AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

PERSPECTIVES ON HEDGE FUND REGISTRATION

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

MAY 7, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–29

U.S. GOVERNMENT PRINTING OFFICE

51–588 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
CHARLES A. WILSON, Ohio
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
BILL FOSTER, Illinois
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
STEVE DRIEHAUS, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan
DAN MAFFEI, New York

SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas
CHRISTOPHER LEE, New York
ERIK PAULSEN, Minnesota
LEONARD LANCE, New Jersey

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

PAUL E. KANJORSKI, Pennsylvania, *Chairman*

GARY L. ACKERMAN, New York
BRAD SHERMAN, California
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
NYDIA M. VELÁZQUEZ, New York
CAROLYN B. MALONEY, New York
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
RON KLEIN, Florida
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
CHARLES A. WILSON, Ohio
BILL FOSTER, Illinois
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan

SCOTT GARRETT, New Jersey
TOM PRICE, Georgia
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
DONALD A. MANZULLO, Illinois
EDWARD R. ROYCE, California
JUDY BIGGERT, Illinois
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
ADAM PUTNAM, Florida
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
THADDEUS G. McCOTTER, Michigan
RANDY NEUGEBAUER, Texas
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas

CONTENTS

	Page
Hearing held on:	
May 7, 2009	1
Appendix:	
May 7, 2009	53

WITNESSES

THURSDAY, MAY 7, 2009

Baker, Hon. Richard H., President and CEO, Managed Funds Association	10
Chanos, James S., Chairman, Coalition of Private Investment Companies	14
Groome, W. Todd, Chairman, The Alternative Investment Management Association (AIMA)	12
Harris, Britt, Chief Investment Officer, Teacher Retirement System of Texas	16
Williams, Orice M., Director, Financial Markets and Community Investment, U.S. Government Accountability Office	9

APPENDIX

Prepared statements:	
Kanjorski, Hon. Paul E.	54
Baker, Hon. Richard H.	56
Chanos, James S.	77
Groome, W. Todd	102
Harris, Britt	127
Williams, Orice M.	136

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Garrett, Hon. Scott:	
Investment Business Daily editorial entitled, "Don't Demonize Chrysler's Debt Holders for Standing up for Their Shareholders," dated May 4, 2009	154
Speier, Hon. Jackie:	
Article from the Washington Post entitled, "Hedge Funds Get Tangled in Bad-Business Cycle," dated October 19, 2005	156
Baker, Hon. Richard H.:	
Responses to questions submitted by Hon. Bill Foster	158
Responses to questions submitted by Hon. Jim Himes	161

PERSPECTIVES ON HEDGE FUND REGISTRATION

Thursday, May 7, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 11:09 a.m., in room 2128, Rayburn House Office Building, Hon. Paul Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Ackerman, Sherman, Capuano, Lynch, Scott, Bean, Hodes, Klein, Donnelly, Carson, Speier, Foster, Grayson, Himes, Peters; Garrett, Castle, Lucas, Royce, Biggert, Capito, Campbell, Posey, and Jenkins.

Ex officio present: Representative Bachus.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Pursuant to committee rules, each side will have 15 minutes for opening statements. Without objection, all members' opening statements will be made a part of the record.

During the past 2 years, our markets have experienced tremendous turmoil as an economic tidal wave crushed down and resulted in the loss of trillions of dollars for investors, the drowning of several companies, and the disappearance of some products and industries. Because we need to decrease the likelihood of similar situations occurring again in the future, regulatory reform has become a topic for considerable debate in Washington.

Today, we will examine one sector of our markets in need of greater oversight, hedge funds. Our singular focus on hedge funds at this hearing, however, should not be taken to mean that we will not revisit the need for oversight of other pools of unregulated capital, including private equity and venture capital. We must also recognize that hedge funds are not villains, as some might seek to infer, although there are almost certainly a very small number of bad ones.

As has happened many times before, this latest financial crisis has revealed that our system of capitalism cannot thrive without a responsible and thoughtful degree of transparency. The question before us today is how Congress can wisely improve hedge fund oversight. We must not regulate for the sake of regulation. Moreover, we should refrain from adding layers of an antiquated patch-

work structure that has become in some instances counterproductive.

In my current view, hedge funds deserve a narrowly tailored regulatory treatment. If they want to continue to swim in our capital markets, they must at a minimum fill out the forms and get an annual pool pass. In this regard, Congressmen Capuano and Castle have drafted a good bill to accomplish the goal of registering hedge funds and investment advisors.

Registration generally makes sense, although we may need to customize the rules to treat small firms differently from big ones. We can best achieve this objective by providing the Securities and Exchange Commission with some flexibility in the implementation of the hedge fund registration law. As we work to put in place a system to obtain greater transparency for the hedge fund industry, we must also make other important decisions about who will monitor them and how.

Because of their sophistication, we should allow hedge funds to continue swimming in the deep end of the pool. However, we also do not want to see them drown, especially in some future financial crisis. As such we need to determine whether they need a lifeguard on watch at all times or whether they can merely follow some general behavioral rules posted on a wall.

Moreover, we must consider how to protect less experienced swimmers in our markets who might be overwhelmed by the wave created when one hedge fund jumps into the pool with a cannonball dive. Hedge fund activities directly affect the fortunes of pension funds and institutional investors. Indirectly, teachers and other hardworking Americans are heavily invested in hedge funds, but many of them were unaware of the risks involved until this crisis.

When the market soars and hefty returns are made, no one really cares. Business cycles happen, and fortunes can fade fast. We need a system that better protects individuals' retirement funds. We must ensure that nest eggs do not disappear as a result of excessive risk taken by pension managers. We have painfully witnessed enough of that last year.

In sum, investors need to regain trust and confidence in our markets and legislation aimed at shining a light on a previously unregulated $1.5 trillion corner of the market will help to accomplish that end. Striking a balance of all of these complicated questions is the task before us.

I look forward to working in a bipartisan manner with other members to design an effective, transparent regulatory system to govern hedge funds going forward.

And now I would like to recognize my ranking member, Mr. Garrett, for 4 minutes for his opening statement.

Mr. GARRETT. Thank you. I thank the chairman and I thank all the witnesses who are about to testify, and I certainly look forward to delving into the issues raised in the registration legislation by Congressmen Castle and Capuano.

But before I do, I want to take a moment to address President Obama's recent comments about the hedge fund industry as it relates to the Chrysler bankruptcy. I was troubled by the President's recent statements that singled out a particular class of Chrysler's creditors. The President's comments displayed a complete disregard

for the rule of law as well as practices which govern our bankruptcy code.

Furthermore, the comments, to me, showed a fundamental misunderstanding of just who hedge fund managers represent as well as the fiduciary responsibilities these managers have to their investors. Millions of retired teachers and other public employees have their retirement savings invested in these funds, and it was due to investors like these that Chrysler was able to stay out of bankruptcy as long as it did. And it wasn't just the President's public comments that were concerning. There were also reports that members of this Administration bullied and threatened investors to accept the Administration's terms or else.

As we examine the potentially increasingly regulation on hedge funds purportedly to protect investors in the broader economy, perhaps we should also be looking at ways to protect hedge funds, the retirees, and the teachers who invest in them in other parts of the economy as well from the over-zealous, strong-arming, and inappropriate meddling on the part of some in the Federal Government.

But let's get back to the topic of our hearing today, hedge fund registration. We will no doubt hear from members of this committee and maybe the panel that registration is a good thing. I hope that others here today, however, will indulge me as I raise some concerns that I have with this approach. First, let's step back for a moment and remember that hedge funds were not the cause of our financial sector difficulties. In fact, they are now being called upon by the government to help pull the banking sector—which as we know is one of the most heavily regulated sectors—out of our current hole.

Secondly, the due diligence performed by sophisticated institutions that invest in hedge funds is significantly more rigorous than anything that they will be subject to under a registration regime. So I am weary that the perceived government imprimatur provided by mandatory registration may now undermine or de-emphasize that due diligence over time.

And perhaps more importantly, without mandatory registration, there is no current expectation by the financial markets that taxpayers would ever be required to bail out a hedge fund, but once you introduce government oversight, expectations change. An additional concern with this approach is that it approaches reform in a piecemeal fashion rather than as part of a comprehensive plan to address reform of the entire financial sector. All the pieces of reform should fit together and should be pursued as part of one complete package.

And finally, while registration may not seem overly onerous to an industry where many of the participants already voluntarily register, I am concerned that mandatory registration is a proverbial camel's nose under the tent. In fact, earlier this week, SEC Chairman Schapiro announced her intention to go further. She said it is probably not enough to register hedge funds. It may well be necessary to put in place particular kinds of rules. She went on to say it is certainly possible that the SEC should consider forcing hedge funds to publicly disclose short sale positions and pose restrictions on leverage and restrict what hedge funds could invest in. Is that what we are leading to?

So finally, again, big banks are among the most heavily regulated firms in our economy, yet are the root cause of many of our problems. But at least with banks there is a rationale that regulation is there to protect the individuals and insure deposits. With hedge funds, investment managers are sophisticated and there are no insured deposits to protect. So let's be very careful about regulations and registrations that could ultimately lead to fundamentally changing the nature of a very important investment option that is available now for millions of Americans.

And with that I yield back, and I just ask unanimous consent to enter into the record an Investment Business Daily editorial from earlier this week entitled, "Don't Demonize Chrysler's Debt Holders for Standing up for Their Shareholders."

Chairman KANJORSKI. Thank you, Mr. Garrett. And now we will have Mr. Capuano for 3 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman, and thank you very much for organizing this hearing.

Ladies and gentlemen, I'm looking forward to your testimony, and I think that most thoughtful people have now come to the conclusion that transparency in our large economic plans and our large financial plans is essential to an effective market.

Let me be very clear. My interest is not in targeting hedge funds at all. My interest in hedge funds started because a few years ago, 5 or 6 years ago, hedge funds were the major players in the entire financial world that were not subject to regulation or oversight or even registration. It has become clear now that you are just one of many private equity funds, sovereign wealth funds. There might be others.

And I will be clear. I am not interested really, terribly too much in any one or even a small number of hedge funds. I'm not interested all that much in a few wealthy players gambling their own money at their own risk as they see fit. Those things don't bother me. What bothers me is the herding mentality that happens, what bothers me is the growth—and again, of hedge of funds, only because you are here today, you are not the only ones.

When I started looking at this, nobody knew, but people thought there might be fewer than 1,000 hedge funds. Today, nobody knows, but they think there might be upwards of 8,000 to 10,000 hedge funds. Now if there are 8,000 brilliant, sophisticated investors out there who can beat the system every time, you are going to have to prove that to the world because no one really believes that.

We are here today to talk about how to move forward, and moving forward to me is not over-regulation. I know that any time anybody in government suggests a little transparency, those who want to keep the opaqueness of anything argue, "Oh, government regulation will ruin everything." The SEC did a pretty good job for a long time with reasonable regulation. That is the concept here, simply allowing investors to know what they are investing in. I don't think it is that difficult, simply allowing—especially if we end up with a systemic regulator, which I think and hope we will—that they understand how the system works.

We cannot have major players in the financial world completely operating in the dark, answerable to no one. It is not just for the

individual investors. Again, if some billionaire wants to risk $100 million and lose it, that doesn't jeopardize my life, it doesn't jeopardize my mother's pension, but it does when those players expand exponentially and start getting money out of pension funds. When they start getting money out of other public funds, that is when I believe we have a societal interest in what is going on, and that is really what this is all about today.

And the bill that Mr. Castle and I filed, in my opinion, is simply a beginning. It is a bill based on some old concepts, in my mind, that have actually changed and gotten a little tighter with understanding the new problems that we have.

But I want to be very clear. Today it is hedge funds. I do not see hedge funds as evil, I do not see them as the major cause of any problem. They participated in it like anyone else. I also want to be very clear in my opinion that regulated banks did not cause this problem. They played with it, no question about it, but the problems we have today were caused by a lack of transparency in credit default swaps and collateralized debt obligations and other such items where everyone was playing. And all I want in the final analysis is a little transparency so that the market can honestly judge what is being done for it and to it.

With that, Mr. Chairman, I yield back, and I thank you very much.

Chairman KANJORSKI. Thank you very much. Now we will hear from Mr. Castle for 3 minutes.

Mr. CASTLE. Thank you very much, Mr. Chairman. I thank you and the ranking member for holding this hearing today. We appreciate it.

Mr. Chairman, over the last decade the number of hedge funds has grown, as we have already heard earlier. The assets they have in their management obviously has grown, and their ability to shake up the marketplace has undoubtedly grown too.

And as I looked over news stories and industry literature and discussed these issues with fund managers and investors back home, it struck me the time was probably right to examine hedge funds more carefully and understand more precisely their role in the marketplace.

The popularity of hedge funds among sophisticated investors speaks for itself and I have no particular agenda here. But I do think the time has come, and I think most in the industry would agree that knowing some very basic information about the funds and their managers is not too much to ask. Furthermore, providing the Securities and Exchange Commission with this information and the ability to examine the funds from time to time seems prudent to me.

Finally, Mr. Chairman, I want to thank my colleague from Massachusetts, Mr. Capuano, for joining me in the introduction of several hedge fund bill proposals.

I also listened to the opening statement of our distinguished ranking member, Mr. Garrett, and I happen to be in agreement with him on certain aspects of that. While I think there should be transparency, we are looking for a way of reaching that—clearly, as he has indicated, sometimes when you get government oversight, expectations change, and I hope bailing out hedge funds

would not be one of those potential expectations that might be reached. In fact, I think it should be legislated out specifically if we were to do anything. But we do have to be careful about that. I mean he is essentially correct. When we get the government involved in anything, even simple oversight and transparency, we need to be careful not to be overreaching with respect to what we are doing.

So I understand we need to be in balance. I would hope we could strike that balance. I have read the testimony of most of the witnesses here today, and I believe that there may be a middle ground which we can find and which can accommodate the interests of the investing market and the interests of the public, and hopefully we can do that.

With that, I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Castle. We will now hear from Mr. Scott for 3 minutes.

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

Hedge funds now constitute $1.3 trillion in terms of their value as an industry, and I think as we move forward we have to understand that we have a free enterprise system. That has been the grounding that has made our Nation as great as it is. So as we move forward, we want to be mindful of how we can keep an emphasis on the word "free." But I do believe we certainly need to, with respect to the hedge funds industry, have the ability to inspect and examine the books and records of hedge funds as well as acquire some increased rulemaking authority.

Now we do not need to spend our time here today simply having a comprehensive session berating the hedge funds industry. We need to take this time today to bounce ideas and solutions back and forth and to remember that we must all work together on these important issues and respect the significance of this $1.3 trillion industry and the impact that it has on our economy and the taxpayers and the people of our country.

I do agree that legislation is necessary to compel hedge fund managers to provide information. But to be fair, many hedge fund operators have already voluntarily registered, and many hedge fund operators are not bad actors. There are some bad actors, but they are not all bad actors.

It is of utmost importance that we continue to assess systemic risk related to these funds, as well as how their processes might be improved to ensure our financial markets are more secure in the future. Hedge funds indeed hold unmatched sway over our markets, and I believe supervisors must have the necessary tools to effectively monitor the systemic risk posed by hedge funds, improve market surveillance, assure effective oversight, and improve transparency of the level of risk in the financial markets related to hedge funds.

There are a couple of key questions, one of which is very important especially with the global impact of this industry, for they are a global industry. Their business activity is linked to foreign entities, so the question has to be to what extent should our interaction be with foreign regulators as well.

There are some very profound questions, Mr. Chairman. I appreciate this opportunity, and I look forward to the hearing.

Chairman KANJORSKI. Thank you very much, Mr. Scott. And now we will hear from Mr. Royce of California for 3 minutes.

Mr. ROYCE. Thank you, Chairman Kanjorski, for holding this hearing today.

While hedge funds have experienced losses, they have not asked for or received any direct government bailouts in an era where the government has become the savior of all things failed. And in the view of the Fed, the losses that have been borne by hedge funds and their investors did not pose a threat to our capital markets or the financial system.

A major reason why this was the case was because of the general lack of leverage within the hedge fund sector. Recently we saw commentary by the chairman of London's Financial Services Authority. He said that he found that the average leverage of hedge funds was two or three to one. Now that is a staggeringly low number, a staggeringly low amount of leverage if you consider that our most heavily regulated institutions like the Government Sponsored Enterprises Fannie Mae and Freddie Mac, were leveraged here in the United States by 100 to 1.

And this was with Congress telling them how to invest and Members of Congress encouraging them to roll the dice on risk, encouraging them to leverage 100 to 1. I remember this quite vividly because we have Richard Baker, a former Member of Congress, here, who tried to support the position to the Federal Reserve to allow the Fed or the regulators to de-leverage these institutions for systemic risk, but that was blocked by the Members of Congress. So we contrast that situation with that kind of over-leverage, and thus far it appears counterparty risk management, which places the responsibility for monitoring risk on the private market participants who have the incentives and capacity to monitor the risks taken by hedge funds, we see that has held up pretty well.

As we move forward with the revamping of the regulatory framework overseeing our financial system, I think it is worth noting that the role of hedge funds and other private pools of capital played in our financial system is a pretty extensive one. They helped the pension funds, they helped the endowments and charities and other institutional investors, and they helped them in diversifying their risk. They are an important source of capital formation and liquidity to the broader financial system.

New regulations should take into account the benefits hedge funds have provided and avoid restricting the ability of institutional investors to take advantage of all alternative investments.

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

Chairman KANJORSKI. Thank you very much, Mr. Royce. And now we have a vote. We are going to hear from Mr. Klein for 2 minutes now, and then we are going to recess, take the vote, come back, and see who else we have who requests time. Mr. Klein?

Mr. KLEIN. Thank you, Mr. Chairman, for holding this important hearing.

Given the current turmoil in financial markets and the broader economy, it is important to examine hedge funds and the proper way to regulate these entities. Hedge funds can be stabilizing market forces, or they can pose systemic risk to the financial system. We have seen the liquidity problems that can arise when hedge

funds with similar market positions, particularly those with large amounts of leverage, are forced to sell assets in the market at the same time. Long-Term Capital Management is the most famous example of how the failure of one highly leveraged hedge fund can threaten ruin to its counterparts and break down the normal functionings of markets.

Given the global nature of financial markets and the speed at which transactions can be made, government has a compelling interest to regulate hedge funds. Yet not all hedge funds are the same, and these hedge funds cover a wide range of leverage and investment strategies. As the GAO acknowledges, hedge funds generally add liquidity to many markets and hedge funds can play an important role in price discovery. They also allow other market participants to prudently hedge risk. We must be careful to create a regulatory system that allows hedge funds to remain dynamic market participants, but ensure at the same time that their positions don't threaten the stability of the financial system.

Given the diversity of hedge funds and the difficulty of classifying all hedge funds under one definition, it may be more useful to impose regulations on leverage, short sales, and offshore entities across all private pools of capital and do it in the proper way. I think the registration of hedge funds with the SEC or other proper regulatory authority is a good first step, and there seems to be a growing consensus on the necessity of registration.

I look forward to a fruitful discussion today on the best way to fit hedge funds into developing systemic risk regulatory framework. Thank you, Mr. Chairman.

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

We are going to take a recess now for 15 minutes and then return for the remainder of the opening remarks and then go to the panel. The committee stands in recess.

[recess]

Chairman KANJORSKI. The subcommittee will reconvene, and for an opening statement, we will now recognize the gentleman from California, Mr. Sherman.

Mr. SHERMAN. I thank the chairman.

Three basic points. One, in drafting this bill, we should not be so over-inclusive as to include family partnerships or family trusts. I'm not sure the bill would do that, but I want to be sure before we proceed. Second, in general, we want to preserve the cowboy capitalism that has started so many new companies in this country and not impose excessive regulation on those entities that are small enough not to affect the system systemically and whose investors are sophisticated enough not to need the full measure of regulation.

Finally, even if hedge funds register under the Act, that is not the end of the discussion of the role that hedge funds play in the system and system risk, and I look forward to other hearings on that issue to see how we can avoid a repeat of 2008.

I yield back.

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

We have now had all of our opening statements and we will move into the panel. First of all, thank you very much for being a part of this and appearing before the subcommittee today. With-

out objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute summary of your testimony.

First, we have Ms. Orice Williams, Director, Financial Markets and Community Investment, U.S. Government Accountability Office.

Ms. Williams.

STATEMENT OF ORICE M. WILLIAMS, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Ms. WILLIAMS. Thank you. Mr. Chairman, Ranking Member Garrett, and members of the subcommittee, I am pleased to be here to participate in today's hearing on hedge funds.

As you know, a hedge fund is a pooled investment vehicle that is privately managed and often engages in active trading of various types of securities, commodity futures, and options, among others. In general, hedge funds qualify for exemption from certain securities laws and regulations, including the requirement to register as an investment company.

When we issued our reports on hedge funds, the hedge fund sector was growing in importance and continuing to evolve within the financial system. Hedge funds, largely driven by investments from institutional investors such as endowments, foundations, insurance companies, and pension plans seeking to diversity their risk and increase returns, have grown dramatically over the last decade. From 1998 to early 2007, the estimated number of funds grew from more than 3,000 to more than 9,000 and assets under management grew from an estimated $200 billion to more than $2 trillion globally. About $1.5 trillion of these assets were managed by U.S. hedge fund advisors, but the exact number of hedge funds and assets under management is largely unknown.

Hedge funds have significant business relationships with the largest regulated banking organizations. The funds act as trading counterparties for a wide range of over-the-counter derivatives and other financing transactions. They also act as clients through their purchase of clearing and other services and as borrowers through their use of margin loans from prime brokers.

However, much has happened in financial markets since we issued our reports last year. According to an industry survey, most hedge fund strategies produced double digit losses in 2008 and hedge funds saw approximately $70 billion in redemptions in the second half of the year. Some observers have blamed hedge funds for dramatic volatility in stock and commodity markets, and some funds of hedge funds were heavily invested in the alleged Madoff fraud. Nevertheless, an industry survey of institutional investors suggests that these investors are still committed to investing in hedge funds in the long term.

The general view on regulation of hedge funds appears to be shifting as well, perhaps signaling recognition that hedge funds have become an integral part of the financial marketplace, including the Treasury Secretary calling for greater oversight of hedge fund advisors and possible increased disclosure to regulators.

Despite changes surrounding the hedge fund sector, the issues and concerns related to regulatory oversight of hedge funds and challenges posed by hedge fund investing that were raised in our hedge fund reports, and more recently our regulatory framework report, remain relevant today. First, the oversight of hedge fund-related activities provided by Federal financial regulators under their existing authorities varies and continues to raise concerns about the adequacy of that oversight.

Second, pension funds face a combination of potential benefits, risks, and challenges in investing in hedge funds that some plans, particularly smaller ones, may not be equipped to manage. Third, while investors, creditors, and counterparties have taken a number of measures to impose market discipline on hedge funds over the past decade, market discipline has its limits, especially in good times. And finally, while hedge funds have not surfaced as major players to date in the current crisis, the potential for systemic risk from hedge fund-related activities remains given their interrelationships with other market participants.

In closing, I would like to note the importance of this discussion as Congress considers how best to modernize the regulatory system. Ensuring that any revised regulatory system is comprehensive and includes a system-wide focus is vital to helping ensure that regulators are able to monitor markets and identify and mitigate issues before the crisis occurs. And having sufficient information about all the relevant participants, risks, and products is critical to achieving that goal, regardless of their legal structure or label.

Thank you, and I will respond to any questions the subcommittee may have at the appropriate time.

[The prepared statement of Ms. Williams can be found on page 136 of the appendix.]

Chairman KANJORSKI. Thank you very much, Ms. Williams.

Next, we will have Hon. Richard H. Baker, the president of the Managed Funds Association, and a former colleague.

Mr. Baker, welcome.

STATEMENT OF THE HONORABLE RICHARD H. BAKER, PRESIDENT AND CEO, MANAGED FUNDS ASSOCIATION

Mr. BAKER. Good morning, Mr. Chairman, Ranking Member Garrett, and members of the subcommittee. I appreciate the opportunity to visit with you this morning.

As president and CEO of Managed Funds, we represent a significant number of hedge funds globally and remain a primary advocate for sound business practices and industry growth for professionals in hedge funds. We do provide liquidity and price discovery to markets, capital to allow companies to grow, and sophisticated risk management to investors like pension plans. I should note, as the GAO testimony indicated, that our funds were not the proximate cause of the ongoing difficulties in our financial markets, but our firms and investors have suffered like many others as a result of the current downturn.

Despite these challenges—some of our firms continue to experience difficulty—we have not sought a dollar of taxpayer money, nor to my knowledge have any hedge funds been a significant concern in the current market environment as a contributor to potential

systemic risk. That is in part the result of our relative size to the broader financial universe, with an estimated $1.5 trillion—and that number varies depending on market conditions—our industry is significantly smaller than the $9.4 trillion mutual fund industry or the $13.8 trillion U.S. banking system.

It is also a function of our strength. Hedge fund managers are some of the best in assessing financial market risk and in managing their own. Our managers interests are also aligned with those of our investors. Their money is engaged in the same investment strategy.

And it is also a function of how we deploy credit. Today, many hedge funds use little or no leverage, and this has been a repetitive mischaracterization of our industry in reports, "the highly leveraged hedge fund industry." It is a continued source of frustration. A recent study, which I will be happy to provide the committee, found 26.9 percent of hedge funds used zero leverage, and a 2009 report by the chairman of the Financial Services Authority in London—not something that we should be able to control—that hedge fund leverage was on average between two and three to one industry wide for a 5-year period, significantly below many of our other financial service sectors.

As a result of these factors, losses at hedge funds have not posed systemic risk the way that losses at more highly leveraged institutions have.

Hedge funds have a shared interest with policymakers in establishing a sound financial system and restoring investor confidence. We only do well when markets function efficiently. The MFA and its members recognize that mandatory SEC registration for investment advisors is among many options being considered by Congress. In our view, registering investment advisors, including advisors to all private pools of capital under the Investment Advisers Act, is the right approach. While not a panacea, it can play an important role toward the shared goals of promoting efficiency in the markets, market integrity, and providing a measure of investor protection.

Mr. Chairman, we didn't come to this decision very easily at all. It has been debated for a considerable amount of time. But I should point out that over half of our members and over 70 percent of assets under management already voluntarily register with the SEC.

What we are recommending today, however, goes beyond what Treasury Secretary Geithner proposed. The Secretary suggested only the largest fund advisors, for the purpose of systemic risk, register. What we are supporting today will subject the vast majority of investment advisors above some de minimis standard, which we do not define, to require registration.

And it is significant. The notification letter that goes out to members pursuant to registration—the initial opening is a 20-page letter that represents hundreds of questions. We are required to make publicly available disclosures to the SEC, detailed disclosures to clients, procedures and policies to prevent insider trading, maintaining extensive sets of books and records, periodic inspections and examinations, requiring chief compliance officer and a written code of professional conduct are among only the major principal points of a registration requirement. We believe it is important to consider

the role of smaller investment advisors through the consideration of a de minimis threshold, and such exemptions should be narrowly constructed.

Mr. Chairman, I look forward to working with the committee as you move forward. We want to be a valued resource in this most difficult task. Thank you.

[The prepared statement of Mr. Baker can be found on page 56 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Baker. We appreciate your offer and I'm sure we are going to take you up on it.

Next, we will hear from Mr. Todd Groome, the chairman of the Alternative Investment Management Association.

Mr. Groome.

STATEMENT OF W. TODD GROOME, CHAIRMAN, THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION (AIMA)

Mr. GROOME. Thank you, Mr. Chairman. I also thank the ranking member and the other members of the subcommittee for inviting AIMA to participate today in this hearing on your consideration of these issues related to hedge fund registration and related matters.

AIMA is a very diverse association representing professionals within the industry from all over the world, different parts of the world. Our members come from over 40 countries. Professionals within our membership are hedge fund managers, investors, and other professionals, lawyers, accountants, and administrators involved in the industry. So we represent geographically and professionally a very diverse group of professionals involved in the hedge fund industry.

After the November G20 meeting in Washington D.C., we actively engaged our members around the globe, and policymakers nationally and internationally, as well as other associations like the MFA, the Hedge Fund Standards Board, and the President's Working Group to try to come together as an industry and consider the issues raised by the G20 and the Financial Stability Forum on their behalf, as well as the national authorities looking to take forward a way for the industry to respond to the financial stability related concerns raised by the G20.

On February 24th, having completed substantially that consultation, we issued a new policy statement emphasizing, consistent with some of the opening statements I have heard today, an emphasis on increasing the transparency of hedge fund activities and markets.

What I would like to do now with the remainder of the time is to highlight three or four of the key points from that policy statement. First, we support the registration of hedge fund managers within the jurisdictions in which they are principally based. So, for example, as currently structured in the United States, a hedge fund manager operating in the United States would register with the SEC, much as they have done in the U.K. for a number of years, and other jurisdictions.

We have provided, in appendix three of our written testimony, a wide variety of examples of how that registration and pre-authorization process may be conducted. We do not believe that any par-

ticular method is any better than another per se, but the key point that I would bring from all of these examples, and it is consistent with some of the other opening statements, is whatever process is agreed upon, it needs to create an informed and ongoing dialogue between the hedge fund manager and the supervisory authority they report to. Without that informed dialogue, the exercise just increases cost and does not improve financial stability or otherwise benefit society.

Second, and consistent with seeking an informed dialogue, we support periodic reporting requirements by larger—and I will come back to what "larger" may mean—hedge fund managers. This information should be designed to improve supervisory understanding of what is happening within the hedge fund industry and the portfolios of hedge funds, but also what is happening in the broader financial markets, as well as improve financial stability analysis. The hedge fund managers within our membership support this initiative, and view hedge funds as a mature, and as an established industry, and thus time to contribute to the analysis on a national and international basis to financial stability considerations, and in this sense help build the G20's early warning system, as they have called it.

The information that we recommend to include in such reports would be provided strategy by strategy or asset class by asset class, and focus not just on leverage, but also look at the liquidity in portfolios and liquidity in markets, which can be measured in a variety of ways, look at volatility in markets by asset class and strategy, and look at concentrations within portfolios and how concentrations tend to build in certain pockets of the market. We think this information is sufficiently important that we would encourage you to have a similar reporting template for banks and other non-banking institutions operating in our global markets.

Third, we have called for and have been working towards a harmonization of hedge fund standards. MFA, AIMA, Hedge Fund Standards Board, IOSCO, the President's Working Group, and others have created standards over the last 5 and 10 years, and we think it is now time to try to harmonize these on a more global basis. On our Web site, you can see a hedge fund standards matrix where we have attempted to do that, and in the last 8 weeks, we have been working with all of these associations to try to provide some input by mid-May to the Financial Stability Forum on how that process may look going forward.

Supervisors may then use these converged standards in their dialogue with registered managers, and even expect that the larger hedge funds should substantially meet those standards or explain why they do not meet them, and thus to essentially incorporate them into the registration and the supervisory dialogue that we contemplate.

Finally, we think there should be a de minimis test as well, probably for registration, but certainly for some of this reporting and other standards that I have just talked about. In our paper we have suggest $500 million of assets under management as a de minimis test on a manager and the broader hedge fund family that he or she manages. There is nothing magic about that number, and in many cases I think it makes more sense as a registration hurdle

than it does for the other hurdles. For example, the other hurdles could arguably be much larger. If you set such hurdles at $1 billion AUM, you would have over 300 hedge funds today which would meet that criteria, representing 80 percent of the assets in the industry, so you get a full and clear picture of what is happening.

However, we have to also think about creating that informed dialogue that I have suggested should be the goal, and with 311 hedge fund managers, 70 percent of which in this country, we have to also ensure that we have the supervisory capacity to compile, analyze, and execute on that information.

Thank you very much, and I look forward to your questions.

[The prepared statement of Mr. Groome can be found on page 102 of the appendix.]

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

And next, we will hear from Mr. James Chanos, the chairman of the Coalition of Private Investment Companies.

Mr. Chanos?

STATEMENT OF JAMES S. CHANOS, CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

Mr. CHANOS. Good afternoon, Chairman Kanjorski, Congressman Garrett, and members of the subcommittee. I am here today testifying as chairman of the Coalition of Private Investment Companies. Thank you for the opportunity to testify on this important subject.

The damage done by the collapse of global equity credit and asset-backed markets has been staggering in scope. There is not a single market participant, from banker to dealer to end user to investor, that does not have to absorb some degree of responsibility for the difficulties confronting us today. But while there is plenty of blame to spread around, there is little doubt that the root cause of the financial collapse we have experienced lies with the large, global, diversified investment and commercial banks, insurance companies, and Government Sponsored Enterprises under direct regulatory scrutiny today.

Hedge funds and investors have generally absorbed the painful losses of the past year without any government cushion or taxpayer assistance. And as our government looks for ways to bring more capital into our markets, hedge funds are now seen as part of the solution.

