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HEDGE FUNDS AND SYSTEMIC RISK: PERSPECTIVES OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

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HEDGE FUNDS AND SYSTEMIC RISK: PERSPECTIVES OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS

Wednesday, July 11, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Watt, Meeks, Capuano, Clay, McCarthy, Baca, Lynch, Scott, Green, Cleaver, Sires, Hodes, Klein, Mahoney, Boren; Bachus, Baker, Pryce, Castle, Royce, Shays, Capito, Feeney, Hensarling, Garrett, Brown-Waite, Neugebauer, McHenry, Campbell, Bachmann, and Marchant.

The CHAIRMAN. The hearing will begin. This is a hearing of the Financial Services Committee with the members of the President's Working Group, which I guess is about 20 years old. And it is part of a series of hearings we are having on the issue of hedge funds and private equity, the increase in the amount of financial activity that goes through.

We had a hearing earlier with some of the representatives of hedge funds themselves. We will continue to deal with this and we are pleased to have the President's Working Group before us.

I think, as I read the testimony, we have a kind of uneasy consensus that there is a potential problem here that we wish we were more sure about how to approach. I, for instance, read with great interest the speech by Assistant Secretary Ryan of the Treasury a couple of weeks ago. I don't think anybody can be confident that all is entirely well here, but neither is there any obvious thing we ought to be doing.

This is a matter for concern. It is an interesting issue in that it's a challenge to our regulatory system both within the United States and internationally. I mean the fact that we have a wide range of entities here, we have two quasi-independent commissions, and we have the Treasury and the Federal Reserve all with pieces of this.

We have obviously a very important interface with the international community, and I know that people don't generally believe this, but it is the case that sometimes, not often, I acknowledge, but sometimes, congressional committees have hearings because they want to know things. That's not the norm, but it is true today.

This is a subject of great importance and considerable uncertainty. There is obvious value to the activity of these entities. The market is not irrational. People profit because they are doing things that are ultimately beneficial, but there are also potential dangers.

In particular from this community standpoint I think, not all of us but most of us, is the potential for systemic risk. We are not here largely in an investor protection capacity. Particularly after what the SEC has done, we are not talking about small investors.

There is one exception to that. There is a great deal of concern about the potential for pension funds to get involved beyond what they should be doing. And I've talked to the chairman of the Committee on Education and Labor, Mr. Miller, who has jurisdiction there. We are going to be working at—one of the things we have to address is whether or not there should be some special rules regarding pension funds.

But beyond that, the question is systemic risk. The question is whether, given the proliferation of forms of investment that have high leverage, whether or not if there is a rapid change in the basic financial environment, people will be able to deal with the consequences. So far, there have been some good signs.

The Amaranth situation was a problem for people for whom it should have been a problem but it did not have broader systemic problems. It does not appear so now, but we'll be interested in people's sense of whether the Bear Stearns issue is going to be something that causes broader problems. But those have happened within a stable financial context.

The question, I guess, is what happens if the current financial context regarding international liquidity and interest rates were to change. And I don't think anyone thinks that's going to remain forever in both contexts. So what we are talking about is, are we now ready to deal with a potential problem, and if so, what should we be able to do about it and how do we get ready to do that without causing some damage?

So as I said, I regard this as a study that's ongoing, and I'm glad to say that it has been a collaborative one between the Congress and the various regulators and it's good to see them working together on this. And as I said, we are here to learn some things and to talk about things in general, and this is part of a continuing inquiry into this problem which is we have quantitatively, and as Marx said, "Changes in quantity can become changes in quality." We have what could be a qualitative change in the extent to which investment is carried on.

Our question is, does that pose potential problems, and is the regulatory structure adequate to this new set of issues. That's what we will be dealing with. I'll now recognize for 5 minutes the ranking member of the committee, the gentleman from Alabama.

Mr. BACHUS. I thank the chairman. I thank you for holding this hearing.

This is the third hearing we've held on the rapid growth of private pools of capital including hedge funds and private equity funds. I'd also like to associate myself with the remarks of the chairman when he said that we're unsure about what to do, and we're not confident about any action that we may take at this time.

So that is, as he said, a clear indication that we ought to be listening, we ought to be learning, but we should not be taking legislative action. What we are doing, I think, is very appropriate. We're talking with each of you, your agencies, and we're confident that the regulators appreciate the problems and we're also confident that you know more about it than we do.

We're really fortunate to have with us our four witnesses today. They are distinguished representatives of the Presidential Working Group on Financial Markets.

And the President's Working Group, as you all know, but the audience may not know, was formed in the wake of the 1987 stock market crash. It is chaired by the Treasury Secretary, and it is made up of the Chairmen of the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. It was formed to promote integrity, efficiency, orderliness, and competitiveness in our financial markets.

Since then, it has issued periodic reports on these issues affecting the U.S. markets including the 1999 report on Long Term Capital Management.

Earlier this year the President's Working Group endorsed an approach to hedge fund regulation that relies primarily on market pressures and incentives to contain risks. The group concluded, correctly in my opinion, that market discipline together with statutory limits restricting access to hedge funds to wealthy investors can sufficiently mitigate industry risk.

By emphasizing the importance of free market forces, rather than the hand of excessive government regulation, I believe that the President's Working Group struck the right balance in regulating and overseeing the activities of these highly innovative investment vehicles.

Hedge funds and private equity funds have in recent days, as we all know, become convenient targets for those favoring higher taxes and more government intervention in our capital markets. While this is certainly a debate worth having, I hope that it will be an informed debate, informed by the appreciation for the vital role that these private pools of capital play in an efficiently functioning market and their importance in maintaining America's competitive standing in the global economy.

Hedge funds actively pursue arbitrage opportunities across markets, and in the process often reduce or eliminate mispricing of financial assets. That actually can bring stability to a market.

As former Federal Reserve Chairman Alan Greenspan said, "Their willingness to take short positions can act as an antidote to the sometimes excessive enthusiasm of long-term investors. Perhaps more importantly, they often provide valuable liquidity to financial markets both in normal market conditions and especially during periods of stress.

"They can ordinarily perform these functions more effectively than other types of financial intermedia because their investors often have a greater appreciation for risk and because they are largely free from regulatory constraints on investment strategies."

Private equity funds offer tools for providing capital and expertise to underperforming companies and companies struggling with the tremendous pressure of the public markets to meet quarterly

earnings expectations in order to improve corporate performance. Private equity funds recruit top managers and directly tie compensation to long-term performance and growth. They develop strategic business plans and implement operational improvements to revitalize these companies in a manner that can only be achieved when the firm's owners are directly and actively engaged in its management.

Let me conclude by saying that hearings like the one we're having today are important because they allow Members of Congress to better understand the industries and markets we oversee. If Congress attempts to regulate or tax any specific sector of the financial services industry without a thorough understanding of the role it plays in our financial system the risk of unintended, unnecessary, burdensome and harmful regulation is real. The last thing we want to do is drive investment—whether it's hedge funds or private equity funds—and their capital offshore.

So I again commend Chairman Frank for his attention to this issue, and I welcome our distinguished guests.

The CHAIRMAN. Next, the gentleman from Louisiana, Mr. Baker, is recognized for 4 minutes.

Mr. BAKER. Thank you, Mr. Chairman, and thank you, Ranking Member Bachus, for the time. I have some significant questions about where we stand with this matter.

From the President's Working Group recommendations of April 1999, there were at that point in financial history some observations I think worthy of reviewing. The Working Group recommendations at that moment emphasize the promotion of sound risk management practices by all market participants and to allow individual market participants therefore to make more informed investment and credit decisions.

So the message in 1999 was to the market, get your act together so people can make informed decisions. I think some assessment of what has taken place from 1999 until now on the market side of the fence might be instructive for the committee to hear in light of the fact of market factors that have changed rather dramatically since 1999.

There was legislation that was filed pursuant to the 1999 report, H.R. 2924, implementing the Working Group recommendations, requiring, interestingly enough, the largest unregulated funds to disclose certain public information which was nonproprietary, including a new meaningful measurement of risk.

I also note that the internationally generally accepted FSA regime does require the larger funds to make such disclosure of nonproprietary information to enable governmental regulators to assess not only leverage, but the potential for systemic risk events. Consistent with the 1999 Working Group, H.R. 2924 did not call—and I can't make this any more clear—for direct regulation, but instead provides for enhanced public disclosure by only those funds that, if large enough, if one were to fail, that failure could potentially pose systemic risks to those innocent third parties.

That set of findings and comments were made by Mr. Sachs, who was then the Assistant Secretary for Financial Markets for the Department of the Treasury. Mr. Patrick Parkinson's comments, who was an Associate Director, Division of Research, for the Federal Re-

serve, went on to say that there was strong support for the 1999 Working Group recommendations and that the very largest funds should be required to publicly disclose information about their financial activities.

The only modification to H.R. 2924 suggested by the Fed at that time was that the disclosure should be made to the SEC rather than the Federal Reserve Board because of the SEC's broader responsibilities in the field of public disclosure.

My point is that from 1999 until now, it is not only the explosive growth in the number of funds, but the enormity of growth in individual's funds. The advent of the fund of funds, which enables the $25,000 investor to take on risks that were intended for sophisticated, qualified investors and that pension funds now, as a matter of practice, routinely invest in funds for which I do not believe fund managers necessarily are adequately equipped to assess the risk for which the third parties they represent are undertaken.

I foresee a circumstance in which an Amaranth matter might lead to significant upheaval in State pension funds of some region. I can think of several in my own State that have displayed significant inadequate governance capabilities that would then lead to a school teacher or a fireman or a policeman to find their reserves for retirement dissipated because the fund manager did not fully understand the counterparty risk that the hedge fund investment really represented.

I don't have a remedy for this problem, but I have an observation about what the recommendations may mean if not fully heeded by the market, if the 2007 Working Group recommendations and that message is not fully received. And I have concerns because the message was sent in 1999, and I don't know that market discipline has yielded any regulatory constraints in market practice. Should we have one of those undesirable events I read from the 1999 Working Group report, page 26, "Generally government regulation becomes necessary because of a market failure or the failure of pricing mechanisms to account for all social costs. Government regulation of markets is largely achieved by regulating financial intermediaries who have access to the Federal safety net, the banks, that play a central dealer role or that raise funds from the general public. Any resort to governmental regulation should have a clear purpose and be carefully evaluated in order to avoid unintended consequences."

I think here my cautionary note is if self-regulation in the market does not work, and we have an untoward event, the resulting actions of this Congress will be very unhelpful to the market at large. This is no casual warning. This is a plea for the market to act, and if they do not, the consequences are very undesirable.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Pennsylvania is recognized for such time as he consumes.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

First of all, let me thank the chairman and ranking member for commissioning this hearing. It is certainly a topic in which all of us are interested, and I think that we have labored in the forest together with Mr. Baker over the years to get some information and enlightenment.

From my perspective, I look forward to hearing a real definition of a hedge fund. I understand that you all have defined it today so that I will be able to clearly understand the entity with which we are dealing.

But in all seriousness, the difficulty lies in defining what a hedge fund is and the import of how it operates in the marketplace; I myself am not worried about protecting individuals of high net worth or constricting their right to invest and participate in helping the marketplace to level the field and provide the liquidity that is necessary out there.

On another point, I am disturbed about potential systemic risk and particularly about the great deal of financing that comes out of federally insured institutions. This leveraging could cause risk to the government or systemic risks to the system. I think we are going to rely on the testimony of this group today to see where we are headed and what the Congress should do in response to some of the existing problems out there.

But, I would also agree with Mr. Baker: We hope self-regulation can be the order of the day. However, if it fails, I hope we do not hear the cry that we have over-regulated because the Congress will be called upon to move in very swiftly and very deeply into a control situation. We hope that is not necessary.

I look forward to the Working Group's report to the Congress today, and I look forward to working with them in the future.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Delaware is recognized for 2 minutes.

Mr. CASTLE. Thank you, Mr. Chairman. I thank you and the ranking member for holding this hearing, and I agree with your comments, those of the ranking member and everybody else who has spoken, particularly Mr. Baker, with respect to pension funds and their investments.

This Working Group has already indicated the tremendous influence hedge funds have on our markets. The hedge funds have more than doubled in the past 5 years, growing to over 9,000 hedge funds. Since your last study in 1999, the industry has grown by more than 400 percent, now totaling nearly $2 trillion. And the combined assets of the 100 largest hedge funds represent about 65 percent of the total industry.

Secretary Steel further explained the vast amount of trading volume hedge funds are generating. It is speculated that they may represent up to 50 percent of trading in particular instances, which is something to think about. The group also discussed how institutional investors like pension funds constitute more than half of the investments in hedge funds.

With pension funds placing more of their money in hedge funds, American workers, retirees, and other average investors may unknowingly be exposed to hedge fund losses. The President's Working Group recommended that investors in hedge funds gather necessary information regarding the fund's strategies, terms, conditions and risk management to make informed investment decisions and perform due diligence, yet hedge funds are not required to disclose this information.

I am concerned with this lack of transparency because the manager of a pension fund cannot fulfill their fiduciary duty and may not understand the risk to their investments to perform due diligence before committing funds. The lack of transparency in the industry may also pose systemic risk. The long-term capital management incident showed how overexposure of counterparties had the potential to cause systemwide damage to financial markets.

After LTCM, the Working Group recommended the very largest hedge funds be required to disclose information about their financial activities, including meaningful and comprehensive measures of market risk. The Working Group now concludes that no government agency needs any information about hedge fund activities and that we can rely on hedge fund investors themselves to protect the markets from systemic risk.

It is unclear to me why the Treasury now appears a lot less cautious than they were in 1999 since the industry has grown considerably. More recently the New York Federal Reserve has repeatedly warned that hedge funds pose the largest risk since the LTCM crisis and Treasury officials have forewarned financial institutions about hedge fund vulnerability.

There are many instances of pension fund involvement now. And the bottom line is that while I don't know the answers either, as the chairman and ranking member indicated, I do think we need to be looking very carefully at what we are doing here. I yield back the balance of my time.

The CHAIRMAN. The gentlewoman from California for 2 minutes, or as much time as she consumes.

Ms. WATERS. Thank you very much, Mr. Chairman and members. I want to thank Chairman Frank and Ranking Member Bachus for holding the second in a series of hearings on the issue of hedge funds.

These hearings are designed to examine the emerging role of hedge funds and private equity pools in the United States and global markets. Indeed, this is a timely hearing because I have become somewhat fascinated by hedge funds and their dramatic growth over the last several years.

The estimate suggests that hedge funds have grown in number to more than 9,000—double what they were just 5 years ago. The assets have also grown by some 400 percent to $1.4 trillion.

The primary purpose of hedge funds is to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions.

Have the funds grown because they are the most flexible investment tool in today's volatile financial system? I ask this question because in the past few months it has been revealed that a number of hedge funds are heavily invested in mortgage backed securities related to subprime loans.

According to the New York Times, the Bear Stearns Company, an investment bank, pledged up to $3.2 billion in loans to bail out one of the hedge funds that was collapsing because of bad bets on subprime mortgages. It is the biggest rescue of a hedge fund since 1998 when more than a dozen lenders provided $3.6 billion to save Longterm Capital Management.

Unfortunately, it is precisely this type of investment activity that raises concerns in the marketplace. I'm sure that we have just seen the tip of the iceberg as it relates to subprime lending, 2.2 million defaults, according to some estimates, by next year.

Interestingly, some hedge fund strategies are designed to capitalize on these negative conditions in the market. So what are the cost benefits associated with hedge fund activity in the United States and in the global economy?

I thank you and I look forward to hearing our witnesses today. I yield back the balance of my time.

The CHAIRMAN. The gentleman from California, Mr. Royce, is recognized for 3 minutes.

Mr. ROYCE. Thank you very much, Mr. Chairman.

The CHAIRMAN. Before the gentleman begins, let me just say to the people here that we have a limited number of opening statements. We have about 10 more minutes of opening statements, so I do want to reassure people that we will get to you.

The gentleman from California.

Mr. ROYCE. Thank you, Mr. Chairman, and thank you for holding this hearing on hedge funds and the effect on our capital markets that they have. I'd also like to commend the members of the President's Working Group for their work on this issue.

The role of hedge funds clearly continues to evolve, and as you've mentioned, the hedge funds have experienced incredible growth—the numbers I've seen, from $50 billion in assets in 1988, to today totaling over $1 trillion. While both the size and scope of these private pools of capital have changed over the years, their unique ability to bring significant benefits to the financial markets still remain.

The varying strategies utilized by hedge funds, which results in additional liquidity, has helped the U.S. financial markets become the deepest and most liquid markets in the world today. The ability of hedge funds to target price inefficiencies between markets has also proven to be a useful tool that has resulted also in more efficient markets.

Furthermore, their ability to transfer and distribute risk allows market participants to more easily manage the level of risk held on their portfolio. While the broader financial system has gained from the presence of hedge funds, an inherent risk will always accompany those private pools of capital that we call hedge funds.

Banks and other depository institutions that choose to extend credit or choose to be counterparties to hedge funds must make well-informed, sound business decisions. Regulators with authority over banking systems should focus their attention on preventing the institutions which they oversee from taking on excessive risk. If market discipline and prudent risk management is practiced, the likelihood of a systemic shock will be greatly reduced.

Again, Mr. Chairman, I would like to thank you for exploring this issue today, and I look forward to hearing from our distinguished witnesses.

The CHAIRMAN. The gentlewoman from New York, for 3 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman, and Ranking Member Bachus, for holding this incredibly important hearing. I welcome

the members of the President's Working Group, and I very much look forward to your testimony.

I hope that I hear in your testimony answers to some of the concerns that my colleagues and I have about hedge funds. There has been a tremendous amount of media coverage of the potential that a fire sale of CDOs triggered by Bear Stearns hedge funds could have upon the entire financial system.

At the heart of these concerns appears to be a fear that such a public sale of CDOs would clearly set market prices that are way below the value at which many pension funds and endowments and banks are carrying these products on their books.

I specifically hope to hear what steps the President's Working Group is taking to ensure that there are best practices for evaluation of these types of securities and products across all types of institutions. I specifically want to hear, did any of the agencies comprising the President's Working Group weigh in with the creditors of the Bear Stearns fund to encourage them to forebear on selling off the collateral until such time as Bear could decide to back the funds with their own capital.

I share the concerns of my colleagues of the impact this has on pension funds invested in hedge funds. I am deeply concerned and hope you will address what, if any, concerns you have with the size and complexity of collateralized debt obligations, these CDOs, especially the difficulty investors have in adequately understanding and identifying the true value of these securities.

And given the difficulty in having a day-to-day value on collateralized debt obligations and given the sheer size of these CDOs, what concerns do you have about the systemic risk of these securities?

I was really surprised and startled to learn from the head of the SEC, Chairman Cox, that he is investigating 12 separate investigations in this particular area, which raises a concern that he must have, and I want to know, do you share that concern, and what best practices and advice do you give us today? I thank you for your work and for your time.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling, for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. I too look forward to this hearing.

As of yet, I haven't seen evidence of a level of systemic risk that warrants direct Federal regulation but I certainly have an open mind so I look forward to hearing from the witnesses.

I have noted in previous statements of our former Fed Chairman and our present Fed Chairman that have cautioned us about the risk involved in direct regulation of the hedge fund industry. And although it has been many years, and I hold myself as no expert, there was a time when I was employed at a hedge fund. And at that point I saw a level of expertise from the investors, endowments, pension funds, and charitable foundations that led me to believe that certainly private market discipline was alive and well and that properly informed sophisticated investors provide that level of discipline which is needed.

We all know that there has been a certain amount of negative press recently regarding hedge funds and I hope we all remember

in this committee the role that they play in helping create jobs and our economy, helping our investors receive superior returns, and keeping the economy growing.

And as the gentleman, the ranking member from Alabama well noted, capital can move overseas. So the area of regulation is one that we need to approach, I believe, with some trepidation.

Although this hearing is focusing on systemic risk, I am too disturbed, as the ranking member noted, by a flurry of proposals to do everything from increasing taxation on carried interest to penalizing tax exempt organizations that invest in hedge funds. And potentially these proposals may pose even a greater risk to our economy, and so I believe that should be duly noted.

And I trust any of these proposals that come around will be thoroughly vetted and debated at some length. With that, I thank again, Mr. Chairman, for holding this hearing. I yield back the balance of my time.

The CHAIRMAN. The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman. This is indeed a very important hearing, but I think we have to look at the facts and be able to make some very objective decisions.

Hedge funds are playing a very important and significant economic role in our economy. The whole private equity transactions in the United States last year totaled over $400 billion, and between 1991 and 2006, created more than $30 billion in profit for our investors.

The funds hold unmatched sway over our markets. They are responsible for more than a third of our stock trades, control more than $2 trillion worth of assets, and each of the top hedge fund managers earned more than $1 billion in 2006. So this is a very serious and impactful area.

My major concern is, taking the example of Bear Stearns, which recently admitted it would need to add some $1.6 billion to prevent the fund from a total collapse—now granted, many bankers and regulators consider this process to be one of the great advances in finance over the past 5 years, however the trouble, as Bear Stearns points out and shows that this system may not be as crash-proof as we once thought.

How dependent has our system now become on hedge funds, for example? Are these trades becoming more risky? Should more of these funds begin to unravel? Who absorbs the losses and at what costs to all who are involved?

