the subject stocks immediately after the issuance of his research reports that was contrary to the information in the reports.

In another case, *SEC v. Michael Lauer, Lancer Management Group, LLC, et al.*, (July 23, 2003), the Commission alleged that the defendants systematically manipulated the month end closing prices of certain securities held by their funds to overstate the value of the funds' holdings. The complaint alleged that the manipulative trading practices employed by the defendants were designed to attract new investors and to induce current investors to stay in the funds and to raise the value of the funds, both of which resulted in increased management fees paid to the defendants.

The short selling cases can be generally categorized into two groups. The first group involved allegations of illegal activities in connection with "PIPE" ("Private Investment in Public Equity") transactions. *SEC v. Hilary Shane* (May 2005); *SEC v. Langley Partners* (March 2006); and *SEC v. Deephaven Capital Management* (May 2006). While the specific facts alleged in each case vary, the general pattern is as follows: In these cases, the Commission has alleged that hedge fund advisers have agreed to buy public company shares in a private offering from the issuer on a confidential basis. The PIPE transaction will dilute the public float, which may decrease the issuer's share price. The hedge fund adviser then misuses its knowledge of the impending PIPE to sell shares of the public company short, profiting when the share price decreases due to the dilutive effect of the PIPE transaction that it entered into. The second group involved allegations of rule violations regarding the source of shares used to cover short sales. *In the Matter of Galleon Management* (May 2005); *In the Matter of Oaktree Capital* (May 2005); and *In the Matter of DB Investment Managers* (a subsidiary of Deutsche Bank) (May 2005). These actions allege violations of a rule that prohibits covering a short sale with securities obtained in a public offering if the short sale occurred within five business days before the pricing of the offering.

Q.5. Have you seen evidence of systemic risks or instability caused by hedge funds?

A.5. There were two episodes over the past two years during which a significant number of hedge funds experienced losses. In May 2005, credit rating agencies' downgrade of the U.S. automobile manufacturing sector precipitated a painful period for a number of hedge funds that traded credit derivatives. A year later, in May 2006, a spike in equity and emerging market debt volatility resulted in losses for a number of hedge funds trading in those markets. During neither of these events did we see any evidence that hedge funds were having difficulty in meeting collateral calls from prime brokers or over-the-counter derivatives counterparties. Such difficulties would be early warning signs of events that might have systemic implications for the broader financial system.

Nonetheless, we continue to encourage the major securities firms that we supervise on a consolidated basis to strengthen their credit and operational risk management infrastructure, which will further reduce the likelihood of systemic instability. A useful blueprint in this regard remains the report published by the Counterparty Risk Management Policy Group in July 2005 entitled *"Toward*

Greater Financial Stability: A Private Sector Perspective." We have regular discussions with firms under our supervision regarding their progress in implementing the recommendations regarding the management of exposures to hedge funds produced by that industry group.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM CHRISTOPHER COX

Q.1. Chairman Cox, will the SEC appeal the *Goldstein* decision or seek a rehearing? When does the SEC intend to make public its position with respect to the decision? Will advisers who registered under the rule be required to file a Form ADV–W to withdraw their registrations?

A.1. On August 7, 2006, I issued a statement (available at *http://www.sec.gov/news/prcss/2006/2006-13S.htm*) indicating that the Commission would not seek en banc review of the Goldstein decision or petition the U.S. Supreme Court for a writ of certiorari. Any adviser that wishes to withdraw its registration with the Commission must file Form ADV–W. As noted earlier, we believe a substantial number of hedge fund advisers will need to, or choose to, remain registered.

Q.2. In the past, the PWG has rejected direct regulation of hedge funds. Can you tell us a little more about what is involved in fostering market discipline in the hedge fund context and if this is a superior approach to direct regulation?

A.2. Market discipline in the hedge fund context relies on adequate information reaching participants, including counterparties and investors. The Commission has always supported dissemination of adequate information so that investors and counterparties can make informed decisions and the market can act efficiently. Because hedge funds are offered privately, this information exchange is often privately negotiated. The Commission, of course, would take appropriate action in the event of fraud.

Q.3. The media and the press always tend to suggest that hedge funds are unregulated or that hedge funds are the wild west of capital markets. It that true? It is my understanding that hedge funds are subject to the same anti-fraud and anti-manipulation requirements as any other market participant, as well as a host of other rules and regulations. Can you please clarify this for the record by providing a list of all the rules and regulations hedge funds and their activities therein, are subject?