While private investment companies were not the primary catalyst for our current situation, I believe we should not be exempt from the regulatory modernization and improvements that you are developing based on lessons learned from this crisis. I would point out that increasing the regulation of private investment companies carries both risks and benefits. For example, if institutional investors believe they can rely upon the fact of direct regulation in lieu of conducting their own due diligence, it will undermine those parts of the private sector that continue to work well.

But while there will always be a need for investor due diligence, Congress can give investors better tools and also provide direct Federal oversight of private investment funds without trying to wedge them under statutes written 70 years ago for other purposes, for example, the Investment Advisors Act and the Invest-

ment Company Act. Attempting to shoehorn hedge fund regulation under either of these acts will not serve to protect investors or to mitigate those activities that could potentially disrupt markets.

I am a strong supporter of the SEC, its dedicated staff, and its mission. If we are going to put more work on the plate of this already overburdened agency, we need to provide it with a statute designed for the unique characteristics and activities of private investment funds. Such a statute could of course draw upon the established regulatory practices.

To guide the development of such an oversight regime, we offer the following principles for your consideration. First, any new regulations should treat all private investment funds similarly, regardless of the investment strategy, including hedge funds, private equity, and venture capital. Second, a regulatory regime for private funds could draw upon the work of the President's Working Group asset managers and investors committees. Their reports suggest many specific areas for improvements crafted for the unique nature of private investment companies, and a number of the proposed standards exceed the standards for other market participants currently. Third, regulation for systemic risk and market stability should be scaled to the size of the entity with a greater focus placed upon the largest funds or family of funds.

Now let me briefly turn to what is perhaps the most important role that hedge funds play in our markets, the role of investor. Because of this role, CPIC believes that maximum attention should be paid to maintaining and increasing the transparency and accuracy of financial reporting to shareholders, counterparties, and the market as a whole. Undermining accounting standards, for example, may provide an illusion of temporary relief, but will ultimately result in less market transparency and will undermine investor confidence, thereby lengthening the possibility of recovery.

Private investment companies also play an important role in providing pricing efficiency and liquidity to our markets, and funds that engage in fundamental directional shortselling, for example, often play the role of financial detectives, uncovering overvalued securities and uncovering fraud. Government actions that discourage investors from being skeptical or that seek to throw sand in the gears of price discover ultimately harm investors' interests. Indeed, some have conjectured that if Madoff Securities had been a public entity, shortsellers would have blown a whistle a long time ago.

I would close by saying that honesty and fair dealing are at the foundation of investor confidence. A sustainable economic recovery will not occur until investors can again feel certain that their interests come first and foremost with the companies, asset managers, and others with whom they invest their money, and until they believe that the regulators are effectively safeguarding them against fraud.

CPIC is committed to working with the committee and other policymakers to achieve this difficult but necessary goal. Thank you very much.

[The prepared statement of Mr. Chanos can be found on page 77 of the appendix.]

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

And finally, we will hear from Mr. Britt Harris, the chief investment officer for the Teacher Retirement System of Texas.

Mr. Harris?

STATEMENT OF BRITT HARRIS, CHIEF INVESTMENT OFFICER, TEACHER RETIREMENT SYSTEM OF TEXAS

Mr. HARRIS. Thank you, Mr. Chairman. Good afternoon, ladies and gentlemen. My name is Britt Harris and I am the chief investment officer for the Teachers Retirement System of Texas. I am also a current member of the President's Working Group on Financial Markets, the former chairman of CIEBA's investment committee, and also the former CEO of Bridgewater Associates, which is perhaps the largest hedge fund in the world today.

The Texas Teacher's Fund is valued at approximately $80 billion, serves 1.2 million people. We have a long-term mandate, and we have an 8 percent annualized return target, and few liquidity requirements. The trust is widely diversified, and utilizes a variety of risk management systems, but for the purposes of this morning's meeting, we have approximately 5 percent of the total trust invested in a wide variety of hedge funds, 45 in total, representing approximately $4 billion.

When you think about the industry backdrop, I'm sure you all know that hedge funds are not new. In fact, we are aware that both John Maynard Keynes and Benjamin Graham both engaged in investment activities during the 1930's that would have been called hedge funds under today's nomenclature.

With that said, however, until the early 1990's, the hedge fund industry was relatively small and served primarily high net worth individuals. In the early part of the 1990's, those individuals were joined by foundations and endowments and a smaller set of private pension funds. And then particularly in the early 2000's, when hedge funds performed extremely well during an equity market correction, institutional investors began to use hedge funds in a much more dramatic fashion, and since that time they have grown significantly.

And they are now, as others have said, over 8,000 in number and at their peak had more than $2 trillion of assets under management. It should also be noted that the evolution of the hedge fund client has also occurred. Today, approximately 50 percent of hedge fund clients are now institutional investors, whereas in previous periods that number would have been vastly smaller.

Texas Teachers uses a diversified portfolio of hedge funds as an overall portion of its total strategy for three reasons. First, hedge funds are employed as a direct source of diversification, particularly during down markets. Last year's major market declines produced hedge fund returns that were approximately 50 percent less than what our domestic stock market produced. That was not the absolute performance that we desired, but it was vastly better than the S&P 500. Second, properly structured hedge funds have posted returns of approximately 8 percent over time. That is the return targets for the vast majority of pension plans, and have done so with less volatility. And then finally, they help us to achieve our long-term return target. Hedge funds earn returns that are not to-

tally dependent on the overall market results and provide a different means for achieving returns.

Looking at 2008, it was clearly a difficult year for global equity investors, among others. However, as many have already stated, the hedge fund industry was not the principal source of the systemic risk that developed within our markets. That risk came through our banking system, our insurance system, and our real estate markets. Still, it would be hard to conclude that hedge funds as a whole covered themselves with glory, using Barton Biggs' term, and it is likely that the redemptions and deleveraging that occurred in hedge funds during the fourth quarter exacerbated that decline.

We also know that difficult periods always have revealed rogue participants, and that was the case in 2008. And although the vast majority of participants in the industry operate ethically, a small fraction of unethical characters surfaced within the hedge fund community.

While many were directly affected, the vast majority of those most affected were not the sophisticated institutional investors that I cited a moment ago. What is different about hedge funds? Rather than trying to track the movements of the market, most hedge funds try to seek return through positive returns regardless of market conditions. Their typical benchmark is generally some version of a cash proxy rather than something like the S&P 500.

Hedge funds are able to create a certain amount of downside protection through the use of shortselling, thereby reducing market exposure. Then in order to bring their returns back to a targeted level, they introduce the practice of leverage. Thus, equity oriented risks are replaced by increased leverage. This generally works reasonably well when practiced by professional investors with good judgment, high ethical standards, sound investment policies, and solid risk controls. Because the investment approach relies more on skill than on the overall market, the compensation is often different and frankly more expensive and more performance oriented.

These different objectives and different routes to investment performance have both strengths and weaknesses. I have already highlighted some of the strengths. The relative weaknesses are the reliance on leverage, a more fragile business model, lack of transparency in some cases. In most cases there is also the fact that they operate in perhaps the most competitive market in the world.

So turning to regulation as a result of the recent events, renewed discussions are again underway regarding modifications to regulation and government oversight. At the same time, it must be pointed out that many believe that regulations that are already in place are more than adequate, and it is only ineffective enforcement that was lacking, due particularly to the lack of resources and in certain instances potential blind spots in the agencies themselves.

So what is the proper response? The first objective should be to do no harm. When regulation is ineffective, it is generally because it is either inadequate or excessive. The two bimodal outcomes are too common, and one generally results from an overreaction to the other. Effective regulation does not overreach its reasonable bounds based solely on a more is always better approach.

Nor does it excessively regulate those who are not large enough to comply with the regulations and are designed to prevent outcomes that they could never realistically create. Thus I encourage everyone to proceed with caution, thoughtful deliberation, and in collaboration with others. Congress can best achieve its mission by focusing on a limited by unusually important set of key factors, and also on the types of investment organizations that might realistically create large, prolific, and systemic problems.

We also now know that the oversight must be properly matched with the resources supplied. Excessive bureaucracy and a scope that is too broad will likely result in nothing but long-term disappointment and continued frustration to everyone.

A one-size-fits-all process is not appropriate and is unlikely to work. While it is my belief that all investment organizations should be encouraged to apply for SEC registration, it is not appropriate to force all organizations to do so, and moreover, excessive reporting requirements would likely overwhelm smaller organizations and discourage competition and innovation. It also might reduce the access for smaller investors to small, high quality hedge funds.

Three of the primary risk issues are undoubtedly systemic risk, fraud, and favoritism of large investors at the cost of smaller ones. Regarding systemic risk, it should be kept in mind a hedge fund is highly decentralized and comprised primarily of investment organizations managing relatively small amounts of money for investors who are defined by statute as sophisticated. At the same time, the vast majority of assets are controlled by approximately 50 funds. These funds are generally very well managed and are very highly resourced, and collectively they are large enough to disrupt market activity and should be carefully monitored. These are the most likely sources of systemic risk and they also have very sophisticated standards. You will also be pleased to know, as has already been stated, that the vast majority of these are currently registered with the SEC today.

The set of risks that should be monitored and disclosed should be focused on a relatively short list of key factors that have largely defined every catastrophic outcome on record. These risk categories are well know and they are well recognized. They include the following: assets under management in a notional sense; leverage and access to leverage; liquidity; concentration; counterparty risk; valuation trends in all that I have just mentioned; and the opportunity set within which they work. The formula for unusually negative outcomes is almost always the same, excessive leverage placing an unattractive or misvalued opportunity that is either concentrated or two illiquid. Thus, those are the factors that should be carefully monitored.

So in conclusion, I would recommend you consider the following. First, understand that hedge funds are not the primary cause of systemic risk that we have just experienced, although it cannot be said that they did not contribute to its power. Thus my first request is that you seek to do no unwarranted harm. Second, do not seek a one-size-fits-all solution but rather focus on the funds that are large enough to individually or collectively create the systemic risk that most threaten the largest number of investors.

Third, keep your oversight practical and simple. Don't try to focus on so many things that you distract yourselves from the very short list of key factors that truly matter. Fourth, don't overreach the level and quality of resources that you are prepared to allocate to this area. And finally, before coming up with a litany of new and potentially complex and disruptive rules and regulations, look carefully at the ones that are already in place and determine whether they could have been applied more effectively.

So with that said, I conclude my remarks. I will be happy to take questions.

[The prepared statement of Mr. Harris can be found on page 127 of the appendix.]

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

I want to thank the whole panel for their testimony. Certainly the subcommittee will have some questions, and I will start on mine initially.

It seems to me it is almost unanimous. Everybody agrees that we should have registration. Everybody agrees that we should exercise some control and constraint on those hedge funds that may cause or contribute to systemic risk. How much regulation do we impose, and how do we determine what size or what manner of operation would trigger the best regulatory response of the government?

I for one could care less about high-wealth individuals who want to contribute their money to a group of investors. If they want to take the shot of losing it, it does not really affect the rest of society. Our problem is only if these high-net-worth people invest hugely in a fund that leverages up like long-term capital and becomes so large and so pervasive that they then have the capacity to make so many loans from insured institutions that they cause a systemic risk to result.

Now that poses a question. How large is too large? And when does a triggering mechanism for governmental involvement come into place? I am not going to direct it to anybody in particular, but maybe you could just take some shots at it as members of the panel. Mr. Baker probably has some ideas on that, and Mr. Harris certainly just addressed them. Mr. Baker, go on. Tell us how large is too large.

Mr. BAKER. I don't know that there is a "too large" answer. I do believe that the regulators should be constantly vigilant, because there are a number of variables beyond assets under management which could trigger systemic consequences. Some years ago, there was a small bank in Germany called Herstatt Bank that was involved in currency conversions and was exchanging deutsche marks into U.S. dollars for a bunch of New York banks. In between receipt of the deutsche marks and conversion of those into U.S. dollars they went bankrupt, leaving the New York banks unfulfilled.

That is now known in the regulatory world as the "Herstatt risk." No one would have looked at that institution and that activity and thought it could in any way have a relationship that would consequently affect so many people. Interconnectedness, leverage, assets under management, there are an array of things. Even market timing. If you look at the Lehman arrangement, no one knew the number of firms that were all engaged with that particular counterparty at that time.

So what may not be systemically relevant today may become relevant next month or next year, and so for that reason, we view the role of that systemic regulator, whomever that poor person will be, to be given broad authority to make those judgments based on current market conditions.

Chairman KANJORSKI. AIG FP would fall in the same category that you are talking about. Who would ever have suspected that they put counterparty positions in place of $2.7 trillion without really having first line assets at risk but instead used the corporate assets of the insurance company back here in the States?

That being the case though, how do we structure a situation that does not get charged with being too intrusive? Are we going to make every one of the 8,000 hedge funds disclose all possible circumstances and situations that potentially could be or could contribute to systemic risk? When I hear people argue for a systemic risk regulator, systemic risk seems like an after-the-fact inclusion. If it were discernible before-the-fact, it would not happen.

Our problem is that if you really want to stop systemic risk as a regulation beforehand, you would have to have the legal authority to examine every transaction engaged in by every company and individual in the economy, which means we would have a totally controlled economy. That is the only time that we could literally say that systemic risk could be prevented. That is stupid and incapable of us to do.

So our measure is going from that extreme, down to where we parcel out regulatory control, size of the organization, and the assets that we are going to look at. But I think in the future more than size of the organization or assets—I think Mr. Harris was making this point—the convoluted nature of the investments, the conduits, that are going to be developed, particularly after this disaster.

I would say that there are going to be 50 entrepreneurs worldwide looking at insurance companies of middle size that could be acquired and used as methodologies of being highly speculative. If there is not a downturn in the market, they will be making fortunes. If there is a downturn in the market, we will discover they do not have any trunks on. But we do not want to go through that discovery, we do not want to have that problem.

So how do we as a Congress, how do we as a government, not become too intrusive and yet not get caught up in a problem just looking at size as opposed to the convolutions they could be going through? And what would your opinion be, to all of the panel, as to prevent that being too intrusive?

Mr. BAKER. Mr. Chairman, if that is directed to me, my observation is we have come to a very considered opinion that disclosure of the registration information is sufficient to give the tools to a well-funded and properly staffed regulator the information they need to make those assessments. And it would not require that regulator to be constantly involved in an individual firm's business.

And I would point out, Mr. Chairman, that in the current environment for our currently voluntarily registered firms, that examinations can take well over a year. They can take up to 2 years. There is something not appropriate about that model, and so we enter into this with great reservation, but we believe that disclo-

sure of the information that is now required by the registration model are the appropriate items that we should disclose to a regulator to make those difficult judgments. And I'm also very glad I'm not sitting on your side of the dais.

Mr. HARRIS. Just to—with respect, I think it is unrealistic to expect any organization to oversee 8,000 to 10,000 individual funds that are spread all throughout the world with the limited resources that they are going to have.

So I would suggest a practical approach, which is the proverbial 80/20 rule. What you have heard here is that 80 percent of the assets are with less than 20 percent of the participants. It is highly unlikely that you are going to get a serious systemic risk from a hedge fund which is less than $1 billion. The resources that are going to be applied to this are not sufficient to fish in every single pond in the entire country. And I think you divert your resources and make them less effective unless you focus on the areas where you are really, truly likely to get a serious issue.

Mr. BAKER. Mr. Chairman, if I could just add one concern about that view, though. Once you identify a systemic category that is deemed too-big-to fail or systemically risky and that the Congress may likely take action, they will have a preferential pricing advantage in the marketplace, a la Fannie Mae and Freddie Mac. So that standard should be very malleable and not definitive, or otherwise you will create that advantage in capital markets.

Chairman KANJORSKI. I know I am over my time now, but suppose that we run across the situation that size is causing extraordinary exposure to systemic risk. Should we empower the regulator with the power to dissolve that fund or break it apart just as a regulatory power?

Mr. BAKER. I would be very cautious, Mr. Chairman, about the dissolution of business merely because of its size or assets under management. There should be very careful examination and thought given to the precedent steps—

Chairman KANJORSKI. I agree with the thought, but should the power just—

Mr. BAKER. Well although size is a considerable contributor to potential for systemic risk, I do not believe size in and of itself is of the concern that would warrant a regulator to take that action.

Chairman KANJORSKI. Granted convoluted connections, an opportunity that lends itself, creation of the worm holes out there, if the regulator sees that and says that this is exacerbated by a factor of two, three, or four it could be a systemic risk, should we empower the regulator to step in and give an order of dissolving that size or those convoluted activities to prevent that?

Mr. BAKER. There would be a number of alternative remedies that should be available to a regulator before you would get to that adverse conclusion, but at some point under the most adverse of circumstances, perhaps. But that would be a very remote and improbable outcome.

Chairman KANJORSKI. I agree with you, but would anyone else like to answer?

Mr. GROOME. Just one point, Mr. Chairman. In response to that last discussion between yourself and Mr. Baker, I actually like to think about this more as supervision, as opposed to regulation, and

so that is why you heard me talk in my remarks and our written testimony about providing better information to create a more informed conversation and understanding for supervisors. If a nonbank institution such as a hedge fund or any other were deemed to be presenting some sort of systemic risk.

As I heard someone say in their opening comments, it is very unlikely that somebody is going to bail out or protect a hedge fund. What the supervisor will do, therefore, I imagine, particularly given Secretary Geithner's initiatives on the resolution of nonbanks, is to wind down those institutions and protect the systemically important institutions, which are more likely to be their counterparties, such as banks or brokers.

So I do not believe you need to think about it in the way of how do I wind down a hedge fund, or how do I dissolve a hedge fund. The supervisory authority at the end of the day, collectively—beyond hedge funds, but collectively—still will be looking at systemic risk on those institutions that provide some public good such that we have deemed them to be systemically important, such as banks.

Chairman KANJORSKI. I am sorry I have taken the excess time. Mr. Garrett of New Jersey, you are recognized, and I will be lenient.

Mr. GARRETT. To Mr. Baker's comment, yes, I wish you were on this side of the dais too when our discussions become involved in this and also the GSEs issue.

The chairman made his opening comment with regard to unanimity on the decision of regulation, and I think there might be unanimity on the issue of regulation. There may not be unanimity on whether it should be voluntary or mandatory.

Listening to all of this, I have come away with two or three or four takeaways. The first one from everyone, starting with you, Ms. Williams, was that hedge funds were not the ultimate cause or underlying cause of the problems that we are in right now. I think your comment was they were not players to date in the current crisis, which I think is important in our entire discussion here. Is there anyone who disagrees that hedge funds were the fundamental problems here?

[no response]

Mr. GARRETT. No. So I think that is an important takeaway as we try to spend much of our time to deal with the global economic situation. Let us focus our attentions on what was the cause and not as much time on those areas it was not the cause.

Ms. Williams also made the comment that there are dangers from relationships with other market players, however, as far as what the underlying cause was, and I assume what you meant by that is that hedge funds did deal with some of these other parties which were systemically important. And so isn't the answer there not so much to direct your attention on looking at the hedge funds, but we do have—I think your testimony in other hearings was we do have regulators in place for the regulated marketplace, the banks and what have you, and if we looked a little more closely with them on what they are doing with the hedge funds and the derivative trades—was your earlier discussion on another panel—we could have possibly avoided some of this. Is that not your previous testimony and that comment here as well?

Ms. WILLIAMS. I think that is accurate.

Mr. GARRETT. So focus on where the problem is and focus on giving authority to those regulators and make sure those regulators actually do their job in those other areas.

Ms. WILLIAMS. That is definitely part of it.

Mr. GARRETT. Second takeaway is whether or not regulation would have stopped the current situation we are in right now. And Mr. Harris, you point out—maybe you can help me with some statistics or something like that—we have voluntary regulation today, correct?

Mr. HARRIS. Correct.

Mr. GARRETT. A number of those larger institutions I believe you said are already registered. How long have a significant number of the larger institutions already been registered?

Mr. HARRIS. For quite a while. I mean the large—my guess is 70 to 80 percent of the largest hedge funds are fully registered and have been for many years.

Mr. GARRETT. Many years. So if the issue is—and I know there is a little bit of debate whether we should register everybody or just register the systemically important ones, either way, we have already registered for a number of years the significantly important hedge funds, and so we see that registration apparently didn't prevent us from getting into the situation.

So we have to step back for a second and think, well, mandating registration of the insignificant hedge funds—whether that will have any impact other than creating some of the other dilemmas, the bailout dilemma that was referenced before, the potential of us stepping in, the wind down question that has been alluded to before, whether Congress will come back and say whether we should create authority to start winding down these things.

So I think that is another question that we have to take away and consider, is that we have already had registration of most of those entities out there, and it hasn't solved the problem.

The other takeaway is that this is, for most of your opinion, just the start of the process as far as registration? Well, I say that because the opening comments from this panel and Mr. Capuano was that this is just the beginning. Mr. Sherman said this is not the end of the discussion.

So were we to have a markup today and were we to pass this bill with registration, is it any of your understanding that Congress would not—and as the SEC said in my comments as well—be looking back to say registration is really not just the be all and end all here, we really need to have the overall supervision and some of these other constraints put in place. Does anybody think it is going to end at registration? Yes, Mr. Baker?

Mr. BAKER. I just would hope so, Mr. Garrett.

Mr. GARRETT. But what is the feedback from your—

Mr. HARRIS. No one believes that.

Mr. GARRETT. Excuse me?

Mr. HARRIS. No one believes this would be the final word.

Mr. GARRETT. Mr. Chanos, you made some sort of comment with regard to—and you made a couple of good ones. I can't get them all in right now—but we are looking at hedge funds here, but I think you also made reference to venture capital, equity funds, and

the like. Spend just 10 seconds on that. We are looking at this, but you are saying if we do something, we should be looking at all of these guys?

Mr. CHANOS. I think that it is important that we look at all the actors on the financial stage who are structured the same way because attempts to single out different groups because it is the concern of the moment doesn't really help us sometimes prospectively. And if we are going to be looking at all private investment funds, I think there should be a framework in which we look at all of them in the same way.

Having said that, I don't think the 40 Act is appropriate for today's financial reality. In fact, I have long personally felt that all of our securities acts need to be overhauled. Unfortunately sometimes it takes a crisis to bring that to the fore again, but we really keep trying to put a 21st Century financial system into an early 20th Century regulatory framework. And I think that leaves a lot of things lacking on both ends, both on the regulatory side and on the investor side.

Mr. GARRETT. I see my time is up, and I don't know how much latitude he is giving me here, but I appreciate it.

I think that is a very good takeaway to end with. Chairman Frank has said that we need a comprehensive look, and we have been doing this ourselves, of all the issues out there. And if we try to fit a square peg in a round hole, I guess is the expression, on just this one, we may be making a mistake. And if we try to do it just today, then we are going to come back tomorrow, someone else comes up with the idea for venture capital funds or equity trades and do them into another square hole, and then later on we come up with the idea of a systemic regulator.

Well by the time we do that, we may have created a whole new—well maybe we wouldn't have created a mechanism, maybe we will have used your analogy of the old law, which may not be the good one, and then we will be coming back to say, let's revisit it again. So I think you raise a great point.

And Mr. Groome, you also raised a great point—I can't get into it—with regard to an informed dialogue. I don't know where we actually have any informed dialogues at all outside in the real world between them and government. But I think all those things really have to come together in a comprehensive way rather than a piecemeal approach.

But I appreciate the latitude and I appreciate the answers.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. And now we will hear from Mr. Capuano for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

Ladies and gentlemen, have any of you ever robbed a bank?

[no response]

Mr. CAPUANO. No? Have any of you ever murdered anyone?

Mr. HARRIS. I have seen a bank robbed. Does that count?

Mr. CAPUANO. Have any of you ever murdered anyone?

[no response]

Mr. CAPUANO. No? Did you not do it because there was a law or did you not do those things because you didn't think it was the right thing to do? Did any of you not do it because the law says you can't?

[no response]

Mr. CAPUANO. You didn't do it because you thought it was the right thing to do. So therefore, you would agree that on some things, a societal line that says you cannot cross this line through the versions of a law works, because those laws are written not for the good people of society or the good people of any group, but for the handful of people who would break that law, who would cross that line. Is that a fair statement or do you think that is an unfair statement?

I assume from your silence you assume it is a fair statement?

[no response]

Mr. CAPUANO. That is what regulation is. It is not about the 80 to 90 to 99 percent of any group of people who do the right thing and do it well and do it professionally and adequately. It is about the 1 or 2 or 3 or 5 percent of the people who don't. That is what regulation is. Do any of you think that the SEC over the last 80 years has destroyed the economy?

[no response]

Mr. CAPUANO. Do any of you think that the Fed has destroyed the economy?

Mr. HARRIS. Well, we could debate that one.

[laughter]

Mr. CAPUANO. Reasonable regulation works. That is all we are talking about here. Is it a fair discussion to decide and debate where the appropriate line is? Of course it is. And those lines change over time because the economy changes, the situation changes, society changes. Absolutely, we all agree with that. But to say that there should be no regulation on some segment of any group belies the fact that humans have frailties. There is always somebody willing to cross the line.

Let me ask another question. How many of you can tell me how many hedge funds are in the United States of America right now? How many are there? Not an estimate and not a range, how many?

Mr. HARRIS. I think that is an unfair question.

Mr. CAPUANO. How is it an unfair question? How many are there?

Mr. HARRIS. No one would know exactly.

Mr. CAPUANO. I can tell you how many corporations there are.

Mr. HARRIS. Can you tell me how many private corporations there are?

Mr. CAPUANO. I can tell you how many corporations there are that sell stock. Yes, I can. But can you tell me how much money is under management by those hedge funds? Not an estimate, and not a range, tell me. Can you tell me how much of that money is put forth by institutional investors, so-called sophisticated investors who apparently weren't so sophisticated in the last year or so? Can you tell me how much money has been put forth by public institutional investors such as pension funds, such as yours? The answer is you can't. I don't think those are unreasonable questions.

Mr. HARRIS. With due respect, you can. I don't have that number right in front of me.

Mr. CAPUANO. You can't. Well then if you can, I would ask you to submit that later on—I understand you may not have that at the

top of your head—because if you can, you are the only person in America who can.

Mr. HARRIS. Just keep in mind, for better or worse, every pension fund is public has to report, so that information is available.

Mr. CAPUANO. I understand that. But pension funds are not the only ones who do it, number one, and number two, they don't all report uniformly. And number three, they don't report to a singular group. So I would love you to put together—I really would. I would appreciate if you could get every pension fund in America, especially the public funds—I would love to see that number because you will be the first one to ever put it together. And I would hope that you have the staff to do that, and I hope you do.

How is it unreasonable to simply say we want a general look? I'm not trying to be prurient. I'm certainly not trying to find out the investment ideas of individuals. That is not what we are looking for. I don't ask that from mutual funds. I don't ask that from banks. I don't ask that from pension funds. What we simply is when you get to the point when you can move the economy, it is reasonable for society to say show us something, tell us what it is.

Yes, Mr. Baker?

Mr. BAKER. Thank you, Mr. Capuano. I just want to point out that although I don't dispute the public need for understanding of something that is significant in the market, there are a lot of venture capital, private equity, private partnerships, and small hedge funds which should not be economically subjected to a rigorous registration regime.

Mr. CAPUANO. I totally agree.

Mr. BAKER. And where that standard or that line is drawn is of course your decision, but we would like to be involved in that discussion.

Mr. CAPUANO. Absolutely. We are on the exact same page. We may not be on the same page on what the answer is, but those are fair questions and reasonable questions.

I would also argue that the 80/20 rule, it is a nice place to start, but again, without knowing the exact number, it seems that everybody agrees that hedge funds—just hedge funds, I agree. Private equity shouldn't be treated any different—that anybody who can put enough money on the table to move a market should be subject to some transparency. But if the numbers is $1 trillion, 20 percent of that is $200 billion. It might be $2 trillion, and then we are talking $400 billion. Now if I were to sit here and suggest that $200 billion be used, oh, say for housing, my expectation is that some of my colleagues might find that a little bit too much money. $200 billion is a lot of money. It still is at least in my district.

So I'm not saying that 80/20 is not a good place to start, but to simply say that that is the line, don't look below that, and they are subject to nothing—especially if they act as a herd, which many of them do and you all know it, we all know it. And I don't blame them.

I don't think these proposals, especially the one on the table, can be considered radical by anybody except those who are just absolutely beholden to the total idea of an absolute free market, which is fine, I respect that view, I just, number one, don't agree with it, and number two, think it has been proven wrong time and time

and time again. Reasonable regulation is necessary for an effective, efficient, and equitable and stable economy. Where those lines are, as Mr. Baker points out and I totally agree, that is the discussion we need to have. That is the discussion.

The discussion is no longer, I think, among reasonable people about whether there should be some transparency. For those who want to hold to that, good luck. You go home and explain it to the people you represent.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Capuano. Now we will hear from Mr. Castle for 5 minutes.

Mr. CASTLE. Thank you, Mr. Chairman, and let me thank all of you. I felt your comments were thoughtful and give us some things to think about in terms of what we think we need to do here in our committee and in the Congress of the United States.

One concern I have—I guess it is a concern—is you have cited—a couple of you, two or three of you cited that you are not as big as other entities, as, obviously, banks, but also mutual funds, etc. And this is may not be the right time to be mentioning growth in this world of investment, but I think you are probably in as much of a growth area as any of those entities, ultimately.

As we see more institutional type investments going in to hedge funds with some of things that have made when the market has been stronger, I think that can return in 1, 2, 3, 5, or 10 years, something of that nature. So my sense is that it is something we need to pay a lot of attention to. We can't be dismissive just because hedge funds aren't as big as something else.

And one concern I have is that a lot of what you do deals in fairly rapid market turnover, volatility, either in selling short or in rapid gains, or whatever it may be. While it may not be leveraged, as you have well pointed out here today, it still could be a great influence in terms of what is happening to our markets out there. And I'm not trying to be an expert on the markets; I don't really know a lot about that or who the real buyers are or whatever it may be.

But my impression, just from the little I know about hedge funds, is that you are dealing with a lot more volatility. It is sort of a welcome aspect of what you do, and that concerns me somewhat because volatility—I mean you could talk about the stability of it. I may talk about it as a matter of volatility, which may not necessarily be all good. I would be interested in your comments on that.

Mr. CHANOS. If I could take a shot at that, since I think I am the only actual investor up on the panel here. In my day job, I actually run a hedge fund.

First of all, as a couple of my colleagues on the panel have pointed out, hedge funds are less volatile than traditional investment funds, often by quite a bit.

Mr. CASTLE. I don't mean to interrupt you—I do mean to interrupt you, I guess. But with respect to that, while you may be less volatile per se, aren't you interested in volatility? I mean you—maybe not you, but somebody may have a hedge fund that is selling short that wants to see volatility—

Mr. CHANOS. Which isn't what we do, actually.

Mr. CASTLE. Somebody else may want volatility on the upside. In other words, you are looking for volatility.

Mr. CHANOS. But in fact we are often the cushion to the volatility against it. When people are selling in a hole, my fund, for example, would often be buying, and vice versa, providing liquidity on the other side of the market. The volatility would be worse without players like that in the marketplace. So that is an important factor.

Number two, investors have lost far less money in volatile times in hedge funds than in more plain vanilla investment vehicles like mutual funds, which are highly regulated. Leverage is a concern, as a couple of people on the panel have expressed, and I agree with that. And it also needs to be in conjunction with the interconnectedness, to bring back a previous theme, of the financial system, for example, the banking system with the hedge fund industry.

Going back to 1998 in the LTCM crisis, what made it so bad was not simply LTCM's positions, which were considerable, but the fact that their lenders had actually also followed them into similar positions for their own account. Some have expressed concern about the rise of the shadow banking industry over the past 5 years. I know one professor, Andrew Lo at MIT, remarked that he was more concerned by the rise of the shadow hedge fund industry as banks and brokers became increasingly trading entities for their own accounts.

So all of this is interconnected, and it is not just hedge funds. And when you say trading patterns for volatility, the largest hedge funds we saw were the trading desks of the banks and brokers. So it is all of our markets which have seen increased turnover, but hedge funds specifically are not simply the only vehicle for either enhancing or dampening volatility.

Mr. CASTLE. Let me go on to Mr. Baker because I want to get another question in.

Mr. BAKER. Just to follow up on Mr. Chanos' observation, the goal of well-run hedge funds is to minimize potential volatility. For example, if you are going to go long or buy computer stock A, you may go short on computer stock B, just because you are skilled, you do your good analytics, and you think you are right. But just in case you are wrong, if the market goes sideways and you are short B, that pays off or mitigates your losses on being long on A.

And so there are firms out there calling themselves hedge funds which really don't deploy that kind of analytic skill or hedging that are in the market, but the members of our association do that with the exact intent of minimizing the downside risk. That is why, in the current marketplace, as Mr. Chanos has referenced, the hedge fund losses—although we have lost—in broad measure are far less than you will see in other regulated financial sectors because of that strategy.