What I'm really concerned about is that no one really knows, including the funds' lenders, what its exotic portfolio or risk mortgage derivatives is really worth.

And finally, as hedge funds are purchasing all sorts of illiquid, hard-to-value assets, are we worried about or do we even care to know what these assets are really worth, and are we worried that hedge funds' managers are coming up with suspicious valuations using financial models that aren't necessarily based on what the assets would fetch in the open market?

These are very serious questions. No decision has been made whether we—and what type of regulation, but it is very, very incumbent upon us to ask the serious, in-depth, clear, incise ques-

tions when you look at the extraordinary economic impact that hedge funds have in our investment community.

Thank you, Mr. Chairman. I yield back the balance of my time.

The CHAIRMAN. I thank the gentleman.

As we proceed to the testimony, several of us have talked about the international aspect. We have, I am pleased to acknowledge, recognition of that because observing the hearing is Duzana Vavrova, who is the administrator in the directorate general on internal policies of the Committee on Economic and Monetary Affairs of the European Parliament, presumably our counterpart. So we welcome this.

Several of us have been meeting with our European counterparts. Indeed, a delegation from this committee, members and staff, bipartisan staff met in both London and Brussels with EU and British regulators because of the importance of this.

Secondly, I'm going to ask unanimous consent to introduce into the record two items. First, an item which is related, not specifically to hedge funds, but a very interesting and sobering comment from Moody's Investors Service, a special comment of July 2007 on rating private equity transactions expressing some concerns about their ability to do that and about the risks that are increasing.

And second, an article from yesterday's Financial Times by Mohamed El-Erian, who runs the Harvard Firm, entitled, "How to Reduce Risk in the Financial System," expressing concern that some of the investors in these funds are themselves regulated by entities that are not up to the job of regulating instruments of this degree of complexity. None of you here, you're off the hook. But they are talking about some of the buyers, and it relates to pension funds, insurance industry.

As we know, one of the things that this committee will be looking at is the structure of the insurance industry because uniquely in America you have this very important financial industry, the insurance industry, particularly in the life side but in general that's entirely State-regulated. And what that means is to the extent that insurance companies are big players here, and pension funds to a great extent, none of you have the kind of supervisory role that you'll have over banks and other counterparties.

And that is one of the issues that will deserve some attention, so I ask that these two articles be put into the record. There being no objection, they will be put in.

And we will begin our testimony, and we will begin with an introduction. Our colleague from Connecticut, he's very busy when we deal with hedge funds because half the time he's introducing the people who run hedge funds, and live in his district, and then the other half he's introducing the people who regulate the hedge funds who live in his district.

So if we just—we could probably move the whole thing to Greenwich and save a lot of travel time on witness fees. But the gentleman from Connecticut is recognized.

Mr. SHAYS. Thank you, Mr. Chairman. I feel a little guilty, because last time I didn't introduce this individual, and I did introduce someone else, so I would like to welcome all our of witnesses, but in particular, Under Secretary Robert Steel, who hails from

Connecticut's 4th District, and you nailed Greenwich pretty well, Mr. Chairman.

The Under Secretary leads the Treasury Department's activities with respect to the domestic financial system, fiscal policy and operations, government assets and liabilities, and related economic and financial matters. I have appreciated the chance to get to know Secretary Steel, who has extensive experience in the private sector as well as academia. Bob Steel is straightforward, sharp, and someone whose perspectives and recommendations I appreciate and respect a great deal, and I welcome him.

The CHAIRMAN. Thank you. Mr. Steel, with that, why don't you begin with you, and we'll down the list after that.

STATEMENT OF THE HONORABLE ROBERT K. STEEL, UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. STEEL. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee. It's a privilege to be with you today. Thank you for holding this hearing and inviting the Treasury Department to present our perspective on the important topic of hedge funds and systemic risk.

Today I am representing both the Treasury Department and more specifically, Secretary Paulson, in his capacity as the Chairman of the President's Working Group on Financial Markets. Fostering financial preparedness is part of the core mission of the Treasury Department.

Under Secretary Paulson's leadership, the four members of the President's Working Group, along with the Office of the Comptroller of the Currency and the Federal Reserve Bank of New York, have issued a call to action directing all market participants to undertake efforts that mitigate the likelihood and impact of a systemic risk event caused by private pools of capital.

Private pools of capital, which include hedge funds as well as private equity and venture capital funds, exemplify the innovation that make our capital markets the strongest in the world. These investment vehicles bring many benefits to our markets, including liquidity, price discovery, and risk dispersion. Yet the rapid growth in size and scope of private pools of capital has brought challenges to our markets, particularly in areas of investor protection, market integrity, and the potential for systemic risk.

To address these challenges, the President's Working Group released principles and guidelines for private pools of capital in February. These ten principles and the clarifying guidelines do not represent an endorsement of the status quo, but instead reflects, we hope, the uniform view of all relevant regulators that heightened vigilance is necessary and appropriate.

While it is not our current expectation, we should remain vigilant to the possibility that significant losses by a highly leveraged hedge fund could present systemic challenges to the broader financial system. Therefore, the principles and guidelines make a number of very specific suggestions for improved vigilance in market discipline so as to mitigate systemic risk.

Hedge funds' clientele, originally wealthy investors, has shifted to become one that is comprised more of institutional investors, in

many cases representing individual investors who may be less sophisticated. Investment fiduciaries, such as pension funds, do have a responsibility to perform due diligence to ensure that their investment decisions on behalf of these beneficiaries and clients are prudent.

These principles also emphasize the responsibility of managers to provide accurate and timely information so that investors can make informed decisions. Additionally, supervisors must work within the existing regulatory framework, utilizing their broad anti-fraud and anti-manipulation authority to address these issues of investor protection.

Our next step is to ensure that all four groups of the market participants—the regulators and supervisors, the counterparties, and the creditors, the actual managers of the private pools of capital themselves, and the pool investors—adopt and use these principles and guidelines. We are very encouraged by the initial response, as much good progress is currently underway.

Additionally, these principles and guidelines have been very well received by policymakers, regulators, industry leaders, and the general public, both in the United States and overseas.

Regulators and supervisors are already involved in a range of important initiatives. Supervisors are engaged in ongoing reviews of creditors' and counterparties' practices. These efforts are aimed at improving the sophistication of stress-testing practice, counterparty credit risk management and over-the-counter derivatives, structured credit, hedge funds, and the post-trade processing infrastructure of the over-the-counter derivatives market.

Consistent with my representation that we are not standing still, just 2 weeks ago, Secretary Paulson announced that we, at the President's Working Group, will work with the private sector to develop and adopt industry best practices for both investors and the asset managers of hedge funds.

The President's Working Group is facilitating the establishment of two separate yet complementary private sector groups, one comprised of hedge fund managers, and the other comprised of hedge fund investors. These two groups will develop best practices for their respective stakeholder groups that address investor protection, enhanced market discipline, and also help to mitigate systemic risk.

The President's Working Group will serve as an ongoing facilitator for these groups. We are engaging a broad spectrum of market participants to develop high quality best practices. The nature of a competitive marketplace is such that when leaders adopt best practices, others in the industry feel pressure to do the same. All market participants must be accountable to help ensure the integrity of our capital markets.

While substantial progress has already been made, there is still much work to be done. Building upon efforts to date, all stakeholders must continue to do more. We look forward to the development and implementation of coherent best practices for the investors and hedge fund managers.

Our system works well when market participants recognize the benefits, mitigate the risks, and choose to be diligent. We look for-

ward to a continued dialogue with this committee on these important issues.

Thank you, sir, and I look forward to your questions.

[The prepared statement of Under Secretary Steel can be found on page 61 of the appendix.]

The CHAIRMAN. Next we'll hear from Kevin Warsh, who is a member of the Board of Governors of the Federal Reserve System.

STATEMENT OF THE HONORABLE KEVIN M. WARSH, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. WARSH. Thank you very much, Chairman Frank, Ranking Member Bachus, and other members of the committee here today. I appreciate the opportunity to appear on behalf of the Board of Governors of the Federal Reserve System to discuss the systemic risk implications of hedge funds.

The Board believes that the increased scale and scope of hedge funds has brought significant net benefits to financial markets. Indeed, hedge funds, as many of you have mentioned in your opening statements, have the potential to reduce systemic risk by disbursing risks more broadly and by serving as a large pool of opportunistic capital that can stabilize financial markets in the event of disturbance.

At the same time, the recent growth of hedge funds presents some formidable challenges to the achievement of key public policy objectives, including significant risk management challenges to market participants. Of course, if market participants prove unwilling or unable to meet these challenges, losses in the hedge fund sector could pose significant risks to financial stability.

The Board believes that the principles and guidelines regarding private pools of capital issued by the President's Working Group on Financial Markets, just in February, provide a sound framework for addressing these challenges associated with hedge funds, including the subject of today's hearing, the potential for systemic risk.

The Board shares the considered judgment of the PWG: The most effective mechanism for limiting systemic risks from hedge funds is market discipline. And the most important providers of market discipline are the large global, commercial, and investment banks that are their principal creditors and counterparties.

This emphasis on market discipline neither endorses the status quo nor implies a passive role for government. In recent years, the global banks have significantly strengthened their practices and procedures for managing risk exposures. But further progress on this front is needed, in no small part because of the increasing complexity of structured credit products such as collateralized debt obligations.

The Board believes that even those banks with the most sophisticated risk management practices must further strengthen their enterprise-wide systems to put the PWG principles fully into practice. As these principles rightly emphasize, supervisors of global banks are responsible for promoting market discipline by monitoring and evaluating banks' management of their exposure to hedge funds.

As the umbrella supervisor of U.S. bank holding companies, the Fed continues to pay keen attention to hedge fund exposures and

is working to ensure stronger risk management practices. In addition, through the Reserve Bank of New York, the Fed is actively facilitating collaboration and coordination among domestic and international supervisors of these global banks that are key counterparties and key creditors.

This area of significant focus targeting management of exposure to hedge funds is part of a broader, comprehensive set of supervisory initiatives that seeks to ensure that banks' risk management practices and market infrastructures are sufficiently robust to cope with stresses that may accompany a deterioration in market conditions.

To this end, the Federal Reserve has been focusing on five key supervisory initiatives: First, comprehensive review of firms' stress-testing practices; second, a multilateral supervisory assessment of the leading banks' current practices for managing their exposures to hedge funds; third, a review of the risks associated with the rapid growth of leveraged lending; fourth, a new assessment of practices to manage liquidity risk; and fifth, continued efforts to reduce risks associated with weaknesses in the clearing and settlement of credit derivatives and other over-the-counter derivatives.

Indeed, this committee should be assured that the Federal Reserve has taken on these initiatives with great purpose and resolve. The initiatives are fully consistent with the founding purpose assigned to the Fed by Congress to help mitigate the risks to the financial system and the broader economy caused by periodic bouts of instability and financial stress.

Thank you again, Mr. Chairman. I'd be happy to respond to your questions.

[The prepared statement of Governor Warsh can be found on page 67 of the appendix.]

The CHAIRMAN. Next, Mr. Jim Overdahl, who is the Chief Economist at the Commodity Futures Trading Commission. We welcome you in your rare appearance away from the Agriculture Committee here, where you really belong.

[Laughter]

STATEMENT OF JAMES A. OVERDAHL, CHIEF ECONOMIST, U.S. COMMODITY FUTURES TRADING COMMISSION

Mr. OVERDAHL. Thank you, Mr. Chairman, Congressman Bachus, and members of the committee. I am pleased to have this opportunity to testify on behalf of the CFTC regarding hedge funds and systemic risk.

The Chairman of the CFTC is a member of the President's Working Group on Financial Markets, and he participated in the deliberations that resulted in the agreement announced by the PWG in February, setting out principles and guidelines regarding private pools of capital, including hedge funds.

I will focus my remarks today on how hedge funds intersect with the CFTC's responsibilities under its governing statute, the Commodity Exchange Act, or 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 regulated futures and commodity options markets regardless of whether their operators and advisors are registered or not. With respect to investor protection, if a collective investment vehicle such as 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.

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 who are willing to accept it, for a price. In order for businesses to hedge the risk they face in their day-to-day commercial activities, they need to trade with someone willing to accept the risk the hedger is trying to shed. Data from the CFTC's larger trader reporting system are consistent with the notion that hedge funds and other professionally managed funds often are the ones absorbing the risks hedgers are trying to shed.

Hedge funds also play a vital role in keeping the prices of related futures contracts in proper alignment with one another. In addition, hedge funds add to overall trading volume, which contributes to the formation of liquid and well functioning markets. Over the past decade, the average number of funds participating in futures markets has grown across nearly all market segments. Also it appears that funds, on average, hold positions in more markets today than they did a decade ago.

One notable development over the past 5 years has been the increased participation by hedge funds and other institutional investors in futures markets for physical commodities. These institutions have allocated a portion of the investment portfolios they manage into commodity-linked investment products. A significant portion of this investment finds its way into futures markets, either through the direct participation of those whose commodity investments are benchmarked to a commodity index, or through the participation of commodity index swap dealers who use futures markets to hedge the risk associated with their dealing activities.

The CFTC relies on a program of market surveillance to ensure that markets under CFTC jurisdiction are operating in an open and competitive manner. The heart of the CFTC's market surveillance program is its large trader reporting system. For surveillance purposes, the larger trader reporting requirements for hedge funds are the same as for any other larger trader. In addition to regular market surveillance, the CFTC conducts an aggressive enforcement program that deters would-be violators by sending a clear message that improper conduct will not be tolerated.

The financial distress of any large futures trader poses potential risks to other futures market participants. With respect to commodity pools operating as hedge funds, the CFTC addresses these risks through its oversight of futures clearinghouses and the clearing member firms of each clearinghouse. This oversight regime is designed to ensure that the financial distress of any single market participant, whether or not that participant is a hedge fund, does not have a disproportionate effect on the overall market. It is through this oversight regime that the CFTC does its part in helping to mitigate systemic risk.

In closing, the CFTC will remain vigilant in utilizing the tools provided in the CEA: Market surveillance; disclosure; reporting; recordkeeping; and enforcement authority, to fulfill its statutory responsibilities as hedge fund participation in futures markets continues to expand.

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

[The prepared statement of Mr. Overdahl can be found on page 42 of the appendix.]

The CHAIRMAN. Next, Dr. Erik Sirri, who is the Director of the Division of Market Regulation at the SEC.

STATEMENT OF ERIK R. SIRRI, DIRECTOR, DIVISION OF MARKET REGULATION, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. Sirri. Chairman Frank, Ranking Member Bachus, and members of the committee, on behalf of the Securities and Exchange Commission, I appreciate the opportunity to speak to you today regarding recent initiatives being taken by the Commission with respect to hedge funds.

As you know, the President's Working Group released principles and guidelines regarding private pools of capital. These principles complement and inform the regulatory and supervisory work of each of the PWG agencies with respect to investors, fiduciaries, creditors, and counterparties.

Even as the Commission believes that private pools of capital such as hedge funds bring significant benefits to financial markets, the Commission is also working diligently to protect hedge fund investors and other market participants against fraud, and to ameliorate, through its oversight of internationally active securities firms, the broader systemic risks such funds potential pose to our financial system.

The Commission's work in this area includes vigorous enforcement activities related to the Federal securities laws, the Commission's Consolidated Supervised Entity Program, and as appropriate, regulatory improvement.

I will focus my oral remarks today on the oversight function. At present the Commission supervises five securities firms on a consolidated or groupwide basis. These include Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. These firms are known as the CSEs. For such firms, the Commission oversees not only the registered broker-dealer but also the consolidated entity; that is, the holding company, which may include regulated entities, such as foreign-registered broker-dealers and banks, as well as unregulated entities, such as derivatives dealers and the holding company itself.

The Commission's CSE program is designed to provide holding company supervision in a manner that is broadly consistent with the oversight provided to bank holding companies by the Federal Reserve. The aim of this program is to diminish the likelihood that weakness in the holding company itself or any of the unregulated entities places a regulated entity, such as a bank or a broker-dealer, or the broader financial system, at risk.

The CSEs are subject to a number of requirements under the program, including monthly computation of a capital adequacy

measure consistent with the Basel II Standard, maintenance of substantial amounts of liquidity at the holding company level, and documentation of a comprehensive system of internal controls that are subject to Commission inspection.

The primary concern of the CSE program with regard to hedge funds revolves around the risks they potentially pose to CSE firms specifically, and through CSEs to the financial system.

The Commission's CSE program monitors and assesses these risks in several ways.

First, the Commission staff meets at least monthly with senior risk managers at the CSEs to review market and credit risk exposures, including those to hedge funds. The process provides information not only concerning the potential risk to CSEs, but also a broader window into the relationship with hedge funds, and those hedge funds' potential impact on the broader financial markets.

Second, Commission staff has recently engaged in targeted discussions with the CSEs about the challenges of measuring credit exposures to hedge funds.

And finally, the Commission's staff has embarked on a joint project with the Federal Reserve and the UK's Financial Services Authority to understand current in Street practices of banks and broker-dealers in managing their exposures to hedge funds. The agencies have identified a number of issues related to the extension of credit to hedge funds and are now addressing those issues in a second phase which entails more detailed work by the principal regulator of each firm.

Taken together, these efforts allow us to identify some trends that we and our supervisory colleagues, as well as the risk managers at the large banks and securities firms, will follow more closely. The demise of Amaranth and the issues associated with the Bear Stearns managed hedge funds also provide some interesting datapoints to consider.

First, some of the largest and most systemically important hedge funds are beginning to look more and more like mature financial institutions, diversifying their portfolios beyond leveraged equity and fixed-income strategies, and diversifying beyond their activities in proprietary trading.

Second, hedge funds generally have become more sophisticated about risk management, in part by negotiating more flexible credit terms with dealer banks.

Third, in some markets, hedge funds are the major providers of liquidity. The impact that the Bear Stearns' hedge funds losses is having on the subprime market illustrates this point.

Finally, leverage can be achieved in a myriad of ways. The ability to engineer economic leverage through structured products is almost infinite, and that can be seen in the CDO markets.

The supervisory focus on excessive leverage, we believe, is the right one. It is far from simple in today's innovative financial markets. While these trends will continue to challenge the regulated institutions and their supervisors, the focus in recent years on counterparty credit risk management has clearly been good for financial institutions and the financial system as a whole.

After the failure of long-term capital management in 1998, the Counterparty Risk Management Policy Group brought together

senior policy managers from the major commercial and investment banks—excuse me, senior risk managers—to consider the lessons of that event. The report addressed systemic risk concerns by articulating best practices in counterparty risk management appropriate to such regulated entities such as banks and securities firms.

The Counterparty Risk Management Policy Group also issued a second report in July of 2005 that dealt with developments since the initial report, including the proliferation of products with embedded leverage and securitization. More work remains to be done in these areas, and we must not in fact become complacent here.

In conclusion there is no guarantee that the favorable conditions that allowed for the orderly unwinding of Amaranth, and thus far Bear Stearns managed hedge funds will persist. We must assume, in fact, that they will not. The supervisory community must continue to engage with systemically important banks and securities firms and encourage additional efforts to expand their risk management capabilities.

We will continue to work with our PWG colleagues and other market participants, hopefully including some of the larger hedge funds, to further this agenda.

I thank you for the opportunity to testify today, and I'd be happy to take any of your questions.

[The prepared statement of Mr. Sirri can be found on page 49 of the appendix.]

The CHAIRMAN. Thank you. I'm going to begin with a very specific question. It would be aimed to probably the SEC. When we had the hedge fund managers, a panel of them before us, one issue that came up was that they noted that many of them are already required to register with somebody or another. Ms. Robinal mentioned many of them do that.

One suggestion that somebody made, I forget who, but they all seemed to agree with was this: There is a potential for insider trading here because of the kind of integrated degree of activity. There was a proposed suggestion that all of them agreed to that over and above any other form of regulation or registration, there be a document retention requirement so that if allegations came up of inappropriate practices, that could be done.

You mentioned, Dr. Sirri, that you're working on enforcement. What would your response be to a document retention requirement for those entities that did not otherwise have one because they were required to register for some other reason?

Mr. SIRRI. Well, I think it's important to consider the Commission's authority over hedge funds. You quite correctly make the distinction that there are two groups of hedge funds. There are those that are registered—there are about 2,000 of those—and then there are those that are unregistered.

But it's important to realize that with respect to either of those, the Commission maintains anti-fraud authority—

The CHAIRMAN. Well, I understand that. But what some people suggested was that the ones that are unregistered don't have a document retention requirement. And the suggestion was simply to give a document retention requirement to those so that was there if you needed enforcement.

Mr. SIRRI. Sure. And on the registered end, books and records requirements are in place. For the unregistered entities, we would have no authority to require that. That may be—

The CHAIRMAN. Well, I understand that. But you're not before a court now. You're before the Congress. We make the laws, sometimes. Sometimes we don't. My question to you, I'm sorry if it wasn't clearer, is what would you think about our passing a law that would enhance your authority to require document retention among the unregistered?

Mr. SIRRI. I think we'd have to be very careful of the tradeoff there. The potential benefit of something like that has to do with fraud in the markets and the example that you gave. The potential cost of something like that is to cause those hedge funds to leave the United States and perhaps locate overseas.

The CHAIRMAN. But I will say, none of them raised that when we asked them. They all—or maybe we had an unusually quiescent group. I don't think we tried to find that.