A.3. Press articles typically refer to hedge funds as "lightly regulated" investment pools. In a sense, they are correct. Hedge funds are organized and operated so that they are not subject to the Investment Company Act of 1940. In addition, hedge funds issue securities in "private offerings" that are not registered with the Commission under the Securities Act of 1933, and hedge funds are not required to make periodic reports under the Securities Exchange Act of 1934. After the *Goldstein* decision some hedge fund advisers will not be registered under the Advisers Act. Further, until the Commission adopts a new rule, hedge fund advisers may not have the same fiduciary obligations as other advisers.

However, hedge funds are subject to the same prohibitions against fraud as are other market participants. In addition, they are or may be—depending upon their investment and offering activities—subject to provisions of state, federal and foreign securities laws too numerous to comprehensively list. These include:

- Registration with and regulation by the Commission as a broker-dealer, as an investment adviser, or registration of the hedge fund or its securities);
- Compliance with Regulation D in making the private placements of their securities.
- Compliance with position and transaction reporting under rules of the SEC, CFTC and Federal Reserve Board.
- Compliance with commodities laws and regulations, including registration requirements, that may apply if the hedge fund is trading in futures.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM REUBEN JEFFERY, III

Q.1. I asked Mr. Quarles this question at the last hearing on hedge funds, so now I am going to ask Chairman Cox and Chairman Jeffery. In a regulated mutual fund industry, many questionable practices that were not in the best interest of the individual investor and the markets had to be corrected by government intervention. Why would we assume in a lightly regulated hedge fund industry that we wouldn't encounter similar indiscretions by managers? And do you think transparency requirements should be similar for mutual funds and hedge funds?

A.1. As the Committee is aware, the Commodity Futures Trading Commission ("CFTC") does not regulate mutual funds and I will defer to Chairman Cox to respond with respect to issues concerning them. Under the Commodity Exchange Act ("Act"), the CFTC has jurisdiction over persons who operate and advise collective investment vehicles that trade CFTC-regulated commodity futures and options contracts. Generally speaking, those who operate or manage a commodity pool must register with the CFTC as CPOs, and those who make trading decisions on a pool's behalf must register as CTAs. Some of these commodity pools, or collective investment vehicles, have been commonly referred to as "hedge funds." The CFTC does not use that term because neither the Act nor CFTC regulations refer to that term nor define it.

Pursuant to the Act's investor protection mandate, the CFTC has implemented a regulatory scheme for CPOs and CTAs that fosters full and timely disclosure intended to protect investors from abusive or overreaching sales practices by persons who operate or advise commodity pools. Registration is the cornerstone of this scheme. The primary purposes of registration are to ensure a person's fitness to engage in business as a futures professional and to identify those persons whose activities are covered by the CEA. Notable exclusions or exemptions from registration are available for operators of pools that are otherwise regulated; that have only sophisticated participants and de minimis commodity interest trading; and that have only the very highest level of sophisticated participants, regardless of the amount of commodity interests traded. Hedge fund operators frequently fall within one of the latter two exemptions from CPO registration. Irrespective of registration status, all CPOs and CTAs are subject to the anti-fraud and anti-manipulation prohibitions of the Act and CFTC regulations and they must make their books and records available to the CFTC and National Futures Association ("NFA"), a futures industry's analogue to the National Association of Securities Dealers, upon request.

Registration triggers certain disclosure, reporting, and recordkeeping requirements designed to ensure that prospective and current participants in commodity pools receive all the information that is material to their decision to make, or maintain, an investment in the pool. For example, prospective participants must receive information regarding the pool's investment program, risk factors, conflicts of interests, and performance data and fees. Thereafter, a CPO must provide pool participants with an account statement at least quarterly, and an annual report containing specified financial statements which must be certified by an independent public accountant and presented in accordance with Generally Accepted Accounting Principles.

The oversight functions of CPOs and CTAs are carried out by the NFA. In this capacity, NFA is responsible for registration processing, review of CPO and CTA disclosure documents, review of commodity pool annual reports and related extension filings, and processing of exemption notices under Part 4 of the Commission's regulations. In addition, NFA monitors CPO and CTA sales practices and conducts periodic examinations of CPOs and CTAs.

The CFTC maintains an oversight role with respect to NFA's performance. CFTC staff engages in ongoing communication and coordination with NFA with regard to NFA's supervision of CPO and CTA compliance. For example, NFA and CFTC staff members meet quarterly to discuss registration issues, meet as needed to discuss CPO and CTA oversight issues, and communicate frequently on issues that must be handled promptly. In addition, Commission staff conducts periodic oversight examinations of NFA's compliance program for CPOs and CTAs. The most recent oversight examination was completed in early 2006.