Mr. CASTLE. Mr. Chairman, may I ask another question briefly?

Mr. Groome, if you could just give a brief answer, because I do want to ask another question quickly.

Mr. GROOME. A lot of questions have been raised about high net worth individuals versus pension funds, and such. I am also in the industry as well. I am in a $3 billion fund to funds and a hedge fund business, and our fund to funds clients in particular are very large public and private pension funds and a few sovereign wealth

funds. When you ask them why they are considering hedge fund exposure, or even more broadly, alternative exposure, their overriding reason is to reduce volatility. So the diversification benefits reduce volatility in their overall portfolios.

The second very quick point I would make—you ask about the size of the industry, hedge funds versus mutual funds versus banks. I think the size does matter to some respect, but size—as you heard me talk about the information template we would propose, we are talking about a variety of risk metrics. And when you think about the banking industry, as I think was previously noted, hedge funds may have been and may currently be somewhere between 1 and 3 times leveraged.

Well banks, even in their ongoing deleveraging process, are still well over 30 times leveraged, and many of the major banking institutions of the world which we have been concerned about throughout the fall of 2008 were closer to 50 or 60 times leveraged and have moved down. So that leverage, by definition, will create significant volatility in those institutions, and if you had equal transparency of their balance sheets that you have with hedge fund balance sheets, it would be more clear.

Mr. CASTLE. Thank you. I appreciate it.

Let me ask another question, and I'm going to need very brief answers. My time is really up. You made some suggestions about the hedge funds, but I am concerned about private equity funds in general and venture capital, and some of the other things that you have alluded to as well in terms of their impact on the markets and things that we—we being the whole investing world as well as the public in general and us in Congress and the regulating agencies—may not know a lot about.

And I just don't know what your thoughts are about how we can deal with systemic risk and investor protection issues beyond anything we have talked about today. We have talked about registration, other things we could do, but there is a lot which is happening out there, and a heck of a lot of it is simply unreported at this time. Do you have any thoughts about that, even perhaps beyond hedge funds?

Mr. HARRIS. I guess I will start.

Mr. CASTLE. You will have to be brief. I apologize for that.

Mr. HARRIS. It is unlikely that there—my opinion is there is not a lot of systemic risk from private equity. There may be a lot of losses, you know, over the course of the next year or two, but not a lot of systemic risk. The reason for that is there is $1 trillion of dry powder that has not yet—that has been committed by investors but not invested into the private equity area. So there are highly leveraged transactions, but it is unlikely that they will require any kind of governmental support.

Mr. CASTLE. Yes, Mr. Groome?

Mr. GROOME. I would echo a couple of things. Number one, I do not think regulation in any form that I have ever really, truly observed, has taken a huge step toward preventing systemic risk in and of itself, which is why in my earlier remarks I said it is the informed conversation, it is informing supervisors, getting supervisors to understand the business models that they are supervising and be more engaged, whether it is a hedge fund, a bank, an insur-

ance company, a pension fund, or what have you. That informed supervisor and the behavioral changes they can have on the managers of a supervised institution through their ongoing conversations, by asking intelligent, good questions, will change the behavior of those institutions much more than any set rules or regulations will do.

Unfortunately, I think in the last 15 years, the model has moved much more to a rule-based system in a number of jurisdictions, not just the United States, and not just hedge funds, but banking and elsewhere. And when I have gone to some of those supervisors and said, "Why aren't you—still have someone who is 45 or 55 years old and who has been for 15 years involved with one institution and understands that institution so well that they understand it better than the CEO and the CFO?" And the answer seems to be that they have changed their models consciously because they think there is no system, quite frankly, in the world, that can prevent outright fraud.

And so what they get criticized for, as supervisors, are frauds and missing frauds. But they don't get credit, in this person's words, who is a longstanding bank regulator in a G7 country—he said, "We never get credit for the institutions that never failed. We never got credit for telling the board, 'That CFO needs to go.' We never get credit for that. We only get criticized when somebody committed fraud far afield from anything we ever had systems to deal with or supervisory capacity to understand."

So we need to be careful, and in my opinion, I have argued for a number of years, we need to hire better supervisors, we need to pay them more, we need to give them better systems. The playing field is not level. The institutions they are trying to monitor and supervise are so far ahead of them that they are always playing catch-up. And it is supervision, not regulation, which will help prevent systemic risk and financial stability.

Mr. CASTLE. Well, thank you all. Just a final comment, I don't disagree with you, Mr. Groome, on that, but we as a committee are sort of scouting at how we better can handle systemic risk, so we are very interested in the insights with respect to that issue as well.

I yield back, Mr. Chairman. Thank you, sir, for the extra time.

Chairman KANJORSKI. Thank you very much, Mr. Castle. Now Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman, and I want to thank the witnesses for their willingness to help the committee with its work.

I do agree with one part of what was just said, and that is the government hasn't had the ability to keep up from the regulatory side. We are basically operating with the same set or rules, the Constitution, and statutes that—we may get rid of the powdered wigs up here, but we are still acting and dealing with a lot of the same issues we have for the past 100 or so years.

I do want to say, though, one of the victories, I think, of regulation was the FDIC that stopped a lot of bank failures and created a lot of stability in that market. And I actually see the opposite, Mr. Groome, that we had Glass-Steagall and we had a somewhat borrowing, solid banking industry, and then we got away from that

through Gramm-Leach-Bliley, it was a deregulation model that led us into this mess.

And as well, there are a couple of things that play here. One is the opacity of some of our institutions and hedge funds especially. And complexity. The complexity of the instruments that people are investing in now have just made it very difficult. I am on the Oversight Committee as well, and trying to make heads or tails out of these collateral debt obligations and other very complex derivatives, it is a pretty tough task for the average person, I would say.

That much being said, I think that there is a role for responsible regulation here, and I think all hedge funds should have to at least register to say, "Hey, we are in this business, this is what we are doing." And regardless of their size, I think everybody ought to step up and say, "We are in this business and we are doing this in a public market."

One of the things that kind of ticked me off was the President's Working Group asked for recommendations. They set up a couple of panels to offer recommendations about going forward. And most of their recommendations—all of them, actually—just talk about market discipline and say folks have to understand more about what they are investing in, they have to do this, they have to do that, and put the onus on the—it is basically buyer beware.

And at the same time, you do have all this complexity and opacity. You know, you really can't get the information as a market participant on a lot of this stuff. And a lot of these pension funds that are representing regular people, their fiduciary responsibility is there of course, but their ability to conduct this research is highly problematic.

How do we get at that? Look, you have a bunch of hedge funds and market participants who take major positions, highly leveraged on one side of a trade, and it goes bad. And they all scramble to liquidate their positions and we have a major problem. This is a $1.4 trillion industry, and you are going to have definite systemic risk when those things happen, as we have seen. How do we get at that with just market discipline, be careful of what you buy?

Mr. CHANOS. Well, let me take a shot at that. Again, I have pension fund clients and I have endowments as clients, and I have high net worth families as clients. And I have to tell you, they are some of the most sophisticated investors who come in regularly, look at our books, look at our positions, ask questions, do the kind of work that I think you would hope that people do from the investor side in our fund, and they do a pretty good job.

I don't have all my clients do that, but the vast majority, representing over 90 percent of my assets, do that regularly and do a good job, because in many cases they are required to on behalf of their fiduciary clients. So I think it does happen. It does happen in a—

Mr. LYNCH. Well as someone who sat on a pension fund as a trustee with the ironworkers, I can tell you there are a lot of funds out there that folks meet once a month for about an hour, and they are representing other people in the pension fund, and sure, you know what percentage is going into hedge funds, but trying to figure out what the hedge fund—and actually, hedge funds do provide a valuable opportunity for some of these pension funds.

I don't disagree with that, but what I'm saying is that fiduciary responsibility to understand what the investment is and what the value of the assets are and how those values were arrived at, that is a deeper understanding than I think the great majority of these pension funds have.

Mr. CHANOS. Most hedge funds allow their investors the right to do that. If that work is not being done, it is not the fault of the hedge fund industry. It is their—

Mr. LYNCH. Right. I understand.

Mr. CHANOS. It is the pension fund advisors you should be talking to.

Mr. LYNCH. I'm sorry. Mr. Groome?

Mr. GROOME. I would echo that. Our client base is also very heavily from the pension fund side of the world, and they come in and have stringent due diligence sessions on a very frequent basis, and they get all the information they ask for. We provide it extensively in advance, and when they come in, they have free reign of asking what they wish to receive and they will receive it. And we know that if they don't, they have the ability to take their money and go elsewhere.

I'm not sure if you were here for our statements, but just to repeat, in February, we came out and stated very clearly that our organization, AIMA, supports registration, but registration alone is not the answer. It really requires a transparency improvement, and that itself will lead to an informed dialogue, an intelligent dialogue, between the supervisory authority and the hedge fund manager that is being supervised and has registered.

Therefore, to complement that, we also recommended periodic reporting by larger hedge funds. We can debate, as we have, about what larger means and where that cut-off should be, but I think if that number is too low, if that cut-off is too low, the entrepreneurial nature of the industry will be endangered. The economics of a small hedge fund will be challenged to meet some of the standards we are talking about putting in place or the reporting requirements we are proposing to put in place. But transparency is important—market discipline without transparency doesn't work.

Mr. LYNCH. All right, we agree.

Mr. GROOME. Market discipline needs transparency.

Mr. HARRIS. Just to follow up on your comments, there is always a resource issue on some of these funds that you are talking about. So I agree that many times, it is—the hedge fund is perfectly willing to show you their books. There is just nobody on your side to look at them, and that has to be stated. If you go to a fully resourced fund like ours, we require full transparency, we have access to the books any time that we want, we take advantage of that.

I am on the President's Working Group, and we are requiring all of our hedge funds to be fully compliant with the President's Work Group by the end of the year; 37 of the 45 are already compliant. And the high water mark issue that is associated with pension funds will take some of these pension funds out the game and the market will work its way through back to a response that will bring us back into parity.

Ms. WILLIAMS. Could I jump in for a minute? I would also like to echo that we found in our report when we looked at pension fund investment in hedge funds and private equity that resources were an issue. But I think you have also heard on this panel the issue of hedge funds providing any information that is requested. So that requires knowing what information to ask for and then knowing what to do with the information once you get it, and we found that to be a challenge for many smaller pension funds.

Mr. LYNCH. I agree.

Mr. BAKER. Mr. Lynch, if I may join in?

Mr. LYNCH. Sure.

Mr. BAKER. Ten years ago or a little over, the first President's Working Group report came out. A Member of Congress took that, turned it into the Hedge Fund Transparency Act, had a hearing, and everybody came down from the MFA and opposed it. I was the Congressman who had that bill.

Ten years subsequent to that, we now have just finished—at great expense and a lengthy process—incorporating all the President's Working Group sound practices—recommendations into our own sound practices document. That in itself is not of note. What is of note is that we send that out broadly to all investor groups, to pensions, to individual investors we can identify, and say to them measure your potential investment opportunity against these minimum standards. You can go beyond what we recommend, but if there is an aberration in what we recommend—and they are significant, I would be happy to provide them to the committee, they are on our Web site.

We are also working very closely with AIMA on an international harmonization of those sound practices so that there is a global standard. And there are some regional disparities where we won't ever come together, but in large measure what we are doing is in response to our investors. They are demanding these standards of disclosure and we are providing them because it is what the market is asking for, and we believe them to be very high standards of responsible conduct.

Mr. LYNCH. Fair enough. Thank you for your forbearance, Mr. Chairman. I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Lynch. See, we try and be fair up here.

Mr. Posey for 5 minutes.

Mr. POSEY. Thank you, Mr. Chairman.

It is my belief based on observation and experience that government will never get ahead of the leading edge of technology or creativity. I just think it is an unrealistic expectation. But when that creativity or technology is misused, I think that is when we have laws like racketeering laws that you would come in and set the record straight on what is an acceptable standard of use or misuse of that creativity or that technology. I think the standards, overall, obviously is are you treating the people who are paying you or are you treating the public fairly? I think that is a pretty well recognized standard that could be used and should be used.

And as an example I think somebody referred earlier to how the public reacts to different laws. You know, if you are late for your plane flight and there is a 5-mile stretch that if you do the speed

limit you will miss the flight, if you exceed it, you will probably make the flight. If you know the police are all over that road and they run radar regularly, you are probably going to miss your flight. If you know nobody ever gets a ticket on that road, you are probably going to make your flight.

And so I think the public expects us and the creative people and the techie people expect us to set a boundary, and I think we have kind of failed to do that. I use the example, and I think a couple of you mentioned it in your writings, I know Mr. Chanos that you did, of Mr. Markopoulos going to the SEC almost a decade ago. Now they were empowered to do most of the things I believe you said we needed to look out for, but they failed to do it. They had 1,100 lawyers who filed an average of one case every other year, and so it is just like having no police on the highway. You can expect people to speed if they know that there are no consequences.

And the chairman said before that we need to have people and be able to pay people to meet the standards that we expect to challenge, but I think it is almost going to be impossible to try and get ahead of the technology and the creativity curve. Again, I think we need to have laws in place for the abuse of that stuff. And to my knowledge, after the Markopoulos screw-up and $70 billion evaporated or however many it was, I don't know that anybody was even reprimanded, I don't think anybody was fired.

I mean if it was any of your companies or any of our companies, all senior management would have been gone in 24 hours. But somehow it is just acceptable to go along and not do your job up here, and the consequences are that we are looking to point fingers and over-regulate down the road in the future. If my logic is bad, I would like one of you to point it out.

Mr. CHANOS. It gets back to my comment about smart regulation, not more regulation. I mean we have a body of people who are trying—I think trying their best, but in many cases are overmatched or just don't have the financial experience to look at what they are regulating. Quite frankly, we have an army of attorneys trying to oversee an army of market participants, and there are some flaws in that.

Mr. POSEY. My thought was not that we try and regulate how you build a car, if it is capable of exceeding the speed limit, but if in fact you use it to exceed the speed limit you abuse people, just like Enron did or just like other people have. If people have been abused in this process and haven't been dealt with fairly, there should be consequences for that.

Don't try and reinvent the car, don't try and reinvent the wheel. Enforce the law, enforce a standard of fairness. And whether the public or individual clients have been dealt with fairly, I think that is a reasonable standard, a bottom line standard, that we should have the Justice Department, the SEC, the FTC, and everybody else on top of right now to start—

Mr. CHANOS. But my point is they don't even see the crimes. One of the ideas that has been bandied around in our industry more and more refers to the ranking member's, I think, concern earlier, is in law enforcement, to use the metaphor, and the military, we have academies, we have colleges to teach our officers or law en-

forcement people the latest in law enforcement techniques or military theory as they go on in their career.

We need this in our financial area as well. We need financial boot camp. We need retired hedge fund managers and trainers to come in pro bono—and a lot would do it, quite frankly—to help teach junior regulators, and middle and senior level regulators how to detect fraud, how to detect malfeasance on a trading desk, how to spot some of these things. There are patterns that have occurred down through history that just, I think, over and over and over again our government regulators miss. Again, smart regulation, not more regulation.

Mr. POSEY. Mr. Chairman, if I can just follow up?

Actually, we did that in another State. We had a problem cracking down on fraud and the excuse was we couldn't get competent people because they get hired away as soon as we train them, and so instead of going out and just searching these people we have started training our own, and I think that is a real good suggestion maybe that we might take under consideration and think about that.

Mr. CHANOS. I have people in our industry who are coming forward to me and my organization to say they would volunteer or they are retired people, and would be happy to do that as a public policy.

Mr. POSEY. That is a good idea, thank you.

Chairman KANJORSKI. That is an excellent idea. Can you give us a little two-pager on that?

Mr. CHANOS. I would love to submit something on that.

Chairman KANJORSKI. I appreciate it.

Mr. GROOME. Mr. Chairman, if I may?

Chairman KANJORSKI. Yes.

Mr. GROOME. You might also reach out on the same topic to the FSA in the U.K., because they too reach out to the industry and have people come into the FSA for some time period where they benefit from their knowledge and understanding of the industry. I would endorse everything that Jim just said, but rephrase it differently. We really want to have supervisors who understand what the right questions are. It is understanding the questions even more than the answers that are really, really important.

Chairman KANJORSKI. Before I—

Mr. BAKER. Mr. Chairman, if I can jump in just at the tail end of that process? I just wanted to volunteer that the MFA staff will be meeting with SEC staff next week on exactly that discussion, how to improve the accuracy of their examination process. We have found that all too often they spend an inordinate amount of our time for no apparent end result. We think they can get in and get out with the right tools much quicker and go to the material facts that really make a difference, and we have voluntarily reached out to the agency to help in that effort.

Chairman KANJORSKI. That is pretty good, but Mr. Baker, may I make a suggestion that perhaps we have staff from the committee or even members of the committee knowledgeable about these conversations participate because what you may put in their hands never tends to get here. In reality, we are the ones who are going to write and charter what has to be done in the future, so if you

think about it, maybe we could have a better line of communication by getting some of—I don't think that violates any separation of power.

Mr. BAKER. Mr. Chairman, subject to appropriate ethical oversight, I will always say yes to a chairman.

Ms. WILLIAMS. I have one thing to add about SEC. SEC, when they first required registration, they had hedge fund—members from the hedge fund industry teach OCIE and enforcement staff when they first moved toward registration that was ultimately turned over by the court. So they have been engaging in some of this type of activity in the past.

Mr. HARRIS. I would just counsel you that when you do that, you need to discriminate between two types of risk. One type is risk monitoring, which frankly is a huge distraction to what you are doing. The other type, which is for lack of a better term I call bullet to the brain risk is what you need to focus on, and that list of questions is probably no more than ten. It is not 100. And when you go beyond 10 or 12 key questions to 100 or 200 or 300, you diminish the effect of the 10 that really matter.

Chairman KANJORSKI. Very good. Before I recognize Mr. Foster, I think we have had him get ready to start several times, but I am not trying to block him.

What I do not understand—and if we could hear from someone on the point, later on after the session—about the Madoff disaster, is that with the amount involved and 13,000 victims, and most of those victims were very sophisticated people, how did due diligence fail? It shocks my understanding of what we can do to improve the situation of examination and knowing what is going to happen given the size and sophistication of the victims. So if you could just give that—

Mr. HARRIS. May I respond? First of all, to give an institutional perspective, I have been doing this since 1985. I have run three or four of the biggest funds in the country. I had never heard of Madoff in my entire life, so he was not operating in the realm where this kind of due diligence was being done.

The individuals that you are citing are sophisticated, but they are not financially sophisticated. This was country club, you know, this guy does great, put the money with him. There was no—as far as I can see, and I have just read what you have read in the papers—there was no due diligence being done. He was operating outside the system with individuals mouth to mouth in a long-term Ponzi scheme. People like me who operate in an institutional world, he never came across our doorstep once.

Mr. GROOME. Or, to say the same thing in a different way, we had someone actually approach our organization several years ago and ask us if we knew that fund, knew that person, and if we would on their behalf meet them. And because it was an existing client in a different part of the business, they did so. Prior to the meeting our due diligence team was told, "These are the questions you are allowed to ask," and we said, "We are not interested in the meeting." So the signals can be quite clear. This is why my point about knowing the questions is much more important sometimes than the answers.

Chairman KANJORSKI. I am tempted to go on, but I am going to stop it right here and say Mr. Foster, you have been kind and diligent to give us the time. You are recognized for 5 minutes, or more, as the case may be.

Mr. FOSTER. I guess the first question is for Mr. Baker. You had characterized the hedge fund industry as a relatively small $1.3- to $1.5 trillion industry with leverage in the range of two to three, industry average. And I was wondering, what is the notional value of all the swaps and off balance sheet obligations in the hedge fund industry?

Mr. BAKER. It would be difficult for me to give you an accurate estimate, but I will try to get back to you subsequent to the hearing.

Mr. FOSTER. Well, can you assure me it is under $10 trillion, for example?

Mr. BAKER. I won't make a representation to you this morning until I do some analysis, but I will be happy to get back, and of course forward it to the chairman and the ranking member as well.

Mr. FOSTER. I guess it was one of the—I guess it was Ben Bernanke and others—have made the analogy between AIG is a healthy insurance company with an unregulated hedge fund grafted onto it, and from that point of view, the collapse of AIG is sort of a preview of what the collapse of a big hedge fund would look like. And I was wondering if you have a reaction to that analogy and is it a fair—

Mr. BAKER. I was hoping that the chairman was misquoted and that he was hoping AIG was a hedge fund because its losses would not have been so precipitous had they been exercising any standard of due diligence in their investment activity.

No, in a serious mood, I took affront for our industry that we would be characterized in such a fashion. The closer one gets to the taxpayer's wallet, I understand the regulatory encroachment. But hedge funds raise their money, they invest their money, and their investment advice is on the table with their investors. And if the fund makes money, sure, they make money. If they lose money, guess what, they lose money. And if the unfortunate event occurs where they go out of business, strange people show up and sell your furniture. That is the end of the story. There is not tax—

Mr. FOSTER. Which works, that is a model that works, as long as they don't have off credit sheet obligations that are enormous compared to their actual assets. Then there is huge counterparty risk. Can you assure me that there are no AIG Financial Products out there in the guise of the hedge fund industry?

Mr. BAKER. And to date there has been not one—

Mr. FOSTER. I understand. I understand they have not yet blown up. The question is, can you assure me that there is not an equivalently violent explosion waiting in the wings?

Mr. BAKER. If the question is, do I believe there will be some failures in the future that I cannot name? It is a probability. Will those future failures result in some systemically significant event? That is very unlikely.

Mr. FOSTER. Okay. Let's see. Mr. Groome, you said you supported periodic reporting by large hedge funds, and I was won-

dering what exactly periodic might mean. We had some discussion of large.

We have learned in the collapse that the timescale for the collapse is hours or days, and so it seems to me that periodic reporting has to be the same sort of thing that happens internally to the investment banks that still exist, and also, I presume, large hedge funds where they net out the enterprise-wide exposure to various things almost on an hourly basis. And I was wondering, is there anything short of that sort of very frequent reporting that will actually allow a systemic risk regulator to do its job?

Mr. GROOME. Yes, I think so. In the conversations we have had in this country and elsewhere with our membership, we have heard everything from monthly to annual, and that includes all parts of that spectrum. Annual is clearly not enough, monthly is probably too frequent for the cost involved and the ability of the supervisor to analyze it and use it effectively. And so what I have tended to hear is people gravitating towards quarterly or maybe semi-annually, but that tends to be the timeframe people are talking about.

Mr. FOSTER. Now why then do investment banks and large hedge funds do it at least daily? Why is it not useful for something that is responsible for the stability of the whole financial system, why is that a less stringent requirement than just for the survival of an individual firm?

Mr. GROOME. Well you could—I mean I would phrase it this way. Systemic risk doesn't occur overnight. It builds up over time as it has in our system over the last several years to the detriment of what we experienced in the fall of 2008. And in Jim's business, for example, a number of hedge funds dedicated to the shortselling effort were the canaries in the coal mine as far back as 2006 telling us exactly what those risks looked like and executing transactions to demonstrate their disbelief in the valuations of certain bank portfolios and mortgage values.

The system we are contemplating, we are proposing, we have discussed with supervisors—we think it has two benefits. It has a national benefit to, say, the SEC or the FSA, where they can identify outliers in the system. They can look across strategies and see consistency as they usually will among the approach to that based on liquidity, leverage, and other risk factors. To the extent somebody stands out, that is where Ms. Schapiro or others have said that it would be very useful to take a rifle approach, and not have a shotgun approach, and be able to identify outliers.

On the international stage, the Financial Stability Board, as well as the Treasury and the Fed in this country, would take that information and monitor developments over time and asset classes, and you can clearly see the build-ups of risks, as we did see and everyone has talked about for years in the structured credit and the mortgage markets, which ultimately did explode.

Mr. FOSTER. So you don't believe it is a logical possibility for a systemic risk to build up on the timescale of days?

Mr. GROOME. Well, I wouldn't say it is impossible, but I cannot contemplate it right now. What I am saying is the risk in the system doesn't just generate over the course of hours or days. Risk builds up to such an extent that you are exposed to market disruptions, and we have seen that occur, time and again.

Mr. FOSTER. I yield back.

Chairman KANJORSKI. Thank you, Mr. Foster. Mr. Royce of California for 5 minutes.

Mr. ROYCE. Thank you.

I was going to ask Mr. Baker, you had mentioned in your opening remarks about the extensive trading rules and reporting requirements that hedge funds are subject to under existing law. As I understand it, on top of that, the majority of hedge funds do not register voluntarily with the SEC and I think it is about three-quarters of the assets that hedge funds have in their portfolio. But could you expand on the requirements themselves?

Mr. BAKER. Yes, I would be happy to provide you and the committee with the document that gets distributed to an office when the SEC is about to visit. The historic document is about 20 pages, it is very extensive in the disclosures that are required. It is not name, rank, and serial number only, and that is the beginning of the process. Obviously, the agency, after entering a firm, as it discovers areas that it has interest, will then expand the scope of those inquiries as it deems appropriate.

I mentioned earlier in the hearing to the chairman that it is not uncommon for those examination processes to extend months. In fact, longer than a year is not that unusual, so that contrary to most public perception about the current oversight system, voluntary though it is, it is very extensive, very time consuming, and very difficult for the firm to be responsive to all of the questions that are raised.

That being said, others on the panel have indicated that SEC resources are very limited and that the experience of the examiners all too often is not appropriate for the business models they are examining, and we believe that leads to unproductive work on the government side, and that a sharper, focused examination trigger and then a sharper set of skills being involved in the examination process would yield benefits to everyone.

Mr. ROYCE. Let me ask the witnesses this. We witnesses some gross negligence on behalf of the SEC, I guess is the way you would view it in terms of the Bernie Madoff circumstance. And Mr. Markopoulos testified here and we had an opportunity to talk with the investigators for the SEC. Do you believe that the SEC and other financial services regulators are currently equipped to conduct examinations and other necessary regulatory steps?

To me, one of the interesting aspects of this is the amount of market discipline and due diligence that you see in institutions—and I guess Britt Harris might have some observations on this with the pension funds—the amount of examination you do—I opened my remarks this morning just contrasting this. You are leveraged two or three to one. Fannie Mae or Freddie Mac, the Government Sponsored Enterprises that we had oversight with, we allowed them to go into arbitrate—pushed them into leveraging 100 to 1, and at the same time Congress, against my advice and certainly against Mr. Baker's, did not heed the request of the Fed when they said these need to be regulated for systemic risk, you have to deleverage these portfolios. So here you are contrasting leveraging 2 or 3 to one to leveraging 100 to 1, which was done under, perhaps, the most regulated environment.

But with the regulation by Congress came something else, came also the ability of Congress to direct those investments, to set those goals for subprime, to set those goals for Alt-A loans, to set those goals in terms of who you are going to loan to, and to build up the risk between the over-leveraging and the type of activity.

And I suspect that one of the concerns is always with congressional oversight comes the assumption that the regulators that are involved in this have the expertise, and I guess one of the real questions, looking at the SEC as a result of the investigations and the hearings that we held, this was a sobering hearing when we had Mr. Madoff here with the loss of $65 billion over something that the SEC failed to catch. Any observations on that?

Mr. BAKER. Mr. Royce, I would jump in and say from a market discipline perspective, the regulatory team should be viewed as—I hope this is not an inappropriate characterization—as the law enforcement officials who get called when the act is obvious to everyone. In my home State, we have a lot of neighborhood watch subdivisions where the community itself reports suspicious activity to law enforcement, because they can't be everywhere all the time. That is the function of the private market in the financial world.

When Mr. Chanos engages in his work and determines that values are improperly inflated, he takes a financial position on that matter. When the pension fund, Mr. Harris, does his examination, he goes through a series of sophisticated steps to make sure that when he writes the check for his pensioners dependent on his judgment, that he has asked all the right questions and gotten responsible answers.

That is the neighborhood watch response. Sure, you do need to have some police around, but they can't be in every neighborhood on every day to stop every violation when you are trying to get to the airport on schedule. So I think the responsible way to balance this is to rely on a strong neighborhood watch program, and where market participants do the due diligence.

And frankly, I didn't get in on the Madoff matter and how it got that far advanced. Members of our association looked into the Madoff matter and voluntarily decided this wasn't a place for their client's money to be placed. There were a lot of warning signals, but the attractiveness of inflated returns over a long period of time and having such—you may remember from the Fannie and Freddie days, a steady Freddie label. Anybody who promises no volatility on returns for a decade or more, you need to be careful. And just that alone should have been sufficient for people to have exercised better judgment. The man was a great fraud, one of the best ever, and he made up the trades. He reported non-factual figures. Everybody did what they should have done appropriately, but the man lied, and the result is a lot of people got hurt.

Mr. ROYCE. Thank you, Mr. Baker. Thank you, Mr. Chairman.

Chairman KANJORSKI. We still have one holdout here. Mr. Himes, we are going to give you your 5 minutes too.

Mr. HIMES. Thank you, Mr. Chairman, and thank you very much to the witnesses. Assuming those doors stay closed, you are less than 5 minutes away from being done.

I appreciate your testimony. I have a small question and a big question. I appreciate much of what you said. I take small excep-

tion though. There was a lot of discussion about the average level of leverage in the hedge fund industry, and when the witness said it—and I forget who said it—I was reminded of that old song never ever try to walk across a river that is on average 4 feet deep. We do not care about the average. We obviously care about that institution which once every year or once every 2 years is going to get itself into trouble, so that is what we are focused on here.

My small question is, were this simply an industry of high net worth investors, I would be a lot less worried than I am. It is an industry in which we have seen pension and other public monies come in where there is a whole set of issues there. I want to set that aside. It is a little beyond the scope of this hearing. But what really does worry me are those entities that are employing the kind of leverage that we saw with long-term capital management and whatnot.

So my question is this. I'm not convinced that assets under management is necessarily what we want to watch. How do we best watch those entities that are taking on a lot of leverage? And I will ask for maybe one or two responses because I have a larger question behind this one. What is the number? Do we watch the banks, do we watch a set—what is the number at which we should make a cut off of who we watch for this purpose?

Mr. CHANOS. Well one of the ways in which the Fed, both Chairman Bernanke and Chairman Greenspan, pointed out was the one way to monitor leverage in the hedge fund industry is to be looking at the prime brokers, the breaks and brokers that domicile their accounts. They typically are in banks and brokers, not in trust accounts. So you can in fact monitor from the systemic point of view from the other side of the telescope the amount of leverage relative to equity in major accounts, in the top 20 percent, with 80 percent of the assets, for example.

There are ways to get at this from where the accounts are housed, a more practical point of view. You still might miss various forms of hidden leverage or derivative exposure, which was alluded to earlier—

Mr. HIMES. I would like to come to that, but just—and in fact I want to come to that right now—but just ballpark figure, give me a sense, give the committee a sense, if we are really after those hedge funds capable of employing the leverage that produces a systemic risk, order of magnitude, are we talking about 10, 100, 1,000? How many hedge funds are we talking about?

Mr. GROOME. Well, let me try to answer that. In my testimony I said that we proposed $500 million as a possible cut-off for registration, and I think that actually needs some real thought for ongoing reporting or standards to be required. And I gave an example. If you change that to $1 billion assets under management by the hedge fund manager, you are still capturing 311 hedge funds worldwide, by our count. Approximately 215 of those are in the United States. That group would represent 80 percent of assets under management, so you get a very full picture of the industry.

Two comments, I guess, qualitatively. If you move that number, by the way, to $2 billion, you really only go down to about 200 hedge funds and 70 percent of assets, so you don't get a lot of bang for your buck by that move.

Mr. HIMES. Thank you. Okay, a larger question, and I direct this to Mr. Baker. Mr. Baker, I'm also interested in synthetic leverage, and I want to pick up on an example that you used. You go long in computer company A, short in company B. Let's take a huge position because we have leveraged out all but the risk that we want to take. Well, as you and I know, occasionally you get whip-sawed and you are short and computer company B rises, and your long falls and you are now in a position where you are effectively taking on an awful lot of synthetic leverage.

I really worry about that, partly because even though I spend time in the industry, I'm not sure I can identify all of those generators of synthetic leverage, if you will. So I'm going to ask you, I'm wondering if you have done any work, your organization has done any work identifying those areas, and in the very limited time that remains, can you talk a little bit about those areas where it is not bank lending, but it is significant leverage?

Mr. BAKER. Sure I can. We don't have any studies particularly on the point, but we can certainly provide you with a more detailed response. The quick answer would be don't forget the manager's money is on the table with his investors. That is an extremely important factor in taking outsized risks.

Secondly, where you do have bank lending, the Fed has supervision over the bank holding companies, which is a way in which Mr. Bernanke and others can get access to look exactly inward at those activities and make judgments about risk. Ultimately I think it is the management of the entity and his responsibility to his investors that attempts to seek some sort of operational balance.