Let me just ask you, with regard to registration, Mr. Overdahl, you mentioned that some are registered with you. Now you say 2,000 are registered with the SEC. Are there funds that register with the CFTC that don't register with the SEC?

Mr. OVERDAHL. We do not register funds per se. We register advisors and operators.

The CHAIRMAN. Right.

Mr. OVERDAHL. And there will often times be overlap between—

The CHAIRMAN. Are there some that register with you, though, that don't have to register with the SEC?

Mr. OVERDAHL. Absolutely. There are some funds or operators of funds that are operating pools that are exclusively futures pools that will be registered with us as opposed to the SEC.

The CHAIRMAN. Is that at all a problem that jurisdiction, should you share information about them? How does that work? We have entities that many of us would think are doing very similar things, and some of them aren't registered at all, and some are registered with the SEC, and some are registered with the CFTC. My sense is that was due to nobody's plan, but that just was a result of other decisions. Is that something we ought to be trying to rationalize? Let me ask Mr. Steel, what's your sense of how that breaks out? In terms of the split between those that register at the CFTC, those that register at the SEC, and those that aren't registered—is that a rational distribution now, do you believe?

Mr. STEEL. No. I think that consistent with things that we've talked about at Treasury, this has developed in a patchwork basis, and there isn't an overarching strategy, that people have chosen a regulator or chosen not to be regulated, and that's the reality of the situation today.

The CHAIRMAN. Should we change that if we could work together on a collaborative way to do that?

Mr. STEEL. Well, I think that there's no question. Just a week or two ago, Secretary Paulson announced that one of the goals he had was to look at this on a holistic basis, and I would think that as part of that examination, with the goal of writing a blueprint of what regulations should look like—

The CHAIRMAN. Very good.

Mr. STEEL.—that this would be part of that.

The CHAIRMAN. Well, I appreciate it. So in other words, when we talk about the regulation, which includes banking and other things, I think that's—I mean, whatever one thinks about what degree of registration or whether there should be or shouldn't be, it ought to be the result of conscious decisions by people, not just random.

Let me say in closing, and I understand we're not rushing to register and regulate, but regulation shouldn't be a bad word. As we look at the subprime crisis, it strikes me that there are two groups of entities that have made loans to people in the subprime category: regulated entities, i.e., depository institutions regulated by the banks; and unregulated entities, brokers and others, who are subject to no such regulation.

I think it's fairly clear. If only regulated entities had made subprime loans, we wouldn't have a crisis. The overwhelming number of loans that have caused problems were made by unregulated entities. And it does seem to me an argument for the sensible kind of regulation that I believe we have with regard to depository institutions. So I would hope that people would not automatically assume that regulation has to be a bad thing. If we would have had more regulation of lenders in the subprime area, we would have had less of a subprime crisis.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. Mr. Chairman, first I'd like to acknowledge our former staff director of the committee, Bob Foster. Bob, if you'd stand up, we welcome you back to the committee. You did a very professional job here, and I think you will do the same at the Treasury Department.

The CHAIRMAN. You haven't mentioned his new position. You just had him stand up. You didn't mention his new job.

Mr. BACHUS. He is—Under Secretary Steel, is he—

Mr. STEEL. He's working in Legislative Affairs as a Deputy Assistant Secretary, and we welcome him to Treasury with his good wisdom.

Mr. BACHUS. Thank you.

The CHAIRMAN. And he comes with a due respect for congressional prerogative.

[Laughter]

Mr. BACHUS. Or disrespect. Let me start by saying, I don't think anyone on the Republican side discounts the existence of risk. In fact, you know, risk is inherent in the market and probably—the markets, so there's a high degree of risk in the markets at this time. I think the President's Working Group has acknowledged that some of these sophisticated investments, although they diminish risk in many respects, there is the potential for systemic risk.

I think what many of us, Mr. Hensarling and I particularly discussed in our opening statements, what we discount is the ability of Congress to intervene constructively at this point. In other words, as the chairman said, pass a law.

I'm not sure that that—I don't see that bringing stability to the market. In fact, especially some calls recently to increase taxation on capital, I don't in any way see how that could bring stability or have a positive effect on the market. So, in fact, I see them having a very detrimental effect at this particular time.

Some of the members in their opening statements also mentioned transparency and disclosure. You know, we talk about those terms almost as "mom" and "apple pie."

But—Secretary Steel, you made a speech to the Manhattan Institute when you talked about one potential problem with further regulation, and that's that investors begin to take comfort in, you know, the—almost like a stamp of approval. The government is regulating these. Would you like to comment on that?

And before you do, Dr. Sirri pointed out something else. Yes, you know, we could require or regulators could require more disclosure, more transparency, but, you know, we run into two things, two problems there that I see. One is that a lot of this is proprietary. These are proprietary methods. There are strategies that they engage in, and I'm not sure that would not have a chilling effect, and I'm not sure even some constitutional limitations we may have on asking people to give out their proprietary—you know, their actually property right.

But as Dr. Sirri pointed out, they have an option to disclose. They have an option to paying greater taxes, and that option is taking that capital to China or India or South America or offshore. And I can tell you, if anything that I do believe this morning, withdrawing capital out of the United States, I do know that would have a destabilizing effect on our economy and our market, and just the last thing we need at this time is taxation or regulation that would cause a flight of capital out of the United States.

So with that, let me ask Secretary Steel, would you comment again on your remarks at the Manhattan Institute, which I believe are very valid?

Mr. STEEL. I think if I could frame this through the lens, as you said, of the important issues of transparency and disclosure, and then I think you asked me to comment further on the issue of moral hazard, I think that you're correct. Transparency and disclosure are important issues, but I would want to frame it with to whom and for what end.

Basically, we believe the key aspects of transparency and disclosure in the President's Working Group, that we've tried to codify in the principles and guidelines, really relate to two specific areas—very good transparency and disclosure from the fund manager to the regulated entities that are providing the capital and loaning them money, and the disclosure there should be quite good. In our guidelines, we've written about this and tried to give very specific examples of the type of transparency and disclosure that's appropriate. And if you don't have that type of very, very high transparency and disclosure, it should be reflected in margin and the terms of credit. And that should be the Governor on that issue to provide the protection, the best protection that we could, for mitigation of systemic risk.

The second key issue of disclosure really is between the investor and the fund manager. And once again, in our guidelines and principles, we tried to give very specific examples of what one should expect so as to invest. And hopefully raising that standard, and we intend to raise the standard further with specificity with the committees that I described, then we think that's the key issues of disclosure and transparency.

With regard to the more specific issue about the talk that I made on moral hazard, I think there's a clear issue. These are investments of a certain type. They're less liquid. They're private partnerships, and they're different than buying and selling a security that offers instant liquidity. And so there are very specific requirements for investors to meet which the SEC has outlined historically and is now in the process of adjusting.

And, therefore, the idea that approval or regulation or registration provides a comfort, it would be a false comfort that might not—has the potential to be a false comfort—that does not recognize the distinct characteristics of the private pools of capital.

Mr. BACHUS. And Governor Warsh, both you and Secretary Steel have talked about that you all have made recommendations, principles which you have asked all the stakeholders to put into practice. How do you assure that they do this? How do you assure that they do move towards market discipline?

Mr. WARSH. Thank you. I would say that one thing that is certain, which is by virtue of the oversight that this committee and others can bring to bear, by virtue of the discussions that Under Secretary Steel and I have, is that there is a laser-like focus in the markets on trying to ensure that all of the stakeholders around hedge funds really need to continue the progress that has been made in recent years on subjects of due diligence and valuation, and making sure that stakeholder community is fully vested and fully understands what is going on.

This is, I think, an important opportunity for them to step up to the challenge put before them by the principles outlined by the President's Working Group.

Moreover, I would say for these hedge funds, the group that has the most skin in the game—the most responsibility, the most focus on ensuring that they have the right collateral—are these very counterparties and creditors that we're talking about. They are the life blood for hedge funds, maybe equal to importance of the investors themselves.

And when we talk about market discipline, we say that they really need to make sure that they're putting their money where their mouth is, and we are very encouraged by the discussions that have commenced that they're going to adopt these principles and put them into action. And, obviously, those of us here at the table will do our best to make sure of that.

Mr. BACHUS. You know, when you have somebody who is both a creditor and investor and a counterparty at the same time, it does become very difficult to do that. But I would like to commend all of you. I believe that you are very active on the job. You appreciate the danger that you are working with the stakeholders and market participants, and I commend you for what you've done.

Mr. KANJORSKI. [presiding] Thank you, Mr. Bachus. In the absence of our chairman, I will take my questioning period now, if I can.

I am really interested more in the process of what the Working Group represents and whether or not they have created certain authorities and where these authorities, whatever authority that they use, emanate from. One of the important questions that I have raised up here on the Hill is that so often now, we fail to provide

legislative leadership as to where we should go: We hold a hearing such as this one where we invite up a working group about which I am not at all sure. Maybe I will ask: Who wants to represent the role of chairman here? Where do you come from? I mean, can you name your parents? Does anybody want to answer? You know, it is a simple question, and it is an honest question.

Mr. STEEL. Let me start, sir, and I'll invite my colleagues to comment. The establishment of the President's Working Group in 1988 was born out of an issue which was basically understanding and learning from the market dislocation of 1987.

Mr. KANJORSKI. Right.

Mr. STEEL. And President Reagan had the idea that you needed to have this multi-headed group look at these issues, because they crossed borders, crossed markets, and crossed different jurisdictions, and that was the idea.

And in my brief period, I think that this is the appropriate way to consider them, and Secretary Paulson has convened the President's Working Group actively and with all of the principals of the President's Working Group in, as Governor Warsh said, in a laser-like way, to use his word, focused on these issues. And so the idea of financial preparedness, which really is the link-up to systemic risk, has been the focus, one of the key focuses of the President's Working Group.

Mr. KANJORSKI. Obviously, the Working Group is a continuing body. As I understand, it emanates from a former White House executive order in 1988. Has that order been enlarged upon or drafted subsequent to 1988 to include more authority?

Mr. STEEL. Not that I know of. But I would comment that the Secretary doesn't view our lens on these issues as being limited or circumscribed—needing any additional scope or aperture.

Mr. KANJORSKI. Now, under normal circumstances, I would agree with you. But, now you are really propounding regulations or guidelines. I think you call them guidelines. That is very interesting. They are not legislatively constructed guidelines. They are from the Working Group.

Mr. STEEL. Yes, sir.

Mr. KANJORSKI. And, of course, they come out of the Working Group's office downtown?

Mr. STEEL. They come—Treasury is the convener, as I said.

Mr. KANJORSKI. I was being facetious. If I try to locate the Working Group's office, where would I go?

Mr. STEEL. You can call mine, I guess. But the Secretary of the Treasury is the convener.

Mr. KANJORSKI. I understand, and as an initial study group, it worked well. But why have you not all felt that perhaps there was a time since 1988—that is 19 years ago—to come to the Congress to get some legitimate legislative authority to pursue formal activity? If you really analyze what you're doing, your whole sense of controlling or influencing industry and the participants is the threat of your capacity to regulate. That is a pretty dangerous way of operating within our system.

You call in the people that you regulate, and you say we are going to construct guidelines for you. We have no legislative authority to do that. There is no law allowing us to do that, just an

executive order. But, we anticipate that you are going to participate and follow those guidelines.

You don't seem to ask why, and I'm just asking the question now: Why would they follow your guidelines? Other than the fact that they have the fear of God that if they do not, they have four massive regulators that are going to come down on them in some way? Is that a good principle to get things done?

The other area I wanted to ask you about is who is your counterparty in the Legislative Branch of Government? Who do you talk to up here on the Hill?

Mr. STEEL. Well, the other regulators or people—members can speak for themselves, but from the Treasury Department, we're in constant communication and regular communication with the leadership on the Hill and describing what we're doing both, as I said when I began, I appear here today as a representative of the Treasury Department and also Secretary Paulson as Chairman of the President's Working Group.

And so the regular dialogue that the Secretary has with leaders in Congress includes that same duality of responsibility. And I can comment from having been in meetings that both of those perspectives are discussed and considered.

Mr. KANJORSKI. I just want to break into that response because of a side question that I had. There is a rule in this Administration that no group or representative of the Administration comes to the Congress and makes a speech without having their remarks vetted by the Office of Management and Budget. Mr. Steel, were your remarks vetted today by the Office of Management and Budget?

Mr. STEEL. Not that I'm aware of, sir.

Mr. KANJORSKI. Was anybody else's here?

Mr. WARSH. No, sir.

Mr. KANJORSKI. So you have no vetting responsibility any more in this Administration? I mean, that is great if you do not. But I understood that you just don't make—

Mr. STEEL. Testimony is run by our colleagues and counterparts in other offices.

Mr. KANJORSKI. Who do you vet with?

Mr. STEEL. Within Treasury and discuss with other people.

Mr. KANJORSKI. Who were those other people?

Mr. STEEL. In Treasury, different divisions and different parts.

Mr. KANJORSKI. In Treasury? Nobody outside of the Department?

Mr. STEEL. Well, we would also discuss with people at the NEC and other areas where we work on economic issues continually. I think the idea of having a flat organization and getting the benefit of other people's perspective, but the idea of vetting, which was your choice of words, would not describe the situation at all.

Mr. KANJORSKI. Do you vet your material with these other agencies, like your speech?

Mr. STEEL. Vet with? With these—my colleagues here?

Mr. KANJORSKI. No. I mean, with the other agency. You mentioned the National Economic Council?

Mr. STEEL. They—we shared our perspective with them and have the benefit of ongoing discussions on economic policy continually.

Mr. KANJORSKI. You have on occasion, as a Working Group, sent material to the Congress to consider for legislation, have you not?

Mr. STEEL. Not that I'm aware of.

Mr. KANJORSKI. Nothing over the 20 years that you've sent up?

Mr. STEEL. Not that I'm aware of.

Mr. KANJORSKI. It has never dawned on anyone that it may be wise to codify guidelines that are going to be worked with?

Mr. BACHUS. Would the chairman yield?

Mr. KANJORSKI. Oh, surely.

Mr. BACHUS. Actually, I think the President's Working Group, after Long Term Capital and 9/11, submitted requests to Congress. That's my recollection, but—

Mr. WARSH. Congressman, at the request of Congress, as you know, the President's Working Group as its constituent members, have responded to questions and queries that have come up. We've certainly provided technical assistance. I think the point worth reiterating is that none of us, at least speaking on behalf of the Federal Reserve, cede any of the authorities which Congress has granted to us, to members of the PWG. That is, the PWG has consulted—

Mr. KANJORSKI. Do not call it that. It so disturbs me to have those initials used. Call it the President's Working Group. I hate the initials in Washington. It really illegitimizes your organization, if you know what I mean.

Mr. WARSH. So the point I was trying to make, Congressman, only is that each of us have authority. Certainly the Federal Reserve has authorities granted to us by Congress. We're overseen by this committee in the House.

Mr. KANJORSKI. No, but you understand why I am getting a little disturbed here. I heard in earlier testimony that you are creating two more working groups. You are having babies. A new generation is being born here, and I am trying to figure out when your marriage was held. Where do you think you have the right to form other groups that will exist out there interminably and be exercising leadership by virtue of the coerciveness of regulation?

I mean, does that not disturb anybody at the table?

Mr. STEEL. I'll try to describe it, sir, in a way that's not disturbing, but I view it as encouraging. And basically, what we're trying to do, as we've described in the guidelines and principles, is to get people together to share the very best practices—

Mr. KANJORSKI. Admirable.

Mr. STEEL. Excuse me.

Mr. KANJORSKI. I do not disagree with that, Mr. Steel. I am saying that what it is a sort of ethereal structure.

Mr. STEEL. Excuse me?

Mr. KANJORSKI. There is no body to it. There is nothing we can identify, you know, who is leading it and what rights it has. We do not know how big you are. We do not know how many people you have. You probably have the combined number of employees that exist in every one of your respective organizations and other people that you can get to participate in government. You start to become a very large umbrella operation, and probably find little need to go through the legislative process.

And then finally, one of the questions I am asking is: What do we have as a countervailing weight to you up here in the Legislative Branch of Government? You know, if I want to get tremendous

expertise, I do not have the Congress Working Group filled with experts of huge abilities. They are not around. How many people do we have, Mr. Chairman, on the committee? We have eight people.

The CHAIRMAN. Seventy.

Mr. KANJORSKI. Seventy on the full committee, but in terms of securities staff and things like this, what do we have, eight or ten people? But you have literally hundreds or thousands, and yet I thought under our structure we are supposed to be creating and passing the laws that implement you, that give you the authorities you will exercise. I am going to try and find your address downtown so that I can either come down and meet with you there at the President's Working Group headquarters, wherever that may be.

Mr. Chairman.

The CHAIRMAN. The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. Dr. Sirri, I don't have a question, just an observation. In reading over your rather distinguished resume, I noted your expertise in extra-planetary exploration, and at first wondered how someone with that suitability would be a hedge fund expert. But then when I started thinking about it, anybody who could talk about the details of exploration of Pluto probably has a pretty good grasp of what's going on in a hedge fund. So, I welcome you to the hearing with that acknowledgement.

Mr. SIRRI. Thank you.

Mr. BAKER. Mr. Overdahl, I was curious. In looking at the 1999 President's Working Group report, there was a recommendation relative to CPO filings. What is the Commodity Pool Operator filings? Can you tell me what the current frequency of reporting is today? Is it still annual, or is it quarterly?

Mr. OVERDAHL. I'll have to get back to you on that.

Mr. BAKER. Well, my reason for asking is it was annual. The report suggested that they at least move to quarterly, and the reason for that suggested modification was to provide additional transparency to market participants.

Mr. OVERDAHL. Right.

Mr. BAKER. That brings to the fore my generalized observation about this problem. We can't really describe who it is that we would like to subject to whatever regulatory regime, be it self-regulation or government regulation, who should report. We don't know what it is they should report if we could identify who they are.

But the most troubling aspect of it all is the frequency of reporting is so insufficient in light of the trading strategies, that all you would be able to do is get the license tag number of the truck that just ran over you. You wouldn't really get anything that could be instructive before the untoward event were to occur.

That all leads me to wonder if we couldn't have some set of triggering devices. For example, those commodity pool operators have some set of requirements which they must report to you. But not all hedge funds are registered CPOs. So you have people outside your regulatory regime, and not all CPOs are hedge funds. So we seem to have some regulatory arbitrage that would lead a smart business practitioner to figure out where the radar is weakest, and that's where I make my border crossing.

If, on the other hand, we had a multi-regulatory team agree that under certain triggering circumstances—and Mr. Steel, I'm going to jump to you after I hear Mr. Overdahl's response—if under certain circumstances, for example, high concentration in one economic activity, subprime lending, where it represents some agreed-upon percentage of business activity that would be generally viewed as aberrant.

In bank terms, we have limits on loans to one borrower. As a, for example, parallel, where that individual firm is engaged in a counterparty relationship where the counterparties from a regulatory perspective might not be as strong financially as we would like, where that fund has an excessive investment from certain protected classes; for example, a high degree of reliance on pension fund monies, where that fund has changed its profile within a certain period of time from its routine practice.

Now, all of that said, those are parameters you all should decide. But under those circumstances, what would be wrong when we identify that kind of aberrant actor from making a nonpublic disclosure to the appropriate Federal regulator for the purpose solely of insulating as best we can from a systemic risk shock? Do you have a view? Well, either one.

Mr. OVERDAHL. The way we've handled that at the CFTC, that is a delegated responsibility of the National Futures Association. My understanding is that these are annual disclosures. And beyond that, we do see the operators of the pools, when they're operating within our markets through our large trader reporting system, and that's going to be there whether they're registered, whether they're filing reports or not. And that's going to be true with—

Mr. BAKER. Well, because my time is about to expire, and I apologize for curtailing it. But I'm just saying a certain set of factors that would lead one to identify a fund practice as perhaps aberrant with market practice, shouldn't those folks be subject to some sort of required disclosure in that event? Mr. Steel?

Mr. STEEL. I agree with you completely that the issue of transparency to the funding so as to understand these types of challenges is exactly a good question. I think that the way we've thought about this is I'm going to defer to Governor Warsh, who can describe to you how they're convening all of the regulators to talk about best practices and sharing expertise to exactly accomplish what you're describing.

Mr. WARSH. Congressman Baker, as you know, these are issues that cross agency lines. What we've tried to do is to really have a supervisory review that does the same. Working with the SEC, the OCC and others, domestically and internationally, we at the Federal Reserve have tried to track what these risks are and to compare best practices.

Mr. BAKER. Well, it is possible, depending on the funding source, where a fund could be fairly large and not be subject to anybody's direct regulation at the table?

Mr. WARSH. Absolutely. I think—

Mr. BAKER. Or even reporting? I hate to say "regulation." I'm just talking about a private reporting regime so you can act on our social benefit behalf.

Mr. WARSH. As you and others have rightly pointed out, the regime of regulating hedge funds, for example, within the borders of the United States, is a difficult exercise. This capital is remarkably nimble, and as a result, we're finding ourselves increasingly working with our counterparts overseas to accomplish many of those same objectives.

I think the principles set out by the President's Working Group have been echoed in substantial respects by many of those regulators, so I have some degree of confidence that progress is being made across these jurisdictional lines.