The CFTC takes very seriously its responsibility to protect investors—whether directly or through participation in a professionally managed fund—in the futures markets. Toward that end, the CFTC works to ensure that investors participating in commodity pools receive all the information that is material to their decision to invest in pools, and when problems are uncovered, devotes the full force of the CFTC's enforcement authority to prosecuting those responsible.

Q.2. Since we are talking about hedge funds today, how much do you think hedge fund activity in the commodities sector has contributed to a hike in energy and commodity prices?

A.2. The energy market is perhaps one of the most difficult commodity sectors in which to isolate individual factors that influence prices. These markets are subject to significant geopolitical influences, they involve complex inter-product pricing structures due to the large number of refined products that are derived from crude oil and natural gas, and there have been extensive changes and shifts in the underlying demand and supply fundamentals over the past 5 years, which have significantly impacted prices.

In a study of large traders in energy markets first issued last year by the CFTC's Office of the Chief Economists, the staff concluded that overall, the exchange-traded futures-trading of hedge funds does not appear to have exerted appreciable upward pressure on energy prices. This study indicates that non-commercial traders, a category of traders that generally includes "speculators" and hedge funds, are more likely than not are responding to position changes by commercial traders (i.e., companies or individuals with commercial interests in the commodity underlying the futures contracts). In other words, when a commercial trader sells, it will often be a non-commercial trader who takes the other side of the transaction as the buyer. When a commercial trader buys, it will often be a non-commercial trader who is the seller. This observation is consistent with the notion that non-commercial traders respond to price changes and are not the cause of price changes.

Surveillance data on large non-commercial traders also does not infer a significant price impact by hedge funds. Large non-commercial traders typically hold positions on both sides of the market, although they have tended to be slightly net long in their overall positions. For example, as of September 5, 2006, large non-commercial traders held 15.3% of long open interest and 11.3% of short open interest in the NYMEX crude oil contract. In the unleaded gasoline contract, they held 12.8% of long open interest and 10.1% of short open interest. An exception to this pattern is the gasoline blendstock, or RBOB, contract where non-commercials held 16.1% of the long open interest, but only 1.1% of short open interest. Nonetheless, despite being net long in these contracts, prices have fallen significantly over the period. This observation is contrary to the argument that the net long positions of non-commercials, and hedge funds in particular, have lifted prices. It should also be noted that that typically well over half of the open interest in these markets is held by large commercial entities.

In addition to holding outright long and short positions in energy markets, large non-commercials hold significant calendar spread positions. Such positions tend to be neutral in their effect on price levels. Spread positions are structured to speculate on relative price differences (e.g., prices for October delivery vs. prices for November delivery), and when structured as such, are unrelated to the overall level of futures prices for individual commodities and therefore are not responsible for changes in the level of these prices. As of September 5, 2006, large non-commercial traders held spread positions equal to 20% of the crude oil market, 13.1% of the heating oil market and 38.6% of the natural gas market.

In addition to calendar spreads, it is unknown what portion of the outright positions reflected in the surveillance data are positions held by large non-commercials that represent product spreads, such as the crack spread, which is a position between related products (crude oil and refined products). Again, positions related to such spreads would not tend to influence the overall level of prices in the energy complex.

Q.3. Have you seen evidence of market manipulation by hedge funds?

A.3. Commission surveillance staff monitors on an ongoing basis trading activity in all futures contracts on the regulated futures exchanges to detect and prevent market manipulation. The backbone of the CFTC's market surveillance program is its Large Trader Reporting System. This system captures end-of-day position-level data for market participants meeting certain criteria. Positions captured in the Large Trader Reporting System typically make up 70 to 90 percent of all positions in a particular exchange-traded market. The Large Trader Reporting System is a powerful tool for detecting the types of concentrated and coordinated positions required by a trader or group of traders attempting to manipulate the market. For surveillance purposes, the large trader reporting requirements for hedge funds are the same as for any other large trader.

The Commission's surveillance staff closely monitors large positions, particularly in expiring futures contracts, to detect and deter manipulation, market abuses, market disruptions and other sources of price distortion. Surveillance seeks to prevent these problems before they occur and surveillance staff has been involved in all actively traded exchange futures contracts with a very wide assortment of traders. Should the Commission suspect that there is evidence that manipulation has occurred, or even has been attempted; the matter may be referred to the Commission's enforcement staff. While the Commission staff has reviewed the activities in the futures markets of certain hedge funds as part of inquiries and analysis of whether certain activity was legal, the Commission has not filed a complaint alleging manipulation against a hedge fund.

Q.4. Have you seen evidence of systemic risks or instability caused by hedge funds?