On a given day, yes, people are going to lose money. I go back to the observation that the government role traditionally is not to preclude business failure, it is to make sure that a failure of an entity doesn't affect innocent third parties, and I think we can do that with appropriate operational standards of conduct.

Mr. HIMES. Thank you, and I see I am out of time, but if your organization, perhaps working with the other witnesses, could generate nothing more complex than perhaps a list of mechanisms that can create, if you will, synthetic debt of synthetic credit exposure, that would be very helpful.

Mr. BAKER. We will get back to you soon.

Mr. HIMES. Thank you very much.

Chairman KANJORSKI. I think we are down to Mr. Grayson now. Mr. Grayson, for 5 minutes.

Mr. GRAYSON. Thank you, Mr. Chairman.

I think the lesson of the past year has been that we have to try to avoid systemic risk, and I would like to explore with some of you, in the time that we have available, what the substantive rules should be to prevent institutions from creating risks that lead to taxpayers having to shell out $100 billion and more to AIG in one instance, and many other instances that we have seen from the past year.

So I would like to know not simply about, honestly, cliches like best practices, but rather, what the limits should be. How much leverage is too much, at what size does an institution become counterproductive because of the institution instituting systemic risk

that puts the whole system at risk? Tell me what you think the limits should be. Let's start with Mr. Baker.

Mr. BAKER. I can't give you a direct response to your question, Congressman, in that simply an asset under management test isn't really sufficient for the systemic risk concerns, in my view, that there are other elements to that conversation, as in the prior conversation discussing leverage. A smaller firm, highly leveraged, can have just as much effect as a larger firm that is not. The interrelatedness of counterparties is certainly very important in this current environment.

My members spend a lot of time analyzing the financial stability of the broker/dealers in which we are engaged. That didn't used to be the case. Everybody is watching everybody is the best way to describe the current market condition, because apparently innocuous, not significantly large by any standard asset under management measure can become systemically significant in the right set of market conditions.

Mr. GRAYSON. All right, let's assume that there are a number of different variables that need to be factored in. Of course, making it sound complicated often leads to inaction. But let's assume that we have identified an institution that poses systemic risk. What would you do about it?

Mr. BAKER. Well, if I was Mr. Chanos, I would probably short him. No, I'm kidding.

The end consequence of this question is one that has plagued the Congress for 25 years. We have debated what actions would one take if you identify a potentially harmful event. Who should make this judgment, and what authority should they be given to act in that consequence? There isn't an easy answer to what you are posing in that—I will put it in this context.

If you went back prior to LTCM, LTCM never had back-to-back 2 days of trading losses. They were run by Nobel laureates. They took money for 3 years, and don't call them. They were having outsized rates of returns, and because of an unexpected Soviet currency crisis that no one could have predicted, they went bankrupt in a matter of a few days. How one could have gone back 30 days in advance of LTCM and given a regulator authority to forecast that and then decide what action should have been taken to preclude losses is a difficult question.

Mr. GRAYSON. Is it really? I mean in the case you were mentioning, there was 100 to 1 leverage used with billions of dollars as their capital base. Don't you think that would make most people a little nervous?

Mr. BAKER. There were people lined up wanting to invest in LTCM that couldn't meet their investment criteria. So I go back to Chuck Prince at Citi. As long as the music is playing, it is hard to quit dancing. And when you are having outsized gains to exercise caution, it is a very difficult thing.

Mr. GRAYSON. Well, the right answer cannot possibly be to do nothing, so let's go on to Mr. Groome, and if we have time Mr. Chanos, so you can tell me when big is too big.

Mr. GROOME. Well I would—it is really a continuation of the conversation I had with Mr. Himes, in some respects. You can set a threshold for what, basically, is someone is going to provide infor-

mation to supervisors. But within that, you have to qualitatively understand the business model and ask the right questions.

So for example, to specifically address your question, I would, if I were in the supervisory seat, think very differently, for example, within the hedge fund world about long/short equity funds which are active in very large, liquid markets, than I would think about much smaller hedge funds which are in markets where the margins of their trading activity are very tight, the liquidity of their assets are very sporadic, and therefore sometimes they may be highly leveraged, try to maximize what is going on in that environment. That to me as a supervisor would send off a greater signal of concern than just simply someone's relatively large size.

Mr. GRAYSON. But again, complication leads to inaction. Mr. Chanos, can you give us an answer?

Mr. CHANOS. I will go out on a limb—100 to 1 in anything is too much.

Mr. GRAYSON. I agree with you, but let's try to explore that a little bit further. Why can't we develop a system—or can we develop a system where we can say with reliability that an institution that poses systemic threat will be barred? Why haven't we done that yet and what do we need to do to get to the point where that actually happens on a reliable basis?

Mr. CHANOS. That is beyond my level of expertise, Congressman. I don't know at what point someone with the authority to do a wind-down in a systemically important institution says, "I have to do it here," based on just level of leverage versus, perhaps, incurred losses, or interconnectedness, which was also part of the LTCM problem. Again, it wasn't just the leverage, which was, as you point out, considerable.

And by the way, inter-reporting as well. Some of these entities gear up in between periodic reports and then gear back down, including current regulated entities like banks and brokers.

So all these things are part of a mosaic of risk that my quip about 100 to 1, which I was serious about, only underscores that you need to see just how interconnected some of these entities are and how much additional leverage the herding accounts for. And I don't know. I don't know what the answer is for a systemic risk regulator or the Fed or the Comptroller of the Currency to come in and step in at some cutoff level.

Mr. GRAYSON. All right, my time is up, but I think this is the fundamental question that is facing us right now. We need to have somebody who is willing to say enough is enough. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Grayson. The gentlelady from California, Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman.

I have an article from the Washington Post dated October 19, 2005, which I would like to submit for the record, without objection.

Chairman KANJORSKI. Without objection, it is so ordered.

Ms. SPEIER. It is an article by Steven Pearlstein entitled, "Hedge Funds Get Tangled in Bad-Business Cycle," and it underscores just a number of hedge funds that were in trouble back in 2005. And at the end of the article, he says, "with $1 trillion in assets, hedge funds have become a dominant force in capital markets, accounting

for as much as half the daily trading on the stock market, hundreds of billions of dollars in bank loans, and a healthy chunk of the profits of Wall Street brokerages. Federal regulators cannot guard against systemic risk to global markets if they don't know what hedge funds are doing."

Now this was back in 2005 when it was only $1 trillion. Today it is $2 trillion. And I must tell you that I am not at all sanguined by your comments today that somehow registration is enough because I don't think it is enough. This is very reminiscent of what Congress did with the Modernization Act when we prohibited the regulation of derivatives.

So with that said, I would like the auditor, Ms. Williams, to tell us what kind of regulation you would recommend.

Ms. WILLIAMS. I would really point to our regulatory framework that GAO laid out earlier in the year, that any regulatory structure needs to address several elements, and I will briefly note two.

One is that it needs to be comprehensive. That is, in order to deal with all elements under a system-wide focus, the regulator or the regulators have to have a view of the entire system and all of the players in the system. So with hedge funds, what comes to mind is here we are dealing with a known unknown. We know that hedge funds are players in the market, but specifics about the hedge funds, the number, assets under management, as well as their strategies specifically and their impact on the market is largely unknown. If you dealt with some of the known unknowns, that would allow a systemic risk regulator to begin to focus on the unknown unknowns.

I think getting information to the regulators that provide insight about hedge funds from their role as investors in the market is key, because that is what we are currently seeing with hedge funds. They are expected to be involved in bringing us out of the current crisis through TALF, for example. The markets have come to rely on them as investors.

Therefore, it is important to know where they are investing because they can move their assets to different markets depending on what is going on in any particular market. They can move in and out of equities, they can move in and out of commodities futures and have impacts on those markets when they are there and also when they move to another market.

Ms. SPEIER. All right, having heard that from the representative from the GAO, I would like to have each of you respond to whether you would object to that kind of regulation.

Mr. BAKER. If I may, Congresswoman, I think the registration proposal, as I understand it, would provide much of the information, if not all—just to make sure I'm not overstating the case—that the GAO has indicated would be helpful for a regulator to make an informed determination about action that might be required.

Ms. SPEIER. Let's just go down the line, and then I have a further question for all of you.

Mr. GROOME. We too have said that registration is not the end, that the second component of registration has to be better information gathering and periodic reporting, and we have been working over the last several months with people at the G20 and the Finan-

cial Stability Forum and authorities in this country sharing ideas on what that template should look like. And in fact, starting last week, there was an experiment undertaken, if you will, or a consultation with the FSA and 20 large hedge funds to get their feedback directly on what that template may look like, so our members are very open to starting to provide systemically relevant information to supervisors.

Ms. SPEIER. All right, my time is going to be up very soon, so I think what I would like to do is just ask all of you this final question. Warren Buffett files audited quarterly financial statements. Would you be supportive of, as part of registration, a responsibility to do that, that were indeed financial statements that were audited? Just go down the line, and if you would respond.

Mr. BAKER. I guess I should start. I would say that disclosure to a regulator, as long as it is non-public, we would provide the regulator with any information they would ask us for.

Mr. GROOME. We would do the same thing. Our members have said they would support a periodic reporting system—quarterly has been mentioned as the appropriate deadlines, time period—to supervisors. We have also stated that on a confidential basis such information should be aggregated and shared on a broader level, such as the Financial Stability Forum, but obviously on a confidential, aggregated basis.

Mr. CHANOS. I would agree with that.

Mr. HARRIS. I would just say Warren Buffett doesn't short, so that is where the non-disclosure is the most sensitive. If you were to go down that end—and I also would modify maybe what I thought I heard you say, because I think there are many people here who are for more—for proper disclosure at the right organizations.

The problem with the comprehensiveness is you will dilute your effectiveness. You will be monitoring somebody who is much too small to make a difference and diluting your ability to monitor people who are large enough to make a difference.

Ms. SPEIER. I think my time has expired. Thank you, Mr. Harris. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Ms. Speier.

We have a few more moments. We are anticipating a vote. If there is no objection, do you want to continue for a few minutes? I have a few more questions myself.

In the responses to some of the examiners earlier, I sensed an overtone that there was not a great deal of respect for the professionalism and success of the SEC. Is that correct, or in fact is there—

Mr. CHANOS. I think they are trying hard, Mr. Chairman, I really do. And I think they are working hard and I think they don't have enough resources, but it is not for lack of effort and not for lack of trying to do the right thing on behalf of the American people. But I think they are just over-gunned and over-matched.

Chairman KANJORSKI. That is a good political answer, but is that the real—I mean you are sincere about it. I am sure you are, Mr. Chanos.

No, the question I am asking though, is we are going to have the opportunity to do some patchwork in some of these areas that we

have discovered already lend themselves to systemic risk and other difficulties, and a lot of legislation is occurring to cover that patchwork. On the other hand, as we approach regulatory reform, we also have a great opportunity now, I think—and I am saying opportunity—to fundamentally have comprehensive reform. And I think one of the things I heard mentioned was the FSA in the U.K. It sounded as if there may be an opinion that they may be doing a superior job because of their structure being a singular regulator, having capacities to do things, perhaps look at systemic risk regulation because it is all under one context as opposed to our separate regulators.

Do you think we should speed along patchwork legislation to fill the voids in the holes that we have already discovered, regardless of whether or not these are in conflict in some instances with long-term comprehensive reform? Or should we keep our eye on the long-term comprehensive reform to take us out of the 20th Century and bring us into the 21st Century, which I think I heard one of the witnesses talk about? Yes?

Mr. GROOME. I would—my view on that, Mr. Chairman, would be to take your time and to come up with a comprehensive proposal and identify very clearly what these risks are that we are trying to address and how best to address them. And to repeat something that I said earlier, I think better supervision is welcomed. Increased regulation without better supervision tends not to achieve the goal.

I believe I probably made the comment about the FSA. The FSA is also doing some self-examination. They have had difficult times with their banking system and elsewhere, and so there is some real self-examination going on there as well. And I think as part of that they are also working with the Bank of England and asking what is the appropriate division of responsibilities and coordination between those two bodies? So you might find there is a very similar examination going on.

Chairman KANJORSKI. Just as a little add-on to that, I recently made a presentation in Prague to about a dozen members of the E.U. and about a dozen members of the Congress where we were trying to look at international regulation and the need for it. Are we significantly behind the curve by having to meet the needs of the global economy and dealing from a nation by nation basis of regulation, or do we have to speedily move to some international regulation?

Mr. BAKER. I would suggest—and I know Mr. Groome can address this perhaps better than I—that there is considerable ongoing debate on the continent at the moment as to the measure of oversight and level of accountability that hedge funds should have there, and it has been a very contentious discussion lasting now for a considerable period of time. I don't know that the current directive, which was issued just April 30th, that has come out will ultimately be adopted by the member states in the form in which it was proposed, but suffice it to say that they discussion of financial reform has been ongoing longer than it has here.

And we are attempting, as MFA, to reach out to AIMA to harmonize those standards as best we can suggest to policymakers, be-

cause your concerns about the global consequences are right on target.

Mr. GROOME. We agree. We think it is time to move to a more global set of standards on a variety of issues, including hedge funds, but not just hedge funds. And second, that is not the answer either in and of itself. Due to different legal systems, tax systems, and even the desire, quite frankly, for an intelligent, informed supervisor to maintain some discretion, that national authorities need to maintain the ability to interpret and have discretion on the implementation of those international standards.

But at some level, I believe, in today's world and today's very interconnected markets around the world, it is increasingly important to have global standards with, as I said, some degree of national discretion, just recognizing the obvious differences in tax, legal, but also I think very healthy for supervisors to understand their jurisdictions and employ those rules or standards accordingly.

Mr. CHANOS. One of the things we noticed about the EC proposals, and I mentioned it in my written testimony, Mr. Chairman, is that one of the positive aspects of it is that it does attempt, as we called for today, to craft a specific set of regulation and legislation for private investment funds, keeping them distant from mutual funds on the continent or unit trusts, and so on and so forth.

So that would be along the same lines as we were advocating in our written and oral testimony today about—and maybe even amplifying on the going slow versus patchwork and doing it right and doing it tailored to the various private investment funds and their differences from public investment funds. The E.C. is apparently trying to do that.

Mr. HARRIS. So let me add that I totally agree that you should take a slow go approach here and deal with the long-term issues rather than a reactionary short term response.

And with regard to the global integration, there are some good ideas that are coming out of the U.K. and places like that, but I would much prefer—I mean 70 percent of the investors in the hedge fund world are here, they are not there. And 70 percent of the worst hedge fund investors, not investment organizations, are there and not here. The vast majority of the trouble in hedge fund redemptions and so on comes out of Europe, it doesn't come out of the United States. So I would not—I would look at what they are doing, take the best of what they are doing, but I would not assume a follower position relative to what they are doing over there.

Chairman KANJORSKI. One last thing. Just prior to the economic crisis that occurred in the last year in this country, we were getting tremendous pressure from both Wall Street and internationally that there was a competition between London and New York, and if we did not make some concessions in this country, we were going to lose the financial wherewithal of the New York market. Now this pressure has gone into a hiatus, probably until we get over the international crisis and the national crisis reflected by the recession.

But when the recession is over and we get to recover, do you think that competition is going to rear its ugly head again and we are going to be in a race to the bottom for regulation as an attrac-

tive feature to draw that industry either to London or to New York?

Mr. CHANOS. I live in both cities, Mr. Chairman, and I run offices in both cities, and I know Todd represents a group based in London. I like our chances better than theirs right now. I am concerned by more of the things I see going on in London as it relates as a financial capital than I am in New York or our cities.

I still think there is a strong sense of free enterprise here that I am seeing erode very quickly in London, personally, and a move toward immediate higher taxation over there. And they are actually beginning to worry about losing their ascendancy to places like Geneva or Dubai or other places, so it is all relative. The grass is always greener. But as someone who lives and almost commutes between the two cities, I like our chances better.

Mr. GROOME. I would just add that I do not believe it is a race—there will always be competition between two cities like that, and I think we could arguably see one or two cities in Asia emerge not too long in the future who want to compete for that same sort of financial center type of mantel. That is all healthy.

Mr. Chairman, I would say though, that the winner will not be the one who races to the bottom of regulation. The winner, in my opinion, will be the one who sets very clear rules, very clear standards, and stays with those standards. To the extent that rules and regulations and capital structures start to be redefined and renegotiated on the run, people like Mr. Harris will vote with their dollars and yen and euros and renminbis and go somewhere else. They will be the arbiters at the end of the day.

Mr. BAKER. I think there is a significant flight to quality in that if there is a particular incident in recent months that has created difficulties in the U.K., it has been the apparent difficulty in the Lehman resolution, and that many people's fortunes are to a great extent tied to the ultimate resolution, which appears at this moment to be many months away, and that is an unfortunate development. And so at the end of the process, if we get back to normal in the next 18 months, I still think the memory of 2008–2009 will be quite vivid to most investors and they will demand levels of conduct until we get back into the years when profits run unexpectedly high.

But these things are cycles. When we came here in the 1980's, we were coming out of the S&L crisis, the tech bubble. I foresee at some future point—not near-term—that we will have concerns, but I believe the U.S. system offers quality that folks have difficulty finding elsewhere today.

Chairman KANJORSKI. Mr. Garrett?

Mr. GARRETT. First of all, I appreciate the closing comments most of you assumed in regards to the chairman's comment as far as whether we need patchwork or comprehensive, and comprehensive, thoughtful, and well-thought-out is what I am hearing from the panel, so I appreciate that.

The gentleman from the other side of the aisle knows that inaction is not the answer, but the wrong action directed in the wrong place could actually end up doing more harm, I assume the panel agrees, than no action at all. I see you all nodding.

And also my takeaway from this is so many people said registration is not the end, it is only going to be the beginning, because with registration, as Mr. Harris pointed out before, we already had registration and registration didn't prevent us from getting to where we are right now, even though it is voluntary registration. And then along with Mr. Harris' comment as well, reporting—and Mr. Baker's comment—reporting can do one of two things. If you go the next step from registration to reporting, Mr. Groome is saying that you either have everybody reporting, in which case Mr. Harris would make the argument that we would be diluting our resources, and we have already heard how the SEC can't get the job done.

With all due respect to Mr. Chanos' good comments about the SEC, they have not been able to get the job done, and I guess we still are going to be bring back the SEC to try to get an explanation why, when somebody actually comes to that entity and tells them of a problem they can't get the job done. I don't know how they are going to get the job done if we dilute it to such an extent that we are going to have everybody reporting, but I think Mr. Baker makes a very good point on the flip side of that.

If we say that we are only going to pick a segment of that, then you get into, potentially, too-big-to-fail, and then you have that situation there and that we may create a whole other host of problems, where will we be bailing out, or, as the suggestion has been made, will we be forced to wind them down? Has anybody on the panel agreed with the thought that the government should be able to step in and wind down any of your clients or any of your hedge funds if we see the potential for systemic risk?

[no response]

Mr. GARRETT. No? So at the end of the day, I walk away from here saying that we need to look at more comprehensive reform. And I guess my last question is, are there other areas in the global market—and I was going to ask you when are we going to get out of this recession and get an expert opinion on that, but I will let you submit that in writing—

But at the end of the day, looking at the global issues that this committee looks at—I know Mr. Baker knows them all, but you can presume what we look at—we are looking at hedge funds right now for the last couple of hours. Where would you, if you were sitting up here—Mr. Baker, if you were still sitting up here—what issues would you be looking at and saying, "This should be our number one or number two priority?" If it is not hedge funds and registration, where would you say our focus should be on trying to get the economic house back in order if it is not hedge funds? I will start with Mr. Harris and run down. We only have a minute, so—

Mr. HARRIS. My guess is looking at the investment practices of insurance companies.

Mr. GARRETT. Okay. Mr. Chanos?

Mr. CHANOS. I would look at the long-term structural liabilities that we have overall and how we are fooling ourselves on how we are going to fund those, so just broad concept of funding our future health and retirement liabilities. That is going to drive everything in every financial institution going forward.

Mr. GARRETT. Our $57 trillion liabilities or what have you, yes.

Mr. GROOME. I would approach it from the liability side as well, and I would think about it from an entity standpoint about our insurance industry or pension fund industry and the increasing transfer of risk to the household sector, and trying to actually bring it back, in a sense, to a sort of more balanced management of risk in our system between private institutions, government, and households, a more balanced system. We seem to swing back and forth. In the pension world, for example, we have gone from a DB heavy to a DC heavy. I think getting some of that back in balance would be very helpful.

Mr. BAKER. And I also share concerns about the business environment going forward because of the uncertainty of government resolution in the current matter. We have had modifications in TARP and TALF that make it difficult for business judgments to be made with certainty. If we can get past those issues—then I hope it is appropriate to suggest that I would survey the top 25 or 50 CEOs of the companies who are dealing with that exact same question and trying to figure out how their survival will be facilitated. And then focus on that liability side, how do we get a business plan together for the next 10 years that has any hope of getting future folks out of debt?

Ms. WILLIAMS. I would look at the interconnections among institutions in the system, but also I would broaden the discussion away from just focusing on institutions and look at other sources of risk to the system by looking at products and how certain products are overseen.

Mr. HARRIS. Could I just add one more?

Mr. GARRETT. Sure.

Mr. HARRIS. The financing of our deficits by foreigners could potentially be a huge problem.

Mr. GARRETT. I appreciate all your comments. Thank you very much, gentlemen and ladies.

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

Let me say for a second before we go into the formality that this panel really has been exceptional, in my estimation. I think we have a much better record than I imagined we would come out of today's session with, and it is because we slipped off just the staid questions of what is involved. We really went into some of the theory and some of the critical analysis of what we face, so I want to thank you for going with us that way.

This subcommittee has a big role to fill in comprehensive reform, and I think we are going to try and do it. I want to compliment my ranking member because we are trying to bring civility, and I think to this extent we have, to the Congress and the committee, and we are going to keep along that line. But we do appreciate the collective members of this panel and each of you.

And I would invite you to do one thing. We are one telephone call away, we are one letter away. You all have some great ideas. Please feel free to critique us and to inform us along the line, because what we are attempting to lift is very heavy, and I'm not sure either Mr. Garrett or I are physically fit to do it on our own. We need your help.

So thank you very much, and with that, the Chair notes that some members may have additional questions for the panel which

they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

With no further statements necessary for the record, the panel is dismissed, and this hearing is adjourned.

[Whereupon, at 2:22 p.m., the hearing was adjourned.]

A P P E N D I X

May 7, 2009

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON PERSPECTIVES ON HEDGE FUND REGISTRATION

MAY 7, 2009

During the past two years, our markets have experienced tremendous turmoil as an economic tidal wave crashed down and resulted in the loss of trillions of dollars for investors, the drowning of several companies, and the disappearance of some products and industries. Because we need to decrease the likelihood of similar situations occurring again in the future, regulatory reform has become a topic for considerable debate in Washington.

Today, we will examine one sector of our markets in need of greater oversight: hedge funds. Our singular focus on hedge funds at this hearing, however, should not be taken to mean that we will not revisit the need for oversight of other pools of unregulated capital, including private equity and venture capital. We must also recognize that hedge funds are not villains as some might seek to infer, although there are almost certainly a very small number of bad ones.

As has happened many times before, this latest financial crisis has revealed that our system of capitalism cannot thrive without a responsible and thoughtful degree of transparency. The question before us today is how Congress can wisely improve hedge fund oversight. We must not regulate for the sake of regulation. Moreover, we should refrain from adding layers to an antiquated, patchwork structure that has become -- in some instances -- counterproductive.

In my current view, hedge funds deserve a narrowly tailored regulatory treatment. If they want to continue to swim in our capital markets, they must, at a minimum, fill out the forms and get an annual pool pass. In this regard, Congressmen Capuano and Castle have drafted a good bill to accomplish the goal of registering hedge fund investment advisers. Registration generally makes sense, although we may need to customize the rules to treat small firms differently from big ones. We can best achieve this objective by providing the Securities and Exchange Commission with some flexibility in the implementation of a hedge fund registration law.

As we work to put in place a system to obtain greater transparency for the hedge fund industry, we must also make other important decisions about who will monitor them and how. Because of their sophistication, we should allow hedge funds to continue swimming in the deep end of the pool. However, we also do not want to see them drown, especially in some future financial crisis. As such we need to determine whether they need a lifeguard on watch at all times or whether they can merely follow some general behavioral rules posted on a wall.

Moreover, we must consider how to protect less experienced swimmers in our markets who might be overwhelmed by the wave created when one hedge fund jumps into the pool with a cannon ball dive. Hedge fund activities directly affect the fortunes of pension funds and institutional investors. Indirectly, teachers and other hard-working Americans are heavily invested in hedge funds, but many of them were unaware of the risks involved until this crisis.

When the market soars and hefty returns are made, no one really cares. But business cycles happen, and fortunes can fade fast. We need a system that better protects individuals'

retirement funds. We must ensure that nest eggs do not disappear as a result of excessive risk taking by pension managers. We have painfully witnessed enough of that last year.

In sum, investors need to regain trust and confidence in our markets, and legislation aimed at shining a light on a previously unregulated, $1.5 trillion corner of the market will help to accomplish that end. Striking a balance on all of these complicated questions is the task before us. I look forward to working in a bipartisan manner with other Members to design an effective, transparent regulatory system to govern hedge funds going forward.

MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

RICHARD H. BAKER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing on

"Perspectives on Hedge Fund Registration"

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

MAY 7, 2009

TESTIMONY OF MANAGED FUNDS ASSOCIATION

"Perspectives on Hedge Fund Registration"
May 7, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises' hearing, "Perspectives on Hedge Fund Registration" held on May 7, 2009. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies around the world.

MFA appreciates the opportunity to express its views on the important subjects of investor protection, systemic risk and prudential regulation for managers of private pools of capital, including hedge fund managers. In our view, any revised regulatory framework should address identified risks, while ensuring that private pools of capital are still able to perform their important market functions. It is critical, however, that consideration of a regulatory framework not be based on misconceptions or inaccurate speculation.

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

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

Hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were, and remain, substantially less leveraged than

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance despite the fact that our industry, and our investors, have suffered mightily as a result of the instability in our financial system and the broader economic downturn. The losses suffered by hedge funds and their investors did not pose a threat to our capital markets or the financial system.

Although hedge funds are important to capital markets and the financial system, the relative size and scope of the hedge fund industry in the context of the wider financial system helps explain why hedge funds did not pose systemic risks despite their losses. With an estimated $1.5 trillion under management, the hedge fund industry is significantly smaller than the U.S. mutual fund industry, with an estimated $9.4 trillion in assets under management, or the U.S. banking industry, with an estimated $13.8 trillion in assets. According to a report released by the Financial Research Corp., the combined assets under management of the three largest mutual fund families are at $1.9 trillion, which exceeds the total assets of the hedge fund industry. Moreover, because many hedge funds use little or no leverage, their losses did not pose the same systemic risk concerns that losses at more highly leveraged institutions, such as brokers and investment banks, did. A study by PerTrac Financial Solutions released in December 2008 found that 26.9% of hedge fund managers reported using no leverage. Similarly, a March 2009 report by Lord Adair Turner, Chairman of the U.K. Financial Services Authority (the "FSA"), found that the leverage of hedge funds was, on average, two or three-to-one, significantly below the average leverage of banks.

Though hedge funds did not cause the problems in our markets, we believe that the public and private sectors (including hedge funds) share the responsibility of restoring stability to our markets, strengthening financial institutions, and ultimately, restoring investor confidence. Hedge funds remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to our capital markets. We are committed to working with the Administration and Congress with respect to efforts that will restore investor confidence in and stabilize our financial markets and strengthen our nation's economy.

I. A "SMART" APPROACH TO FINANCIAL REGULATORY REFORM

A smart approach to regulation would include appropriate, effective, and efficient regulation and industry best practices that promote efficient capital markets, market integrity, and investor protection and better monitor and reduce systemic risk. That will likely mean increasing regulatory requirements in some areas, modernizing and updating antiquated financial regulations in other areas, and working to reduce redundant, overlapping, or inefficient responsibilities, where identified.

The first step in creating a smart regulatory framework is identifying the risks or intended objectives of regulation with the goal of strengthening investor protection and market integrity and monitoring systemic risk. Identifying the underlying objectives of proposed regulation will help ensure that proposals are considered in the appropriate context relative to addressing the identified risks or achieving the intended objectives.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

Regulation that addresses the key objectives of efficient capital markets, market integrity and investor protection is more likely to improve the functioning of our financial system, while regulation that does not address these key issues can cause more harm than good. We saw an example of the latter with the significant, adverse consequences that resulted from the SEC's bans on short selling last year.

A smart regulatory framework should include comprehensive and robust industry best practices designed to achieve the shared goals of monitoring and reducing systemic risk and promoting efficient capital markets, market integrity, and investor protection. Since 2000, MFA, working with its members, has been the leader in developing, enhancing and promoting standards of excellence through its document, *Sound Practices for Hedge Fund Managers ("Sound Practices").* As part of its commitment to ensuring that *Sound Practices* remains at the forefront of setting standards of excellence for the industry, MFA has updated and revised *Sound Practices* to incorporate the recommendations from the best practices report issued by the President's Working Group on Financial Markets' Asset Managers' Committee. MFA also has been working with other industry groups to create unified principles of best practices.

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

Regulation is also not a panacea for the structural market breakdowns that currently exist in our financial system. One such structural breakdown is the lack of certainty regarding major public financial institutions (*e.g.*, banks, broker dealers, insurance companies) and their financial condition, which has limited the effectiveness of government intervention efforts to date. Investors' lack of confidence in the financial health of these institutions has been, and continues to be, an impediment to investors' willingness to put capital at risk in the market or to engage in transactions with these firms, which, in turn, are impediments to market stability. The comprehensive stress tests on the 19 largest bank holding companies are designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. We believe that, to achieve this certainty, it is also important for policy makers and regulators to ensure that accounting and disclosure rules are designed to promote the appropriate valuation of assets and liabilities and consistent disclosure of those valuations.

Though regulation cannot solve all of the problems in our financial system, careful, well thought out financial regulatory reform can play an important role in restoring financial market stability and investor confidence. The goal in developing regulatory reform proposals should not be to throw every possible proposal into the regulatory system. Such an outcome will only overwhelm regulators with information and added responsibilities that do little to enhance their ability to effectively fulfill their agency's missions. The goal should be developing an "intelligent" system of financial regulation, as former Fed Chairman Paul Volcker has characterized it.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

We believe that regulatory reform objectives generally fall into three key categories, discussed in separate sections below. Those categories are: investor protection, market integrity and prudential regulation, including registration of advisers to private pools of capital; systemic risk regulation; and regulation of market-wide issues, such as short selling.

II. HEDGE FUND MANAGER REGISTRATION

In adopting a smart and effective approach to the regulation of managers of private pools of capital, it is important to recognize that many, if not all, of these regulatory issues will be relevant to all such managers, including firms that manage hedge funds, private equity funds, venture capital funds and real estate funds. Treasury Secretary Geithner, in his written testimony before the House Committee on Financial Services, supported this approach, stating that registration and other regulatory requirements should be adopted for managers of private pools of capital, not just hedge funds.[1] While the topic of the hearing today is registration in the context of hedge funds, we strongly encourage policy makers to consider these issues in the context of all private pools of capital and the managers of those pools. Likewise, we strongly encourage regulators to consider regulations that apply to all private investment firms and not just hedge fund managers. This approach will both promote better regulation as well support the many benefits private investment firms provide to the US markets.

MFA and its members recognize that mandatory SEC registration for advisers of private pools of capital is one of the key regulatory reform proposals being considered by policy makers. We believe that the approach of registering investment advisers, including advisers to private pools of capital, under the Investment Advisers Act of 1940 is the right approach in considering this issue. In fact, more than half of MFA member firms already are registered with the SEC as investment advisers. Applying the registration requirement to all investment advisers, instead of focusing solely on hedge fund managers is also a smart approach to registration. We believe that removing the current exemption from registration for advisers with fewer than fifteen clients would be an effective way to achieve this result.[2] The form and nature of registration and regulation of investment advisers to private pools of capital should be evaluated in the context of how to best promote investor protection, market integrity and systemic risk monitoring, each of which may be best achieved by different types of regulation.

We believe that the Advisers Act provides a meaningful regulatory regime for registered investment advisers. The responsibilities imposed by Advisers Act registration and regulation are not taken lightly and entail significant disclosure and compliance requirements, including:

---

1 Available at: http://www.ustreas.gov/press/releases/tg71.htm.

2 We note that this approach is consistent with the approach taken by H.R. 711.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

- Providing publicly available disclosure to the SEC regarding, among other things, the adviser's business, its clients, its financial industry affiliations, and its control persons;
- Providing detailed disclosure to clients regarding, among other things, investment strategies and products, education and business background for adviser personnel that determine investment advice for clients, and compensation arrangements;
- Maintaining of books and records relevant to the adviser's business;[3]
- Being subject to periodic inspections and examinations by SEC staff;
- Adopting and implementing written compliance policies and procedures and appointing a chief compliance officer who has responsibility for administering those policies and procedures;
- Adopting and implementing a written code of ethics that is designed to prevent insider trading, sets standards of conduct for employees reflecting the adviser's fiduciary obligations to its clients, imposes certain personal trading limitations and personal trading reports for certain key employees of the adviser; and
- Adopting and implementing written proxy voting policies.