The CHAIRMAN. Thank you. Let me just announce, we have votes in 15 minutes, so I'll ask the indulgence of the panel. We will have Ms. Waters' questions, and we will then adjourn to vote. We should be back in less than 40 minutes from the voting, and the committee will resume as soon as the people have gotten a chance to vote on the fourth vote.

The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman, and I'd like to thank the members of the President's Working Group for being here today. I am focused on what has happened in the subprime market. And I'm very much aware of the foreclosures that are devastating communities across this country. I've been in communities and cities such as Cleveland, Ohio, and now in Atlanta, and other places where whole blocks are boarded up. You know, people are losing their homes, and we all know why. We know that they were offered exotic products that they could not afford.

And what we did not know and what we did not understand was Wall Street's role in these loans that were being extended and afforded to people, many of whom certainly could not repay them. We are learning about products such as no verification of income, of course, the interest only, and on and on and on.

My question is—well, and also understanding and knowing Bear Stearns' exposure to the subprime loans recently required the firm to bail out two of its hedge funds. Bear Stearns put up $3.2 billion to rescue the two funds. What can you tell me about other hedge funds that might be in trouble because of exposure to subprime loans? And can we expect, as some are predicting, a collapse in the financial markets as a result of the subprime crisis? And recent loan performance in the subprime market appears to support the premise that the crisis certainly is not over, particularly with huge numbers of adjustable rate mortgages setting as we speak here today.

Again, what do you know about this and other hedge funds that may be in trouble? Why didn't you see this coming? And how are we going to correct this?

Mr. SIRRI. Congresswoman, the question about hedge funds and what we know about hedge funds, let me address that first, because your question raised many issues. With regard to—and I don't want to focus too much on any one event such as Bear Stearns. But let me explain to you a bit about the funding situation there.

You raised the point about $3 billion being used to bail out the funds managed by Bear Stearns. The way that funding is done is on a secured basis, by which I mean funds are lent against actual

securities themselves. So in that sense, capital was provided to support that fund, so it was actually only to one of the two Bear Stearns funds as far as we know, and we think that number was a little less than $3 billion. We think it was slightly over $1 billion at the point.

But moving beyond to the general point of your question, how would we know whether more of this is coming, our main window—and some of the other questioners asked questions that were related to this—our main window into this is indirect. It's through the providers of capital into the financial systems. The regulated banks and the regulated securities firms are the primary providers of capital to hedge funds, who in turn purchase securities or instruments linked to subprime mortgages.

When we go in to inspect those providers of capital, in the case of the SEC, we're going to look at prime brokers, the Bear Stearns, the Morgan Stanleys and such, we look very carefully at their practices for funding those instruments. We look at their ability to manage those risks. We look at the valuation practices that they have.

We look at all of those things holistically and make sure, as best we can, that they are not impairing the financial health of the regulated entity itself or of the holding company. In that sense, by doing that, we believe that we're appropriately minimizing the risk and managing the risk that a failure of a large, systemically important firm, such as big investment bank, would in fact bring risk to the financial system.

Ms. WATERS. Would anyone else like to comment?

Mr. WARSH. Thank you, Congresswoman. Let me speak principally on the subject of the financial markets, which I think you raised. Certainly the tumult that you've described and that is no doubt happening, particularly in certain communities, is very real and is generating very real losses in the financial markets.

From the Federal Reserve's perspective, I think our overall view is that there are certainly concerns that we might not be at the bottom of this tumult. But these losses don't appear to be raising, to this point, systemic risk issues. That in no way would suggest that the very real problems that some of your constituents and others are having aren't real. And, obviously, the Federal Reserve, working with other regulators, is doing its best to try to address those issues.

But the financial markets are certainly repricing risk in this environment in the housing markets and more broadly. The losses that have been felt by hedge funds and other financial intermediaries are certainly forcing them to go back to first principles, revisit their exposures. And what we're trying to do in our supervisory capacity is ensure that they still have adequate cushions, that they still have sufficient capital so that they can operate robustly in these markets. From the perspective of the institutions we oversee, we don't see any immediate systemic risk issues that are brought to bear.

Ms. WATERS. Thank you very much, Mr. Chairman. I yield back the balance of my time.

The CHAIRMAN. We'll recess and return in 35 minutes or so, as quickly as we can. I thank the panel.

[Recess]

The CHAIRMAN. The hearing will reconvene. That means the two people over there talking will please take seats. Sorry that we are late, but I do not want to inflict any more time constraints. Let's get those doors closed, please.

And in a very easy choice, I now recognize the gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman. I am glad to be an easy choice.

Dr. Sirri, I think this question should be addressed to you. In just reading Business Week in the last week or two, the magazine, there are all kinds of questions about hedge funds, etc. One of the ones that caught my attention was in the last couple of weeks. It says, "The Street's Next Big Scandal," and it goes on to talk about traders and hedge funds colluding to profit from privileged information. I will not go into a lot of details on this, you can sort of figure out where it is going.

They believe, this particular author believes, that the next big scandal will most likely involve brokerage activities and proprietary trading which long ago surpassed investment banking to become Wall Street's chief profit center, that is, trading on their own accounts in a variety of ways.

At the heart of the new collusion is the practice of frontrunning, essentially trading ahead of big buy and sell orders to profit unfairly from the resulting ups and downs in prices. The concern is that prime brokers are not only tipping off their own traders about big mutual fund orders on deck, but also giving the heads up to their hedge fund clients. The banks' rewards are two-fold, etc., as you can imagine profits on commissions and profits on the trades.

Meanwhile, mutual funds unwittingly subsidize this scheme by buying stocks at higher prices or selling at lower ones than they otherwise would. It's a slippery, slimy slope, lamented a mutual fund manager, adding that all these leaks make pure beating returns harder to achieve.

And then it says, "Regulators have been slow to crack down on what has quickly become an open secret. The U.S. Attorney's Office and the SEC have accused brokers from various companies of allowing clients to listen into their internal speaker systems." A series of things.

I mean the probably—I share very much what the chairman said, and what the ranking member said, and that is, it is hard for us to get our arms around exactly what the problems with hedge funds may be. But I know one thing. When you get a big money operation like this, people are trying to make money on it and, obviously, if brokers can take advantage of this, they may do that. There is just a lot of things we have to do.

And again, like the chairman, and the ranking member, and all of you, to a degree, I am not sure what we should be doing. I do not want to over-regulate. I happen to believe that there is tremendous equity advantage in hedge funds and private equity capital in terms of our markets and I think, frankly, all of you do a good job.

It is just that this is sort of new to everybody. And I am going to get into pension funds here in a moment, but I am concerned about those allegations. And I am concerned about what we are

doing that might prevent that from happening in the future without really judging whether it is really happening now or not and what perhaps, if anything, the SEC is doing in that particular area of this whole business of collusion and people just simply take advantage of information and knowledge.

Mr. SIRRI. Sure. Let me address that question. First let me say it is a very important question. It is one that runs to the heart of the SEC's mission of providing fair capital markets and investor protection. So there are two things that you put together that at times I think make sense in this context.

One is the behavior of a broker dealer protecting customer information and the other is, as you pointed out, the concentration of wealth and hedge funds and the fact that they are large entities that, that like they are big clients of the brokers.

We should be very clear about one thing. The broker dealers have an obligation to protect the proprietary nature of customer's order flow. To not do so would violate the securities laws.

Regardless of whether it is a single entity that is a person who is being tipped or a large hedge fund that is being tipped, the broker dealer must protect the confidential nature of that order flow and not leak it out to people for their own benefit or for the benefit of their clients. That is a violation of the securities' law. We have adequate authority to go after that. And, as you have noted, we have gone after such behavior. We have brought cases out in that way.

With regard to what you specifically mentioned with hedge funds having access to such things, our Office of Compliance, Inspections, and Examinations, has actually publicly said that we are looking exactly for that.

We have gone and requested out of a large number of broker dealers information, data, actual detailed trading data and we are trying to piece together and look for exactly, the footprint of exactly what you are citing. That is, a tip or a trade coming and then or an order coming and other trades front-running the eventual consummation of that trade benefitting some other parties who were actually in process or looking for that.

So I would say that it is probably, you know, the article may have characterized the idea that we are running behind there, but I think we are very much aware of that. The difficulty, of course, is detecting, but we are looking with all our tools to detect that. I think we are crystal clear that violates Federal securities laws.

Mr. CASTLE. And I didn't read the entire article to you obviously, but you may have read it yourself. But it goes on to say how difficult it is to prove all these things. It is hard to get cooperative witnesses, etc. So your work is cut out for you and we appreciate what you are doing on that.

Mr. SIRRI. Thank you.

Mr. CASTLE. Secretary Steel, let me turn to an area that concerns me that I mentioned. You have talked about the principles and the guidelines which were revealed earlier this year and the discussion of the industry's best practices.

My concern—and I'm not that concerned about the extremely wealthy investors in hedge funds, but I am becoming increasingly concerned about the institutional investor, particularly pension

funds. There are many individuals who are not wealthy who may receiving a payment or will receive a payment from that pension fund, the fiduciary which decides to get into a hedge fund. And I am not sure what knowledge they actually have.

I do not know—in some of the due diligence you have spoken about, in some of the best practices you have adopted in your principles and guidelines are—is this information which is available to the individuals who are going to be actually getting involved in that investment or is it just to you as regulators?

I mean I want to make sure these people who are representing more middle America, if you will, actually know what the heck they are getting into. I cannot judge whether they are good investors or not. But at least they would have full knowledge. Is it moving in that direction?

Mr. STEEL. Congressman, you ask an important question. And in my opening comments I chose or tried to highlight this, that we at Treasury and the President's Working Group think this is a crucial issue.

As I said, when hedge funds began, it was the province of wealthy individuals and then it spread to foundations and endowments. But today it is basically pulling others into the area where they are affected and in particular through pension funds and things of that ilk.

When we wrote the principles and guidelines, we dedicated one of the principles to this specific issue. Principal Number 5 basically talks about the importance of this trend and that the key front-line defender has to be the fiduciary. And the fiduciaries representing these people should be a very demanding investor.

We give specific examples of what they should want to understand, the importance of diversification as they construct the proper portfolio for that pension plan.

Next, I'm quite comfortable that the way we're going and the forward-leaning perspective with our declaration that we are not confirming the status quo. Instead when we convene the group of people to help us think about the investors and the best practice for investors, our plan is to include as key members of that group the very best people from the pension world to help set standards and rules that can be a signpost for people who want to understand best practices as fiduciaries as they consider allocating part of the assets of a pension fund to alternative asset products.

Mr. CASTLE. My time is up. If I could just ask one very brief—I cannot.

The CHAIRMAN. If you want to make a statement?

Mr. CASTLE. Well, the only statement I was going to make, Mr. Chairman, is—and I did not get a chance to say this per se—I understand the fiduciary's responsibility, but ultimately I think it is very important to make sure that the fiduciary has the information to be able to make that decision.

I am not 100 percent comfortable with that now although perhaps I can be persuaded with a little more attention to it.

The CHAIRMAN. I think that is right, that is the fiduciary after all is a fiduciary for other people. We have some obligation to make sure that if the fiduciary screws up, it is not only the fiduciary who suffers. So, it is not enough to say, "Well, it was the fiduciary's

fault." Because we have to protect the people who are the fiduciaries' presumed beneficiaries.

Mr. CASTLE. Yes, sir.

The CHAIRMAN. Let me just say, Mr. Secretary, I think you kind of summed up the message. I hope people have taken this which is the fact that there have not been any new proposals for increased regulation, etc., is not an endorsement to the status quo. I think that is the important lesson for people to take. That there is a recognition that this is an ongoing issue. The absence of any specific new regulatory scheme right now is not an endorsement of the status quo. I appreciate your putting it that way.

The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman.

I thank the witnesses for appearing today. I also thank the ranking member, in his absence, and I would like to pick up where the chairperson left off with the responsibility of the fiduciary. But let us start with the notion and premise that historically hedge funds have been available to sophisticated investors. Sophisticated investors are not sophisticated by virtue of their knowledge. Knowledge alone does not make one a sophisticated investor.

Unfortunately or fortunately as the case may be, to become a sophisticated investor, one has to have a certain amount of assets. Does anyone differ with that premise? That you have to have a combination of assets and knowledge to be a sophisticated investor for the purpose of investing in a hedge fund traditionally as we define sophisticated investor.

Mr. SIRRI. The Federal securities laws provide for various tests: Income levels, in some instances investments, and in other instances assets

Mr. GREEN. Okay. So the assets are important to this process. And my concern, and it is a serious concern, is the problem that we have when we commingle sophisticated funds with what Mr. Steel calls less sophisticated and some others may have utilized this terminology, I use the term "unsophisticated" funds.

When you have these funds commingled, then we have a problem because no matter how much knowledge the people acquire who are part of a pension fund, they will not become a sophisticated investor. The knowledge alone will not make them sophisticated investors.

Traditionally the reason we have had these sophisticated investors in hedge funds is because they could suffer the loss. If they suffered a loss, we had an individual or family that lost money and as bad as that is, it would not have the kind of impact that we can have on a market that the system itself, the people who happen to be a part of society because if a pension fund takes a serious hit, then we have a lot of people that we have to concern ourselves with as opposed to a family, as opposed to an individual who has an inordinate amount of money and God bless the person who has it. I think everybody ought to be a millionaire in a country where 1 out of every 110 persons is a millionaire.

In fact, in this country, it is almost unhealthy not to be a millionaire, so everybody ought to want to try to become a millionaire in America. This is the richest country in the world, a country where we can spend $353 million a day on a war and still do well.

So my question and my concern have to do with having these persons who have their pensions who are not sophisticated even if they have Ph.Ds in economics, they are still not sophisticated investors.

And when this, if something goes belly up and the stock market of 1929 would never have gone belly up, should not have gone belly up, but it did. Enron should not have failed, but it did. We have had other instances where institutions, long term capital should not have failed, but it did. And nothing fails until it does. And when it does, then we have problems and taxpayers pick up a large portion of the tab because people eventually who are pensioners will go to the public trough in the form of public assistance and they need assistance and they ought to receive it by the way.

So I do concern myself with this notion of a fiduciary being able to shoulder all of the burden for what can happen when those funds are intermingled and we have a loss. That is a real concern for me. And I don't know that I have heard anything that addresses this concern to the extent that I feel comfortable with this, the continuation of this as it is currently.

Perhaps there is a way to do this and my chairman is very enlightened and I am sure that he will help me through it as well as others, but maybe there is a way to do this and not create the consternation that we are going to—that I have and maybe it is just me but that I have on behalf, I think, of the working people in this country who are finding more and more of their money going into the sophisticated market. This is a sophisticated market. And people who engage in this ought to have a better understanding and the capital to back up the losses that they may suffer.

Is that my time, Mr. Chairman?

The CHAIRMAN. You still have about 30 seconds.

Mr. GREEN. Thirty seconds. The question would be this. Explain to me how we can allay the concern that I called to your attention with reference to the sophisticated and unsophisticated or non-sophisticated or less sophisticated monies being commingled.

Mr. SIRRI. Congressman, let me see if I can shed some light on this. You are quite correct in how you have characterized sophistication. The Federal securities laws provide that you have to be—have some little wealth, income or assets to buy a hedge fund as an individual and that is as you have stated.

You bring up the issue of the fiduciary. One of the reasons—and you are noting that there seems to be something that does not match because unsophisticated people find themselves invested in investments that are normally held by sophisticated entities.

I think there are two things. One, the first, is what you observed, the fiduciary. That person has a heightened responsibility to invest for those people. But the other is the amount of investment that is made.

A fiduciary, if acting properly for say a pension fund, would never plunge 50 or 80 percent of their assets into one or more hedge funds. They would prudently place a small amount of assets in a hedge fund.

When you turn to an individual, one of the reasons why we have wealth and income standards is there is a chance that an individual investor might place half of their wealth in a hedge fund,

and that is dangerous. That is why we have the high wealth standards.

What I am about to point out is that when a fiduciary is acting, and they are investing a pool of say, pension fund monies, it is not going to be the case that 30, 50, or 90 percent of that pool is in hedge funds.

It is going to be the case that hopefully a prudent amount is in hedge funds and it depends on the purpose. And so the exact quantity will serve to protect you.

Mr. GREEN. Just a quick response, Mr. Chairman, and then I yield back my time.

But there is nothing that thwarts a fiduciary from doing the opposite, the antithesis of what you just said.

Mr. SIRRI. Well, the fiduciary has an obligation to invest prudently and what you are pointing out is that fiduciary would not have the best interests of their beneficiaries in mind.

If that is the case—I am not saying that could not happen. But if that is the case, that fiduciary could have just as well put 100 percent of their investments in tech stocks in the late 1990's.

The CHAIRMAN. Would the gentleman yield to me?

Let me say this because I think he is on a very important point and it is really related to what the gentleman from Louisiana had said and the gentleman from Delaware. Yes, it is the fiduciary's responsibility, but if we are talking about an individual investor, if an individual mis-invests several million dollars of her own money that is too bad for her. With a fiduciary, it is other people.

And I think the point is this: You are right. That has always been a problem. The problem is that hedge funds appear to many of us to be a new and more enticing opportunity for the unwary fiduciary. And the problem we think is not just the one who does not have his or her client's interests at heart or beneficiaries, but who does not have the smarts to do it.

And that is why we think this increased set of very complex opportunities promising a very high rate of return create a new potential problem that particularly with regard to fiduciaries that we may have to do some new things.

The gentlewoman from New York has arrived and is now recognized to ask some more questions.

Mrs. MALONEY. Thank you very much.

Going back to my original questions, my concern about the Bear Stearns funds is not whether the funds themselves go under, or even if a major firm loses money, my main concern is what effect a sale of CDOs assets would have had on all institutions holding similar securities. And do each of you believe that the institutions that you oversee are valuing those assets properly? Are the credit rating agencies acting with appropriate speed to downgrade assets that no longer warrant their investment grade?

And what about the customers such as pension funds, endowments, and so forth to whom these securities are sold, the CDOs, other mortgage derivatives. What about them? Are they valuing them properly?

And what is the systemic consequences of a broad downgrade or significant deterioration of those types of securities' values?

So I would like everyone to respond on whether you feel they are valued. Is there a bubble there? And what is the systemic, the systemic effect really on the markets with properly valuing them?

Mr. WARSH. Thank you, Congresswoman. Perhaps I will go first, but I will defer on the specific matter of Bear Stearns that you referenced to my colleague from the SEC who has oversight over them.

Let me talk a little bit more broadly—

Mrs. MALONEY. I want to make it clear. I am not asking about Bear Stearns. I am not talking about a major firm losing money, but what effect it has on the value of the CDOs and the systemic problem it could have on the markets and on the proper valuing of the CDOs.

Mr. WARSH. As you heard from us at the outset, market discipline is going to have a critically important role to play here. Market discipline is tough medicine and I think, Congresswoman, to your point, losses will no doubt be held by some individuals and institutions that own collateralized debt obligations and other securities as the markets turn against them.

And it is these losses which force all institutions to go back to first principles, revisit their valuations, revisit the ratings that have put on these securities to make sure they know where their risks are. The Federal Reserve, as regulators and supervisors of U.S. bank holding companies, is keenly focused on ensuring that the risks held by these institutions are manageable.

We are not in the business of trying to ensure that there are not losses but only to ensure that there are capital cushions, risk management processes, and proper oversight to ensure that those losses do not become systemic.

Mrs. MALONEY. But do you believe that these, that they are being valued—are these assets being valued properly? The credit agencies are still giving them 100 percent rating. Some analysts are saying they are really worth 20 percent. This is problematic.

Do you believe they are being valued appropriately?

Mr. WARSH. I would expect that—

Mrs. MALONEY. Is there a bubble out there?

Mr. WARSH. I would expect that the valuations of these securities are at the crux of what regulated institutions are reviewing as we speak. The valuations that have been put on securities that tend to be more complex, that tend to be less liquid, is both art and science. And I think that those institutions that rely wholly on models, that rely wholly on history of the last 4 or 5 years, are learning market lessons. That is, many of these new products—though they have been tested to some degree in recent months—may not have been subjected to the most adverse stress test.

Speaking for the Federal Reserve, that is part and parcel of one of our priorities to ensure that the stress test work that we have done with our regulatees is taken to the next level to ensure that there are not risks that should be brought to bear.

Mrs. MALONEY. Some analysts have said that they believe there should be broad downgrades. What is the systemic consequence of broad downgrades on these assets? And I would like to go to someone else on the panel.

Mr. WARSH. Would you like me to briefly answer that and then I will defer to—

Mrs. MALONEY. I would like to let someone else speak.

Mr. STEEL. Thank you. You asked an important question and I think my response would be in line with Governor Warsh's, that the key issues here are current pricing which you keep poking at and the issue of cushions or liquidity margin against them.

And I think that right now the market is adjusting and seems to be settling at new prices. And right now there is stress in the subprime market. It does not seem to be a systemic issue which you have asked repeatedly and that would be the representation we would make. But it is going through an adjustment process. And so that will happen as the market develops and it seems as though it is happening in an orderly way.

We have the largest residential financial market for housing in the world. It is $10 trillion, and it is a terribly important asset to the economy and to the housing market.

It is now going through a process of revaluing certain parts of it, but I would not describe it in any alarming way other than it is going to go through the process of resetting prices, people readjusting their margin as the market adjusts and as Governor Warsh said, the harsh medicine of market conditions and the truth of the marketplace.