A.4. The activities of managed money accounts in the futures markets regulated by the CFTC have not created systemic risk to date. Although managed money accounts have incurred substantial losses in futures markets, these situations have not had systemic effects. In such cases, losses have not spilled over as brokerage firms and clearing organizations continued to meet all their obligations. The CFTC has noted however, that potential risk is increasing as managed money accounts establish larger and more complex positions in the futures markets. Consequently, CFTC financial surveillance efforts have focused increasingly on such accounts.

Through the large trader reporting system, staff can identify the traders with the largest positions. Using internally-developed tools, staff can stress test the positions to identify potential losses the account might incur in extreme market moves. These potential losses can be compared to the margin requirements for the positions and to the capital resources of the brokerage firm carrying the account. To the extent these comparisons raise concerns; staff can contact the clearing organization, the brokerage firm, and/or the trader to determine what steps are being taken to mitigate the risks. Staff continues to work to refine its techniques.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM REUBEN JEFFERY, III

Q.1. Chairman Jeffrey, in a Financial Times article on July 20th, you were quoted responding to a Permanent Subcommittee on Investigation's staff report titled: "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat." You were quoted as saying: "I can't resist taking exception to the notion that the cop has not been on the beat. Our enforcement experience over the past several years belies that notion and shows a strong record of commitment and vigilance in the area of anti-manipulation and false reporting in the energy sector." Would you please expand upon these comments?

A.1. The Commission maintains its commitment to addressing potential problems in the energy markets through a combination of vigilant surveillance and vigorous enforcement.

Commission surveillance staff monitors on an ongoing basis trading activity in all futures markets to detect and prevent market manipulation. Commission staff also routinely consults with staff from the Federal Energy Regulatory Commission (FERC) and the Energy Information Administration in analyzing events in these energy markets.

The Commission's Division of Enforcement has broad authority to conduct investigations to determine whether any persons have violated, are violating, or are about to violate the provisions of the Commodity Exchange Act. For example, since December 2002 the Enforcement Program has investigated energy market conduct that potentially involved: (1) false reporting of natural gas trading to companies that compile and publish natural gas index prices for delivery hubs throughout the United States; and/or 2) attempts to manipulate and/or manipulation of natural gas index prices. In addition, the Enforcement Program's investigation of the TET physical propane market resulted in the Commission's filing of an enforcement action against BP Products North America, Inc. charging manipulation and attempted manipulation.

From December 2002 to date, the Commission has filed a total of 34 enforcement actions charging a total of 54 respondents/defendants (30 companies and 24 individuals). The Commission has settled 25 of these enforcement actions and obtained $298,263,500 in civil monetary penalties. Nine CFTC energy market-related enforcement actions remain pending. Complementing the effect of its direct enforcement action, the Commission has also achieved great success in this program area by working cooperatively with the Department of Justice on criminal actions.

The Commission's energy market enforcement actions only tell a part of the story, however, because certain Enforcement Program investigations conclude that no misconduct occurred and the energy markets were operating properly. For example, while it is the Commission's policy to not publicly comment on its investigations, in August 2004 the Commission announced the completion of its seven-month investigation of the sharp upward movement in prices in the natural gas market that occurred in late 2003 when natural gas futures contracts more than doubled in price within a short period. The Commission's investigation did not uncover evidence that any entity or individual engaged in activity with an intent to cause an artificial price in natural gas. According to the information obtained during the investigation, the increase in natural gas prices during that time was the result of distinct factors, including market reaction to colder than expected weather in the northeast United States during the first week in December 2003, and market statements and projections regarding the inventory of natural gas in underground storage caverns made in late November/early December 2003.