In addition to registration of advisers, the hedge fund industry is subject to other, meaningful regulatory oversight. Hedge funds, like other market participants, are subject to existing, extensive trading rules and reporting requirements under the U.S. securities laws and regulations.[4] Increasing investor confidence and promoting market integrity are carried about by the SEC and other regulators through these regulatory requirements.

With a comprehensive registration framework comes additional burdens on federal regulators. A registration framework that overwhelms the resources, technology and capabilities of regulators will not achieve the intended objective, and will greatly impair the ability of regulators to fulfill their existing responsibilities, as well as their new responsibilities. Regulators must have adequate resources, including the ability to hire and retain staff with sufficient experience and ability, and improve the training of that staff, to properly oversee the market participants for whom they have oversight responsibility. The Securities and Exchange Commission, which is the existing regulator with oversight of investment advisers, has acknowledged that its examination and enforcement resources are already seriously constrained.[5] This raises the question

---

[3] Attachment A sets out the extensive list of books and records required to be kept by registered investment advisers.

[4] As discussed in section III below, we are also supportive of providing regulatory authorities, on a confidential basis, with information regarding trading/investment activities to promote better monitoring of systemic risk.

[5] Speech by SEC Chairman Mary L. Schapiro: Address to the Council of Institutional Investors (April 6, 2009), available at: http://www.sec.gov/news/speech/2009/spch040609mls.htm.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

whether the Commission would have the resources or capability to be an effective regulator when advisers to private pools of capital are required to register under an expanded registration framework. We encourage policy makers to consider the issue of resources and regulatory capabilities as they develop proposals for an expanded regulatory mandate.

In addition to questions regarding the resources and capabilities of the SEC to regulate advisers to private pools of capital, consideration must also be given to the organization of the SEC, and whether changes to the current regulatory structure would lead to a more effective regulatory outcome. We applaud Chairwoman Schapiro, who has announced efforts to review such issues to make the SEC a more effective regulator.

In considering the appropriate adviser registration framework, and in light of concerns about resources, capabilities and regulatory structure, we believe that it is important to establish an exemption from registration for the smallest investment advisers that have a *de minimis* amount of assets under management. This exemption should be narrowly, though appropriately, tailored so as not to create a broad, unintended loophole from registration. We are supportive of a comprehensive adviser registration regime, however, we recognize that registration carries with it significant costs that can overwhelm smaller advisers and force them out of business. We believe that the amount of any *de minimis* exemption should appropriately balance the goal of a comprehensive registration framework with the economic realities of small investment advisers. As mentioned above, regulatory resources, capabilities and structure should also be considered as policy makers determine an appropriate *de minimis* threshold.[6] We are not proposing a specific *de minimis* amount, however, we encourage policy makers to determine an amount that is not so high as to create a significant loophole that undermines a comprehensive registration regime, and also not so low that the smallest investment advisers are unable to survive because of regulatory costs. We note that, while we believe it is important for there to be a *de minimis* exemption from registration, MFA's proposed registration framework is more far-reaching than the Administration's plan, as proposed by Treasury Secretary Geithner, which called for registration of only those advisers to the largest and most systemically relevant private pools of capital.

We would like to share with you today some initial thoughts on some of the key principles that we believe should be considered by Congress, the Administration and other policy makers as you consider the appropriate regulatory framework. Those principles are:

- The goal of any reform efforts should be to develop a more intelligent and effective regulatory framework, which makes our system stronger for the benefit of consumers, businesses and investors.

---

[6] We believe that Congress should ensure that any approach in this regard is consistent with state regulation of smaller investment advisers and avoids duplication.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

- Regulation should address identified risks or potential risks, and should be appropriately tailored to those risks because without clear goals, there will be no way to measure success.

- Regulation should not impose limitations on the investment strategies of private pools of capital. As such, regulatory rules on capital requirements, use of leverage, and similar types of restrictions on the funds should not be considered as part of a regulatory framework for private pools of capital.

- Regulators should engage in ongoing dialogue with market participants. Any rulemaking should be transparent and provide for public notice and comment by affected market participants, as well as a reasonable period of time to implement any new or modified regulatory requirements. This public-private dialogue can help lead to more effective regulation and avoid unintended consequences, market uncertainty and increased market volatility.

- Reporting requirements should provide regulators with information that allow them to fulfill their oversight responsibilities as well as to prevent, detect and punish fraud and manipulative conduct. Overly broad reporting requirements can limit the effectiveness of a reporting regime as regulators may be unable to effectively review and analyze data, while duplicative reporting requirements can be costly to market participants without providing additional benefit to regulators. It is critical that any reporting of sensitive, proprietary information by market participants be kept confidential. Public disclosure of such information can be harmful to members of the public that may act on incomplete data, increase risk to the financial system, and harm the ability of market participants to establish and exit from investment positions in an economically viable manner.

- We believe that the regulatory construct should distinguish, as appropriate, between different types of market participants and different types of investors or customers to whom services or products are marketed. While we recognize that investor protection concerns are not limited to retail investors, we believe that a "one-size fits all" approach will likely not be as effective as a more tailored approach. One such relevant distinction is that between private sales of hedge funds to sophisticated investors under the SEC's private placement regulatory regime and publicly offered sales to retail investors. This private/public, sophisticated/retail distinction has been in existence in the United States for over 75 years and has generally proven to be a successful framework for financial regulation. We do not believe this distinction should be lost, and we strongly believe that regulation that is appropriate for products sold publicly to retail investors is not necessarily appropriate for products sold privately to only sophisticated investors.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

- Regulation regarding market issues that is applicable to a broad range of market participants, such as short selling and insider trading, should be addressed in the broader context of all market participants. Market issues are not specific to the hedge fund industry and, therefore, regulatory reform regarding these issues should be considered in the broader context and not in the context of hedge fund regulation.

- Lastly, we believe that industry best practices and robust investor diligence should be encouraged and recognized as an important complement to prudential regulation. Regulators will tell you that their oversight is no substitute for a financial firm's own strong business practices and investors' robust diligence if we are to promote market integrity and investor protection concerns.

III. SYSTEMIC RISK REGULATION

The second area of regulation that I would like to discuss today is systemic risk regulation. In previous testimony given before this Subcommittee on March 5, 2009, I have discussed MFA's thoughts on systemic risk regulation in more detail. Today, I would like to highlight what we believe are the key aspects of systemic risk regulation.

The first step in developing a systemic risk regulatory regime is to determine those entities that should be within the scope of such a regulatory regime. There are a number of factors that policy makers are considering as they seek to establish the process by which a systemic risk regulator should identify, at any point in time, which entities should be considered to be of systemic relevance. Those factors include the amount of assets under management of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants. MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework. As policy makers and regulators seek to determine whether any individual hedge fund is of systemic relevance, however, it is important that consideration be given to the relatively small size of hedge funds compared to other financial institutions, the relatively low levels of leverage used by hedge funds, and the narrower focus of hedge funds. As institutional investors, hedge funds do not provide payment and settlement services to the public nor are hedge funds licensed to open bank accounts or brokerage accounts for the public. For these reasons, and others, hedge fund losses have not caused systemic risk during this global crisis.

As stated in my previous testimony, MFA believes that a systemic risk framework should have the following components:

- A central systemic risk regulator with oversight of the key elements of the entire financial system, across all relevant structures, classes of institutions and products, and an assessment of the financial system on a holistic basis;

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

- Confidential reporting to a systemic risk regulator, from those entities that it determines (at any point in time) to be of systemic relevance, providing information that the regulator determines is necessary or advisable to enable it to adequately assess, on both a current and a forward-looking basis, potential risks to the financial system;
- A clear, singular mandate for the systemic risk regulator to protect the financial system, including the ability to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system, though such authority should be implemented in a way that avoids the unfair competitive advantages gained by market participants with a government guarantee and also avoids the moral hazards that can result from a company having a government guarantee; and
- Ensuring that the systemic risk regulator has adequate authority to enable it to be forward-looking to prevent potential systemic risk problems, as well as the authority to address systemic problems once they have arisen; and implements that authority by focusing on all relevant parts of the financial system, including structure, classes of institutions and products

IV. MARKET-WIDE ISSUES

As stated above, issues that are relevant across market participants should be considered in that broader context, rather than in the specific context of hedge funds. One such issue, which has been the focus of a great deal of discussion recently, is short selling, specifically the role of short selling in capital markets. Short selling, as recognized by the Securities and Exchange Commission (the "SEC"), "plays an important role in the market for a variety of reasons, including providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities and, importantly, limiting upward market manipulations."[7] Similarly, the FSA has noted that short selling is, "a legitimate investment technique in normal market conditions," and "can enhance the efficiency of the price formation process by allowing investors with negative information, who do not hold stock, to trade on their information." In addition, short selling can "enhance liquidity by increasing the number of potential sellers," and increase market efficiency.[8] We strongly agree with the SEC and the FSA that short selling, along with derivatives trading, provides capital markets with necessary liquidity and plays an important role in the price discovery process. Markets are more efficient, and securities prices are more accurate, because investors with capital at risk engage in short selling.

Short selling and other techniques, including listed and over-the-counter derivatives trading, are important risk management tools for institutional investors, including MFA members, and essential components of a wide range of *bona fide* cash

---

[7] Statement of Securities and Exchange Commission Concerning Short Selling and Issuer Stock Repurchases, SEC Release 2008-235 (Oct. 1, 2008).

[8] Temporary Short Selling Measures, FSA Consultation Paper 09/1 (January 2009), at page 4.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

and derivatives hedging strategies that enable investors to provide liquidity to the financial markets. Additionally, hedged investors primarily use short sales and derivatives to prudentially reduce their long side investment risk, so this activity can enable such investors to invest more on the long side. Thus, when the SEC restricted short sales in late 2008, overall volume and investing declined, not just short sales.

We are supportive of providing proprietary nonpublic information to regulatory authorities on a nonpublic, confidential basis. We are concerned, however, that requirements that investors publicly disclose short position information, or that create the potential for public disclosure, would negatively reduce overall market efficiency by undermining the important role that short selling plays in providing liquidity and price discovery to markets. Public disclosure of short trades/positions can be misleading to the public as implying that an investor has a negative view regarding a particular public company stock when the opposite may be true, such as when the investor is primarily long and is using the short sale or short derivative as a prudential risk reduction hedge.

We believe that concerns which have led some to propose public disclosure of short positions could be substantially mitigated through effective, comprehensive reporting of short sale information by prime brokers and clearing brokers. Regulators could require short sales and short position information to be provided by brokers on an aggregate basis. A regulator could request specific information as to short sales and short positions of individual investors if it suspected or became concerned about manipulation of a particular security. Such reporting also would provide regulators with a more effective means by which to identify manipulative activity.

We commend the SEC for their thoughtful, deliberative approach to considering short sale regulation which included holding a roundtable on these issues and publishing notice and seeking comment on the proposals recently put forward. MFA intends to comment on the SEC's short selling release.

V. HEDGE FUND-INVESTOR AND HEDGE FUND-COUNTERPARTY RELATIONSHIPS

MFA and its members fully support investors having appropriate information to allow them to make informed decisions. Hedge funds are limited by U.S. securities laws and SEC private placement rules under those laws to marketing their funds to only sophisticated parties who have the ability to request the information necessary to make an informed decision about transacting with or investing in a hedge fund. We support, and have consistently supported, increasing the income and net worth requirements for investors to be eligible to invest in private placements. Along with the ability to request the information necessary to make an informed decision, sophisticated counterparties and investors have the ability to decide not to transact with, or invest in, a hedge fund. To the extent that an investor or a counterparty believes that it has not received sufficient information during its diligence process, that investor should decline to make an investment (or remain invested) in the fund, and the counterparty should decline to transact with the fund.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

Hedge fund investors request and receive a substantial amount of information from hedge fund managers prior to investing, through the private placement memorandum, a legal document that is analogous to an offering document for other securities, and during their investments they receive extensive information concerning the fund, including returns, risks, and investment activities, pursuant to agreements between the investors and the funds.[9] Once a hedge fund or a hedge fund manager provides information regarding the fund to a current or potential investor, then any intentional material misrepresentation or material omission would be a violation of the anti-fraud provisions of U.S. securities laws. As a result of these market and regulatory forces, we believe hedge fund investors do receive sufficient information to enable them to make informed investment decisions.

CONCLUSION

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

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

---

[9] To assist investors in their diligence process, MFA has published a model due diligence questionnaire, which illustrates the types of information commonly requested by investors prior to investing. MFA's model DDQ is available at: http://www.managedfunds.org/downloads/Due%20Dilligence%20Questionnaire.pdf.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

ATTACHMENT A

§ 275.204-2 Books and records to be maintained by investment advisers.[1]

(a) Every investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b–3) shall make and keep true, accurate and current the following books and records relating to its investment advisory business;

(1) A journal or journals, including cash receipts and disbursements, records, and any other records of original entry forming the basis of entries in any ledger.

(2) General and auxiliary ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income and expense accounts.

(3) A memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser concerning the purchase, sale, receipt or delivery of a particular security, and of any modification or cancellation of any such order or instruction. Such memoranda shall show the terms and conditions of the order, instruction, modification or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed such order; and shall show the account for which entered, the date of entry, and the bank, broker or dealer by or through whom executed where appropriate. Orders entered pursuant to the exercise of discretionary power shall be so designated.

(4) All check books, bank statements, cancelled checks and cash reconciliations of the investment adviser.

(5) All bills or statements (or copies thereof), paid or unpaid, relating to the business of the investment adviser as such.

(6) All trial balances, financial statements, and internal audit working papers relating to the business of such investment adviser.

(7) Originals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security:

---

[1] Available at: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=6143582bf9cd6fce86a19b85a5c4fc21&rgn=div8&view=text&node=17:3.0.1.1.23.0.147.20&idno=17

Provided, however, (*a*) That the investment adviser shall not be required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser, and (*b*) that if the investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if such notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of such notice, circular or advertisement a memorandum describing the list and the source thereof.

(8) A list or other record of all accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities or transactions of any client.

(9) All powers of attorney and other evidences of the granting of any discretionary authority by any client to the investment adviser, or copies thereof.

(10) All written agreements (or copies thereof) entered into by the investment adviser with any client or otherwise relating to the business of such investment adviser as such.

(11) A copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser), and if such notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication recommends the purchase or sale of a specific security and does not state the reasons for such recommendation, a memorandum of the investment adviser indicating the reasons therefor.

(12)

(i) A copy of the investment adviser's code of ethics adopted and implemented pursuant to §275.204A–1 that is in effect, or at any time within the past five years was in effect;

(ii) A record of any violation of the code of ethics, and of any action taken as a result of the violation; and

(iii) A record of all written acknowledgments as required by §275.204A–1(a)(5) for each person who is currently, or within the past five years was, a supervised person of the investment adviser.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

(13)

(i) A record of each report made by an access person as required by §275.204A–1(b), including any information provided under paragraph (b)(3)(iii) of that section in lieu of such reports;

(ii) A record of the names of persons who are currently, or within the past five years were, access persons of the investment adviser; and

(iii) A record of any decision, and the reasons supporting the decision, to approve the acquisition of securities by access persons under §275.204A–1(c), for at least five years after the end of the fiscal year in which the approval is granted.

(14) A copy of each written statement and each amendment or revision thereof, given or sent to any client or prospective client of such investment adviser in accordance with the provisions of Rule 204–3 under the Act, and a record of the dates that each written statement, and each amendment or revision thereof, was given, or offered to be given, to any client or prospective client who subsequently becomes a client.

(15) All written acknowledgments of receipt obtained from clients pursuant to §275.206(4)–3(a)(2)(iii)(B) and copies of the disclosure documents delivered to clients by solicitors pursuant to §275.206(4)–3.

(16) All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser); *provided, however,* that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of d accounts shall be deemed to satisfy the requirements of this paragraph.

(17)

(i) A copy of the investment adviser's policies and procedures formulated pursuant to §275.206(4)–7(a) of this chapter that are in effect, or at any time within the past five years were in effect, and

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

(ii) Any records documenting the investment adviser's annual review of those policies and procedures conducted pursuant to §275.206(4)–7(b) of this chapter.

(b) If an investment adviser subject to paragraph (a) of this section has custody or possession of securities or funds of any client, the records required to be made and kept under paragraph (a) of this section shall include:

(1) A journal or other record showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for such accounts and all other debits and credits to such accounts.

(2) A separate ledger account for each such client showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits.

(3) Copies of confirmations of all transactions effected by or for the account of any such client.

(4) A record for each security in which any such client has a position, which record shall show the name of each such client having any interest in such security, the amount or interest of each such client, and the location of each such security.

(c)

(1) Every investment adviser subject to paragraph (a) of this section who renders any investment supervisory or management service to any client shall, with respect to the portfolio being supervised or managed and to the extent that the information is reasonably available to or obtainable by the investment adviser, make and keep true, accurate and current:

(i) Records showing separately for each such client the securities purchased and sold, and the date, amount and price of each such purchase and sale.

(ii) For each security in which any such client has a current position, information from which the investment adviser can promptly furnish the name of each such client, and the current amount or interest of such client.

(2) Every investment adviser subject to paragraph (a) of this section that exercises voting authority with respect to client securities shall, with respect to those clients, make and retain the following:

(i) Copies of all policies and procedures required by §275.206(4)–6.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

(ii) A copy of each proxy statement that the investment adviser receives regarding client securities. An investment adviser may satisfy this requirement by relying on a third party to make and retain, on the investment adviser's behalf, a copy of a proxy statement (provided that the adviser has obtained an undertaking from the third party to provide a copy of the proxy statement promptly upon request) or may rely on obtaining a copy of a proxy statement from the Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

(iii) A record of each vote cast by the investment adviser on behalf of a client. An investment adviser may satisfy this requirement by relying on a third party to make and retain, on the investment adviser's behalf, a record of the vote cast (provided that the adviser has obtained an undertaking from the third party to provide a copy of the record promptly upon request).

(iv) A copy of any document created by the adviser that was material to making a decision how to vote proxies on behalf of a client or that memorializes the basis for that decision.

(v) A copy of each written client request for information on how the adviser voted proxies on behalf of the client, and a copy of any written response by the investment adviser to any (written or oral) client request for information on how the adviser voted proxies on behalf of the requesting client.

(d) Any books or records required by this section may be maintained by the investment adviser in such manner that the identity of any client to whom such investment adviser renders investment supervisory services is indicated by numerical or alphabetical code or some similar designation.

(e)

(1) All books and records required to be made under the provisions of paragraphs (a) to (c)(1)(i), inclusive, and (c)(2) of this section (except for books and records required to be made under the provisions of paragraphs (a)(11), (a)(12)(i), (a)(12)(iii), (a)(13)(ii), (a)(13)(iii), (a)(16), and (a)(17)(i) of this section), shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.

(2) Partnership articles and any amendments thereto, articles of incorporation, charters, minute books, and stock certificate books of the investment adviser and of any predecessor, shall be maintained in the principal office of the investment adviser and preserved until at least three years after termination of the enterprise.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

(3)

(i) Books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this rule shall be maintained and preserved in an easily accessible place for a period of not less than five years, the first two years in an appropriate office of the investment adviser, from the end of the fiscal year during which the investment adviser last published or otherwise disseminated, directly or indirectly, the notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication.

(ii) *Transition rule.* If you are an investment adviser to a private fund as that term is defined in §275.203(b)(3)–1, and you were exempt from registration under section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)) prior to February 10, 2005, paragraph (e)(3)(i) of this section does not require you to maintain or preserve books and records that would otherwise be required to be maintained or preserved under the provisions of paragraph (a)(16) of this section to the extent those books and records pertain to the performance or rate of return of such private fund or other account you advise for any period ended prior to February 10, 2005, provided that you were not registered with the Commission as an investment adviser during such period, and provided further that you continue to preserve any books and records in your possession that pertain to the performance or rate of return of such private fund or other account for such period.

(f) An investment adviser subject to paragraph (a) of this section, before ceasing to conduct or discontinuing business as an investment adviser shall arrange for and be responsible for the preservation of the books and records required to be maintained and preserved under this section for the remainder of the period specified in this section, and shall notify the Commission in writing, at its principal office, Washington, D.C. 20549, of the exact address where such books and records will be maintained during such period.

(g) *Micrographic and electronic storage permitted.* —

(1) *General.* The records required to be maintained and preserved pursuant to this part may be maintained and preserved for the required time by an investment adviser on:

(i) Micrographic media, including microfilm, microfiche, or any similar medium; or

(ii) Electronic storage media, including any digital storage medium or system that meets the terms of this section.

(2) *General requirements.* The investment adviser must:

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

(i) Arrange and index the records in a way that permits easy location, access, and retrieval of any particular record;

(ii) Provide promptly any of the following that the Commission (by its examiners or other representatives) may request:

(A) A legible, true, and complete copy of the record in the medium and format in which it is stored;

(B) A legible, true, and complete printout of the record; and

(C) Means to access, view, and print the records; and

(iii) Separately store, for the time required for preservation of the original record, a duplicate copy of the record on any medium allowed by this section.

(3) *Special requirements for electronic storage media.* In the case of records on electronic storage media, the investment adviser must establish and maintain procedures:

(i) To maintain and preserve the records, so as to reasonably safeguard them from loss, alteration, or destruction;

(ii) To limit access to the records to properly authorized personnel and the Commission (including its examiners and other representatives); and

(iii) To reasonably ensure that any reproduction of a non-electronic original record on electronic storage media is complete, true, and legible when retrieved.

(h)

(1) Any book or other record made, kept, maintained and preserved in compliance with §§240.17a–3 and 240.17a–4 of this chapter under the Securities Exchange Act of 1934, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this section, shall be deemed to be made, kept maintained and preserved in compliance with this section.

(2) A record made and kept pursuant to any provision of paragraph (a) of this section, which contains all the information required under any other provision of paragraph (a) of this section, need not be maintained in duplicate in order to meet the requirements of the other provision of paragraph (a) of this section.

(i) As used in this section the term "discretionary power" shall not include discretion as to the price at which or the time when a transaction is or is to be

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

effected, if, before the order is given by the investment adviser, the client has directed or approved the purchase or sale of a definite amount of the particular security.

(j)

(1) Except as provided in paragraph (j)(3) of this section, each non-resident investment adviser registered or applying for registration pursuant to section 203 of the Act shall keep, maintain and preserve, at a place within the United States designated in a notice from him as provided in paragraph (j)(2) of this section true, correct, complete and current copies of books and records which he is required to make, keep current, maintain or preserve pursuant to any provisions of any rule or regulation of the Commission adopted under the Act.

(2) Except as provided in paragraph (j)(3) of this section, each nonresident investment adviser subject to this paragraph (j) shall furnish to the Commission a written notice specifying the address of the place within the United States where the copies of the books and records required to be kept and preserved by him pursuant to paragraph (j)(1) of this section are located. Each non-resident investment adviser registered or applying for registration when this paragraph becomes effective shall file such notice within 30 days after such rule becomes effective. Each non-resident investment adviser who files an application for registration after this paragraph becomes effective shall file such notice with such application for registration.

(3) Notwithstanding the provisions of paragraphs (j)(1) and (2) of this section, a non-resident investment adviser need not keep or preserve within the United States copies of the books and records referred to in said paragraphs (j)(1) and (2), if:

(i) Such non-resident investment adviser files with the Commission, at the time or within the period provided by paragraph (j)(2) of this section, a written undertaking, in form acceptable to the Commission and signed by a duly authorized person, to furnish to the Commission, upon demand, at its principal office in Washington, DC, or at any Regional Office of the Commission designated in such demand, true, correct, complete and current copies of any or all of the books and records which he is required to make, keep current, maintain or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the Act, or any part of such books and records which may be specified in such demand. Such undertaking shall be in substantially the following form:

The undersigned hereby undertakes to furnish at its own expense to the Securities and Exchange Commission at its principal office in Washington, DC or at any

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

Regional Office of said Commission specified in a demand for copies of books and records made by or on behalf of said Commission, true, correct, complete and current copies of any or all, or any part, of the books and records which the undersigned is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the Securities and Exchange Commission under the Investment Advisers Act of 1940. This undertaking shall be suspended during any period when the undersigned is making, keeping current, and preserving copies of all of said books and records at a place within the United States in compliance with Rule 204–2(j) under the Investment Advisers Act of 1940. This undertaking shall be binding upon the undersigned and the heirs, successors and assigns of the undersigned, and the written irrevocable consents and powers of attorney of the undersigned, its general partners and managing agents filed with the Securities and Exchange Commission shall extend to and cover any action to enforce same.

and

(ii) Such non-resident investment adviser furnishes to the Commission, at his own expense 14 days after written demand therefor forwarded to him by registered mail at his last address of record filed with the Commission and signed by the Secretary of the Commission or such person as the Commission may authorize to act in its behalf, true, correct, complete and current copies of any or all books and records which such investment adviser is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the Act, or any part of such books and records which may be specified in said written demand. Such copies shall be furnished to the Commission at its principal office in Washington, DC, or at any Regional Office of the Commission which may be specified in said written demand.

(4) For purposes of this rule the term *non-resident investment adviser* shall have the meaning set out in §275.0–2(d)(3) under the Act.

(k) Every investment adviser that registers under section 203 of the Act (15 U.S.C. 80b–3) after July 8, 1997 shall be required to preserve in accordance with this section the books and records the investment adviser had been required to maintain by the State in which the investment adviser had its principal office and place of business prior to registering with the Commission.

(l) *Records of private funds.* If an investment adviser subject to paragraph (a) of this section advises a private fund (as defined in §275.203(b)(3)–1), and the adviser or any related person (as defined in Form ADV (17 CFR 279.1)) of the adviser acts as the private fund's general partner, managing member, or in a comparable capacity, the books and records of the private fund are records of the adviser for purposes of section 204 of the Act (15 U.S.C. 80b–4).

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

COALITION OF PRIVATE INVESTMENT COMPANIES

TESTIMONY OF JAMES CHANOS

CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON "PERSPECTIVES ON HEDGE FUND REGULATION"

MAY 7, 2009

415 Second Street, N.E. ◊ Suite 200 ◊ Washington, DC 20002 ◊ TEL 202-715-0840 ◊ FAX 202-220-3184

Chairman Kanjorski, Ranking Member Garrett, and Members of the Committee. My name is James Chanos, and I am President of Kynikos Associates LP, a New York private investment management company that I founded in 1985.[1] I am appearing today on behalf of the Coalition of Private Investment Companies (CPIC), a group of about twenty private investment companies with a wide range of clients that include pension funds, asset managers, foundations, other institutional investors, and qualified wealthy individuals.

I want to thank the Committee for inviting me to testify on the subject of hedge fund regulation and Congressman Capuano's bill, H.R. 711, the "Hedge Fund Adviser Registration Act of 2009," to require hedge fund managers and managers of other private investment vehicles to register with the Securities and Exchange Commission ("SEC") as investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"). I am honored to have this opportunity to testify on behalf of CPIC and look forward to working with you and your staff in the months ahead.

I. Overview and Summary of Recommendations

This is a difficult time for our nation. A sustainable economic recovery depends upon investors gaining confidence that their interests come first with the companies, asset managers, and others with whom they invest their money, and having confidence that regulators are safeguarding them against fraud.

I am a strong supporter of the SEC, its dedicated staff and its mission. But I am also aware that increased regulation and government supervision does not always bring increased

[1] Prior to founding Kynikos Associates LP, I was a securities analyst at Deutsche Bank Capital and Gilford Securities. My first job on Wall Street was as an analyst at the investment banking firm of Blyth Eastman Paine Webber, a position I took in 1980 upon graduating from Yale University with a B.A. in Economics and Political Science.

protection for investors or support economic growth. After all, before the current economic downturn, some observers predicted that hedge funds and other private pools of capital would be the source of the next financial crisis, because these investment vehicles are not as heavily regulated as other financial firms. As we have all learned, however, the greatest harm to investors and the global economy actually came from comprehensively regulated institutions like banks, insurance companies, broker-dealers, and government-sponsored enterprises. While under direct regulatory supervision, examination, and enforcement, these heavily regulated organizations piled on debt and made and securitized unsound loans beyond all reason, creating a massive credit bubble that finally burst. Similarly, Bernard Madoff used his firm, Bernard L. Madoff Investment Securities, LLC — which was registered with the SEC as a broker-dealer and investment adviser and subject to examination and regulation — to perpetrate his Ponzi scheme under the noses of the SEC and FINRA.

Simply imposing new regulation without properly tailoring it to address the relevant risks would add to the burdens of hard working, but already overstretched agency staffs. Investors would be lulled into the false belief that a problem has been resolved. Therefore, any new regulation must be "smart" regulation, with mechanisms carefully targeted to reduce risks to investors and the economy, without imposing unnecessary burdens.

CPIC, and I believe our entire industry, recognizes that a modernized financial regulatory system – one that addresses overall risk to the financial system and regulates in a consistent manner market participants performing the same functions — will include regulation of hedge funds and other private pools of capital. While there will be much discussion about what the components of new regulation should be, CPIC would like to offer these principles for the Subcommittee's consideration:

- Any new regulations should treat all private investment funds similarly, regardless of the fund manager's investment strategy;
- The Investment Advisers Act and the Investment Company Act are awkward statutes for achieving the policy objectives of increased private investment fund oversight. The Subcommittee should consider drafting a new statute that clearly spells out a preferred means of improving oversight without degrading investor due diligence, stifling innovation, reducing market liquidity, or harming global competitiveness;
- New regulation should draw upon the best practices work of the President's Working Group Asset Managers and Institutional Investors Committees; their reports provide many specific improvements carefully crafted for the unique nature of private investment companies; and
- Regulation for systemic and market risk should be scaled to the size of the entity, with a greater focus placed on the largest funds or family of funds.

II. The State of the Hedge Fund Industry and Financial Markets

As the Subcommittee is aware, in the summer of 2007 and throughout 2008, financial markets began to unravel. Major regulated financial institutions collapsed or went bankrupt as the U.S. Treasury provided capital infusions and U.S.-backed guarantees in order to prevent the demise of banks, insurance companies, and others who were deemed "too big to fail," and stave off a global economic collapse. A chain of interlinked securities – including derivatives and off-balance sheet vehicles – sensitive to housing prices triggered a downward spiral in financial markets worldwide, demonstrating the scale of interdependence in today's global economy and the vulnerability it causes.[2] As the problems became more severe, the crisis mushroomed beyond subprime debt to threaten less risky assets. Credit markets dried up, and equity markets

[2] There are many research papers and studies that examine the source of the financial crisis. One example: Gary B. Gorton, *The Panic of 2007* (Yale Int'l Ctr. for Fin., Working Paper No. 08-24, 2008) (*available at* http://ssrn.com/abstract=1255362). I would encourage you to read the analysis by Lord Adair Turner, Chairman of the U.K. Financial Services Authority ("FSA"), in which he recounts how developments in the banking and the near-bank system caused serious harm to the real economy: Speech at the Economist's Inaugural City Lecture: The Financial Crisis and the Future of Financial Regulation (Jan. 21, 2009) (*available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml). A more extensive discussion is provided in *The Turner Review: A Regulatory Response to the Global Banking Crisis,* (Mar. 18, 2009) (*available at* http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/037.shtml).

in 2008 posted one of their worst years since the 1930s. As a result, the value of financial assets held at banks, investment firms, and others collapsed, jeopardizing their survival as they sharply curtailed activities. The downturn spread throughout our economy and worldwide, fueling job losses, prompting bankruptcies, and causing household wealth to erode.

As might be expected with those events, the hedge fund industry also experienced a sharp reversal. The amount of money managed by hedge funds plummeted, reflecting sharp declines in asset values, a rise in client redemptions, and regulatory closures of margin accounts. Last year was among the worst in the industry's history, with total assets under management falling to $1.41 trillion. This represented a decline of $525 billion from the all-time peak of $1.93 trillion reached mid-year 2008, with more than 1,471 funds (a record in one year) liquidating.[3]

Hedge funds on average in 2008 posted their worst performance since 1990. The Hedge Fund Research, Inc. Fund Weighted Composite Index dropped 18.3 percent for all of last year, which was only the second calendar year decline since 1990.[4] That said, hedge fund losses on average were less than those of the S&P 500, with 24 different hedge fund strategies performing better than the S&P 500 benchmark.[5]

As the first quarter came to a close this year, hedge fund performance, as measured by the HFRI Fund Weighted Composite Index, began to improve. This index posted a gain of 0.53 percent for the quarter, resulting in a performance-based gain of approximately $28 billion, a

---

[3] *See* Hedge Fund Research, Inc., *2008 Worst Year Ever for Hedge Funds,* HEDGE FUNDS REVIEW (Jan. 21, 2009) (available at http://www.hedgefundsreview.com/public/showPage.html?page=835942). "During 2008[,] the industry experienced [] six consecutive months of declines between June and November, interrupted only by December's 0.41 percent gain, including a concentrated, volatile two-month period in September and October in which the cumulative decline approached 13 percent."