The CHAIRMAN. Thank you. Actually I would say to Governor Warsh that I think people are very happy that the Fed is dealing with stress test. The fear is that they will do a little stress reality with interest rates. That will be the—stick with the tests.

The gentleman from Texas is now recognized for one last question and then the hearing will adjourn.

Mr. GREEN. Thank you, Mr. Chairman.

This will be to Dr. Sirri. Sir, would you oppose a codification of what you expressed in terms of a judicious prudent manager surrogate, if you will, having to invest not more than a certain percentage of a certain pension in a hedge fund?

Mr. SIRRI. I do not, you know—

Mr. GREEN. The fiduciary.

Mr. SIRRI. Sure. I think it is very difficult to place that kind of a structure. I understand what you are getting at and let me tell you why. A hedge fund could be in fact a long only equity fund and be a perfect substitute for a common mutual fund that you find today. And some hedge funds do exactly that.

Other hedge funds as we have been talking about invest in exotic instruments. So it is actually the job of the fiduciary to see through all of that and to find in fact a prudent packaging of instruments for the beneficial owners.

It is really—it is very, very difficult to take the fiduciary off the hook in my view here. That is really where the rubber meets the road. And it extends to the point where a diligent fiduciary in many ways—for example, a fiduciary looking to invest for people's retirement who didn't select a small portion of say alternative investments may not always be acting in the best interest of investors.

Mr. GREEN. I yield back. Thank you, sir.

The CHAIRMAN. I thank you for returning. The hearing is adjourned. I must say that I think this has been very useful, and I hope that people will pay serious attention. We have, I think, a pretty good consensus that this is an issue that we have to remain seriously on top of. We have to be considering it and the final chapter has not been written. I think people should have some assurance, though, that there is an awareness of the problems and the risks and serious people are attuned to it.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

A P P E N D I X

July 11, 2007

Commodity Futures Trading Commission
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Testimony

Testimony of James A. Overdahl, Chief Economist
U. S. Commodity Futures Trading Commission
Before the
U.S. House of Representatives
Committee on Financial Services
July 11, 2007

Chairman Frank, Congressman Bachus, and Members of the Committee, I am pleased to have this opportunity to testify on behalf of the Commodity Futures Trading Commission (CFTC) on hedge funds and systemic risk. The Chairman of the CFTC is a member of the President's Working Group on Financial Markets (PWG). In this capacity, the CFTC participated in the deliberations that resulted in the agreement announced by the PWG in February setting out principles and guidelines regarding private pools of capital.

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, regardless of whether their operators and advisors are registered or not. 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 five topics. First, I will share some observations regarding the participation of hedge funds in 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 customers from fraudulent practices in the sale of commodity pools, including hedge funds. Fourth, I will describe the financial safeguard system in place to ensure that the financial distress of a single futures market participant, whether or not that participant is a hedge fund, does not have a disproportionate

effect on the overall market. 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. Comparing findings from the CFTC's 1996 hedge fund study (using 1994 data) to today, we see that the average number of funds participating in futures markets has grown across nearly all markets. Also, it appears that funds, on average, hold positions in more markets today than in 1994.

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 an important role in keeping prices of related markets (and prices of related contracts within the same market complex) in proper alignment with one another. On the one hand, to the extent that hedge funds and other arbitrageurs judge these price relationships correctly, the arbitrageurs profit. On the other hand, if they misjudge these price relationships they may lose. The losses may be significant as market discipline may punish errors in market judgment severely.

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 its 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. These analysts also closely track 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 regular closed surveillance meetings as well as on an as-needed basis.

Market surveillance, however, is not conducted exclusively by the CFTC. Each futures exchange is required under the CEA to affirmatively and effectively monitor 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 speculative position limits and position accountability levels, 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 close positions prior to the expiration month when manipulation is most likely to occur, and simultaneously establish similar positions in more distant months, because most do not have the capabilities or desire to make or take delivery of the underlying commodity. This process is referred to as rolling over a position.

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 that, 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.

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 persons who participate in commodity pools, including hedge funds.

Registration is the cornerstone of the CFTC's customer protection scheme. As of March 31, 2007, there were approximately 1,500 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, the last full year for which data are currently available, 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 a very high 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 that 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 specified financial and sophistication criteria. Relief consisting of reduced 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 investments with an aggregate market value of 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. As with the activities of a CPO or CTA, no matter the size of the pool they operate and/or advise, the CFTC's regulatory framework focuses upon disclosure of relevant, material information to pool participants, rather than prohibitions on conduct.

Finally, the day-to-day monitoring of CPOs and CTAs is carried out by the National Futures Association (NFA), the futures industry analogue of the National Association of Securities Dealers, and an organization of which futures industry registrants must be members. 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 CPOs and CTAs within two years of their becoming active, and every four years thereafter.

Consistent with the recommendations contained in the President's Working Group Principles and Guidelines on Private Pools of Capital, the CFTC participates actively in the work of the International Organization of Securities Commissions (IOSCO) to expand the sharing of information among regulators, address systemic risk issues and strengthen the disclosure of data needed to assess risk. For example, the CFTC participates in work of IOSCO's Standing Committee on Investment Management, which this past year issued a draft consultation report recommending general principles for the valuation of hedge fund assets, and currently is studying regulatory and investor protection issues arising from the participation by retail investors in hedge funds.

Hedge Funds and the Futures Industry's Financial Safeguard System

The collapse of funds operated by Long Term Capital Management in 1998 and Amaranth Advisors, LLC., in 2006 highlight concerns about the risks potentially posed by a large hedge fund on the financial system as a whole. Within the futures industry, the clearinghouse affiliated with each exchange and the clearing member firms of each clearinghouse play a critical role in ensuring that the financial distress of any single futures market participant, whether or not that participant is a hedge fund, does not have a disproportionate effect on the overall market. This is primarily accomplished through a clearinghouse's financial safeguards.

All market participants must have their futures transactions, and the positions resulting from such transactions, cleared at a futures clearinghouse through a clearing member firm of that clearinghouse. Clearing member firms that carry positions on behalf of others must be CFTC-registered futures commission merchants (FCMs). FCMs are financial intermediaries that must adhere to CFTC-specified minimum net capital requirements.

Futures clearinghouses use a variety of financial safeguards to protect the clearing system from the financial difficulties of any firm that is part of that system. A clearinghouse's financial safeguard system involves multiple tiers. The first tier is the payment and collection of daily variation margin. At least once each day, clearinghouses mark open positions to the current market price and collect funds, in cash, from firms whose positions have lost value and pay to firms whose positions have gained value. The second tier includes the performance-bond margin deposited by clearing member firms with the clearinghouse to support open positions held on behalf of their customers or for their own proprietary accounts. The third tier may include the capital of the clearinghouse in excess of the working capital required for continuing clearinghouse operations. Clearinghouses also typically maintain guarantee funds made up of security deposits posted by each clearing firm. If all of these funds are exhausted, many clearinghouses have the right to assess clearing members for unsatisfied obligations. Clearinghouses also hold credit lines to ensure that funds are immediately available in the case of an emergency. Finally, clearinghouses perform daily surveillance of open positions, frequent stress testing, and periodic risk evaluations of clearing member firms in an attempt to detect potential weaknesses in financial condition or risk controls.

In addition to these safeguards at the clearing organization level, each clearing member firm has its own financial safeguards in place to protect itself from the financial distress of a customer—including a hedge fund customer. For example, each clearing firm is required under exchange rules to collect a specified minimum level of performance bond from each customer.

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 seven fiscal years, the CFTC filed 58 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 34 pending litigations and approximately 20 additional open investigations and preliminary inquiries concerning 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 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. Because these hedge funds engaged in futures-related activities, the CFTC took action to punish illegal conduct (whether it occurred during solicitation of prospective participants or as an aspect of trading by the pool), deter future violations, and seek recovery of monies taken from innocent victimized investors. The following two cases, filed within the past three months are illustrative:

On April 25, 2007, the CFTC filed an enforcement action against Anthony A. Demasi and his company, a self-described hedge fund called Tsunami Capital, LLC. Since at least December 2004, the defendants allegedly solicited commodity pool investments based upon a false track record of trading profits when in fact there were either trading losses or no trading at all. Current investor losses have been estimated to be in excess of $12 million.

On April 17, 2007, the CFTC filed an injunctive action against Parish Economics, LLC and its president and owner, Albert E. Parish Jr., alleging commodity pool fraud. The commodity pool in question purportedly invested in "the commodity and stock futures and options markets." However, commencing in or about January 2003, the pool allegedly issued false account statements and also misappropriated funds. The investors' current estimated losses from this alleged fraud, which include a large share of the endowment fund of the university where Parish was a professor, exceeds $50 million.

In many instances, the CFTC works cooperatively with NFA, state regulators, criminal authorities and/or the SEC in bringing such actions. In Parish, for example, based upon the same conduct alleged by the CFTC, the SEC and United States Attorney for the District of South Carolina have also brought charges.

Conclusion

In closing, I want to repeat that 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 prospective investors in commodity pools receive all the information that is material to their decision to invest in pools and, once invested, to remain pool participants; 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.

TESTIMONY
OF

ERIK R. SIRRI, DIRECTOR
DIVISION OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
RECENT INITIATIVES TAKEN BY THE COMMISSION WITH RESPECT TO HEDGE FUNDS

BEFORE THE
COMMITTEE ON FINANCIAL SERVICES

U. S. HOUSE OF REPRESENTATIVES

JULY 11, 2007

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Testimony of Erik R. Sirri, Director

Division of Market Regulation, U.S. Securities and Exchange Commission

Concerning Recent Initiatives Taken by the Commission

With Respect to Hedge Funds

Before the

Financial Services Committee

U.S. House of Representatives

July 11, 2007

Chairman Frank, Ranking Member Bachus and Members of the Committee:

On behalf of the Securities and Exchange Commission, I appreciate the opportunity to speak with you today regarding recent initiatives being taken by the Commission with respect to hedge funds. Even as the Commission believes that private pools of capital, such as hedge funds, bring significant benefits to the financial markets, the Commission is also working diligently to protect hedge fund investors and other market participants against fraud and to ameliorate through its oversight of the internationally active US securities firms the broader systemic risks such funds potentially pose to our financial system.

As you know, the President's Working Group ("PWG")[1] released principles and guidelines regarding private pools of capital, such as hedge funds. These principles complement and inform the regulatory and supervisory work of each of the PWG agencies with respect to investors, fiduciaries, creditors, and counterparties.

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[1] The PWG is composed of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission.

In my testimony today, I am pleased to speak with you about several SEC initiatives that the Commission believes will further these goals. These include our continuing vigorous enforcement of the federal laws in this area; a new rulemaking to clarify our ability to bring enforcement proceedings against an investment adviser who defrauds investors or potential investors in a hedge fund or other pooled investment vehicle; the Commission's rulemaking to add a new category of "accredited investor" under the Securities Act of 1933 with an increased net worth standard; and the Commission's Consolidated Supervised Entity Program.

Enforcement Against Hedge Fund Advisers

A critical component of our efforts to protect investors and the integrity of our trading markets is our enforcement program. The Commission has brought cases alleging frauds by hedge fund managers against the funds they manage and the investors in those funds, as well as violations of the securities laws by hedge fund managers that implicate the integrity and fairness of our trading markets, such as insider trading, market manipulation, illegal short selling, and fraudulent market timing and late trading of mutual fund shares. Insider trading by hedge fund managers is an area of concern to the Commission, and is a focus of our current enforcement efforts. In March of this year, the Commission filed cases alleging one of the most pervasive Wall Street insider trading rings since the days of Ivan Boesky and Dennis Levine. We alleged that participants in the scheme included several hedge funds and their portfolio managers. In another recent case, we charged a pharmaceutical company executive and his three sons with insider trading. We alleged that, in the course of a scheme, in which the father regularly tipped his sons with confidential information misappropriated from his employer, the family created a purported hedge fund to conduct the trading and further obscure their identities. Also in the past year, we have brought enforcement actions against hedge fund advisers and portfolio managers

for illegally trading in advance of PIPEs or similar offerings. We alleged in those cases that the defendants made material misrepresentations to the issuers of the securities, and that some defendants engaged in insider trading in connection with the offerings. We have also brought enforcement actions in the past year against well known hedge fund advisers for allegedly engaging in illegal short sales in connection with multiple public offerings; against an adviser that allegedly engaged in cherry-picking of trades to favor a hedge fund client over other advisory clients; against hedge fund advisers we alleged engaged in fraudulent market timing and late trading of mutual fund shares; and against hedge fund managers we alleged stole money from their investors, and made misrepresentations about matters such as the performance of the funds' investments, strategies, and risk of loss. In some of these cases we have worked side-by-side with criminal authorities who have brought their own cases in connection with the illegal conduct.

Although there are many unregistered hedge fund advisers, more than 1,900 investment advisers to hedge funds are registered with the SEC. These firms, along with other registered advisers, are required by SEC rules to have a chief compliance officer and a compliance program that includes written compliance policies and procedures. They are also subject to SEC examination. During such an examination, the SEC's inspection staff may review the adviser's compliance program with respect to, for example, disclosures to investors, portfolio trading, pricing and valuation practices, its code of ethics, and personal trading activities.

Hedge Fund Related Rulemakings

This past December, the Commission proposed a new antifraud rule under the Investment Advisers Act of 1940 to clarify its ability to bring actions under the Investment Advisers Act against advisers who defraud investors in a hedge fund or other pooled investment vehicles. At

an open meeting today, the Commission will consider adopting that rule, which would prohibit investment advisers to hedge funds from making false or misleading statements to, or otherwise defrauding, investors in hedge funds.

The Commission proposed the rule after a court decision, Goldstein v. SEC, created uncertainty regarding the obligation that investment advisers to pools have to investors. The court vacated a rule that the Commission adopted in 2004 that required certain hedge fund advisers to register under the Investment Advisers Act. In addressing the scope of the exemption from registration in section 203(b)(3) of the Investment Advisers Act, and the meaning of the term "client" as used in that section, the court expressed the view that, for purposes of sections 206(1) and (2) of the Investment Advisers Act, the "client" of an investment adviser managing the pool is the pool itself, not the investors in the pool. The proposed rule would address the uncertainty created by the Goldstein decision regarding conduct aimed at investors by prohibiting advisers from (i) making false or misleading statements to investors in pooled investment vehicles, or (ii) otherwise defrauding them.

The Commission is currently considering increasing financial thresholds for investors in private offerings of hedge funds and private equity funds.

Consolidated Supervised Entities Program

In general, the growth in private pools of capital, such as hedge funds, has made the financial markets wider and deeper, supported significant product innovation, and allowed for greater risk transfer. At the same time, this development has created numerous challenges for regulated financial institutions and their supervisors.

At present, the Commission supervises five securities firms on a consolidated or group-wide basis – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan

Stanley – also known as the CSEs. For such firms, the Commission oversees not only the U.S.-registered broker-dealer, but the consolidated entity, which may include other regulated entities such as foreign-registered broker-dealers and banks, as well as unregulated entities, such as derivatives dealers and the holding company itself.

The Commission's CSE program is designed to provide holding company supervision in a manner that is broadly consistent with the oversight provided to bank holding companies by the Federal Reserve. The aim of this program is to diminish the likelihood that weakness in the holding company itself or any of its unregulated affiliates places a regulated entity, such as a bank or broker-dealer, or the broader financial system, at risk. CSEs are subject to a number of requirements under the program, including monthly computation of a capital adequacy measure consistent with the Basel II Standard, maintenance of substantial amounts of liquidity at the holding company, and documentation of a comprehensive system of internal controls which are subject to Commission inspection.

All five of the CSEs are of potentially systemic importance, trading a wide range of financial products, connected through counterparty relationships to other large institutions and providing services to a variety of market participants. Prudential supervision of CSEs differs from the investor protection activities previously discussed. The primary concern of the CSE program with regard to hedge funds revolves around the risks they potentially pose to the CSE firms specifically and, through the CSEs, to the financial system.

Hedge funds present a variety of management challenges to CSEs. For example, a hedge fund may grow so large in absolute terms that a forced liquidation could lead to a broader unwinding of positions and otherwise disrupt the markets. The demise of Long Term Capital Management in 1998, Amaranth's losses related to natural gas derivatives last year, and the

BSAM hedge funds' losses on securitized products referencing subprime mortgages this year highlights concerns associated with such risks.

In addition, the rapid development of risk transfer mechanisms (such as credit derivatives and securitization) is often cited as evidence that today's markets have better shock absorbers than in the past. However, the transfer of risk from banks and securities firms to hedge funds and other market participants may not be as definitive as some believe. Financing arrangements for certain exposures through repurchase (repo) facilities and derivative transactions serve not only to increase the amount of leverage in the system, but may also bring risk back to regulated financial institutions in ways that can be challenging for the firms to measure and manage.

The Commission's CSE program monitors and assesses these risks in several ways.

First, Commission staff meets at least monthly with senior risk managers at the CSEs to review market and credit risk exposures, including those to hedge funds. This process provides information not only concerning the potential risks to CSEs, but also a broad window into their relationship with hedge funds and these hedge funds' potential impact on the broader financial markets. Importantly, these meetings allow Commission staff to monitor trends in the extension of credit to hedge funds through a variety of channels, including prime brokerage relationships, secured financings such as repos and OTC derivative trades. Regulators have expressed concerns in recent years that competition for lucrative hedge fund business, in some instances, may have led to erosion of financing terms. Through this monthly process, we endeavor to track changes in margin terms and other credit mitigants. Where warranted and where the information we obtain is timely, we can respond with respect to CSEs by requiring that they hold additional capital against such exposures.

Second, Commission staff has recently engaged in targeted discussions with the CSEs about the challenges of measuring credit exposures to hedge funds. For example, risk managers cite the need for stress testing their exposures to hedge fund counterparties. There is a general consensus that measures such as value-at-risk (VaR) may not be sufficient for judging the risk presented by hedge fund counterparties implementing complex strategies, and hence the adequacy of the collateral protecting the bank and securities firms that provide financing. Firms have found it challenging to design and implement stress tests that can be applied effectively and efficiently to the wide variety of fund strategies, especially given that these strategies are continually evolving. The internationally active banks and securities firms, including CSEs, have devoted appreciable time and resources to this task, and further work continues.

Finally, over the past nine months, the Commission's staff has embarked on a joint project with the Federal Reserve and the U.K. Financial Services Authority to understand current industry practices of banks and broker-dealers in managing their exposure to hedge funds. All three agencies met with nine major U.S. and European banks and securities firms in December to discuss broadly their risk management policies and procedures related to interactions with hedge funds both through prime brokerage, the direct financing of positions, and OTC derivatives transactions. Germany's Bundesbank and Financial Supervisory Authority, the Swiss Banking Commission, and the U.S. Office of the Comptroller of the Currency also participated in the meetings with institutions for which they were the principal regulator. The agencies have identified a number of issues related to the extension of credit to hedge funds, and are now addressing those issues in a second phase which entails more detailed work by the principal regulator of each firm.

Taken together, these efforts allow us to identify some trends that we and our regulatory colleagues, as well as risk managers at the large banks and securities firms, will surely continue to follow closely. The demise of Amaranth and the issues associated with the BSAM hedge funds also provide some interesting data points to consider.

First, some of the largest, more systemically important hedge funds are beginning to look more and more like mature financial institutions, diversifying their portfolios beyond leveraged equity or fixed income strategies, and diversifying their activities beyond just proprietary trading. From private equity to middle-market lending, there are few markets where these large hedge funds are still on the sidelines. Likewise, some hedge fund complexes have traditional asset management and market-making divisions that compete with those of established investment banks. Along with this widening scope of investments and activities, a number of hedge funds appear to be strengthening their independent control functions, such as market and liquidity risk management.

Second, hedge funds generally have become more sophisticated about liquidity risk management, in part by negotiating more flexible credit terms with dealer banks. During recent episodes of heightened market volatility – for instance in the energy markets last year, equities and emerging markets this spring, and the mortgage market recently – Commission staff consistently heard that most hedge funds met their margin calls in a timely manner, without difficulty (with a few notable exceptions, of course). To be sure, this increase in sophistication is both a blessing and a curse. On the one hand, more favorable credit terms means more flexibility in times of market turmoil, leading to a lower probability of a forced unwinding of positions and destabilized markets. On the other hand, more favorable credit terms mean more concentrated counterparty credit risk for the banks. In the case of Amaranth, it was able to sell large portions

of its portfolio in an orderly way to satisfy all of its creditors; had it not, the credit risk losses at its creditor banks could have been significant. Assessing whether a healthy balance is being struck will continue to be a challenge for dealer banks and their supervisors.

Third, in some markets, hedge funds are the major providers of liquidity – in short, what they giveth, they can taketh away. The impact that the BSAM hedge funds' losses is having on the subprime mortgage market illustrates the point. The funds were major players in the market for structured mortgage products such as collateralized debt obligations containing asset backed securities ("ABS CDOs"). When it became apparent that the funds needed to liquidate large portions of their portfolios to meet creditor demands, a number of hedge fund market participants moved to the sidelines and market liquidity fell sharply.

Finally, leverage can be achieved in a myriad of ways. The economics of a margin loan can be replicated in synthetic form through derivatives or achieved through repurchase agreements. Even if financial leverage could somehow be constrained, the ability to engineer economic leverage through structured products is virtually infinite, as seen in the CDO markets. The regulatory focus on excessive leverage is the right one, but this is far from simple in today's innovative financial markets.