The Commission's 25 settled energy market enforcement actions include: *In re Dynegy Marketing & Trade, et al.*, CFTC Docket No. 03–03 (CFTC filed Dec. 18, 2002) ($5 million civil monetary penalty); *CFTC v. Enron Corp., et al.*, No. H–03–909 (S.D. Tex. filed March 12, 2003) ($35 million civil monetary penalty; *CFTC v. Hunter Shively*, No. H–03–909 (S.D. Tex filed March 12, 2003) ($300,000 civil monetary penalty); *In re El Paso Merchant Energy, L.P.*, Docket No. 03–09 (CFTC filed March 26, 2003) ($20 million civil monetary penalty); *In re WD Energy Services Inc.*, Docket No. 03–20 (CFTC filed July 28, 2003) ($20 million civil monetary penalty); *In re Williams Energy Marketing And Trading, et al.*, Docket No. 03–21 (CFTC filed July 29, 2003) ($20 million civil monetary penalty); *In re Enserco Energy, Inc.*, Docket No. 03–22 (CFTC filed July 31, 2003) ($3 million civil monetary penalty); *In re Duke Energy Trading And Marketing, L.L.C.*, Docket No. 03–26 (CFTC filed Sept. 17, 2003) ($28 million civil monetary penalty); *CFTC v. American Electric Power Company, Inc., et al.*, No. C2 03 891 (S.D. Ohio filed Sept. 30, 2003) ($30 million civil monetary penalty); *In re CMS Marketing Services and Trading Company, et al.*, Docket No. 04–05 (CFTC filed Nov. 25, 2003) ($16 million civil monetary penalty); *In re Reliant Energy Services, Inc.*, Docket No. 04–06 (CFTC filed Nov. 25, 2003) ($18 million civil monetary penalty); *In re Harmon*, Docket No. 03–25 (CFTC filed Jan. 16, 2004) ($8,500 civil monetary penalty); *In re Aquila Merchant Services, Inc.*, Docket No. 04–08 (CFTC filed Jan. 28, 2004) ($26.5 million civil monetary penalty); *In re Calpine Energy Services, L.P.*, CFTC Docket No. 04–11 (CFTC filed Jan. 28, 2004) ($1.5 million civil monetary penalty); *In re ONEOK Energy Marketing And Trading Company, L.P., et al.*, Docket No. 04–09 (CFTC filed Jan. 28, 2004) ($3 million civil monetary penalty); *In re Entergy-Koch Trading, LP*, Docket No. 04–10 (CFTC filed Jan. 28, 2004) ($3 million civil monetary penalty); *In re e prime, Inc.*, Docket No. 04–12 (CFTC filed Jan. 28, 2004) (a wholly-owned subsidiary of Xcel Energy, Inc.; $16 million civil monetary penalty); *In re Knauth*, Docket No. 04–15 (CFTC filed May 10, 2004) ($25,000 civil monetary penalty); *In re Western Gas Resources, Inc.*, Docket No. 04–17 (CFTC filed July 1, 2004) ($7 million civil monetary penalty); *In re Coral Energy Resources, L.P.*, Docket No. 04–21 (CFTC filed July 28, 2004) ($30 million civil monetary penalty); *In re Biggs*, Docket No. 04–22 (CFTC filed Aug. 11, 2004) ($30,000 civil monetary penalty); *In re BP Energy Co.*, Docket No. 05–02 (CFTC filed Nov. 4, 2004) ($100,000 civil monetary penalty); *In re Cinergy*, CFTC Docket No. 05–03 (CFTC filed November 16, 2004) ($3 million civil monetary penalty); *In re Mirant*, CFTC Docket No. 05–05 (CFTC filed Dec. 6, 2004) ($12.5 million civil monetary penalty); *In re McKenna*, CFTC Docket No. SD 05–03 (CFTC May 20, 2005) (registration revocation); and *In re*

Shell Trading US Company, et al., CFTC Docket No. 06–02 (CFTC filed Jan. 4, 2006) ($300,000 civil monetary penalties).

The Commission's nine pending energy market enforcement actions include: *CFTC v. NRG Energy, Inc.*, No. 04–cv–3090 MJD/JGL (D. Minn. filed July 1, 2004) (charging false reporting); *CFTC v. Bradley, et al.*, No. 05CV62–CVE–FHM (N.D. Okla. filed Feb. 1, 2005) (charging false reporting and attempts to manipulate); *CFTC v. Johnson, et al.*, No. H–05–0332 (S.D. Texas filed Feb. 1, 2005) (charging false reporting and attempts to manipulate); *CFTC v. McDonald, et al.*, No. 1:05–CV–0293 (N.D. Ga. filed Feb. 1, 2005) (charging false reporting and attempts to manipulate); *CFTC v. Whitney*, No. H 05–333 (S.D. Texas filed Feb. 1, 2005) (charging false reporting and attempts to manipulate); *CFTC v. Reed, et al.*, No. 05–D–178 (D. Colo. filed Feb. 1, 2005) (charging false reporting and attempts to manipulate); *CFTC v. Richmond*, No. 05–M–668 (OES) (D. Colo. filed April 12, 2005) (charging false reporting and attempts to manipulate); *CFTC v. Foley*, No. 2:05 849 (S.D. Ohio filed Sept. 14, 2005) (charging false reporting and attempted manipulation); and *CFTC v. BP Products North America, Inc.,* No. 06C 3503 (N.D. Ill. filed June 28, 2006 (charging manipulation, cornering the market, attempts to manipulate).