[4] *See id.*

[5] *See* Hedge Fund Research, Inc., *HFR Global Hedge Fund Industry Report: Year End 2008* (2009), *at* 46, 59, 89.

sharp contrast to the $162 billion in performance-based losses in the previous quarter. Withdrawals, however, continued, totaling $85 billion for the first quarter this year. Total industry capital declined to $1.33 trillion as of March 30 this year.[6] Despite those redemptions, several surveys suggest that institutional investors remain committed to hedge funds. According to the State Street Hedge Fund survey recently published, "three-quarters of institutional investors said they do not plan to modify their portfolio allocations."[7] Further, while the study results indicate a moderate decline in overall allocations to hedge funds, the majority of institutions report an intention to increase or maintain current hedge fund allocations over the next 12 months.

III. Legislative Reform

While it often is said that private investment companies are "unregulated," they are, in fact, subject to a range of securities anti-fraud, anti-manipulation,[8] margin,[9] and other trading laws and regulations that apply to other securities market participants.[10] They also are subject to SEC enforcement investigations and subpoenas, as well as civil enforcement action and criminal prosecution if they violate the federal securities laws. However, private investment companies and their advisers are not required to register with the SEC if they comply with the conditions of

---

[6] Press Release, Hedge Fund Research, Inc., *Positive Hedge Fund Performance Fails to Offset Record Fund of Funds Withdrawals in Q109*, (Apr. 21, 2009) (*available at* https://www.hedgefundresearch.com/pdf/pr_20090421.pdf).

[7] Press Release, State Street Corporation, *State Street Hedge Fund Study Shows Institutional Investors Remain Committed to Hedge Funds Despite Moderate Decline in Allocations*, (Mar. 26, 2009) (available at http://pr.statestreet.com/us/en/20090326_1.html).

[8] *See* Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. § 78j) and Rule 10b-5 thereunder (17 C.F.R. § 240.10b-5).

[9] 12 C.F.R. §§ 220, 221, 224.

[10] See e.g., Exchange Act §§13(d), 13(e), 14(d), 14(e) and 14(f) (15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e) and §78n(f)) and related rules (which regulate and require public reporting on the acquisition of blocks of securities and other activities in connection with takeovers and proxy contests).

certain exemptions from registration under the securities laws. In brief, Section 203(b)(3) of the Advisers Act provides an exemption from registration for investment advisers who do not advise mutual funds, do not hold themselves out to the public as investment advisers, and have fewer than 15 clients.[11] Advisers to hedge funds and other private investment companies rely on this "private adviser" exemption, because a fund counts as one client.

The "Hedge Fund Adviser Registration Act of 2009," H.R. 711, would strike Section 203(b)(3) of the Advisers Act, removing the "private adviser" exemption entirely. By requiring hedge fund managers to register as investment advisers, the bill seeks to provide a number of important protections for investors. However, we believe that using the Advisers Act as the basic template for regulation will ultimately prove ineffective to mitigate systemic risk. Moreover, simply requiring registration under the Advisers Act could degrade investor due diligence, by causing undue reliance upon SEC regulation under a statute that is insufficiently robust to address the unique characteristics of private funds.[12] We believe that the twin goals of improved investor protection and enhanced systemic oversight could be better achieved with a standalone statute tailored for private investment funds.

The Advisers Act, as well as the Investment Company Act of 1940 (which applies primarily to the retail mutual fund sector), is designed primarily for retail investor protection and has no provisions designed to protect funds from counterparties or to control systemic risk.

---

[11] 15 U.S.C § 80b-3. In general, the Adviser's Act defines a person engaged in the business of advising others as to investments in securities as an "investment adviser." Advisers Act Section 202(a)(11); 15 U.S.C. § 80b-2.

[12] At present, investors rely upon their own due diligence before making a decision as to whether to invest in a hedge fund. "The due diligence process is the set of procedures used to gather information about a particular investment for the purpose of deciding whether the investment opportunity is appropriate. The same information collected in this process is also necessary for the ongoing monitoring of an investment." *Principles and Best Practices for Hedge Fund Investors: Report of the Investors' Committee to the President's Working Group on Financial Markets at* 14 (Jan. 15, 2009), (*available at* http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf).

Many requirements of the Advisers Act are irrelevant, or would be counterproductive, if applied to private investment companies. For example, compensation restrictions imposed by the Advisers Act are not particularly well suited to the regulation of managers of investment pools with high net worth and institutional investors. Such investors are fully capable of understanding the implications of performance-based fees. Likewise, client-trading restrictions under the Advisers Act that require client consent on a transaction-by-transaction basis are unduly burdensome for private fund management. In addition, the Advisers Act custody provisions exclude certain types of instruments that are commonly owned by private investment funds, an exclusion that would deprive investors in those funds of the protection that a custody requirement provides.[13] Moreover, the Advisers Act is generally silent on methods for winding down an investment fund or client account, an area which the law should address in some detail for large private investment companies. In sum, the Advisers Act, which was adopted in largely its current form in 1940, is not well suited to investment structures and strategies developed primarily in the last twenty years.[14]

---

[13] These instruments are privately-issued securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, which, under current law, can simply be titled in the name of the private investment fund and the evidence of ownership held in a file drawer at the manager of the private investment fund. The issuers of those assets are permitted to accept instructions from the manager to transfer cash or other value to the manager. This gaping hole in current Advisers Act custody requirements can allow SEC-registered advisers easily to abscond with money or other assets and falsify documentation of ownership of certain categories of assets, and makes it difficult for auditors, investors and counterparties to verify the financial condition of advisory accounts and private investment funds. Requiring independence between the function of managing a private investment fund and controlling its assets, by requiring that *all assets* be titled in the name of a custodian bank or broker-dealer and requiring *all cash flows* to move through the independent custodian, would be an important control. Similarly, requiring an independent check on the records of ownership of the interests in the private investment fund, as well as imposing standards for the qualification of private investment fund auditors— neither of which currently is required by the Advisers Act — would also greatly reduce opportunities for mischief.

[14] While H.R. 711 would not impose Investment Company Act requirements on private funds, it should be noted that doing so would subject private funds to a law that does not fit their purpose or design. For example, current restrictions on mutual funds from engaging in certain types of transactions, such as trading on margin and short selling, would severely inhibit or foreclose a number of hedge fund trading strategies that are fundamental to their businesses and the markets. Convertible bond arbitrage relies on selling short the underlying equity while buying the bond. This strategy provides essential support for the convertible bond market, upon which many corporations

We believe legislation should be developed that would contain targeted controls and safeguards needed for oversight of private funds, while preserving their operational flexibility. Congress may wish to consider more detailed requirements on large private investment companies (or families of private investment companies) in order to address the greater potential for systemic risk posed by such funds, depending upon their use of leverage and their trading strategies.

Congress also may wish to consider giving legal effect to certain measures that were identified as "best practices" for fund managers in a report issued earlier this year by the Asset Managers' Committee ("AMC Best Practices") — a group on which I served at the request of the President's Working Group on Financial Markets.[15] For example, one of the most important of these recommendations is that managers should disclose more details — going beyond Generally Accepted Accounting Standards — regarding how their funds derive income and losses from Financial Accounting Standard (FAS) 157 Level 1, 2 and 3 assets.[16] Another recommendation is that a fund's annual financial statements should be audited by an independent public accounting firm that is subject to PCAOB oversight. Still another recommendation would assure that potential investors are provided with specified disclosures relating to the fund and its management before any investment is accepted. This information should include any disciplinary history and pending or concluded litigation or enforcement actions, fees and expense

---

rely for capital. As another example, requirements for boards of directors set by the Investment Company Act are designed to protect the large numbers of retail investors in mutual funds, and are a poor fit for vehicles that are offered only to high net worth and institutional investors.

[15] *Best Practices for the Hedge Fund Industry: Report of the Asset Managers' Committee to the President's Working Group on Financial Markets* (Jan. 15, 2009) (*available at* http://www.amaicmte.org/Asset.aspx).

[16] In brief, under FAS 157, Level 1 assets are those that have independently derived and observable market prices. Level 2 assets have prices that are *derived from* those of Level 1 assets. Level 3 assets are the most difficult to price — prices are derived in part by reference to other sources and rely on management estimates. Disclosure of profits and losses from these categories will allow investors to better assess the diversification and risk profile of a given investment, and to determine the extent to which fund valuations are based on the "best guess" of fund management.

structure, the use of commissions to pay broker-dealers for research ("soft dollars"), the fund's methodology for valuation of assets and liabilities, any side-letters and side-arrangements, conflicts of interest and material financial arrangements with interested parties (including investment managers, custodians, portfolio brokers, and placement agents), and policies as to investment and trade allocations.

Congress also should require safeguards that I have advocated for many years — simple, common-sense protections relating to custody of fund assets and periodic audits.[17] And, Congress should address areas of importance to the financial system that neither the Advisers Act nor the Investment Company Act addresses, including counterparty risk, lender risk, and systemic risk. These types of issues can be addressed through required disclosures to regulators and counterparties.

IV. Hedge Fund Transparency.

The Subcommittee has asked us to address the issue of disclosure to hedge fund investors and how it might improve transparency and bolster confidence. As noted above, hedge funds and other private investment funds may solicit and accept investments only from sophisticated high net worth and institutional investors — so-called "accredited investors" and "qualified purchasers," and institutions such as pension funds, banks, insurance companies and others that own more than $25 million in investments. Such investors are wealthy and sophisticated; their investments, in general, are managed by investment professionals. They understand the

---

[17] *See* Statement of James Chanos, President, Kynikos Associates, SEC Roundtable on Hedge Funds (May 15, 2003) (*available at* http://sec.gov/spotlight/hedgefunds/hedge-chanos.htm). *See also* Testimony of James Chanos before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on Regulation of the Hedge Fund Industry (Jul. 15, 2004) (available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=79b80b77-9855-47d4-a514-840725ad912c); Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) (available at http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf).

importance of due diligence and are capable of demanding information from hedge fund managers before making any investment. In 2007, the President's Working Group on Financial Markets found that pension plans (and their beneficiaries) are protected by professional asset managers that are held to fiduciary standards, and that concerns with respect to such indirect exposures are "best ... addressed through sound practices on the part of the fiduciaries that manage such vehicles."[18] In our experience, many institutional investors engage in extensive due diligence and ongoing monitoring activities that far exceed the standard disclosures provided by other investment vehicles.[19] Such investors have a simple approach: if you do not provide the information we want, you will not get our business.

Yet, while we do not believe the due diligence practices employed by sophisticated investors are deficient or warrant government intervention into the private contractual relationships among investors, funds, and their advisers, it does seem to us that some simple, common-sense disclosures could be required of private investment funds before they accept an investment. For example, funds could be required to provide potential investors with certain information, and to provide existing investors with ongoing disclosures.[20] Specifically, legislation could require private investment funds to:

- Create, update, and provide investors with a private placement memorandum disclosing all material information regarding the fund, including any disciplinary history or litigation;
- Disclose their fees and expense structures, as well their use of commissions to pay broker-dealers for research (i.e., "soft dollars");

---

[18] *Agreement Among PWG And U.S. Agency Principals On Principles And Guidelines Regarding Private Pools Of Capital*, at 2 (Feb. 22, 2007) (available at http://www.treasury.gov/press/releases/reports/hp272_principles.pdf).

[19] See, for example, the due diligence and monitoring regime employed by the California Public Employees Retirement System *at* http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/aim/home.xml, *and at* http://www.calpers.ca.gov/index.jsp?bc=/investments/policies/inv-asset-classes/aim/home.xml).

[20] This requirement is also consistent with the AMC Best Practices.

- Disclose their methodologies for valuation of assets and liabilities;
- Disclose side-letters and side-arrangements;
- Disclose conflicts of interest and material financial arrangements with interested parties, including investment managers, custodians, portfolio brokers, and placement agents;
- Disclose policies as to investment and trade allocations;
- Provide investors with audited annual financial statements and quarterly unaudited financial statements; and
- Disclose the portion of income and losses that the fund derives from Financial Accounting Standard (FAS) 157 Level 1, 2 and 3 assets.

As noted earlier, the Asset Managers' Committee specifically recommended many of these disclosures. Congress could give the recommendations legal effect.

On the other hand, we believe that requiring hedge funds to make public disclosure of such matters as investments and trading positions would have severely negative consequences. CPIC previously commented on this issue last year in the context of a proposal by the SEC to require public reporting of short sale positions — a proposal the SEC later pared back to a requirement that disclosure be made only to the SEC for staff use in monitoring short sale activity.[21] We strongly supported the SEC's right to obtain this information for regulatory and enforcement purposes, but argued that public disclosure of information relating to investment managers' positions in securities would unfairly penalize investment managers and their investors and potentially expose them to retaliation.

If investments and trading positions were subject to disclosure, trade secrets and proprietary information would be divulged, which is contrary to long-standing market practices, federal law, and the rules of numerous other federal agencies. These practices, laws, and rules recognize the need to protect businesses from the economic and competitive disadvantages that

[21] *Disclosure of Short Sales and Short Positions by Institutional Investment Managers*, Rel. No. 34-58785 (Oct. 15, 2008), 73 Fed. Reg. 61678 (Oct. 17, 2008).

would result from public disclosure of such information.[22] To illustrate, fund managers often conduct rigorous, costly financial analyses that focus on an issuer's business plan, and the quality, integrity, and potential growth of their earnings. They gather information from a wide array of sources and review the businesses of competitors, affiliates, and counterparties to significant transactions. Some managers employ accountants, researchers, and financial analysts. Their analytical techniques may have been developed over years of experience and at great expense. Disclosure of investment positions allows other traders to be "free riders," benefiting themselves while reducing the gains that should accrue to those that actually did the research.

Public disclosure of investment positions may also confuse investors. For example, short selling in a company's stock can occur for many reasons and not necessarily because the short seller has a negative view of a company's outlook (for example, a financial institution may take a short position to lock in a spread or hedge an investment in convertible bonds). In these cases, public disclosure of a short position, especially by a prominent investor, may mislead investors and trigger panicky selling. Finally, public disclosure of trading positions and investment strategies could expose investment managers to retaliation, such as a "short squeeze" campaign. Likewise, issuers may cut off communications with funds who report short positions in the issuers' securities. This type of retaliation prejudices institutional investment managers and their clients and, more broadly, the process of price discovery.

---

[22] For example, the Federal Trade Secrets Act sets criminal penalties for the unauthorized revelation of trade secrets. The Freedom of Information Act (FOIA) and SEC's Rules under FOIA provide that the SEC generally will not publish matters that would "[d]isclose trade secrets and commercial or financial information obtained from a person and privileged and confidential [information]." Also, in connection with long position reporting under Section 13(f) of the Exchange Act, Congress specified that the SEC, upon request, should exempt from public disclosure information that would reveal an investment manager's ongoing trading programs. The legislative history of Section 13(f) in the Senate Banking Committee report emphasized that it "believe[d] that generally it is in the public interest to grant confidential treatment to an ongoing investment strategy of an investment manager. Disclosure of such strategy would impede competition and could cause increased volatility in the market place." Report of Senate Committee on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 87 (1975).

These issues, of course, relate to investment positions. We are of the opinion, though, that the hedge fund industry could benefit from public transparency in other areas. To this end, hedge funds and other privately offered pooled investment vehicles could be required to file with the SEC, and keep current, an on-line publicly-available registration statement. Disclosures could include: the fund's name and principal place of business, the year of formation and the year in which operations commenced; the investment manager of the fund, its principal place of business, and its contact information; names and descriptions of the officers and portfolio managers of the fund, as well as its trustees or directors; the name and address of the public accounting firm that serves as the auditor of the fund; yearly gross and net asset values of the fund since inception; the number of investors as of the most recent calendar year-end; and a brief description of its investment strategy.

V. Don't Shoot the Messenger

In crafting new legislation to regulate hedge funds and other private investment companies, care should be taken not to demonize the funds or impose punitive or restrictive measures that could cause long-term harm to our markets and our economy. Hedge funds and other private investment companies perform many beneficial functions in our markets, without the government backstop. In a recent column, Michael Hirsch in *Newsweek* noted the fundamental misunderstanding of the beneficial role that hedge funds are performing in our economy:

> [A]s the bubble began to overheat in the last few years, our government authorities were most worried about the damage that those unregulated, mysterious hedge funds might do to the financial system.... And after the crash last year, hedge funds came under attack for short-selling .... A lot of people were waiting for the hedge-fund industry—which would get no bailouts à la AIG and Citigroup—to collapse into the dustbin of history.

> It never happened. Sure, plenty of hedge funds went under: a record 1,471 were liquidated in 2008, out of a total of 6,845, according to Hedge Fund Research, a Chicago-based tracking firm. The industry's total capital plunged by $600 billion to $1.33 trillion as of the end of the first quarter of 2009....
>
> But here's the key point: the fallout happened very quietly—with no systemic risk discernible. Compared to the overlong horror movie we've been watching—Night of the Living Dead Banks—what happened in the hedge-fund world sounds almost healthy and clean. After all, that's the way capitalism is supposed to work: incompetents go out of business, smart guys clean up. And overall, the hedge-fund industry has shown remarkable resiliency in the face of the catastrophe....[23]

One of the investment methods used by hedge funds and other private investment companies — as well as by broker-dealers, banks, and other institutional traders — is short selling. Private investment funds use short selling to hedge risk, to bring efficiencies to securities markets by arbitraging away price discrepancies, and in connection with ferreting out overpriced (and fraudulent) securities.

When equity prices collapsed last fall, one of the few regulatory actions taken by the SEC was to impose an emergency ban on short selling — an action then-Chairman Cox and current Commissioner Paredes later recognized as a mistake, in view of the adverse impact it had on investors and the markets.[24] Virtually every study conducted on the ban's impact on the market — including studies on the very stocks it was designed to "protect" — reached the same conclusion: the ban had adverse effects on investors, issuers, and the markets by increasing

---

[23] Michael Hirsch, *Power to the Hedge Funds! Long Demonized, They May be the Model Firms of the Future*, NEWSWEEK (Apr. 23, 2009) (*available at* http://www.newsweek.com/id/194893).

[24] *See* Amit R. Paley and David S. Hilzenrath, *SEC Chief Defends His Restraint*, p. A01, THE WASHINGTON POST (Dec. 24, 2008) (*available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/12/23/AR2008122302765.html); Troy A. Paredes, Commissioner, U.S. SEC, Remarks at "The SEC Speaks in 2009," (Feb. 6, 2009) (*available at* http://www.sec.gov/news/speech/2009/spch020609tap.htm).

volatility, reducing liquidity, clouding price discovery, preventing effective hedging in rapidly declining markets, and severely impeding the convertible bond market.[25]

Currently, the SEC is under tremendous pressure to implement new price restrictions on short selling. Yet, there is no credible data showing that short selling was the cause of the market's decline or that it caused the downfall of individual issuers such as Lehman, Bear Stearns, Fannie Mae, Freddie Mac or AIG. Short sales of financial stocks also constituted a small percentage of trading volume and total shares outstanding. The U.S. experience shows that financial institutions' share prices were reacting largely to problems specific to those institutions' financial health and long-term viability — not to the short-interest positions. In fact, the SEC's Office of Economic Analysis, in a memorandum analyzing the SEC's July 2008 Emergency Order requiring pre-borrowings for short sales, concluded that a control sample of non-financial issuers "experienced no substantive change in short interest since October 2007," a fact that "suggests that the increase in overall short interest reported by the media is driven by financial stocks and most likely the result of negative sentiment induced by the credit crisis."[26]

---

[25] *See* Ekkehart Boehmer, Charles M. Jones, and Xiaoyan Zhang, *Shackling Short Sellers: The 2008 Shorting Ban*, (2008) (working paper) (*available at* http://www2.gsb.columbia.edu/faculty/cjones/ShortingBan.pdf); Ian W. Marsh and Norman Niemer, *The Impact of Short Sales Restrictions* (Nov. 30, 2008) (working paper) (*available at* http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf); Abraham Lioui, *The Undesirable Effects of Banning Short Sales* (Apr. 16, 2009) (*available at* http://faculty-research.edhec.com/jsp/fiche_document.jsp?CODE=1239890717080&LANGUE=1); Arturo Bris, *Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order, IMD Working Paper* (Aug. 12 2008) (available at: http://www.imd.ch/news); Ana Avramovic, *What Happened When Traders' Shorts Were Pulled Down?*, Credit Suisse Market Commentary (Sept. 30, 2008) (*available at* https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=11181&m=-1730413896); Ana Avramovic, *Examining the Wake of the Short Sale Restriction*, Credit Suisse Market Commentary (Oct. 13, 2008); Ana Avramovic and Phil Mackintosh, *The Blame Game: What Caused Spreads to Widen?*, (Nov. 12, 2008) (*available at* https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=11354&m=1083827502); Jeff Benjamin, *Academics Slam Short-Selling Ban*, INVESTMENT NEWS (Dec. 22, 2008) (*available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20081222/REG/812229981).

[26] Memorandum of the SEC Office of Economic Analysis (Jan. 14, 2009) (*available at* http://www.sec.gov/spotlight/shortsales/oeamemo011409.pdf).

The SEC itself, even as it proposes new rules to curb short selling, admits that the price declines in the equity markets were due to long sales (noting that a study by its own Office of Economic Analysis "found that long sellers were primarily responsible for price declines" in September 2008).[27] Thus, the collapse in share prices of these institutions was not due to "bear raids," but due to long selling — investors selling their holdings — motivated by massive losses and the presence of bad assets on these institutions' books.[28]

This should have come as no surprise. According to *Fortune* magazine, corporate profits — in the form of the aggregate earnings of the Fortune 500 — dropped 87 percent in 2008 from their peak in 2006.[29] In the financial services sector, which makes up roughly one-third of the Fortune 500, earnings went from a positive $257 billion in 2006 to a loss of $213 billion in 2008.[30] Earnings collapsed. Balance sheets were in disarray. Share prices in this sector declined because investors sold stocks in response to very weak issuer fundamentals.

The focus on restricting short sales is all the more disheartening because short sellers provide substantial benefits to the marketplace. The vast majority of short sales are *market neutral*. A short sale of one security is made in conjunction with the purchase of a different security, and the paired transaction cannot drive down prices of the market as a whole.[31] The

---

[27] *Amendments to Regulation SHO,* SEC Rel. No. 34-59748, 74 Fed. Reg. 18042, at 18049 (Apr. 20, 2009).

[28] A report by Credit Suisse makes the point that increased volatility since repeal of the uptick rule coincides with the demise of Bear Stern's hedge funds, an event that clearly signaled the weakness in holdings of credit backed securities and the portfolios of large financial firms. *See* Ana Avramovic, *Ticking Off the Shorts*, (Apr. 23, 2009) (*available at* https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=12012&m=-409136585).

[29] Shawn Tulley, *Pop! Went the Profit Bubble*, FORTUNE (Apr. 21, 2009) (available at http://money.cnn.com/2009/04/16/news/companies/tully_profitbubble.fortune/index.htm).

[30] *Id.*

[31] An investor who thinks Microsoft will outperform Apple, for example, may buy shares of Microsoft and sell shares of Apple short. This also occurs, for example, in arbitrage transactions when buyers of convertible bonds short the underlying equity security as a hedge, where the seller has no view of the fundamentals of the company but simply is locking in a spread. An investor also might go long options and/or futures and then short the individual equities that make up the corresponding index. In this case, the investor has no fundamental view of the 2,000

U.S. markets' depth and liquidity depend upon the ability of these various investors to employ short sale techniques.

To the extent that short selling is directional, on the other hand, short sellers play an extremely important role as skeptics in the marketplace. A functioning free market requires buyers *and* sellers. In the U.S. markets, differing points of view meet about the worth of a particular company's business plans, inventions, products, services, and management team. The resulting price for a stock is the sum total of all that information and ideas mixing together in the marketplace. This price discovery function is one of the most important features of our free market system of raising capital. To quote Bernard Baruch's testimony before the House Committee on Rules in 1917:

> To enjoy the advantages of a free market, one must have both buyers and sellers, both bulls and bears. A market without bears would be like a nation without a free press. There would be no one to criticize and restrain the false optimism that always leads to disaster.[32]

The 2003 SEC Staff Report on Implications of the Growth of Hedge Funds describes how, in addition to providing liquidity:

> [s]hort selling also can contribute to the pricing efficiency of the markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on or hedges against a downward movement in a security, the transaction is a mirror image of the person's who purchases the security based upon speculation that the security's price will rise or in order to hedge against such an increase. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price

---

stocks being shorted; he simply is locking in a spread. Risk arbitrage is another area where investors, in connection with an announced acquisition, may short the acquirer and go long the target, since an acquirer often uses its own shares to make an acquisition, thereby diluting and lowering share value.

[32] Testimony of Bernard Baruch, House Committee on Rules, U.S. House of Representatives, 64th Congress, January, 1917.

performance. This evaluation is reflected in the resulting market price of the security.[33]

In the heady years leading up to the 2007-2008 decline in market prices for equity securities, an unfortunate side effect of the tremendous hype of the U.S. marketplace was a tendency to overlook, or at least not seek out, negative information regarding investments. It is natural for a company's management — and often those outside agents who are employed by the company — to want to put the best possible face on the company's operations, plans, and strategies. The role of the fundamental short seller is to test those ideas, to ask the hard questions, and to try to understand if the management team has properly thought through all the things that could go wrong — or whether management is telling the truth.

Short sellers in recent years often have been the watchdogs when others have failed to bark.[34] As I testified in hearings before the Energy and Commerce Committee in 2002, my firm, Kynikos, saw the potential for Enron's collapse nearly a year before it occurred.[35] After reading news reports of Enron's aggressive accounting practices and reviewing the company's SEC filings, we grew suspicious. While Wall Street bulls were content to hype the stock of the "black box" that was Enron, Kynikos went in the other direction, concerned by the issues that proved to be Enron's undoing: aggressive accounting, poor return on capital, numerous one-time gains, poorly explained special purpose entities, high volumes of insider stock sales, and statements

---

[33] *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, at 40 (Sept. 2003) (*available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf).

[34] There is little question of the need for a market watchdog. The SEC, pursuant to a requirement of the Sarbanes Oxley Act of 2002, issued a report reviewing 515 enforcement actions arising out of 227 investigations of alleged financial reporting and disclosure violations in the five years leading up to enactment of the Sarbanes Oxley Act. U.S. Securities and Exchange Commission, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (2003) (*available at* http://www.sec.gov/news/studies/sox704report.pdf). The Commission reported that it brought enforcement actions against 164 entities and 705 individuals who had been involved in improper accounting and reporting practices.

[35] *See Developments Relating to Enron Corp.: Hearing Before the H. Comm. On Energy and Commerce* (Feb. 6, 2002) (testimony of James S. Chanos).

about product lines that simply could not be reconciled with obvious market realities. Had the market responded to what the short sellers were finding, the fiasco that was the collapse of Enron may have been less severe.

Enron is not the only example. Short sellers detected accounting irregularities at Tyco International as far back as 1999. In 2005, the SEC obtained a $200 million disgorgement from the former CEO of AremisSoft, a high tech company that went bankrupt following the exposure of fraudulent statements and accounting practices that were first uncovered by short sellers.[36] Other examples of such financial detective work include Sunbeam Corporation, Coleco, Boston Chicken, Baldwin United, and Conseco. These were not companies that short sellers destroyed in "bear raids." These were companies whose fundamentals were scrutinized by professional investors and found to be inadequate to support their market valuation. In the process of discovering fraud or mismanagement and exposing it, short sellers may have corrected some of the inefficiencies in the market and may have prevented additional investors from losing money in an ongoing fraud. As one columnist correctly observed, "[i]n general, the companies that short sellers target deserve it."[37]

Short sellers also warned of the impending crisis in the financial markets as early as 2006. *Newsweek* recently reported that Paul Singer of Elliott Associates, "in an extraordinarily prescient analysis in September 2006 declared that the subprime mortgage securitization market was a historic scam. He correctly identified the ratings agencies as chief culprits."[38] In the spring of 2007, I joined Mr. Singer in outlining to finance ministers and central bankers at a G-7

---

[36] *SEC v. Roys Poyiadjis, Lycourgos Kyprianou et. al.,* SEC Litig. Rel. No. 19,529, 2005 SEC Lexis 1364 (Jun. 9 2005).

[37] James Surowiecki, *Get Shorty*, THE NEW YORKER (Dec. 1, 2003) (*available at* http://www.newyorker.com/printables/talk/031201ta_talk_surowiecki).

[38] *See supra* n. 21.

finance ministers meeting the looming crisis in credit structures and overleveraged banks and brokerage firms. Our audience listened politely, but, as events now show, failed to take any meaningful action. The decision by those in charge of regulating our economy to ignore fundamental problems has cost us millions of jobs and lost homes, hundreds of billions in government spending, and trillions of dollars in investment losses.

Over the years, the SEC has periodically reexamined its position on short selling, but the results have consistently been the same: short selling is good for the markets, and critics' complaints are unfounded. A number of in-depth studies have borne out this finding.[39] As the highly respected former SEC Commissioner Irving Pollack observed in his 1986 report *Short-Sale Regulation of NASDAQ Securities*, "the early attempts to prohibit short sales did not withstand the test of time, and short sales gradually came to be recognized as essential to the efficient functioning of securities markets."[40]

Congress examined short selling as part of its investigation into the market break of 1987, and again, not only was short selling exonerated, it was identified as a valuable tool for U.S. securities markets. During Congressional hearings in November of 1989, the Director of the SEC's Division of Market Regulation told Congress that short selling "provide[s] the market

[39] Studies were conducted in 1935 and 1951 by the Twentieth Century Fund, and in 1937, 1963, and 1976 by the SEC. A report by Irving Pollack summarized the findings of the 1935 study: "The study found that, in general, short selling does not have any appreciable effect in limiting the extremes to which prices may rise. Its tendency is to accelerate the downward trend in prices during the early and middle phases of movements and either check the price trend in the lower phase or heighten its movement after prices have turned upward. However, the study found that considered in terms of long positions and total trading, short sales … have not been in sufficient volume to warrant the belief that their actual effect is at all material.'" *See* Irving M. Pollack, SHORT-SALE REGULATION OF NASDAQ SECURITIES, at 30 (1986).

[40] Pollack, *id.* at 20.

with two vital benefits: market liquidity and pricing efficiency."[41] The Deputy Director of the SEC's Enforcement Division also commented on short sale complaints. While confirming that the SEC had taken "appropriate enforcement action" in instances where short sales had been "used as a means to achieve an illegal end," he observed that short sellers were often the discoverers, and not the perpetrators, of the illegal behavior:

> [T]he Commission has found occasions where short sellers have detected corporations which are engaged in violations of the securities and other laws themselves in order to inflate the value of their securities. When we have sustainable evidence of this type of violation, we will bring that case as well.[42]

He also emphasized that the SEC "frequently find[s] that the complaints of downward manipulations that we receive from issuers or their affiliates do not lead to sustainable evidence of violations of the antifraud provisions of the federal securities laws."[43]

In 2003 hearings before this Subcommittee, Congress again reviewed short selling amid allegations by certain groups that short sellers and plaintiffs lawyers were sharing information in order to drive down the stock of companies.[44] These allegations were effectively rebutted by Professor Owen Lamont of Yale University, who testified that his research showed:

> [W]hen you have these fights against short sellers and firms, short sellers are usually vindicated by subsequent events. Firms that take anti-shorting actions tend to have falling prices in the following years, suggesting that they were overpriced to begin with, perhaps due to fraud by management; perhaps just due to excessively optimistic investor expectations.

---

[41] *Short-Selling Activity in the Stock Market: The Effects on Small Companies and the Need for Regulation: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs*, 101st Cong. 387 (1989) (statement of Richard G. Ketchum, Dir., Div. of Market Regulation, SEC).

[42] *Id.* at 392 (statement of John H. Sturc, Assoc. Dir., Div. of Enforcement, SEC).

[43] *Id.* at 434.

[44] *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Entities*, 108th Cong. 116 (2003) 28-30 (statement of Paul Kamenar, Senior Executive Counsel, Washington Legal Foundation).