While these trends will continue to challenge regulated institutions and their supervisors, the focus in recent years on counterparty credit risk management has clearly been good for financial institutions and the financial system as a whole. After the failure of Long-Term Capital Management in 1998, the Counterparty Risk Management Policy Group brought together senior risk managers from the major commercial and investment banks to consider the lessons of that event. Their report addressed systemic risk concerns by articulating best practices in counterparty risk management appropriate to regulated entities such as banks and securities

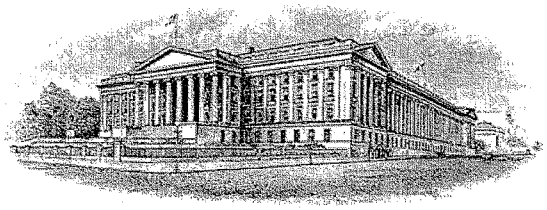
firms. Many regulated firms responded to the recommendations by building the infrastructure necessary to quantify and monitor exposures that are tied to the value of complex financial products. Other efforts to reflect the best practices described in the report entailed tightening standards for, and discipline around, the extension of credit to counterparties, from obtaining initial margin to establishing the right to close out contracts should a counterparty fail to meet its obligations.

The Counterparty Risk Management Policy Group issued a second report in July of 2005 that dealt with developments since the initial report, including the proliferation of products with embedded leverage and securitizations. The new report reemphasized the essential conclusion of the first report that, "[C]redit risk, and in particular counterparty credit risk, is probably the single most important variable in determining whether and with what speed financial disturbances become financial shocks with potential systemic traits." And the second report contained new recommendations, intended to deal with the myriad developments in financial markets, including the growing role of hedge funds and proliferation of credit derivatives, since the first report.

Thus we must not become complacent, and there remains work to be done, even in implementing the recommendations in the Counterparty Risk Management Policy Group reports. The lack of contagion from the Amaranth losses must be viewed against the backdrop of a favorable market environment with ample liquidity and tight credit spreads across a range of markets. These conditions allowed time for an orderly closing out of positions. Although the situation remains in flux, it appears, thus far, that the BSAM funds will similarly be able to unwind in an orderly fashion, with limited impact on the broader markets. But there is no guarantee that such favorable conditions will persist, and we must be prepared to assume that

they will not. Thus, the regulatory community must continue to engage with the systemically important banks and securities firms encouraging additional efforts to improve and expand risk management capabilities. We will work with our PWG colleagues and other market participants, hopefully including some of the larger hedge funds, to further this agenda.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you might have.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 a.m. (EDT), July 11, 2007
CONTACT Jennifer Zuccarelli, (202) 622-8657

TESTIMONY OF TREASURY UNDER SECRETARY FOR DOMESTIC FINANCE ROBERT K. STEEL BEFORE THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

WASHINGTON- Chairman Frank, Ranking Member Bachus, and Members of the Committee, good morning; it is a privilege to be with you today. Thank you for holding this hearing and inviting the Treasury Department to present our perspective on the important topic of "Hedge Funds and Systemic Risk."

Today, I am representing both the Treasury Department and Secretary Paulson in his capacity as Chairman of the President's Working Group on Financial Markets (PWG). Fostering preparedness for financial crises is part of the core mission of the Treasury Department. Under Secretary Paulson's leadership, the PWG - which also includes the chairmen of the Federal Reserve Board, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) - issued a call to action along with the Office of the Comptroller of the Currency and the Federal Reserve Bank of New York, directing all market participants to undertake efforts that mitigate the likelihood and impact of a systemic risk event in the private pools of capital industry.

Private pools of capital, which include hedge funds, private equity and venture capital funds, exemplify the competitiveness and innovation that make our capital markets the strongest in the world. These investment vehicles bring many benefits to our markets including liquidity, price discovery and risk dispersion. However, the growing size and scope of private pools of capital merit appropriate attention, particularly given possible challenges posed by private pools in areas of investor protection and the potential for systemic risk.

To address these concerns, Treasury strongly believes that a collaborative policy effort is required. For that reason, the PWG, as an interagency working group, is well-positioned to provide the leadership to frame the issues and confront the challenges. Over the years, the PWG has periodically evaluated private pools of capital. However, before describing the motive and goals of the PWG principles and guidelines for private pools of capital released earlier this year, I would like to add some context that framed the group's thinking. This Committee has asked for Treasury's remarks on hedge funds and I will focus on that part of the private pools of capital industry.

Hedge Funds: Benefits and Challenges

It is useful to describe the marketplace developments that have occurred since the PWG's 1999 report on hedge funds. In recent years, hedge funds have experienced tremendous growth and dramatic change. Many of these changes have been well-documented:

- In the last five years, the number of hedge funds has more than doubled, growing to over 9,000 funds today.
- Since 1999, hedge fund assets have grown by more than 400 percent, totaling approximately $1.4 trillion.
- They are also generating an increasing share of trading volume. Some experts estimate they may represent up to 50 percent of trading in our markets today.
- The number and nature of investment strategies that these managers deploy have also continued to grow, and today there are over 20 different categories of investment strategies.

Hedge funds broadly encompass pooled investment vehicles that are privately organized, administered by a professional manager and generally not directly available to the retail public. As policymakers, we do not view hedge funds as an asset class or as an industry. Instead, we see them as a business model that asset managers use to manage capital. The objective of this business model is to attract and grow capital and generate returns through a defined investment strategy.

Hedge funds were birthed here in the United States, and this country remains their largest home. A thriving, competitive hedge fund industry brings many benefits to U.S. capital markets. Hedge funds are significant providers of liquidity in our marketplace, making our markets attractive to investors. They bring information to markets, enhance market efficiency and are a crucial ingredient in the price discovery process. Targeting price inefficiencies and wide bid/ask spreads as part of their investment strategy, hedge funds produce the public good of better price discovery and more efficient markets.

Hedge funds help to segment and disperse risk and also help foster innovation in developing new risk-management tools and techniques. For example, hedge funds are often willing counterparties on derivatives transactions with financial institutions seeking to distribute the risks inherent in their normal business activities. Furthermore, hedge funds are also beneficial to investors, as they potentially offer diversification benefits. With their ability to engage in absolute value return strategies, hedge funds provide investors the opportunity to profit in down markets.

While hedge funds can provide benefits to investors and the overall marketplace, they present some challenges as well. The scale, complexity and dynamic nature of these business models and their investment strategies emphasize why we believe heightened vigilance is necessary. Managers are now relying more heavily on the use of leverage, transaction volumes are increasing, and the impact of hedge funds on markets continues to grow.

Innovations in financial products, such as complex derivatives and other structured products, are expanding the ways in which market participants, such as hedge funds, can apply leverage. A concentration of market positions and high leverage may lead to market disruptions and illiquidity if traders simultaneously unwind their positions. Consistent with the growing complexity and often illiquid nature of these innovative products is the difficulty in valuing these securities. In addition, the infrastructure for processing, clearing, and settling trades in these complex products has often lagged product development and volume growth. Industry efforts, such as those of the Counterparty Risk Management Policy Group II, have strengthened clearance and settlement practices.

The PWG's February 2007 Principles and Guidelines

In an effort to preserve the benefits hedge funds provide, while addressing the challenges presented by these market developments, the PWG released principles and guidelines for private pools of capital in February. It had been almost eight years since the PWG last spoke about hedge funds. In 1999, the

PWG released a report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." That well-received report contained a series of recommendations. Those proposals served as a foundation for many of the successful practices of today.

A great deal has changed since 1999 and the PWG believed it was the appropriate time to update and broaden its approach. Last autumn, the Treasury Department conducted a series of educational meetings with participants representing the entire spectrum of the hedge fund industry. Representatives from the pension and investment management communities, the accounting, auditing and legal professions, asset consulting firms, fund administrators, commercial banks and investment banks were interviewed in order to review current practices. As a result of these efforts, along with other meetings conducted by and within the agencies comprising the PWG, we concluded that it would be beneficial to offer some fresh perspective regarding private pools of capital, such as hedge funds.

In developing its principles and guidelines, the PWG desired to create a forward-looking, principles-based framework that recognizes the financial landscape will continue to evolve. As a result, the principles are comprehensive in scope yet flexible.

The PWG's Call to Action

This framework is consistent with the overarching, non-partisan mission of the PWG to maintain investor confidence and enhance the integrity, efficiency, orderliness and competitiveness of U.S. financial markets.

The focus is on two key goals: mitigating the potential for systemic risk in financial markets and protecting investors. As the PWG has said in the past, we believe the issues presented by the size and scope of hedge funds are best addressed through a combination of market discipline and a balanced regulatory approach. We have not given a green light for the participants in the asset management industry to continue with business as usual. Instead, the PWG agreement highlights two areas in which there is a need for heightened vigilance within the current regulatory structure.

Systemic Risk

Systemic risk is the potential that a single event, such as a financial institution's loss or failure, may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected. We must remain open to the possibility that significant losses by a highly leveraged hedge fund could present challenges to the broader financial system. Our principles and guidelines highlight how this potential risk is best mitigated within the current regulatory framework by market discipline that is developed and applied by creditors, counterparties and investors.

The principles and guidelines make a number of suggestions for improved vigilance in market discipline:

- The principles and guidelines recommend that key counterparties and lenders commit resources and maintain appropriate policies and protocols to define, implement, and continually enhance best risk-management practices.
- The guidelines encourage lenders to private pools of capital, including hedge funds, to frequently measure their exposures, taking into account collateral to mitigate both current and potential future exposures.
- Counterparties and lenders should seek to obtain from the pool both quantitative data and qualitative information on the private pool's net asset value, performance, market and credit risk exposure, and liquidity.
- Managers of these firms providing credit and capital should institute protocols so they are kept informed of large exposures. They must appreciate the implications of these exposures and

possess a commitment to ensure that sound risk management practices are developed and implemented.

- Institutional investors in hedge funds have a responsibility to evaluate prudently the strategies and risk management capabilities of hedge funds and ensure that funds' risk profiles are compatible with their own appetites for risk.
- Hedge fund managers must institute and monitor high quality valuation, risk management and information systems.
- Counterparties, lenders and managers must strengthen their processing, clearing and settlement arrangements, especially for over-the-counter (OTC) derivatives.

Investor Protection

Unlike the 1999 report, this year's PWG release also addressed concerns about investor protection. The potential for complexity, illiquidity and opacity of their investment strategies should not by definition suggest that hedge funds are either appropriate or inappropriate. Hedge funds can be a suitable investment vehicle for sophisticated investors. Given certain characteristics of these investments, the SEC has proposed more stringent limits on direct investment in hedge funds.

However, some concerns exist about indirect exposure of less sophisticated investors to hedge funds through their pension fund investments. Investment fiduciaries, such as pension funds managers, have a responsibility to perform due diligence to ensure that their investment decisions on behalf of their beneficiaries and clients are prudent and conform to established sound practices consistent with their responsibilities.

The guidelines encourage hedge fund managers to provide accurate and timely, historical and ongoing information necessary for investors to perform due diligence, enabling them to make informed investment decisions. Investors are encouraged to evaluate the investment objective, strategy, risks, fees, liquidity, performance history, and other relevant characteristics of a hedge fund. Investors should also evaluate the fund's manager and personnel, including background, experience, and disciplinary history.

The philosophy underlying these investor protection principles and guidelines is to encourage and recommend transparency and disclosure by funds and managers to fiduciaries and investors, as well as continued encouragement by regulators to strengthen market and counterparty discipline.

However, this need for transparency and disclosure should not go so far as to materially discourage innovation in the marketplace. There needs to be some balance regarding disclosure. For example, we need to respect sensitive proprietary information, and individual positions should not necessarily be expected to be disclosed.

Regulators also have an important role to play in addressing concerns of investor protection. The existing regulatory framework provides broad authority, which should be utilized to address these issues. For example, the SEC and the CFTC have broad anti-fraud and anti-manipulation authority.

Next Steps

So far, these principles and guidelines have been well-received by policymakers, regulators, industry leaders and the general public, both in the United States and abroad. It is noteworthy that the two largest and most important markets, the United States and the United Kingdom, share a similar regulatory philosophy. The goals put forth by these principles align with the approach used by the Financial Services Authority in the United Kingdom. The European Union countries also adopted a common hedge fund position earlier this year that closely reflects our approach.

The PWG has stressed that this agreement is not an endorsement of the status quo. All industry participants need to accept responsibilities to mitigate risks; therefore, the principles and guidelines speak directly to the four key groups of market participants: regulators and supervisors, counterparties and creditors, managers of private pools of capital, and pool investors.

Our next step is to ensure that all four groups of participants adopt and use these principles and guidelines. We are encouraged by the initial response, as much progress is already underway.

Regulators and supervisors are already involved in a range of important initiatives. Supervisors are engaged in ongoing reviews of creditors' and counterparties' practices. They are working with the large financial firms that serve as counterparties to hedge funds. These efforts are aimed at improving the sophistication of stress–testing practice, counterparty credit risk management in OTC derivatives, structured credit, and hedge funds, and the post–trade processing infrastructure in the OTC derivatives markets.

Regulators are also looking carefully at liquidity risk management practices and the management of the bridge exposures institutions run in leveraged lending, leveraged buyout and merger and acquisition financing, and credit activities more generally.

Just two weeks ago, Secretary Paulson announced that the PWG will encourage the development and adoption of industry best practices for asset managers and investors in hedge funds. The PWG is facilitating the establishment of two separate, yet complementary private sector groups, one for hedge fund managers and the other comprised of hedge fund investors. These two groups will develop best practices for their respective groups that address investor protection, enhance market discipline and mitigate systemic risk.

The PWG is looking to highly respected leaders in these industries to create these guidelines because when leaders adopt best practices, others in the industry feel pressure to do the same. The intense competition in this market pushes the rest of the market to follow the standards of excellence set by those at the top.

The investors group will develop detailed guidelines for best practices for hedge fund investors, including practices regarding information, due diligence, and investment appropriateness. Specifically, we expect to see them address many issues including risk assessment and management, conflicts-of-interest, valuation, performance reporting, operations and controls, leverage, reporting and administration to name a few.

The hedge fund managers group will define best practices for managers regarding information, valuation and risk management systems. Specifically, we expect to see them address many issues including reporting, conflicts-of-interest, valuation, trading practices, risk management, codes of ethics, settlement, recordkeeping, regulatory filings, compliance and business continuity and disaster recovery to name a few.

Conclusion

Hedge funds bring many benefits to our markets, but they also pose potential challenges. Our principles and guidelines seek to preserve the benefits that these hedge funds provide, while highlighting how risks posed by such funds are best addressed by increased vigilance within the existing regulatory environment.

All participants must be accountable to help ensure the integrity of our capital markets. While substantial progress has already been made, there is still much work to be done by all participants. We

look forward to the development and implementation of coherent best practices for investors and hedge fund managers.

Thank you. I look forward to your questions.

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July 11, 2007

Statement of

Kevin Warsh

Member

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

July 11, 2007

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate the opportunity to appear today on behalf of the Board of Governors of the Federal Reserve System to discuss the systemic risk implications of the growth of hedge funds.

The Board believes that the increased scale and scope of hedge funds has brought significant net benefits to financial markets. Indeed, hedge funds have the potential to reduce systemic risk by dispersing risks more broadly and by serving as a large pool of opportunistic capital that can stabilize financial markets in the event of disturbances. At the same time, the recent growth of hedge funds presents some formidable challenges to the achievement of public policy objectives, including significant risk-management challenges to market participants. If market participants prove unwilling or unable to meet these challenges, losses in the hedge fund sector could pose significant risks to financial stability.

The Board believes that the "Principles and Guidelines Regarding Private Pools of Capital" issued by the President's Working Group on Financial Markets (PWG) in February provides a sound framework for addressing these challenges associated with hedge funds, including the potential for systemic risk.[1] The Board shares the considered judgment of the PWG: the most effective mechanism for limiting systemic risks from hedge funds is market discipline; and, the most important providers of market discipline are the large, global commercial and investment banks that are their principal creditors and counterparties.

The emphasis on market discipline neither endorses the status quo nor implies a passive role for government. In recent years, the global banks have significantly strengthened their practices and procedures for managing risk exposures to hedge funds. But, further progress on this front is needed--in no small part because of the increasing complexity of structured credit

[1] www.ustreas.gov/press/releases/hp272.htm

products such as collateralized debt obligations.[2] The Board believes that even those banks with the most sophisticated risk-management practices must further strengthen their enterprise-wide systems to put the PWG Principles fully into practice.

As the PWG Principles rightly emphasize, supervisors of global banks are responsible for promoting market discipline by monitoring and evaluating banks' management of their exposures to hedge funds. As the umbrella supervisor of U.S. bank holding companies, the Federal Reserve continues to pay keen attention to hedge fund exposures and is working to ensure stronger risk-management practices. In addition, through the Federal Reserve Bank of New York, the Federal Reserve is actively facilitating collaboration and coordination among domestic and international supervisors of the global banks that are key counterparties and creditors of hedge funds. This area of significant focus--targeting management of exposures to hedge funds--is part of a broader, comprehensive set of supervisory initiatives that seeks to ensure that banks' risk-management practices and market infrastructures are sufficiently robust to cope with stresses that may accompany a deterioration of market conditions.

To that end, the Federal Reserve has been focusing on five key supervisory initiatives: (1) comprehensive reviews of firms' stress-testing practices; (2) a multilateral supervisory assessment of the leading global banks' current practices for managing their exposures to hedge funds; (3) a review of the risks associated with the rapid growth of "leveraged lending"; (4) a new assessment of practices to manage liquidity risk; and (5) continued efforts to reduce risks associated with weaknesses in the clearing and settlement of credit derivatives and other over-the-counter (OTC) derivatives.

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[2] A collateralized debt obligation (CDO) is a security that entitles the purchaser to some portion of the cash flows from a portfolio of assets, which may include bonds, loans, mortgage-backed securities, or other CDOs. For a given pool, CDOs designated as senior debt, mezzanine debt, subordinated debt, and equity often are issued.

Indeed, this Committee should be assured that the Federal Reserve has taken on these initiatives with great purpose and resolve. These initiatives are fully consistent with the founding purpose assigned to the Federal Reserve by Congress: to help mitigate the risks to the financial system and the broader economy caused by periodic bouts of instability and financial stress.

Hedge Funds

Although there is no precise legal definition, the term "hedge fund" generally refers to a pooled investment vehicle that is privately organized, administered by a professional investment manager, and not widely available to the public. The assets, investment strategies, and risk profiles of funds that meet this broad definition are quite diverse. In no sense are hedge funds an "asset class," like stocks, bonds, commodities, or real estate. While some hedge funds pursue investment strategies similar to those pursued by private equity funds, the strategies of the sector as a whole are quite varied. Some hedge funds are highly leveraged, while many use little or no leverage.

The hedge fund sector has grown very rapidly in recent years. By the end of 2006, more than 9,000 funds managed more than $1-1/2 trillion of assets.[3] Assets managed in the United States are estimated to account for about 60 percent of the total. The hedge fund industry remains small relative to the U.S. mutual fund industry, which included more than 8,000 funds with about $10-1/2 trillion of assets under management at the end of 2006.[4] Hedge funds, however, can make greater use of leverage than mutual funds. Their market impact is further magnified by the active trading of some funds. The aggregate trading volumes of hedge funds

[3] www.fsforum.org/publications/HLI_Update-finalwithoutembargo19May07.pdf
[4] See Investment Company Institute (2007), *2007 Investment Company Fact Book* (Washington, D.C.: ICI, May).

reportedly account for significant shares of total trading volumes in some segments of the financial markets.[5]

Possible Implications of Hedge Fund Growth for Financial Stability and Systemic Risk

In important respects, the activities of hedge funds tend to foster financial stability. They are significant providers of liquidity across the financial markets. Many hedge funds are devoted to exploiting arbitrage opportunities that emerge when financial asset prices become misaligned. For example, when interest rates spiked in the summer of 2003, demands by hedgers of mortgage prepayment risks strained the liquidity of interest rate options markets, sending option prices soaring. Some hedge funds saw profit opportunities in selling interest rate options, and their actions helped restore liquidity to the markets and reduced the cost of hedging.

The growth of hedge funds has also contributed to a broader dispersion of risks in the financial system, which thus far seems to have made the financial system somewhat less volatile. For example, in 2001 and 2002, significant losses caused by corporate bond defaults were absorbed without causing any discernible stress in the financial system. This experience contrasted with earlier periods when financial risks were concentrated at banks and other insured depositories. In those earlier periods, declines in asset prices created considerable financial and economic stress--the losses produced failures of many depositories and severely impaired the capital and lending capacity of others.

At the same time, the growth of hedge funds clearly presents risk-management challenges to participants in financial markets. If those risk-management challenges are not addressed successfully, problems in the hedge fund sector could pose risks to the broader financial system.

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[5] Greenwich Associates (2004), "Hedge Funds: The End of the Beginning?", December; Greenwich Associates (2006), "For Hedge Funds, Fixed-Income Trading Volumes Soar, While Costs Take on New Importance," December.

For example, when the hedge fund Long-Term Capital Management (LTCM) nearly failed in September 1998, market participants were concerned that LTCM's losses would force liquidation of its very large positions in a wide range of financial markets, which could amplify price movements and erode market liquidity. Indeed, the primary factor that induced LTCM's counterparties and creditors to recapitalize the institution was their fear that liquidation of LTCM's positions would adversely affect the value of their own trading positions and their exposures to other counterparties.

In recent months, many market participants have expressed concern that a widening of credit spreads from relatively narrow levels could lead to hedge funds losses that would make funds unwilling or unable to maintain their existing positions, thus potentially eroding market liquidity. Such circumstances could pose significant challenges to hedge funds' counterparties and creditors and perhaps to other market participants. Thus far, however, the repricing of credit risk does not appear to have imposed significant strains on the financial system.

Limiting Potential Systemic Risks from Hedge Funds

Since the LTCM episode, policymakers have continued to discuss the best approach to limiting potential systemic risks from the activities of hedge funds. In the immediate aftermath of the episode, the PWG studied the implications for financial stability and published its conclusions in April 1999 in a report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management."[6] The report concluded that the episode had posed a threat to financial stability as a result of a breakdown in market discipline by its creditors and counterparties, which allowed LTCM to become leveraged excessively. The report concluded that the most effective means of limiting systemic risk from hedge funds was to reinvigorate

[6] www.treas.gov/press/releases/reports/hedgfund.pdf

market discipline. To that end, the PWG made various recommendations, which were directed primarily at enhancing credit risk management by hedge funds' creditors and counterparties.

Late last year, the PWG reassessed how best to address the challenges posed by the continued growth of the hedge fund sector. The results of that reassessment were reflected in the PWG's release on February 22 of this year of an "Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital." The term "private pools of capital" was intended broadly to describe pooled investment vehicles that are privately organized, administered by a professional manager, and not generally available to the public. Thus, the definition includes hedge funds, private equity funds, and venture capital funds. The PWG highlighted certain overarching principles, followed by principles that specifically addressed investor protection and systemic risk.

The balance of my testimony will focus on the application of the systemic risk principles to hedge funds. As I have noted, the overarching principle is that the most effective mechanism for limiting systemic risk from hedge funds is market discipline. In this regard, the 2007 PWG Principles are consistent with the 1999 PWG report. Four specific systemic risk principles set out by the PWG furnish guidance to four sets of parties that have important roles in imparting market discipline: creditors and counterparties, investors, hedge fund managers, and supervisors of creditors and counterparties.

The key creditors and counterparties of hedge funds are a relatively small group of global commercial and investment banks. These global banks provide credit to hedge funds through securities repurchase agreements (repos) and act as counterparties to the funds' OTC and exchange-traded derivatives. The terms at which these global banks transact with hedge funds can act as an important constraint on hedge fund leverage. Furthermore, losses to these global

banks from their credit exposures to hedge funds or from market disruptions that could accompany liquidation of hedge funds' positions are the most plausible channel through which excessive leverage by hedge funds could threaten the broader financial system or the real economy. Thus, the management by these banks of their exposures to hedge funds is extremely important.

The PWG Principles call upon the key counterparties to commit resources and maintain policies and procedures consistent with best practices for counterparty risk management. These policies and procedures relate to due diligence; exposure measurement, including stress testing; and margin requirements and other credit terms. There should be a strong correlation between the information held by a counterparty about a hedge fund's risk profile and the terms on which credit is extended. The principles indicate that counterparties should seek quantitative and qualitative indicators of a fund's exposures to market and credit risk and its vulnerabilities to liquidity pressures from counterparties and investors. When sufficient information is not forthcoming from a fund, a counterparty should correspondingly tighten its margin requirements and other credit terms.

Since 1999, foundations, endowments, public and private pension funds, and other institutions have become an increasingly significant source of capital to the hedge fund sector. These institutions, many of which are quite sophisticated, are another source of market discipline on risk-taking by hedge funds. Accordingly, the PWG Principles call upon investors to carefully evaluate the strategies and risk-management capabilities of hedge funds and to ensure that a fund's risk profile is compatible with the investor's appetite for risk. The Board supports the PWG's formation of an "investors group" to develop detailed guidelines for best practices for

investors in hedge funds, including practices relating to due diligence and ongoing assessments of a fund's risk profile.

Managers of hedge funds also can contribute to limiting the systemic risks from their activities. In particular, their management of funding liquidity risk is a crucial determinant of whether losses suffered by a fund in adverse market conditions spill over to their counterparties. Since 1999, the Managed Funds Association, the International Organization of Securities Commissions (IOSCO), and other organizations have issued and updated guidance on sound practices regarding valuation, risk management, and disclosure. The PWG Principles call for fund managers to meet those industry sound practices. Furthermore, the hedge fund industry should periodically review guidance on sound practices, and when necessary, enhance it. The Board supports the PWG's formation of a hedge fund "managers group" to review and enhance existing guidance on sound practices in light of the PWG Principles.

Finally, because all the key counterparties of hedge funds are subject to prudential regulation, their supervisors have a vital role to play in limiting systemic risks, including those that may emanate from hedge funds. The PWG Principles call for supervisors to communicate clearly to counterparties their expectations regarding prudent management of the counterparties' credit exposures to hedge funds and to other leveraged counterparties. The principles also emphasize the need for international policy coordination among the supervisors of the key counterparties, which are organized in the United States and several European countries.

The Federal Reserve's Responsibilities as a Banking Supervisor

The Federal Reserve continues to work with other domestic and international prudential supervisors to communicate supervisory expectations with respect to prudent management of credit exposures to hedge funds and other leveraged counterparties. After the LTCM episode,

the Federal Reserve contributed substantively to a report by the Basel Committee on Banking Supervision (BCBS) that identified sound practices for managing such exposures. These practices covered the overall strategy for credit risk management, the processes for information gathering and due diligence, the measurement and control of credit exposures, the limit-setting process, the use of collateral and other mechanisms for limiting losses, and the ongoing monitoring of positions and exposures. IOSCO issued similar supervisory guidance around the same time.

As the umbrella supervisor of U.S. bank holding companies, the Federal Reserve began issuing supervisory guidance on the management of counterparty credit risks in the early 1990s. The BCBS sound practices were incorporated in this guidance to reflect the lessons learned from the LTCM episode. Adherence to the guidance is assessed as part of examinations of the global banks that are among the principal hedge fund counterparties.

The Federal Reserve's supervision of counterparty risk management practices is part of a broader, more comprehensive set of supervisory initiatives. The goal of these initiatives is to assess whether global banks' risk-management practices and financial market infrastructures are sufficiently robust to cope with stresses that could accompany a deterioration of market conditions, including a deterioration that might result from the rapid liquidation of hedge funds' positions. As I will discuss in greater detail, those supervisory initiatives include (1) comprehensive reviews of firms' stress-testing practices; (2) a multilateral supervisory assessment of the leading global banks' current practices for managing their exposures to hedge funds; (3) a review of the risks associated with the rapid growth of "leveraged lending"; (4) a new assessment of practices to manage liquidity risk; and (5) continued efforts to reduce risks

associated with weaknesses in the clearing and settlement of credit derivatives and other OTC derivatives.

1. Stress-testing. Global banks perform stress tests to assess the potential effects of a variety of adverse scenarios, including the effects of greater market volatility or reduced liquidity on their market risks and counterparty credit risks. They also consider scenarios in which their access to funding could be reduced, and develop contingency funding plans accordingly. A review of selected global banks' stress-testing practices that the Federal Reserve conducted in 2006 indicated a need for the banks to enhance their capacity to aggregate credit exposures at the firmwide level, including across counterparties; to assess the potential for counterparty credit losses to be compounded by losses on the banks' proprietary trading positions; and to assess the potential effects of a rapid and possibly protracted decline in asset market liquidity.

2. Management of Exposures to Hedge Funds. In the fall of 2006, the Federal Reserve Bank of New York initiated a multilateral supervisory review of the leading global banks' current practices for managing their exposures to hedge funds. The U.S. Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), and prudential supervisors in Germany, Switzerland, and the United Kingdom are participating in this review. The first phase of the review was completed last December. The reviewers found that banks' current and potential future credit exposures to hedge funds were small relative to the banks' capital, largely because of the pervasive use of collateral agreements. It was not clear, however, how well the banks' measurement of potential exposures captures the possible size of those exposures under more adverse market scenarios. The multilateral review is ongoing.

3. Leveraged Lending. The Federal Reserve is focusing on the risks to U.S. bank holding companies from leveraged lending activities--that is, from lending to relatively higher risk

corporate borrowers, often to finance acquisitions or leveraged buyouts. The largest U.S. banks typically distribute a large share of the loans that they originate to other banks and institutional investors. Nonetheless, the banks can be exposed to significant risks, and the review is intended to assess the scale of these risks and the effectiveness of the banks' associated risk-management practices. The Federal Reserve's efforts in this area are being coordinated with the OCC and the SEC.

4. Liquidity Risk Management. The financial system's capacity to cope with stress depends critically on the management of funding liquidity pressures that may arise, especially pressures on the large global banks that play a central role in financial markets. The Federal Reserve is beginning a review of liquidity risk-management practices at the largest U.S. bank holding companies, focusing on the firms' efforts to ensure adequate funding in more adverse market scenarios.

5. Weaknesses in Clearing and Settlement of OTC Derivatives. The Federal Reserve first brought together the group of supervisors participating in the multilateral review of management of hedge fund exposures in September 2005 to oversee derivatives dealers' efforts to address weaknesses in settlement practices in the credit derivatives markets. Our intent has been to ensure that the clearing and settlement practices for all OTC derivatives are sufficiently robust that they would not be a source of increased risk during a period of significantly greater price volatility or trading volumes. Of greatest concern in September 2005 was the widespread failure of derivatives dealers to enforce a contractual requirement that a counterparty receive the dealer's prior written consent before assigning a credit derivative to another dealer. The failure to enforce this requirement fundamentally compromised counterparty risk management by creating confusion about the identity of counterparties. It also contributed to growing backlogs

of unconfirmed credit derivatives trades. The assignment problem was quickly resolved by widespread adoption of an industry protocol that created strong incentives to obtain prompt written consent to assignments. The broader problem of confirmation backlogs for credit derivatives is being addressed through more widespread use of an electronic confirmation platform. Building on the success of that initiative, the supervisors are now overseeing dealers' efforts to address confirmation backlogs in the over-the-counter markets for equity derivatives.

Conclusion

The PWG Principles provide a sound framework for addressing the public policy issues raised by the growth of hedge funds, including the potential systemic risk consequences. These principles are not an endorsement of the status quo. To the contrary, hedge funds, their creditors and counterparties, and their investors, need to take action to put these principles fully into practice. The Federal Reserve has worked, and will continue to work, with the PWG and others to promote practices consistent with the PWG's Principles for Private Pools of Capital. In particular, the Federal Reserve will continue to work with other supervisors to ensure that global banks manage their exposures to hedge funds prudently. More generally, the Federal Reserve will continue to pursue a comprehensive set of initiatives that seek to ensure that banks' risk-management practices and market infrastructures are sufficiently robust to cope with any stresses that may result from a deterioration of the benign financial conditions experienced in recent years.

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COMMENT

How to reduce risk in the financial system.

By MOHAMED EL-ERIAN
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Regulatory authorities face two challenges that need to be addressed forcefully if they are to contain a new source of systemic risk in international finance. First, the increasing migration of complex market activities to supervisory bodies that lack the necessary sophistication to oversee them; and, second, a growing threat of politically motivated changes to regulatory regimes.

There has been much talk recently about the extent to which the proliferation of derivative products has allowed banks to manage their balance sheets better. By enhancing the ability to hedge and shift various risks, advances in what is called "credit risk transfer" technology have lowered the vulnerability of the international financial system to any individual bank crisis.

There has been less discussion about where the transferred risk has ended up and why. Increasingly, it is being borne by a new set of investors who previously had limited access to complex derivative products. These include insurance companies and public and private pension funds. They see the products as a way to earn higher yield.

The growing purchase by such investors of "structured products" is, in itself, acting as a catalyst for the creation of these products by banks. Indeed, given the considerable fees involved, banks' business models are being reorientated away from the traditional structuring and holding of individual loans. Instead, the emphasis is now on originating and quickly distributing structured products.

For the purposes of analysing the implications for systemic risk, the new investors bring two important characteristics into play. First, many rely on external risk assessments rather than in-house due diligence, with a particularly heavy dependence on rating agencies; and second, they are supervised by bodies lacking the financial sophistication inherent in structured products. Both point to an increase in risk for the international financial system.

Recent analytical work raises concerns as to whether rating agencies' (and others') modelling of structured products has kept up with the massive growth in the volume and complexity of these products. The recent experience with US subprime products adds to such concerns. Worries centre on the "correlation modelling" that underpins rating designation. Given the leverage in many of the products, even a small change in correlation specifications can have a large impact on ratings.

Meanwhile, the responsibility for supervising the transfer in balance sheet risk increasingly falls outside the purview of those best equipped to handle such a complex task. Especially when compared with bank regulators and boards, bodies overseeing insurance companies and pension funds have had limited exposure to the structured products that increasingly populate the balance sheets they supervise. These concerns come at a time when politicians are looking more actively at the investment vehicles that, directly or indirectly, facilitate risk transfer to insurance companies and pension funds. Political activity will increase further should some of the new investors find themselves in the midst of large derivative-related losses.

In a recent FT View from the Top interview, Lloyd Blankfein, chief executive of Goldman Sachs, sounded a cautionary note based on something that he picked up at Harvard Law School. He remarked that politically inspired changes triggered by a reaction to a specific situation or an individual firm can have unintended negative consequences for the system as a whole.

What about the future? If left unchecked, systemic risk in the international financial system will increase owing to the combination of insufficient internal due diligence, excessive dependence on rating agencies, uneven supervisory coverage and politically driven legislative reactions. In the process, much of the initial beneficial impact of credit risk transfer technology may be negated.

Three steps can mitigate this new component of systemic risk: first, stimulate greater co-operation and sharing of expertise among the spaghetti bowl of supervisory bodies; second, encourage rating agencies to improve their modelling of new and complex derivative products; and third, induce new investors to evaluate the ratings issued by the agencies against improved internal risk management capabilities. The longer action is delayed in these three areas, the higher the likelihood that costly clean-up operations will be needed.

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Special Comment

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Rating Private Equity Transactions

The current environment of significant private equity deal volume, along with the very large size of some transactions, highlights concerns for Moody's analysts regarding the review of private equity sponsored transactions. While much transformation activity continues, creditors are not participating in the potential "upside" available to private equity firms or original shareholders. Future performance of current transactions will likely hinge on the economy remaining relatively stable and the credit markets remaining forgiving as many of these transactions will need to be re-financed over the coming years.

Under these conditions, Moody's:

- is skeptical that stated plans to de-leverage or exit via the IPO market will actually be carried out given current market conditions which provide ample opportunities for dividend distributions;
- will continue to factor in the characteristics of an industry when evaluating the risk of high leverage, as well as opportunities for cost reductions and operational improvements, but notes that many recent leveraged buyouts ("LBOs") are in industries with high capital requirements, competition, or cyclicality, increasing risk;
- has seen the equity component of private equity owned issuers diminish, making valuation more of a challenge, particularly as private equity firms increase dividend activity, sometimes completely eliminating the amount of contributed capital in their investments;
- is concerned that debt holders have less rights given the prevalence of no or minimal financial maintenance covenants and modest amortization requirements among current transactions.

Overview

This comment explores the role of private equity in highly leveraged transactions and the analytical considerations for corporate family ratings of private equity owned issuers.

For Example:

- WideOpenWest (sponsor firm, Avista Capital Partners) and San Juan Cable (sponsor firm, MidOcean Partners) were both downgraded to B3 from B2 during the first quarter of 2007 following unanticipated dividends within 18 months of the original equity contribution. Avista's dividend was greater than twice the size of the company's initial equity contribution.
- Deluxe Entertainment Services (sponsor firm, MacAndrews and Forbes Holdings Inc.) was purchased in January of 2006. In May 2007, the company made a dividend distribution in excess of the original equity investment.
- In December 2004, WMG Holdings Corp, an LBO of the music subsidiary of Time Warner Inc. (sponsor firms, Music Capital, Thomas H. Lee, Bain Capital and Providence Equity) made a distribution which removed substantially all of the equity originally committed by the sponsors. This distribution occurred within the first year of operations despite public comments made by the company to the contrary.
- During 2004, Celanese US Holdings was downgraded to B1 from Ba3 after issuing additional operating company subordinated debt to fund repayments of holding company PIK notes held by its sponsor, Blackstone Group, one month after completion of the initial transaction. Three months later, the company issued holding company notes to fund a dividend that removed over 95% of the cash equity originally contributed. At the time of the initial rating, Blackstone communicated to Moody's that the exit strategy was an IPO within 18 months so there would be no need for special dividends.
- In January of 2004 and within 4 months of Nalco Company's initial rating, the company's sponsors (Blackstone Group, Apollo Management and Goldman Sachs Capital Partners) issued holding company notes in order to provide distribution of roughly half of the initial cash equity.

The reason for the dividends – whether pressure to increase returns, because the market's liquidity allows for such transactions, or something else – is not always apparent. Future performance of many of these transactions will likely hinge on the economy remaining relatively stable and the credit markets remaining forgiving as these transactions will need to be re-financed over the coming years.

Private Equity's Lack of Transparency

Some of Moody's credit concerns regarding sponsored transactions are unlikely to be resolved because they arise from the lack of transparency typical of private equity firms. For example, in Moody's view, a sponsor's equity contribution in a leveraged transaction (LBO or acquisition) may not necessarily become a permanent part of the company's capital structure. We note that the amount of capital contributed tends to fluctuate at least in part because of several exogenous factors that analysts have little ability to measure:

- the financial needs of the overall fund of which this investment is one part, and
- the relative liquidity of the capital markets and opportunistic financing offered the firm.

Moreover, we believe underperformance by a particular issuer in a private equity firm's portfolio can impact other issuers in the fund. If deterioration at one investment constrains a return of capital, it puts additional pressure on other firms in the portfolio to compensate.

As a result and despite certain strengths that sponsors often contribute (i.e. management depth, sophistication, access to capital) Moody's remains cautious of the merits of private equity capital contributions, although corporate family ratings to date generally reflect the impact of the equity component of a transaction. However, while companies often commit to de-levering, execution is not consistent.

If in the past Moody's did assume that a private equity firm's exit strategy would be the IPO market or sale to a strategic operator, this is no longer the case. In times when the IPO market is less receptive or the credit market particularly generous, issuers have re-levered and returned capital with "one-time" (although potentially several) dividends. However, we do believe it is more likely that the larger the equity investment, particularly versus other same-fund investments, the more motivated the private equity firm to insure the overall success of the company.

For example:

- Marquee Holdings, Inc. committed to de-lever following the merger of AMC (Marquee subsidiary) with Loews Cineplex. However, when the company's planned IPO was suspended in May of 2007, the company increased leverage instead by providing a $675 million special dividend to its sponsors, including JPMorgan Capital Partners, Apollo Management, BainCapital, Carlyle Group and Spectrum Equity Investors.
- In July 2004, Hexion Specialty Chemicals, Inc. stated that its financial strategy would include debt repayment, notwithstanding the debt continued to increase due to acquisitions and special dividends. Originally contributing $204 million of equity in July 2004, Hexion then went on to provide a $550 million merger dividend in May 2005 and a subsequent $500 million dividend in October of 2006 after a failed IPO.

Moody's Key Credit Concerns for Private Equity Transactions

There are several elements of private equity sponsored transactions that are addressed as a part of our credit considerations during committee:

- Percent of common equity contributed at inception
- Potential for future equity distributions
- Thesis for de-leveraging:
  - cost reduction,
  - improving operations,
  - organic growth
- Private equity and management track record and expertise
  - Management fees – presence and magnitude
- Valuation
- Exit strategy/time frame
- Level of disclosure and transparency of organizational structure
- Complexity of capital structure
  - Types of securities issued (preferred, toggle notes, etc.)

Leveraging the Firm

Moody's speculative grade corporate family ratings will be higher in situations where increasing levels of leverage are balanced out by some key mitigating factor such as: sector stability or growth, non-cyclical or non-capital intensive industry, future IPO opportunity, long term contracts, etc. Moody's analysts tend to be more circumspect where industries are cyclical, in decline, or volatile, and thus where projections in the industry are less reliable. We regularly review LBO issuers with meaningful capital requirements (industrial, cable), limited sale/IPO opportunities (CLECs), and in highly competitive and cyclical or volatile operating environments (technology, music, etc.).

In general, when Moody's is evaluating the benefits of an LBO, we consider the potential cost reductions and operational improvements although we are sensitive to circumstances where restructuring charges seem to be ongoing. Alternatively, we often see the benefit of a divestiture from a large corporate entity and recognize the opportunity to take private an under-managed subsidiary where at a minimum corporate expenses can be removed. We also remain open minded regarding transactions with issuer-specific advantages such as real estate opportunities in the retail sector (i.e. ToysRUs). However, we remain mindful that the ultimate beneficiary of these advantages may be the private equity firm.

Management Strength

We attribute credit to an equity firm's expertise unless it is offset by aggressive financial risk taking. Mostly this is because a private equity firm is usually quick to fire ongoing management and hire new people to manage the operations if goals are not being met. In addition, private equity has become a very compelling opportunity for motivated executives looking for significant pay packages linked to performance.