"Short sellers," he opined, "are good at detecting and publicizing fraud on the part of firms. . . . To protect investors, we need a vibrant short seller community."[45]

In 2006, the SEC completed an eight-year series of studies and pilot programs on the "tick test" of Rule 10a-1, including extensive data gathering and analysis by the SEC's Office of Economic Analysis. From these studies, the SEC found little empirical justification for maintaining price test restrictions on short selling. The SEC study determined that price test restrictions on short selling actually amplify volatility in large capitalization companies.[46] The SEC study did not find "any indication that there is an association between extreme price movements and price test restrictions" on short selling.[47]

However, in the face of blistering criticism from Congress, the press, and shareholders about its perceived failure to effectively regulate the investment banks, broker-dealers, and markets under its jurisdiction, the SEC is attempting to resurrect short sale price tests through a rulemaking proposed last month, even while stating that it is "not aware of specific empirical evidence that the elimination of short sale price tests has contributed to the increased volatility in U.S. markets."[48] In other words, the SEC has decided to "round up the usual suspects."

According to Amity Shlaes, author of *The Forgotten Man: A New History of the Great Depression*, one of the parallels between the recent past and that of 80 years ago is that "they had a witch-hunt against their short sellers in the early 1930s just as we have a lot of pressure on the short sellers now, making short sales illegal, [and complaining about] hedge funds . . . ." Ms.

---

[45] *Id.* at 34 (statement of Owen Lamont).

[46] SEC, *Regulation SHO and Rule 10a-1*, 71 Fed. Reg. 75068, 75073 (Dec. 13, 2006) (footnotes omitted) (Release proposing repeal of Rule 10a-1 and amendments to Regulation SHO).

[47] SEC, *Regulation SHO and Rule 10a-1*, 72 Fed. Reg. 36348, 36351 (Jul. 3, 2007) (release adopting amendments to Regulation SHO and repealing Rule 10a-1) (footnotes omitted).

[48] *Amendments to Regulation SHO,* SEC Rel. No. 34-59748, 74 Fed. Reg. 18042, at 18046 (Apr. 20, 2009).

Shlaes noted, "Hedge funds did not cause this problem."[49] We hope that a second parallel to the 1930s does not develop — one where economic recovery is slowed by refusal to recognize true causes and continued blame on the messengers. As stated by Nobel economics laureate Gary Becker last fall, "[t]he temporary banning of short sales is an example of a perennial approach to difficulties in financial markets and elsewhere; namely, 'shoot the messenger.' Short sales did not cause the crisis, but reflect beliefs about how long the slide will continue."[50]

VI. Perspectives on the EC-AIF Proposal

The Subcommittee has asked for our views on the European Commission's April 30, 2009 proposal to regulate alternative investment funds ("EC-AIF Proposed Directive"). We would be happy to provide you with our more detailed views on this very recent and lengthy proposal at a later time. In general, at first reading, we agree in principle with the approach of the EC-AIF Proposed Directive to create a special, carefully tailored proposal designed for regulation of private investment funds, rather than to extend the coverage of the existing framework aimed at retail investment funds or investment advisers. The Proposed Directive appears to have a number of positive elements. For example, it includes registration requirements, allows for appropriate access to information by regulators, requires delivery to investors of audited financial statements, and addresses custody practices. It also provides measures relating to the identification and disclosure of, and procedures to address, conflicts of interest. It establishes requirements for risk management policies and procedures and sets independent pricing service and valuation requirements.

---

[49] "Morning Joe," MSNBC (Oct. 13, 2008). Ms. Shlaes is a syndicated columnist for Bloomberg and a senior fellow at the Council on Foreign Relations.

[50] Gary S. Becker, *We're Not Headed for A Depression*, Wall St. J. (Oct. 7, 2008), *available at* http://online.wsj.com/article/SB122333679431409639.html.

Other aspects of the EC-AIF Proposed Directive may be problematic. For example, we do not believe regulatory approval should be required before a private fund retains certain service providers, as the Proposed Directive contemplates. Moreover, the EC-AIF Proposed Directive includes a one-size-fits-all maximum 1:1 equity to debt ratio. This is essentially a random number and not an appropriate restriction to be imposed across all private investment funds. Finally, other aspects of the Proposed Directive, such as those imposing restrictions or requirements on portfolios and investment strategies, seem to be aimed less at protecting investors and the E.U. economy than serving certain constituencies, such as management. We hope that the European Commission continues to engage with all constituencies and address these matters before proceeding further.

VII. Conclusion

Honesty and fair dealing are at the foundation of the investor confidence our markets enjoyed for so many years. A sustainable economic recovery will not occur until investors can again feel certain that their interests come first and foremost with the companies, asset managers, and others with whom they invest their money, and until they believe that regulators are effectively safeguarding them against fraud. CPIC has offered the Subcommittee its views on the issues we believe should be addressed in crafting legislation to regulate private investment companies. We are committed to working diligently with this Committee and other policy makers to achieve that difficult but necessary goal.

Thank you for this opportunity to provide this statement.

Alternative Investment Management Association

TESTIMONY

OF

W. TODD GROOME

CHAIRMAN

THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION
(AIMA)

For the Hearing on

"Perspectives on Hedge Fund Registration"

Before the

US HOUSE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

7 May 2009

The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA
Tel: +44 (0)20 7822 8380 Fax: +44 (0)20 7822 8381 E-mail: info@aima.org Internet:
http://www.aima.org

Registered in England as a Company Limited by Guarantee, No. 4437037. VAT registration no: 577 5913 90. Registered Office as above

Alternative Investment Management Association

Introduction

The Alternative Investment Management Association ("AIMA") is pleased to provide this statement in connection with the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises' hearing "Perspectives on Hedge Fund Registration" to be held on 7 May 2009.

AIMA is the trade body for the hedge fund industry globally and submits this evidence on behalf of its global membership of hedge fund managers, fund of hedge funds managers, advisors and service providers. AIMA's membership comprises 1,100 corporate bodies in 43 countries and its members manage approximately 75% of global hedge fund assets and over 70% of fund of hedge funds assets. AIMA has been active since its foundation in 1990 in working to enhance the regulatory framework in which its members operate and in seeking to promote sound practices within the industry although it is not a self-regulatory body, and appreciates the opportunity to express its views on the important topic of hedge fund registration.

Further information about AIMA is attached as Appendix 1.

Committee's specific questions

As detailed in the Financial Services Committee's invitation, AIMA has been asked to address a number of specific questions; this written testimony is structured around answering these questions.

1. Your views on H.R. 711, the Hedge Fund Advisor Registration Act of 2009, and suggestions on how it can be improved.

AIMA understands that this Bill, sponsored by Representatives Michael Castle (Delaware) and Michael Capuano (Massachusetts) has been referred to the House Committee on Financial Services.

This Bill would amend the Investment Advisors Act of 1940 to repeal the exception to the registration requirement for any investment advisor who: (1) during the preceding twelve months has had fewer than 15 clients; and (2) neither holds himself or herself out generally to the public as an investment advisor, nor acts as an investment advisor to any registered investment company or any business development company. Therefore, AIMA understands that, in effect, this would lead to a compulsory registration regime for all US investment advisors (and non-US investment advisors, if they have US clients) under the Advisors Act.

AIMA supports the registration of investment managers, including hedge fund managers, with the appropriate national authorities in the country in which they are principally based, as envisaged above. On 24 February AIMA announced a policy platform which consisted of major proposals to increase transparency and to support the concept of manager-registration globally (see Appendix 2 for a copy of the platform). Such a process of registration leads to a supervisory relationship between managers and the appropriate national supervisor, creates a relationship and dialogue which supports greater understanding of hedge fund activities and allows for increased oversight of markets more generally.

AIMA is aware of discussions taking place regarding a *de minimis* threshold for registration and/or reporting requirements; if this debate is being driven by considerations of the ability of

a manager to provide systemically relevant information and broad market insights, we would advocate that managers with $500m of assets under management (AUM) or more be obliged to register. Indeed, as a practical matter, it may be very difficult to gather such information from so many firms and managers, and a larger figure (e.g. $1bn or $2bn minimum AUM), may be both more practical and still capture the majority of AUM in the industry.

This Bill would seem to put the US registration approach on substantially the same basis as that operating in the UK, which we have found to provide effective oversight and supervision. One important difference would remain however - the UK's current approach is not extra-territorial, and non-UK based investment managers who do not operate from a place of business in the UK are not registrable with the UK's Financial Services Authority (FSA), even if they have UK clients, whereas AIMA assumes that, pursuant to this Bill, any non-US investment managers with one or more US clients would be registrable under the Advisors Act even though they do not have a US presence. This raises the issue of dual registration - a process that is not endorsed by the G30, as can be seen in Recommendation 4 of the G30's January 2009 Report; and AIMA shares the view of the G30 in this respect.

Other countries with a significant hedge fund management industry presence (see Appendix 3 for details) favour an approach which involves authorisation/licensing and/or registration of hedge fund managers, together with a continuing supervisory dialogue with a specialist supervisory team. These registration templates, together with ongoing supervisory dialogue, have assisted authorities to achieve their two main objectives of enhancing investor protection and monitoring issues concerning market integrity and financial stability. The details vary by country, but the essential components comprise some or all of the following:

- A fit-and-proper persons test, with a suitable business plan, providing for robust systems and controls.
- Notification/pre-approval of certain material changes (such as changes to ownership control).
- Periodic reporting of key firm, client and risk metrics.
- Cooperation in the conduct of ad hoc, themed supervisory visits to assess current market practices.

These requirements and ongoing controls help to ensure professionalism, soundness and qualification of the management company and foster market integrity and investor protection. A very important component to the success of such a registration and supervisory regime is the ongoing dialogue between the regulated manager and the supervisory authorities.

Appendix 3 provides a global overview and comparison of hedge fund manager registration regimes in the UK, France, Sweden, Switzerland, Japan, Singapore, Hong Kong and Australia.

2. How you believe Congress can achieve the appropriate balance between providing appropriate regulation of the industry aimed at protecting investors without unduly inhibiting the benefits hedge funds provide investors and the market more broadly?

AIMA believes that a combination of manager registration and greater transparency is the most appropriate mechanism for achieving this balance.

As stated in Question 1, AIMA supports the registration of investment managers, including hedge fund managers, with the appropriate national authorities in the country in which they are principally based. There are clear and demonstrable benefits to this approach in those countries which already operate such a regime.

Whereas investor protection for hedge fund investors is perhaps best served by increased transparency and disclosure by managers (and there is much anecdotal evidence to suggest that this balance has recently shifted materially in favour of investors), it is possible that there may be inadequate risk data provision in the aggregate by larger, more systemically relevant managers to their national macro-prudential supervisors, and in turn there may be insufficient dialogue internationally between national supervisors to track composite activity. There may also be a gap that could be filled by confidential dialogue by the Senior Supervisors' Group, IOSCO and/or the Financial Stability Board if concentrated risk exposures are identified that may present a financial stability risk.

AIMA is promoting the concept of a Systemic Data Reporting Template (SDRT) which is explored in more detail in the answer to Question 4. This template would be shared by the main national regulators and would be completed by the managers with AUM in excess of a specified *de minimis* level.

Hedge funds, although not the cause of the current economic and market crisis, recognize that they, as mature market participants with a substantial investor base, have a role in bolstering financial stability and improving investor protection by enhancing transparency of their investment processes and market impact.

Achieving the appropriate balance is of course not unique to hedge fund managers and will apply equally to other market participants; a successful approach in this area may offer a way forward for other industry sectors.

3. The degree to which institutional investors and pension funds affect your industry, their recent demands for increased transparency, and their recent efforts at negotiating your fee structure.

Historically, high net worth individuals and private banks accounted for most of the AUM in the hedge fund industry globally; however, in this decade institutional investors have steadily increased their investments with hedge funds and other alternative investment managers and, according to our research, now constitute an absolute majority of AUM within the alternative investment industry.

Chart 1 at Appendix 4 depicts the growth of the hedge fund industry, and AIMA attributes this rapid growth from $900bn to (at or even over) $2 trillion to the significant growth and presence of institutional investors. Institutional investors have also increasingly been the source for new inflows to the industry, and during the past 5 -6 years are estimated to represent the vast majority of new capital (see Chart 2 at Appendix 4).

In the past year, it can very clearly be seen that investors are demanding - and receiving - greater transparency and disclosure; improved provisions related to liquidity; segregated or managed accounts; and a wider diversity of fee structures. In some cases this is resulting in lower fee levels, changing the mix between base fees and performance fees, and better aligning fees with expected investment or return durations, size of investments, and balance between hurdle rates and relative performance. As such, a much greater differentiation of fee structures is emerging, which tends to reflect an even greater alignment of interests between investors and managers. On a variety of operational issues, institutional investors are also demanding - and receiving - increased third-party services, such as independent administration, including NAV calculation and verification, as well as independent custody.

The benefits of hedge fund investment are increasingly recognised by many of the most demanding institutional investors. Hedge funds have repeatedly demonstrated that they provide the most attractive and consistent risk-adjusted returns.

4. What type of information you will voluntarily disclose to improve investor confidence and increase transparency - as well as any other self-imposed reforms the industry is considering and the consequences of not abiding by these policies?

AIMA believes, as a result of extensive consultation with its larger manager members globally, that the industry is not only ready but also willing to provide specific and regular transparency across a wide variety of investment and operational risk metrics to national supervisors (the regulator of the jurisdiction in which the manager is located and registered to operate), with the objective of contributing to an improved understanding of the hedge fund industry's activities and a broader contribution to a national and international analysis of financial stability related issues. To obtain a complete picture, the same information should be gathered from all bank and non-bank industry groups.

We would urge that due regard is paid to the wide variety of investment strategies deployed by hedge funds, and that definitions or measures used to monitor volatility, liquidity, leverage, counterparty exposures and risk concentrations are sufficiently flexible to avoid a one-size-fits-all approach. For example, there is a justifiable desire to understand the extent to which the hedge fund industry can amplify market movements as a result of the deployment of leverage but not only are there justifiably different definitions of leverage (see Appendix 5 for examples), but leverage cannot usefully be tracked in isolation: for example, a relatively low degree of leverage in an illiquid or volatile portfolio may present concerns, whereas a more highly leveraged or repoed portfolio of short-dated government securities represents very little market risk.

AIMA is working with international policy makers and regulators to develop an appropriate risk reporting and increased transparency system, allowing regulators to better understand hedge fund and market activities, and thus be better able to prevent future events of potential market or financial instability. AIMA advocates that managers of larger hedge funds provide regular periodic reporting of systemically relevant information and risk exposures to their national supervisors.

'Increased transparency' in this context relates to what is deemed to be of systemic or broad market relevance, i.e., information that would contribute to an 'early warning system'. In practice, care will need to be taken to ensure that the information is relevant, proportionate and cost-effective to implement; AIMA has been at the forefront of constructing a template for systemic data reporting.

Full and plain disclosure of all relevant systemic data will not alone address the issue of better supervisory understanding of market activities and financial stability; it requires further analysis and qualitative understanding of the data. In the end, the desired result of better understanding of risks requires an informed dialogue, on an ongoing basis, between the regulated entities and their supervisors. Hedge fund managers have welcomed and continue to welcome such a dialogue with national and international authorities.

Harmonisation of sound practices

Over the last 10 years, the hedge fund industry has developed a vast body of work on sound practices. The importance of this work should not be underestimated, as it has not only been

developed by those with vast amounts of industry knowledge, but it has been endorsed by regulators around the world and serves as a very useful tool in enhancing regulation and helping managers adhere to sound practices.

Many of the core principles in existing sound practice guidelines are substantially similar, and in October 2008 AIMA, together with the International Organization of Securities Commissions (IOSCO), the Hedge Fund Standards Board (HFSB), the Managed Funds Association (MFA) and the Asset Managers' Committee of the US President's Working Group on Financial Markets (US PWG) created the Hedge Fund Matrix (www.hedgefundmatrix.com). The Hedge Fund Matrix, a website bringing together all the sound practice works by the aforementioned bodies and allowing users to compare the various guidelines side-by-side, was the first step towards harmonisation of existing sound practices on a global basis.

As referenced in the G20's recent Progress Report on the Washington Action Plan, AIMA has been proactively engaged with the Financial Stability Board and various national and regional authorities and, together with other aforementioned bodies, is working to put forward a common set of principles for the hedge fund industry, which will still allow for local interpretation of hedge fund standards and practices. AIMA is confident that harmonisation of these standards will represent a major step forward for the industry in terms of increased transparency.

5. Your views on the recently issued EU directive on the regulation of collective investment trusts (including hedge funds).

On 30 April 2009, the European Commission ("the Commission") published a proposal for a Directive on alternative investment fund managers ("AIFM"). This is a draft text which is aimed at further regulating the European alternative asset management industry as a whole and its reach goes well beyond hedge funds. The proposed Directive would apply to any AIFM established in an EU member state who provides management and administration services to one or more alternative investment funds (AIF). An AIF is defined as any collective investment undertaking, whether domiciled in or outside the EU, which is not a UCITS fund and thus includes not only hedge funds but also funds of hedge funds, private equity funds, real estate funds, infrastructure funds and long-only funds which are not collective investment undertakings under European legislation, referred to as UCITS funds.

Although the proposed Directive will apply to all AIFMs established in an EU member state which provides management and administration services to one or more AIF, it is our understanding that, as currently drafted, it may severely impact any non-EU, including US-based managers, (not just hedge funds and hedge fund managers, but many types of funds and fund managers as explained above) and may prevent them from accessing EU-based institutional and other professional investors, therefore raising possible issues of financial protectionism.

AIMA regrets that there has been no coordination between the Commission and the G20-ordered work in this area, particularly the IOSCO Task Force on Hedge Fund Oversight and the work being carried out by the Financial Stability Board, all seeking to identify and provide a globally consistent approach and appropriate solutions. Neither does the proposed Directive take into account the highly effective existing regulatory framework for European hedge fund managers. The proposed Directive draws on several other European Directives, primarily those regulating the UCITS products which are solely aimed at the retail sector. Therefore the proposed Directive does not logically or practically address the way many of the investment sectors covered by this proposal are structured, organised, or operate.

The proposed Directive will now undergo a complex consultation and negotiation process which could last many months.

A more detailed briefing note, based on a memorandum from AIMA's counsel, on some of the significant issues raised by the proposed Directive can be found in Appendix 6.

6. There is always a tension between market efficiency and market integrity. In the last few years, a good bit of the integrity disappeared. What steps has the industry taken, and what steps will it take, to restore this balance?

There are a number of industry-led initiatives which have either taken place or are due to take place that AIMA would like to bring to the attention of the Committee:

- In late February 2009, AIMA issued an important press release (see Appendix 2) stating its intention to work closely with regulatory supervisors and policymakers on universal templates for manager registration, systemic data transparency, reporting disclosure for short positions and the harmonisation of hedge fund practices.

- AIMA has developed, over many years, a substantial number of specific sound practice guides for the industry on hedge fund management, administration, valuation, business continuity, governance, anti-money laundering and due diligence for managers and service providers. Other important guidelines have been produced by IOSCO, the US President's Working Group on Financial Markets, the Managed Funds Association and the Hedge Fund Standards Board. This demonstrates both the amount of work already achieved in this area to date as well as the industry's continued focus on documenting and enhancing its practices. Additionally, in early May AIMA will be publishing the world's first guide to sound practices for funds of hedge funds managers.

- AIMA believes that investor education is as important as transparency from managers. Many of the world's leading investors have joined AIMA's global Investor Steering Committee and, in 2008, produced *AIMA's Roadmap to Hedge Funds* - the world's first collaborative educational guide for institutional hedge fund investors. The guide, which provides guidance on investing in hedge funds, also meets the Financial Stability Forum's Highly-Leveraged Report (2007) recommendation that industry and investors work more closely to develop positive initiatives.

- AIMA is working with industry participants to take forward the proposals of the G20 and the Financial Stability Board to develop a common set of principles for the hedge fund industry. As mentioned earlier in Question 4, AIMA and other industry groups are devoting a large amount of time and effort to developing these principles, which will be applicable to hedge fund managers globally.

7. Additionally, any other information or opinions you deem relevant to this hearing.

Global overview of the hedge fund industry

For the Committee's information, AIMA has provided at Appendix 7 an overview of the global hedge fund industry.

Alternative Investment Management Association

"Systemic importance" vs. "systemic relevance"

AIMA does not believe that hedge funds pose a systemic risk to the capital markets in which they operate. To put matters in context, there are single banks, insurance companies and single traditional investment management houses, which are larger in terms of assets than the entire global hedge fund industry.

On the other hand, hedge funds are responsible for a number of positive features within the financial markets, such as enhancing pricing efficiencies and improved liquidity. Many issues affecting the capital markets are still, despite the undeniable evidence to the contrary, wrongly attributed to hedge funds alone, rather than being recognised as, in fact, symptomatic of a wider more complex system. If all hedge funds disappeared tomorrow, all these issues would still exist. One would, though, have lost an important contributor to market efficiency across numerous and important markets. During these very difficult times hedge funds should be seen as part of the solution for recovery and a return to properly functioning markets.

Most commentators accept, as mentioned above, that the current crisis has been caused by substantial failures in the regulated banking sector. Banks because of their size, leverage and concentrated positions, pose a systemic risk to the markets. Hedge funds are not banks or bank-like, and operate a completely different economic model.

AIMA accepts that hedge funds and other non-banks provide an increasingly important role to a variety of important financial markets and that some of these non-banks, including hedge funds, have become more systemically relevant. Therefore, it seems appropriate for supervisors and other national and international authorities to gather information and thereby develop a better understanding of non-bank activities. Likewise, all non-banks and hedge funds do not pursue the same strategies. However, rather than this being a threat, we believe this diversity of market behaviour is a positive feature for markets and acts to improve financial stability.

In contrast to those of banks, the risk management systems employed by hedge fund managers have better withstood many of the challenging problems of the past year, and where a wind-down of a hedge fund business has become necessary, bar a couple of examples, it has been orderly and successfully undertaken.

AIMA believes that it is entirely logical for increased regulatory attention to be paid to hedge fund managers given the role these managers play in many markets, as well as the desire to better understand broader market activity by developing a better understanding of hedge fund activity. However, it is wrong for hedge funds to be the sole, or even the main, focus of that attention. A reassessment of the systemic relevance of hedge funds is only of value if it is part of a wider review of the capital markets as a whole and that of all bank and non-bank participants. One must look at the market holistically in order to better monitor market and financial stability issues.

The need for global coordination

There is currently much national and international activity aimed at identifying and correcting regulatory deficiencies in financial services, including those of the hedge fund industry.

AIMA welcomes these initiatives, although we would have wished for much greater coordination between the various initiatives in this area. AIMA is working with numerous regulatory and

policy bodies in order to develop a regulatory landscape which is effective and capable of allowing the flexibility for innovation which hedge funds provide, and which has been so important for the development of the capital markets.

It is vital, given the number of different bodies examining these issues, that the findings which result are consistently aligned and therefore likely to produce reforms which will endure and promote long-term financial stability. An international perspective and approach are needed to handle what are global issues. If this is not the case it will lead to regulatory arbitrage and would cause harm to markets and undermine the confidence of investors.

The resulting reforms must be capable of being implemented internationally with relative speed. We support proportionate and well-judged rules, tightening up in those areas where shortcomings have been clearly identified, but resisting the urge to make change for change's sake in those areas where no problems have been encountered.

In the realm of industry-led initiatives, AIMA has been working with other global associations to develop a common set of principles for the hedge fund industry, which will still allow for local interpretation of hedge fund standards and practices.

Short selling

Short selling is a legitimate investment technique; its beneficial role in the efficient operation of markets is widely recognised by regulators. Short selling is a technique that is used by the wider asset management industry including, but not limited to, hedge funds in order to reduce risk to investors.

As a matter of principle, AIMA believes that new regulations should only be introduced if and when there is demonstrable evidence of market failure. In the case of short selling, there has been no such demonstration. The market is already well placed to regulate the level of short selling. The holders of long positions are best placed to be able to police whether short selling is permissible or not by their acceptance or refusal to lend stock.

AIMA believes that transparency and the timely provision of information to regulators should be the central feature of any global short selling regime and is developing a template for a global reporting regime - further details can be found at Appendix 8.

In addition to AIMA's template, AIMA would like to highlight the following reporting considerations:

- AIMA believes that it is quality of information, rather than quantity, that should drive disclosure to regulators.

- Disclosure of positions should be made privately to the regulator and kept confidential. Cross border exchange of information should be subject to appropriate controls in order to ensure confidentiality. Also, the amount and nature of information exchanged should be proportionate to the purpose of the exchange. Any information provided to the market on short positions should be provided on an aggregate basis.

- The cost, quality and utility of the information requested by regulators should be very carefully considered - AIMA highlights the situation in Canada where the local regulator has, in fact, attempted to discontinue the twice-monthly position report due to issues associated with its cost, usefulness and accuracy.

- There is potential for moral hazard, with regulators seeking information from the market which they may lack the means or expertise to interpret fully. This is a regulatory risk but also poses the danger of giving false comfort to the market, namely that the regulator is happy that the market is functioning properly or condones existing practices.

- AIMA's members do not, in the main, undertake 'naked' short selling to any significant extent. However, members pursuing certain investment strategies (e.g., statistical arbitrage) legitimately make use of short selling without locate/pre-borrowing activity and it should be noted that it is settlement failure, rather than 'naked' short selling per se, that is a risk to orderly markets.

- Furthermore, any attempt to ban 'naked' short selling requires a clear and consistent definition of what is a 'naked' short sale, something that, in practice, would be very difficult to achieve. AIMA, therefore, believes that a better approach is to regulate the settlement side of short selling. Penalties should not be applied to those who can demonstrate that they have taken all reasonable steps to provide for settlement (e.g., if the locate counterparty fails to deliver resulting in settlement failure).

- AIMA broadly supports greater transparency by alternative investment managers to regulators. However, thought should be given by regulators as to what information they require to achieve their aims, and to select the least costly and / or disruptive means for obtaining it.

- Ultimately, AIMA would wish to see convertibles / warrants / rights included in the denominator in the net short position calculation (subject to this information or calculation being workable on a global basis) but it is assumed that, initially, the denominator would be the current issued equity share capital (since information providing a diluted denominator is not yet widely available).

- AIMA believes that a globally agreed and adopted approach to short selling disclosure is required.

Alternative Investment Management Association

APPENDIX 1

About AIMA

AIMA is the not-for-profit trade association which represents the hedge fund industry globally. Its membership comprises 1,100 corporate bodies in 43 countries and is drawn from all constituencies which make up the hedge fund sector - including hedge fund managers, fund of hedge funds managers, prime brokers, administrators, accountants and lawyers.

AIMA's members manage approximately 75% of global hedge fund assets and over 70% of fund of funds assets. Membership is corporate and, within these firms, AIMA services in excess of 4,800 individual contacts worldwide. AIMA is not a self-regulatory body. New members are vetted for their bona fides; manager members must be supervised by a recognised regulator in order to qualify for membership.

AIMA's member profile is as follows:

- Hedge fund managers - 44%
- Fund of hedge funds managers - 21%
- Investors - 2%
- Advisers/service providers - 33%

Members in the Europe/ Middle East/ Africa region account for 55% of the association's membership, those in the Americas 23% and those in the Asia-Pacific region 22%. They all benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice guidelines and its excellent reputation with regulators worldwide.

Since its establishment in 1990, AIMA has worked with the aim of enhancing the regulatory framework in which its members operate. AIMA has a central tenet that good regulation makes for good business. Over the years AIMA has developed contacts with 144 separate regulatory or policy-making organisations in 62 countries.

AIMA has produced, over many years, a number of specific and detailed sound practice guides which have been widely used across the industry; these include guides on hedge fund management, administration, valuation, business continuity, governance, anti-money laundering and comprehensive due diligence of managers and service providers.

AIMA has worked closely with its counterpart the Managed Funds Association ("MFA") in the United States, as well as with the UK Hedge Fund Standards Board and the US President's Working Group on Financial Markets' Asset Managers Committee. AIMA is currently involved with the work on unification of best practice standards as requested by the G20 and is working closely with the Financial Stability Board towards achieving this important objective.

AIMA has a history of working closely with institutional investors and recently published the world's first collaborative educational guide for institutional hedge fund investors, *AIMA's Roadmap to Hedge Funds.*

AIMA is committed to developing industry skills and education standards and is the co-founder of the Chartered Alternative Investment Analyst designation (CAIA) based in Massachusetts - the industry's first and only not-for-profit specialised educational standard for alternative investment specialists. Over 10,000 industry professionals have enlisted in this programme since its launch in January 2003.

Alternative Investment Management Association

APPENDIX 2

AIMA's policy platform press release

AIMA LAUNCHES MAJOR TRANSPARENCY INITIATIVE

London, 24th February 2009: **The Alternative Investment Management Association ("AIMA"), the trade body for the global hedge fund industry, has announced a major new transparency initiative. AIMA says that it will support the principle of full transparency and supervisory disclosure of systemically significant positions and risk exposures by hedge fund managers to their national regulators (the regulator of the jurisdiction in which the manager is authorised and registered to operate).**

The initiative is one of a series of policy positions in the association's new platform. Other key new strands of the platform include an aggregated short position disclosure regime to national regulators, support for new policies to reduce settlement failure (including in the area of naked short selling), and a global manager-authorisation and supervision template based on the model of the UK's FSA and a call for unified global standards for the industry.

AIMA's members manage approximately 75% of hedge fund assets globally and the association has over 1,100 member firms in 43 countries. Members include leading hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms and fund administrators.

The association is representing the global hedge fund industry in on-going international discussions about the future regulatory framework for the industry, notably with the organisations tasked by the G-20 to address the issue, such as IOSCO and the Financial Stability Forum. AIMA supports these efforts to achieve global consensus, and is providing active cooperation and leadership on behalf of the industry. It is also working closely with leading national regulators regarding the supervision of hedge fund managers.

The policies in AIMA's new platform are:

1) support for regular reporting and increased transparency of systemically significant positions and risk exposures by managers of large hedge funds to their national regulators (the regulator of the jurisdiction in which the manager is authorised and registered to operate);
2) support for an aggregated short position disclosure regime to national regulators;
3) support for new policies to reduce settlement failure (including in the area of naked short selling);
4) support for a global manager-authorisation and supervision template based on the UK's FSA model; and
5) a call for a common set of principles and standards for the hedge fund industry, based on the existing industry standards work, such as that authored by AIMA, HFSB, IOSCO, PWG and MFA.

Andrew Baker, Chief Executive of AIMA, said, "We want to dispel once and for all this misconception that the hedge fund industry is opaque and uncooperative. That's why we are declaring our support for the principle of full transparency of systemically significant positions and risk exposures by hedge fund managers to their national regulators through a regular reporting framework. We are confident that our members recognise that it is in everyone's best interests if we cooperate fully in the important on-going international efforts to examine and improve the supervisory framework of the future."

Alternative Investment Management Association

APPENDIX 3

Hedge fund manager authorisation regimes - a global overview

	UK	France	Sweden	Switz[1]	Japan[2]	Singapore[3]	HK	Australia[4]
1. Firm structure and core information requirements								
Disclosure of core firm details (e.g. place of business, staff details, legal status of firm)	•	•	•				•	•
Disclosure of changes to core firm details	•	•	•				•	•
Requirement for particular legal form							•[5]	•[6]
2. Firm details								
a. Business experience								
Disclosure of background to firm (previous experience, business strategy, shareholding structure etc.)	•	•	•				•	•
Disclosure of any previous sanctions, or offences committed by the firm	•							•

[1] At present hedge fund managers in Switzerland are only subject to anti-money laundering requirements and are not otherwise regulated (although fund of hedge fund managers are bound by UCITS regulation if they manage assets in such a vehicle).
[2] Fund managers operating in Japan are typically located overseas and so are not authorised by the Japanese regulator. Firms appoint Japanese investment advisers, who are authorised in Japan to provide investment advice. The fund manager then takes discretionary decisions based on this advice. The requirements set out in this matrix are based on obtaining authorisation to provide investment advice in Japan. Authorisation to make discretionary investment management decisions in Japan is more onerous and time-consuming to obtain.
[3] No authorisation is required in Singapore for an investment manager which undertakes fund management for not more than 30 'qualified investors' and has a substantial presence in Singapore. Hedge fund managers in Singapore commonly rely on this exemption and this matrix sets out the position for a fund manager falling within this exemption.
[4] Some overseas hedge fund managers may not require any authorisation from the Australian regulator (e.g. where it is authorised by another regulatory body).
[5] The firm must be a company incorporated in Hong Kong, or an overseas company with a company registry in Hong Kong.
[6] The 'responsible entity' must be a public company.