Equity Valuation

In the high-yield credit environment and particularly for single-B credits, Moody's analysts consider valuation a key part of their overall analysis. For private companies, valuation is inevitably more challenging. Analysts are forced to rely more heavily on information from the firms themselves. Notwithstanding the large number of transactions, valuations have become more volatile recently as private equity firms increase dividend activity and reduce the amount of common equity in their investments. It seems reasonable to assume that firms that have already made an attractive return on their investment may consider increasing the financial risk associated with that issuer. We have seen examples where a private equity firm has effectively repaid its entire investment as well as additional dividends and management fees over a very short time horizon (3 years or less) including Deluxe Entertainment (1.5 years), WideOpenWest (1 year), Warner Music (less than 1 year), etc. Therefore we may assume there is additional risk through excessive leverage in part because the private equity firm's downside has significantly diminished.

Exit Strategy

While recent activity in the marketplace supports Moody's premise that equity sponsor capital is not permanent, some equity firms are floating their investments and yet continue to retain a meaningful ownership position. These firms have, as a matter of course, more disclosure and potentially less volatility given the reporting requirements associated with operating a public company. Their dividend policy has become more explicit and there is less uncertainty. The ratings on these companies are likely to stabilize.

Alternatively, certain industries do not lend themselves to the public market and it is these firms that Moody's expects will continue to operate privately and generate returns for the owners through capital distributions, for example small, niche players. These firms are more likely to see their ratings constrained by anticipated returns of capital. In other words, de-leveraging is expected to be offset by dividends and private share repurchases. For example, this phenomenon is highlighted in the CLEC sector. (Please refer to "US-Based CLECs: The Outlook for Continued Success", October 2006.)

Current Market Liquidity and Opportunistic Financing

In the current credit environment, Moody's has witnessed a proliferation of all-bank transaction structures - albeit frequently including first and second lien loans. In our view, this could lead to increased vulnerability to expanding interest costs and weaker debt service metrics as interest rates inevitably rise. Therefore, Moody's is looking for a high degree of hedging on the part of issuers so that a reasonable proportion of a company's debt is fixed.

Please refer to "Refunding Risk and Needs for U.S. Corporate Speculative Grade Issuers, 2007 – 2009, February 2007" for more information regarding refinancing risk within the speculative grade universe.

Key Safeguards Provided by Credit Agreements and Bond Indentures

Within the credit agreement there are several means to enhance creditor protection from some of the inherent conflicts with private equity firms. Notably, recent bank transactions have had a diminishing amount of protection, potentially also affecting bondholders who may have historically relied on bank covenants to restrain aggressive behavior by issuers/sponsor firms. In the past, credit agreements included standard financial maintenance covenants and cash flow sweeps in speculative grade transactions, debt repayment from asset proceeds took precedence over capital distributions, and firms occasionally committed to capital calls when the business plan was subject to a high degree of uncertainty.

In Moody's view, bond indentures that provide reasonable protection would be expected to include covenants limiting debt incurrence, restricted payments, and change of control at a minimum.

(For more details please refer to "Moody's Approach to Evaluating Indenture Covenants and Assigning Covenant Quality Assessments, November 2006").

Response from Erik Sirri, Director, Division of Market Regulation:

The CBOE and FINRA (formerly the NYSE and NASD) amended their margin rules to permit broker-dealers to compute customer margin requirements using a portfolio margin methodology. Under this methodology, positions that reference or are composed of the same underlying equity security (*e.g.*, IBM stock, IBM options, IBM short positions, and IBM securities futures) are grouped into discreet portfolios. Each portfolio is stressed by potential future market moves in the price of the underlying security. For example, if the underlying or reference security is a single stock (*e.g.*, IBM, Exxon, Apple) or a narrow-based securities index the potential market move points are -15%, -12%, -9%, -6%, -3%, +3%, +6%, +9%, +12%, +15%. At each potential market move point, positions that would result in losses are offset by positions that would result in gains to determine a net gain or loss for the portfolio. The largest net loss among the potential market move points is the margin requirement for the portfolio and the margin requirement for the account is the total of the margin requirements for each of the discrete portfolios in the account.

In addition to single stocks and narrow based indexes, the rules permit portfolios to be made up of instruments based on broad-based securities indexes (*e.g.*, the S&P 500, DJIA, NASDAQ 100), including positions in futures based on securities indexes and options on such index futures. For example, a portfolio of S&P 500 index securities positions (*e.g.*, options, ETFs, mutual fund shares, and open short sales) could include S&P 500 futures and futures options. Thus, the portfolio margin rules permit customers that use futures products to hedge securities positions to get credit for the reduced risk and to benefit through lower portfolio margin requirements.

If futures are part of the portfolio, the rules require that they be held with the securities positions in a single securities account. This approach is often referred to as the "one-pot" approach. Some have suggested using an alternative to the "one-pot" approach in which securities would be held in a securities account and futures would be held in a futures account (the "two-pot" approach). In 2006, the Commission received several comment letters in connection with the NYSE's and CBOE's proposals to expand their portfolio margin pilot programs. Two commenters supported the one-pot approach[1] and one commenter supported the two-pot approach.[2] These comments letters can be found on the Commission's Web site.[3]

The commenters supporting the one-pot approach expressed concern that the two-pot approach presented operational and legal challenges. For example, one commenter noted that firms currently have the systems in place to calculate the risk reducing offsets associated with

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[1] Letter to Nancy Morris, Secretary, Commission, from William H. Navin, Executive Vice President, General Counsel, and Secretary, The Options Clearing Corporation, dated May 19, 2006; and letter from Timothy H. Thompson, Senior Vice President, Chief Regulatory Officer, Regulatory Services Division, CBOE, to Nancy Morris, Secretary, Commission, dated June 5, 2006 at http://www.sec.gov/comments/sr-nyse-2006-13/nyse200613.shtml.

[2] Letter from Craig S. Donohue, Chief Executive Officer, Chicago Mercantile Exchange Inc., to Jonathan G. Katz, Secretary, Commission, dated May 9, 2006.

[3] *See* http://www.sec.gov/comments/sr-nyse-2006-13/nyse200613.shtml.

combining futures and securities in the same account. If a two-pot approach were required, however, firms would have to develop new systems for determining margin requirements. Moreover, a two-pot approach would make it difficult to allocate positions between a futures account and a securities account in a manner that preserves the risk reducing benefits of portfolio margining. To the extent that a customer uses futures-related cash balances to offset its securities positions and reduce its margin requirements, it is important that such cash balances be held in the same as account as the securities because, in the event of a firm's insolvency, cash held in a futures account would be distributed for the benefit of all futures customers of the firm and would leave the customer's securities positions unhedged. To avoid this result, firms would have to, in effect, double segregate customer cash, which would reduce the economic benefits of portfolio margining.

The commenter supporting the two-pot approach argued that such an approach would provide greater legal certainty with respect to how portfolio margin accounts would be treated in an insolvency. This commenter said that the inclusion of futures and futures options in a securities account raises an issue as to how these positions would be treated in a liquidation of a broker-dealer under SIPA.

SIPA was enacted to protect customers of a failed broker-dealer. In general, it provides customers with access to their securities and cash without having to go through a lengthy bankruptcy process. In particular, customer securities and cash held by a failed firm are segregated into an estate of customer property that is distributed to the customers prior to any distributions to general creditors. Further, if this distribution does not make a customer whole, the trustee in the SIPA proceeding can make advances to the customer up to $500,000 per customer to be used to return securities or cash that are missing or otherwise not available to be returned. Consistent with FDIC protection, only $100,000 of the $500,000 maximum can be used to return cash. The advances and the other costs of a SIPA liquidation are financed through a fund maintained by the Securities Investor Protection Corporation ("SIPC"). If the trustee does not recover the amounts advanced from the estate of the failed broker-dealer, the SIPC fund incurs the loss (rather than the customer who received the advance).

Under SIPA, a claimant must have a claim for a "security" as that term is defined in SIPA or cash related to the purchase or sale of a "security" to obtain the protections afforded by the statute. The definition of "security" specifically excludes futures and futures options and, consequently, they currently would not be entitled to the protections described above. The SEC believes it could be appropriate to extend the SIPA protections to futures and futures options held in a portfolio margin account

To this end, the SEC proposed rule amendments in March 2007 that are designed to provide the protections of the Commission's customer protection rule (Rule 15c3-3) and SIPA to all futures positions held in a portfolio margin account. Rule 15c3-3 requires a broker-dealer to segregate customer cash by creating a reserve of cash equal to the net amount of cash it owes to customers (*i.e.*, net of amounts owed by the customers). This reserve must be held at a bank in an account for the benefit of customers in the form of cash or U.S. Treasury securities. If the broker-dealer fails, the reserve is available to return cash owed to customers ahead of other creditors of the firm. The goal of the rule is to protect customer assets in the event of a broker-dealer's insolvency and, thereby, minimize the need to liquidate the firm in a proceeding under SIPA, which imposes costs on the SIPC fund. The proposed amendments would require a

broker-dealer to include futures-related cash balances held in a portfolio margin account, including daily marks to market, held in a portfolio margin account when computing its customer reserve requirement under Rule 15c3-3. Thus, these funds would be afforded the same protections as securities-related cash balances.

Further, the proposed amendments would define the futures-related cash balances, including daily marks to market, as customer "free credit balances." This proposal would group them with securities-related cash balances that receive SIPA protection. As for futures options, the proposed amendments would provide that if the broker-dealer fails and is placed in a SIPA liquidation, the liquidation value of the futures options would be deemed a "free credit balance" and that value would be part of the customer's claim to the estate of customer property. [4] These proposals would provide the futures and futures options with the SIPA protections described above.

SIPC, however, is concerned that the proposals would conflict with the SIPA statute, given the definition of "security" specifically excludes futures. SIPC prefers providing SIPA protections to futures products in a portfolio margin account through Congress amending the statute. For example, the definition of "security" in SIPA could be expanded to include futures options held in a portfolio margin account and the definition of "customer property" could be expanded to include "cash" held in a portfolio margin account.

The SEC continues to work with the Commodity Futures Trading Commission on these issues and remains committed to achieving the full potential benefits of portfolio margining.

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[4] A futures option is not liquidated daily and, therefore, may have unrealized gains.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

September 17, 2007

The Honorable Melissa L. Bean
U.S. House of Representatives
Washington, DC 20515

Dear Representative Bean:

Thank you for your Question for the Record following the House Financial Services Committee hearing of July 11, 2007 on "Hedge Funds and Systemic Risk."

Question

Portfolio margining may seem like an arcane topic, but I believe it is a vitally important tool if American capital markets are going to remain competitive. By using technology to measure the true risk presented by the positions in an account, we can free up capital that must now be held as unnecessary margin, or collateral, and put that money to work in the markets. I applaud the SEC and the SROs for their leadership on this front.

I also understand that there is an issue regarding the treatment of futures products under *The Securities Investor Protection Act of 1970* that prevents our capital markets from maximizing the benefits of portfolio margining. Can you describe what the problem is and why it is important? Does the SEC have the authority to address this issue or is legislation necessary? Would each of you support a legislative fix?

Answer

As stated by Secretary Paulson, the Department of the Treasury is focused on maintaining the global leadership of America's capital markets. We have formulated a capital markets competitiveness action plan, which includes pursuing a modernized regulatory structure with improved oversight, increased efficiency, reduced overlap, and the ability to adapt to market participants' constantly-changing strategies and tools.

The benefits of portfolio margining are well documented, including risk-based margin levels and the more efficient allocation of capital. However, margin requirements historically were calculated separately for the related futures and securities components of a portfolio, since futures and securities are subject to different statutes, regulators, self-regulatory organizations (SROs), and investor protection regimes.

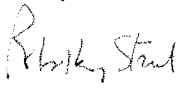
In 2005, the President's Working Group on Financial Markets (PWG) sent legislative language to Congress that committed its member agencies to working to ensure that action would

be taken to permit risk-based portfolio margining for security options and security futures products. Portfolio margining for futures products has been permitted by the Commodity Futures Trading Commission (CFTC) and employed by futures exchanges, clearinghouses, and Futures Commission Merchants since 1988. The Securities and Exchange Commission (SEC) more recently has taken action to permit securities firms to use portfolio margining for securities products.

The issue that you refer to, as I understand it, is that there is uncertainty regarding customer coverage under the Securities Investor Protection Act of 1970 (SIPA). There is concern that non-security futures products (such as broad-based stock index futures contracts) and futures-options placed in a securities portfolio margin account might not be entitled to the protections afforded to "securities" and cash related to the purchase or sale of "securities" under SIPA. As a result, in March 2007 the SEC staff proposed amendments to SEC Rule 15c3-3 that the SEC believes would provide protection to futures and futures-options positions in a securities portfolio margin account that is liquidated. I understand that the SEC has received numerous comments and serious concerns about its proposal, including concerns expressed by the Securities Investor Protection Corporation (SIPC), and that the SEC continues to review the issues.

The Department of the Treasury remains committed to working with the PWG members and the Congress to ensure that investor protections are unambiguous and that the necessary actions are taken to permit portfolio margining in the U.S. so that the benefits to capital markets and participants can be realized. We look forward to continuing to work with you and the House Financial Services Committee on issues regarding the competitiveness of our financial markets and investor protection.

Sincerely,



Robert K. Steel
Under Secretary for Domestic Finance

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

KEVIN M. WARSH
MEMBER OF THE BOARD

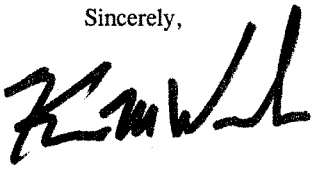
August 8, 2007

The Honorable Melissa L. Bean
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

I am pleased to enclose my response to the written questions you submitted in connection with the July 11, 2007, hearing before the House Financial Services Committee regarding hedge funds. I have also forwarded a copy of my response to the Committee for inclusion in the hearing record.

Sincerely,



Enclosure

Governor Kevin Warsh subsequently submitted the following in response to questions received from Congresswoman Melissa L. Bean in connection with the July 11, 2007, hearing before the Committee on Financial Services:

Portfolio margining may seem like an arcane topic, but I believe it is a vitally important tool if American capital markets are going to remain competitive. By using technology to measure the true risk presented by the positions in an account, we can free up capital that must now be held as unnecessary margin, or collateral, and put that money to work in the markets. I applaud the SEC and the SROs for their leadership on this front.

I also understand that there is an issue regarding the treatment of futures products under *The Securities Investor Protection Act of 1970* that prevents our capital markets from maximizing the benefits of portfolio margining. Can you describe what the problem is and why it is important? Does the SEC have the authority to address this issue or is legislation necessary? Would each of you support a legislative fix?

Many investors hold portfolios that contain futures and securities whose risks are related. For example, an investor might desire to hold futures on a stock-index contract as well as securities options and equities for the individual companies in that index. Ideally, margin requirements for related positions would reflect the risk of the portfolio as a whole. However, in the United States, the futures and securities that may be components of portfolios are governed by different statutes, different investor protection regimes, and different regulatory structures. This results in different margining systems for futures and securities. For the benefits of portfolio margining to be realized fully, policymakers must devise a regime that allows futures and securities to be margined on a combined basis while providing sound investor protection. This regime might be one in which securities are carried in a futures account, one in which futures are carried in a securities account, or one in which a securities account and a futures account are linked. The critical policy issue is to ensure that, regardless of the type of account, investor protection is not compromised.

The Commodity Futures Trading Commission has allowed portfolio margining for futures products for many years. The Securities and Exchange Commission (SEC) has recently permitted securities firms to adopt portfolio margining for securities, and in addition, the SEC has proposed regulatory amendments designed to provide the protections of the *Securities Investor Protection Act* (SIPA) to futures positions in a securities account under portfolio margining rules. As noted by the SEC in its proposal, however, the SIPA protects customer claims for securities and cash and specifically excludes from protection futures contracts that are not also securities. In its comment letter

on the SEC proposal, the Securities Investor Protection Corporation expressed concerns about the apparent conflict between the proposed amendments and the SIPA.

The Board has not taken a position on whether the proposed rule amendments would ensure that a customer's futures positions would be protected under SIPA. The Board believes, however, that the protections available to investors utilizing portfolio margining should be clear and certain. The Board is willing to work with the other members of the President's Working Group to achieve this goal and the Board will help to develop any necessary legislative fixes, whether of commodities or securities statutes, to that end.

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Division of Clearing and
Intermediary Oversight

Ananda Radhakrishnan
Director

September 6, 2007

The Honorable Melissa L. Bean
318 Cannon House Office Building
Washington, DC 20515

Dear Representative Bean:

The Commodity Futures Trading Commission ("CFTC" or "Commission") is pleased to respond to the questions you raised in connection with the U.S. House of Representatives Committee on Financial Services hearing, held on July 11, 2007, on "Hedge Funds and Systemic Risk: Perspectives of The President's Working Group on Financial Markets." Your letter asks members of the President's Working Group to address the treatment of futures products under the Securities Investor Protection Act of 1970 ("SIPA") that "prevents our capital markets from maximizing the benefits of portfolio margining." The Commission hopes the following information is helpful to you in assessing the use of portfolio margining and cross margining in U.S. financial markets.

The Securities and Exchange Commission ("SEC") approved a portfolio margining/cross margining program which became effective as of April 2, 2007 ("Pilot Program"). The Pilot Program has two components: (1) portfolio margining among securities products; and (2) cross margining between securities and futures products. The cross margining component requires that the securities and futures positions[1] eligible for the program be held in a single account regulated as a securities account under Section 15(c)(3) of the Securities Exchange Act. The required use of a securities account raises customer protection, operational, risk management, legal, regulatory, and supervisory issues.

The customer protection issue is that there is no Securities Investor Protection Corporation ("SIPC") coverage for futures positions held in a securities account. This lack of protection for futures positions is because SIPA specifically excludes futures positions from its coverage. Further, futures positions held in a securities account would not be covered by the

[1] As used in this letter, the term "futures positions" refers to both futures and options on futures.

customer protection regime for futures customers because they would not be held in futures accounts segregated pursuant to Section 4d of the Commodity Exchange Act ("CEA"). In short, if futures positions were held in a securities account, they would not be protected by the customer protection regimes that apply to either futures or securities accounts.

Your letter also asks whether legislation is necessary to address the issue. While the Commission believes that the only way to expand SIPC coverage is to amend SIPA, such legislative action would not resolve the other operational, risk management, legal, regulatory, and supervisory issues that would arise from holding futures positions in a securities account. Ultimately, the Commission believes that legislative action is not necessary because a solution already exists that would allow cross margining to take place between futures positions held in a futures account and securities positions held in a securities account. If implemented, this existing solution would provide customer protection for futures positions, thereby eliminating the need to amend SIPA.

Cross margining is an arrangement in which positions at one exchange are margined together with positions at another exchange. The amount of margin required takes into account any risk offsets in the overall portfolio of positions.

There are two possible account structures that can be used for cross margining: (1) the "one-pot" approach; and (2) the "two-pot" approach. Both of these cross margining account structures have been used. Under the one-pot approach, all cross margined positions (futures and securities) are held in a single account.[2] The Pilot Program approved by the SEC would use a one-pot approach.

Under the two-pot approach, securities are held in a securities account and futures are held in a futures account, with cross margining accomplished pursuant to a cross collateralization agreement between the securities and futures clearinghouses. To date, three two-pot programs have been approved or otherwise allowed into effect by the SEC and the CFTC.

Lastly, your letter asks if each member of the President's Working Group would support a legislative fix for portfolio margining. The Commission believes that it is not necessary for Congress to amend SIPA in order to achieve the benefits of the cross margining component of the Pilot Program, because the two-pot approach to cross margining offers a viable alternative to the mandatory use of the securities account. Under this approach, the securities positions would be protected by SIPA and the futures positions would be protected by the special bankruptcy provisions applicable to customer positions and funds segregated pursuant to Section 4d of the CEA and Part 190 of the Commission's regulations.

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[2] The most significant one-pot approach currently in existence is a cross margining program between the Chicago Mercantile Exchange and the Options Clearing Corporation that involves the proprietary accounts of clearing members and the accounts of certain securities options market makers and futures floor traders. It provides for holding the securities and futures positions in a futures account. No customer protection issue exists with respect to the securities positions held in the futures accounts under this program because neither the clearing firms nor the market makers involved are "customers" under SIPA.

As the Commission notes above, the mandatory use of the securities account for the cross margining component of the Pilot Program also raises operational, risk management, legal, regulatory, and supervisory issues that warrant further deliberation. While the Commission recognizes that a discussion of these other issues is beyond the scope of your current inquiry, we believe it is necessary to point out that, in addition to the customer protection issue that has been the focus of your inquiry, the other issues relating to the required use of a securities account could have significant implications for the futures industry and the ability of the CFTC to discharge its statutory duty to oversee and uphold the financial integrity of the futures markets.

The CFTC thanks you for your interest in this matter and is available to provide you with any additional information you may need. In addition, the CFTC continues to collaborate with the SEC to ensure that U.S. capital markets remain competitive and market participants can put their capital to work in our markets.

Sincerely,

Ananda Radhakrishnan
Director

cc: The Honorable Kevin M. Warsh, Board of Governors of the Federal Reserve System
Robert K. Steel, U.S. Department of Treasury
Dr. Erik R. Sirri, Securities and Exchange Commission

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