	UK	France	Sweden	Switz[1]	Japan[2]	Singapore[3]	HK	Australia[4]
b. Scope of firm authorisation								
Authorisation limited to certain activities (advising, dealing, managing etc.), certain securities (shares, debentures, options etc.) and certain clients (retail, professional etc.)	•	•	•				•	•[7]
Requirement for pre-approval for certain changes in activity, assets or customers	•	•	•				•	•
c. Financial resources								
Initial requirements								
Complete financial resources questionnaire including regulatory capital and liquidity calculations	•	•	•				•	
Ongoing requirements								
Maintenance of required capital and liquidity levels	•	•	•				•	•
Notification of inability to maintain required capital and liquidity levels	•	•	•				•	•
d. Compliance arrangements								
Requirement for internal risk management/compliance system	•	•	•			•[8]	•[9]	•
Requirement for anti-money laundering system	•	•	•	•		•		
Requirement for anti-market abuse system	•	•	•					

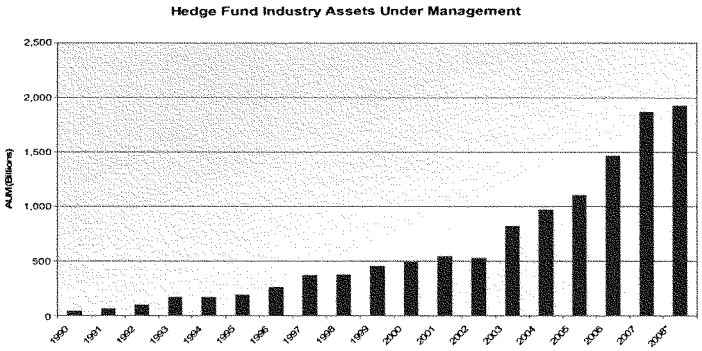
[7] The firm, as the 'responsible entity', is the authorised person
[8] Exempt fund managers in Singapore are still required to comply with various securities and finance regulations e.g. the Securities and Futures Act.
[9] Appropriate to size and nature of firm.

	UK	France	Sweden	Switz[1]	Japan[2]	Singapore[3]	HK	Australia[4]
3. Key firm personnel (directors, partners etc.)								
Relevant experience and/or qualification requirement	•	•	•		•[10]		•	•[11]
Evidence of fitness for role e.g. disclosure of any previous improper conduct	•	•	•		•	•[12]	•	•
Authorisation requirement for commencement of role and function	•	•	•		•[13]		•[14]	
Authorisation requirement for change in role and/or function	•	•	•				•	
4. Key owners and influencers								
Notification of details of substantial owners/controllers of firm and respective holdings	•	•	•			•	•	•
Evidence that substantial owners/controllers are fit and proper persons	•	•	•			•	•	
Ongoing notification and/or pre-approval requirement for changes to substantial owners/controllers	•[15]	•	•				•	•
5. Appointed representatives								
Notification of any representatives appointed by the firm	•		•					

[10] At least 4 suitably experienced individuals must be employed in providing the investment advice
[11] The firm must demonstrate it has "responsible managers" who meet certain professional standards, although these individuals are not directly authorised.
[12] An exempt manager is still required to ensure it employs fit and proper persons for fund management roles.
[13] As described at footnote 2 above, obtaining authorisation to provide investment advice in Japan is less onerous and time-consuming than obtaining authorisation to provide investment management services in Japan.
[14] Two "responsible officers" are required for each regulated activity carried on by the firm, one of whom must be resident in Hong Kong.
[15] Extensive pre-approval requirements exist for changes in control

APPENDIX 4

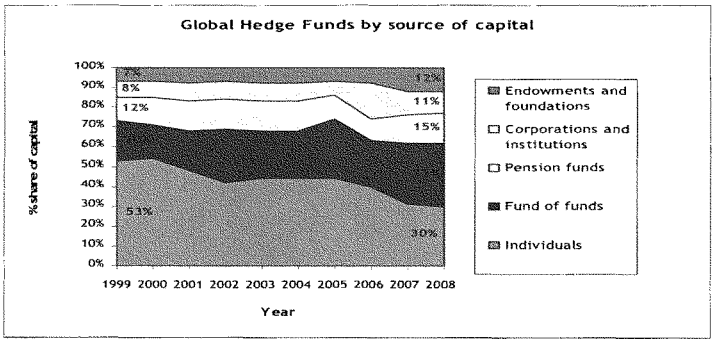
Chart 1: Growth of the global hedge fund industry



Source: Hedge Fund Research

The increase in hedge funds assets ("AUM") since 2002 has been mostly driven by substantial allocations from institutional investors. The individual investors' share has dropped from 53% in 1999 to 30% in 2008. As shown in Chart 2 below, pension funds and fund of funds have significantly increased their hedge fund market share during this time - they now account for approximately 47% of all hedge fund AUM. Additionally, pension funds are forecast to be the greatest source of asset flows between now and 2013.[1]

Chart 2: Institutional investors involvement in hedge funds



Source: Hennessee Group LLC

[1] Bank of New York Mellon, Casey Quirk, "The Hedge Fund of Tomorrow, Building an Enduring Firm".

Alternative Investment Management Association

APPENDIX 5

Examples of leverage measures

Type of measure	Definition	Observations
Financial statement/asset based (classic)	▪ Gross assets/equity ▪ Gross debt/equity	▪ Does not incorporate on-balance sheet hedges and off-balance sheet instruments
	▪ Net assets/equity ▪ Net debt/equity	▪ Does incorporate on-balance sheet hedges (therefore "net"), but does not include off-balance sheet instruments
Risk based	▪ Portfolio volatility/equity ▪ VAR/equity ▪ Stress loss/equity ▪ Other loss measure/equity	▪ Usually incorporates all (on- and off-balance sheet) hedge positions ▪ But does not account for mitigating measures by manager in times of distress

Source: Hedge Fund Standards Board, Final Report

Alternative Investment Management Association

APPENDIX 6

Commission publishes proposal for a Directive on alternative investment fund managers

The European Commission published on 30 April 2009 the final text of a draft proposed European Directive on alternative investment fund managers (AIFM). The proposed Directive would apply to any AIFM established in an EU member state which provides management and administration services to one or more alternative investment funds (AIF). An AIF is defined as any collective investment undertaking, whether domiciled in or outside the EU, which is not a UCITS fund and thus includes not only hedge funds but also funds of hedge funds, private equity funds, real estate funds, infrastructure funds and long-only funds which are not UCITS funds.

The proposal has not been subject to the usual consultation process and introduces unwarranted and inappropriate changes to the way in which AIFMs operate and, indirectly, to the structure of the AIF industry itself not only inside but also outside the EU. The draft also prejudges the outcome of the work being undertaken by IOSCO and the G20 in relation to the regulation of hedge funds and other alternative investment funds on a global basis.

Significant issues raised by the draft proposed Directive for AIFM which are managers of hedge funds include the following:

Which AIFM are covered

The proposed Directive will apply to AIFM with assets under management in excess of €100 million (about US$ 130 million), irrespective of the number of AIF which they manage. The €100 million threshold is phrased as "assets under management, including any assets acquired through the use of leverage" and it is not clear whether this means net or gross assets. The official press release announcing the proposal indicates that this threshold has been chosen so as to exclude AIFM for whom the requirements would be disproportionate and that as a result approximately 30 per cent of hedge fund managers, managing 90 per cent of EU domiciled hedge funds, will be covered by the proposed Directive. AIMA estimates that the Directive will in fact cover approximately 87 per cent of all assets under the management of EU hedge fund managers in EU and non-EU domiciled hedge funds.

Marketing passport for non-EU AIF delayed until 2014

Although AIFM established and authorised in an EU member state under the provisions of the Proposed Directive will be granted a passport to market the AIF which they manage to professional investors (as defined in Annex II of the MiFID Directive) throughout the EU, AIFM will only be permitted under the same passport to market in the EU AIFs which are domiciled outside the EU, including US hedge funds, subject to certain conditions, including a requirement that each EU member state in which such an AIF is to be marketed has entered into an agreement with the country in which the AIF is domiciled to share information on tax matters complying fully with the standards laid down in the OECD Model Tax Convention. This requirement has nothing to do with the regulatory objective of the Proposed Directive but rather, as the Commission admits in the Explanatory Memorandum accompanying the draft, it is designed to ensure that tax authorities in the EU may obtain such information from the tax authorities in the country in which an AIF is domiciled as is necessary to enable them to tax investors in the AIF. We believe it is inappropriate to use a directive on investment funds to achieve a tax objective.

The passport to market AIF domiciled outside the EU will, however, only become available three years after the rest of the proposed Directive has come into force, and until then an AIFM domiciled in one member state will be permitted to continue to market AIF domiciled outside the EU in the other member states under the existing domestic private placement rules currently in force in those member states. During this three year period, AIFs domiciled outside the EU will be at a competitive disadvantage when compared to AIFs domiciled in the EU, particularly in countries such as France and Italy which do not currently allow AIFs domiciled outside the EU to be marketed even on a private placement basis.

No level playing field

The proposed Directive will not apply to EU credit institutions which provide management services to AIFs, so long as they do so through a division and not through a separate company. This carve-out appears to have been included in the draft at the last moment, presumably as a result of lobbying by large continental European banks. Given the objective of the proposed Directive, AIMA questions why it should not apply to such institutions.

It also appears that entities which are authorised in an EU member state to market but not to provide management services to AIF, as well as AIFMs established in an EU member state which do not provide management services to EU domiciled AIFs nor market AIFs in the EU, are not covered by the proposed Directive.

Non-EU AIFs may be denied marketing access to the EU

AIFMs or other entities which are not established in an EU member state (such as all US and Asian hedge fund managers and marketers) will be prohibited from marketing AIFs in the EU, even under the existing domestic private placement rules of the member states. In theory, such non-EU established managers may apply to a member state to become authorised to market their AIFs to professional investors in the EU, but in practice it may be impossible for the requirements for authorisation to be satisfied. These requirements include a determination having been taken by the Commission (rather than the relevant member state) that the legislation of the non-EU country in which the AIFM is established in relation to prudential regulation and ongoing supervision is equivalent to the provisions of the proposed Directive, that AIFMs established in the EU are granted comparable effective market access to professional investors in that non-EU country and that, as described above, the non-EU country has entered into an agreement on sharing information in tax matters with each EU member state in which the AIF is to be marketed. As regards the market access condition, it is notable that regulators in the EU and the US have been endeavouring without success for over 30 years to agree reciprocal access for UCITS funds and their US equivalent. The above requirements do not, however, apply to AIFMs established in an EU member state, and therefore non-EU hedge fund managers wishing to continue to market their AIFs in the EU will be forced to establish a place of business in the EU and become authorised under the proposed Directive.

Depositaries, prime brokers and liability issues

An AIFM will be obliged to ensure that each AIF that it manages appoints an EU credit institution as a depositary of its cash and other assets (the concept of a depositary is borrowed from the UCITS Directive and indicates a custody function with additional regulatory responsibilities beyond those normally attaching to mere custodians). The proposed Directive provides that the depositary may delegate its tasks to other depositaries (presumably acting as sub-depositaries/sub-custodians) but while it is silent as to whether such other depositaries must also be EU credit institutions, that appears to be the position, except in the case of the depositary of a non-EU domiciled AIF which will be permitted to delegate to a depositary

established in the same domicile subject to certain conditions. Since currently only two of the principal prime brokers are EU credit institutions or have such an institution in their group, and none of the principal prime brokers are established in any of the non-EU domiciles in which AIFs are usually established, these restrictions will clearly make it difficult, if not impossible, for an AIF to appoint or continue the appointment of the prime broker(s) of its choice. If US hedge fund managers are forced to establish a place of business in the EU as an AIFM and become authorised under the proposed Directive in order to market their AIFs in the EU, their prime brokerage arrangements will also need to be changed to comply with the proposed Directive.

The obligation to appoint a depositary will also extend to AIFs which are US or other limited partnerships. The structure of a limited partnership, which is managed for the benefit of its investors who are limited partners by a general partner that will usually be the AIFM itself or an affiliate thereof, does not lend itself well to the concept of appointing a depositary. It seems likely that, when faced with compliance with this obligation, many US hedge fund managers who have delegated responsibility for the investment management of an AIF to an AIFM which is a UK or other EU affiliate will consider closing that affiliate down.

Independent valuation agent required

An AIFM will also be obliged to ensure that each AIF that it manages appoints an independent valuation agent and, if the registered office of the valuation agent is outside the EU, the European Commission must first have determined that the valuation rules and standards used by valuation agents in the relevant third country are equivalent to those applicable in the EU (which assumes that there are EU rules and standards). Although IOSCO, AIMA and the Hedge Fund Standards Board recommend that an independent valuation agent be appointed, they all recognise that circumstances can exist where it is not always appropriate, and it is not yet a generally recognised practice among US hedge fund managers. The proposed Directive will have the effect that UK AIFMs which are affiliates of US hedge fund managers will not be able to comply with the requirements for authorisation, unless each AIF in respect of which they have been appointed as sub-adviser by their US parent has appointed an independent valuation agent.

Leverage

The proposed Directive contains provisions relating to AIFMs which manage one or more AIFs "employing high levels of leverage on a systematic basis". It is notable that this test differs from that expressed by IOSCO, the G20 and the Turner Report, which refers to hedge funds which are "systemically important". Under the Proposed Directive, the test will be deemed to be met by any AIF which employs leverage exceeding the "value of [its] equity capital", in which case certain disclosures to investors and regulators will have to be made. The level at which the test has been set will result in virtually all hedge funds being deemed to have met it (AIMA recently calculated that the average level of leverage employed by hedge funds is 1 times net assets and this was recognised in the FAQs issued by the European Commission when officially announcing the proposal for the proposed Directive).

The proposed Directive also contains a provision which requires that the European Commission, in order to ensure the stability and integrity of the financial system, adopt measures setting limits to the level of leverage which AIFMs can employ taking into account the type of AIF, their strategies and their sources of leverage. The proposed Directive suggests that such limits could either consist of a threshold that should not be breached at any time or a limit on average leverage employed during a given period (such as monthly or quarterly). This provision represents an undue interference by the European Commission in the commercial sphere.

Master-feeder structures and prime brokerage not addressed

The proposed Directive does not recognise that the majority of hedge funds operate through a master feeder structure, and it is not therefore clear how a number of its provisions will apply in practice. This is despite the fact that the UCITS Directive itself is currently being amended to cater for master-feeder structures. The proposed Directive does not recognise the concept of prime brokerage, and refers only to the concept of a depositary.

Timing and process

The proposed Directive will now be sent to the European Parliament and the European Council, where according to the European Commission itself "it is expected to be the object of intense political discussion and negotiation". Interested parties will also have an opportunity to influence such discussions and negotiation, both directly and through AIMA and other trade associations. It is hoped that this will result in a final text of the proposed Directive which is more proportionate and less protectionist, as well as being more sensitive to the differences between the structures employed by hedge funds and other AIFs and avoiding wholesale modifications to the structure of the asset management industry, including hedge funds. If political approval of the proposal is reached by the end of 2009, the proposed Directive could come into force in 2011. AIFM operating in the EU at that time will have a further year in which to obtain authorisation under the Directive.

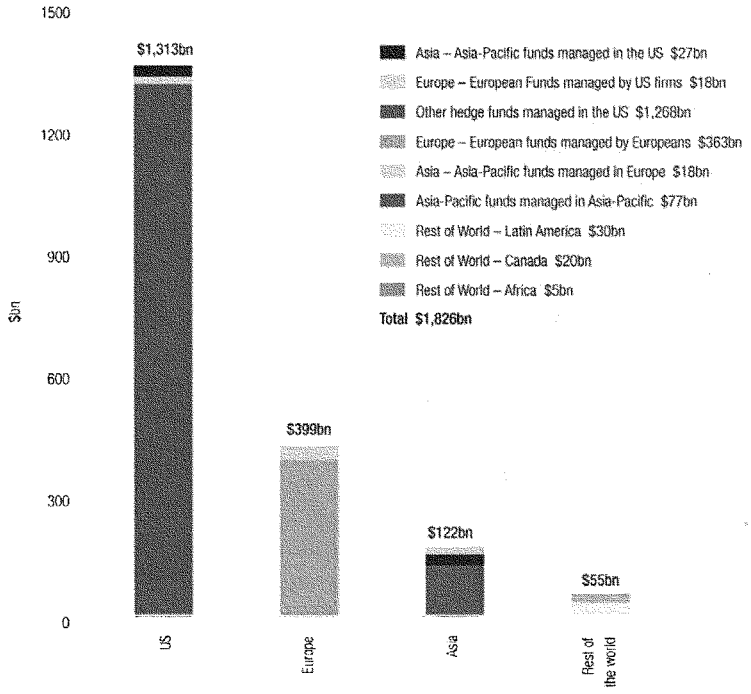
The above list of issues is not intended to be exhaustive and there are numerous additional areas where the drafting of the proposed Directive could and indeed will need to be improved.

Alternative Investment Management Association

APPENDIX 7

Overview of the global hedge fund industry

Chart 1: The $1.8 trillion hedge fund management industry and where it is located



Source: HedgeFund Intelligence (31 December 2008)

Chart 1 (above) shows that hedge funds are very much a global industry. The US is by far the leading location accounting for approximately 72% of the total of net AUM. Europe and Asia also provide significant offerings. These statistics represent single-manager hedge funds only. (To avoid double counting, fund of hedge funds are not included in these numbers.)

Hedge fund managers invest in a variety of strategies from equity related, plain vanilla to more sophisticated type strategies. Larger hedge fund management groups typically have a presence in multiple geographic regions.

Alternative Investment Management Association

Table 1: Assets under management by firms managing in excess of $1 billion

Hedge Fund Firms Greater than $1 bn AUM				
Date	Firms with >$1bn	Asset size Billion Dollar Club ($bn)	Total of hedge fund global assets ($bn)	% of billion dollar club
Dec-08	311	1455	1826	79.7%
Jun-08	395	2161	2697	80.1%
Dec-07	391	2083	2646	78.7%
Jun-07	381	1892	2482	76.2%
Dec-06	351	1564	2079	75.2%

Source: Hedge Fund Intelligence

As at 31 December 2008, there were 311 hedge fund manager firms globally that managed $1 billion hedge fund AUM or greater (together they managed over $1.4 trillion in hedge fund AUM. 70% of these firms are US based and 23% European, mostly London based.

New York remains the biggest location for hedge funds with over 123 firms that manage 46.2% of the total hedge fund AUM, thereafter followed by London with over 65 firms that manage 17% of the total of hedge fund AUM.

Global estimated number of hedge funds

As at the end of Q1 2009, Hedge Fund Research ("HFR") estimated that there were approximately 8,860 hedge funds and fund of funds operating worldwide. Of this, approximately 75% (or 6,644 funds) were single manager hedge funds while the remainder 25% (or 2,216 funds) being funds of hedge funds.

Global Regional Breakdown of Hedge Fund Industry

As per Chart 1, AUM for the US hedge fund industry accounts for approximately $1.313 trillion. Tables 2 and 3 below provide an overview of the European and Asian hedge fund industry AUM.

Alternative Investment Management Association

Table 2: Total European hedge fund assets by location

Country	Funds	AUM ($ millions)	% of Universe by AUM
UK	957	317,313.95	79.61%
Switzerland	153	13,747.67	3.45%
France	127	13,324.43	3.34%
Sweden	67	12,245.85	3.07%
Netherlands	25	9,798.67	2.46%
USA	41	9,462.35	2.37%
Norway	36	4,082.64	1.02%
Cyprus	10	2,767.16	0.69%
Ireland	24	1,841.82	0.46%
Italy	18	1,714.93	0.43%
Russia	19	1,592.46	0.40%
Spain	18	1,538.01	0.39%
Denmark	13	1,056.99	0.27%
Austria	18	1,053.14	0.26%
Finland	18	1,021.11	0.26%
Other	94	6,014.57	1.51%
Total	1638	398,575.75	100.00%

Source: Eurohedge

The UK accounts for approximately 80% of the total of hedge fund AUM managed in Europe. Other key locations for hedge fund managers in Europe include France, Switzerland and Sweden. Growth of the UK and European hedge fund industry has also primarily been driven by increased investment from institutional investors.

Table 3: Total Asia-Pacific hedge fund assets by location

Country	No of Funds	AUM ($billion)	% of Universe by AUM
UK	104	17.3	14.13%
USA	136	27.39	22.37%
Australia	145	27.05	22.09%
Japan	69	8.52	6.96%
Hong Kong	245	22.18	18.12%
China	9	0.62	0.51%
Singapore	150	15.93	13.01%
Other	70	3.44	2.81%
Total	928	122.43	100.00%

Source: Asiahedge

The Asia Pacific region is also increasingly important, both as a source of capital and location for managers. Both the UK and the US are leading locations for management of Asian hedge fund assets' making up for approximately 36% of Asian hedge fund AUM.

Alternative Investment Management Association

APPENDIX 8

AIMA's template for a global short selling reporting regime

Confidentiality requirement
Disclosure of positions should be made privately to the regulator and kept confidential.

Aggregation requirement
Any information provided to the market on short positions should be provided on an aggregate basis.

Position reporting requirement
Reporting should be on the basis of net short positions rather than on a trade marking basis, at manager rather than investor level (where practicable). A short position is deemed to arise at the time it is opened (i.e., time contract, not time of settlement).

Threshold reporting requirement
Net short positions above 1% of the issued share capital of the relevant stock should be reported.

Banding reporting requirement
An additional report should be made when a net short position increases by every 0.25% over 1%.

'Home state' nomination requirement
Each issuer should nominate a 'home state' to determine the destination and timing of reports (assumed to be the location of the primary listing for dual-listed securities).

Single report requirement
A single report should be made to the 'home state' regulator. (Arrangements should be made among regulators for appropriate sharing of reports, for example, where securities are dual listed. Sharing requirements already exist for sharing of some reports among EU regulators.)

Timing requirement
The aggregate net position should be calculated at midnight on the day on which the short position was opened (i.e., time of contract), referenced to the time-zone in which the 'home state' regulator is located. The report should be made within 48 hours of that time.

Language requirement
Reports may be made in English or the local language of the 'home state' regulator, at the option of the disclosing party.

Scope requirement
The reporting regime should apply to all 'listed' equities (with each regulator to produce a list of recognised exchanges) with a carve-out for baskets / indices / ETFs (subject to certain exceptions e.g., if a relevant stock makes up at least 1% of the class in issue and 20% or more of basket). Investments relating to un-issued equities would also be caught. In principle, derivatives will also be included on a delta-adjusted basis, although we appreciate that substantial complexities will need to be addressed to make derivative reporting workable and meaningful[4].

Perspectives on Hedge Fund Registration

Britt Harris, CIO of Teacher Retirement System of Texas

The Teacher's Retirement System of Texas is an $80 billion pension fund allowed (by law) to allocate up to 5% of total Trust assets to hedge funds. The allocation is made as a part of a more diversified strategy and serves three principle purposes. First, as a source of diversification, particularly during equity market corrections. Second, as an additional contributor to the Trust's long-term rate of return. Third, as a source of value added generated through skill (alpha) rather than market performance (beta). Hedge funds are not considered an important source of liquidity for our Fund.

Prior to selecting an individual firm, a strategic approach is established based on the objectives set out above. This results in the prioritization of certain investment approaches and in the de-emphasizing of others. This also establishes a set of expectations (before the fact) for how the overall strategy is expected to perform under various market conditions, relative to other investments made throughout the Trust, and in relationship to one another. This is central in the effective oversight to the investment process after funding, and in various market conditions.

Please describe in detail how your fund selects its hedge fund investments and the portion of its assets allocated to them.

The selection of individual investment firms is based on a multi-pronged process. First, a limited "Premier List" is established based on various parameters and the collaboration of all related experts employed by the Trust. That Premier List is updated at least twice annually and fully disclosed to the TRS Board. After placement on the Premier List each firm is subjected to a "Certification Process" that includes over 100 questions across eight key categories. The Certification Process is not intended to be a ranking system, but rather is designed to create a systematic and standardized body of information related to each firm. The results of this process form the minimum level of information that we require to warrant potential investment consideration. The eight categories are: Organization, Investment Process, Portfolio Exposure, Risk Management, Operations, Policies & Procedures, Transparency and Fund Terms. Investment firms that effectively pass through the Certification Process then enter into a risk management evaluation, where the final set of portfolios is based on risk systems rather than return outcomes. We are seeking the combination of portfolios that produces the highest projected return at a particular risk level and in the most reliable and understandable fashion. Due to the specific mandate that we have established at TRS, particular emphasis is now also placed on absolute return (e.g., positive results) during periods of equity market declines. The final portion of the selection process involves a detailed evaluation of the specific portfolio that the potential is likely to purchase, making sure that incentive structures are carefully established, and a thorough negotiation of legal terms.

This work is conducted by an internal team of dedicated and experienced investment professionals and presented to the senior investment management committee for approval prior to funding. Any funding approved is also reported to the full Board of Trustees by the first of the next month, along with a summary of the process, rationale and compliance with the Board's approved selection process.

Your views on H.R. 711, the Hedge Fund Advisor registration Act of 2009, and suggestions on how it can be improved.

It is first important to point out that no universally agreed upon definition of a "hedge fund" exists. Therefore, it becomes very difficult (if not impossible) to implement consistent legislation, which seeks to monitor and control the activities of a class of advisors which is not well defined. It is partly for this reason that it is difficult to draft an amendment to the existing Investment Advisor Act which will accurately target the class of advisors, typically referred as "Hedge Funds".

HR 711 proposes to eliminate the Private Advisors Exemption under Section 203(b)(3) of the Investment Advisor Act. The Private Advisors Exemption exempts advisors from registration under the Investment Advisor Act if it has less than 15 clients during the last 12 months, does not hold itself out to the public as an investment advisor, and does not act as an investment advisor to certain persons. A hedge fund manager falls squarely within the definition of an investment advisor as defined by the Investment Advisor Act, however the fund to which the manager advises is generally counted as 1 "client" for purposes of the Private Advisors Exemption. Accordingly, hedge fund managers have not typically had to register as an investment advisor under the Investment Advisor Act.

Before summarizing some of the issues with HR 711, it is worth noting that it essentially just revives a previous requirement for Hedge Funds (and other types of funds) to register with SEC. In and of itself this should not feel unreasonable to any market participant (including hedge fund managers). It is, after all, the norm for hedge funds to be registered in most other financial centers. Indeed, many managers claim to act 'as if they were registered' even if they have chosen not to.

However, a summary of issues raised by various leading law firms such as Dechert, Morrison Forester, Foley Hoag, and Hunton & Williams on HR 711 is listed below:

1. **Sweeping Scope of Hedge Fund Advisers Registration Act**: The title of the Bill suggests the aim is directed at HFs to register under the Investment Advisors Act. The proposed rule however would require many other advisers to register (i.e. investment managers and GPs of other pooled investment vehicles such as VC funds, PE fund, CDOs, and family limited partnerships.). The SEC "Look-Through Rule" that effectively eliminated the Private Advisers Exemption for HFs, but later vacated by the Goldstein decision, was carefully drafted so that pooled vehicles with investors having more than a 2 year holding period (most VC and PE funds) was exempted from the Look Through Rule.

2. **Non US Adviser Registration:** Foreign investment advisors are not currently required to count their "non-US" clients in determining whether the advisor has fewer than 15 clients under the Private Advisors Exemption and can have up to 15 US clients without registration, provided certain conditions are met. The proposed bill would effectively render this counting rule irrelevant. Under the proposed bill, it is possible that if a non US investment advisor has even 1 US client, registration may be required. This is contrary to previous SEC guidance and it is unclear what the jurisdictional basis will be to compel non-US investment advisors to register.

3. **Restricted Ability to Charge a Performance Fee:** Under the current Advisers Act, advisers cannot enter into a contract to share in the capital gains or capital appreciation of the client's account with certain classes of client. This would not affect institutional investors, which are qualified purchasers as well as other investors deemed to be a qualified client. It may be difficult for smaller investment managers to operate under this new registration regime without being able to charge performance fees, especially since HF registration would increase compliance costs. However, this is unlikely to affect investors like TRS.

4. **No Grandfathered Provisions Record Keeping Requirements:** As a registered investment advisor, extensive records are required. It is not clear from the proposed bill whether HFs can use information which may be of interest to investors even if those old records are not up to the Investment Advisors "standard" (i.e. past performance information presented to clients).

We would add that this amendment to existing legislation is likely to prove unsatisfactory, as:

- it is a piecemeal response and does not address the actors that actually caused the financial crisis – banks, brokers, rating agencies
- the Investment Company Act is designed primarily for investor protection and is not designed to control systematic risk
- the Investment Company Act was adopted in 1940, and as such is not tailored for the investment structures and strategies that have prevailed over the last 30 years.

It is a one-size-fits-all legislation and is not tailored for the risk areas – entities that have scale, are complex and are systematically important.

Furthermore, it does not address what regulators need to do to assess systematic risk and may be unduly burdensome for smaller funds and investors.

- While it may be appropriate to require that essentially all firms register with the SEC, it is not appropriate to require that all firms produce detailed reports for that, or any particular, regulatory organization. The results from the vast majority of smaller firms do not create any significant systemic risk to the overall system and collection of that data would be a distraction and unduly burdensome for both the

managers and the regulatory bodies. However, basic and accurate information and reporting should be required for communication with all potential investors.

- Systemic risk stems from highly identifiable sources and it is those sources that should be most aggressively monitored. First, there are only a small number of investment managers who are large enough to potentially create a significant systemic event, either individually or collectively. That number is perhaps fifty to one hundred firms globally. Those firms are sufficiently important so that their investment processes should be monitored (on a confidential, non-invasive, and non-public means) and aggregated. The factors that should be monitored however are important, but few in number. Those factors would include: assets under management, leverage (including trends), liquidity (including trends), accuracy of valuation, concentration (including trends), leverage relative to a reasonable measure of the historically normal opportunity set, and exposure to counterparties.
- The regulator needs to engage with industry participants (e.g., President's Working Group, etc.) and collaborate on this and other issues.
- Information requirements should also be flexible enough to capture the different types of risks that will be identified by the industry and regulators over time.

How you believe the Congress can achieve the appropriate balance between providing appropriate regulation of the hedge fund industry aimed at protecting investors without unduly inhibiting the benefits hedge funds provide investors and the market more broadly.

The mission of the SEC is to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. Investment and capital markets function based on trust and a belief in the long-term effectiveness of specific economic theories, political policies, and legal structures. The principle issues that can prevent the SEC from fulfilling its mission are systemic risk, fraud and inequity between investors.

When regulation is ineffective it is generally because it was either inadequate or excessive. These two bi-model outcomes are common. Effective regulation does not overreach its reasonable bounds, based solely on the fact that more must always be better. Nor does it excessively regulate those who are not large enough to comply with regulations designed to prevent outcomes that those firms could never realistically create. It is also very important that regulation does not stifle innovation, reduce productivity and inappropriately skew the risk/reward system that creates an effective and productive society.

Congress can best achieve its mission by focusing only on a limited, but unusually important, set of key factors and also primarily on the types of investment organizations that might realistically create large and prolific problems. A one size fits all process is not appropriate and will not work. In addition, it is important that whatever appropriate regulations might be developed are fully resourced so that proper oversight and enforcement is possible and likely. It is unlikely that whatever organization might be created to oversee this process will be highly resourced or stable over long periods of time. For this reason, the factors and the firms that are fully monitored and fully included should be highly focused. Under these conditions, it will be much more important to

monitor and regulate the few things that really matter than to over-reach and cover everything ineffectively. In fact, a strong argument can be made that the current "rules and regulations" are more than sufficient but were simply not adequately monitored and enforced due to various issues, but primarily limited resources and excessive distraction.

Finally, simplicity should be preferred over complexity and a "common language" should be developed to assure accurate interpretation of whatever data is eventually required.

Describe the benefits of having a diverse asset allocation.
Diversification has been called the only "free lunch" in investing. Its premise is that the combination of two, or more, investments with low correlations will allow the projected return of the combined portfolio to remain "high" while the combined risk of the portfolio falls. This is a well documented and highly accredited phenomenon and has largely served long-term investors well. Many say that the route to wealth is through concentration, but that the way to remain wealthy is through diversification. Those statements are for the most part correct. In addition, either concentration of assets or attempts to aggressively forecast market movements have generally proven unsuccessful strategies for the vast majority of investors.

However, proper diversification is sometimes more difficult than it appears, principally for the following reasons. First, long-term correlations are often inadequate guides to what the actual correlations will be when periods of significant stress arise. Specifically, when significant equity market corrections occur many correlations that were projected to be relatively low often rise dramatically. Secondly, dollar allocation is a poor guide to actual diversification when measured as the marginal contributor to risk. For instance, while most funds allocate approximately 60% to equity investments it is generally the case that equity investments contribute more than 90% of the actual risk of the portfolio. Of course, this is using the standard measures of risk relative to prospective returns that vastly mismatches time horizons (e.g, long term investment planning with short-term risk measures). Third, the number of asset classes for use in diversifying is highly limited and more correlated than desired.

Many of the strategies followed by hedge funds are attempts to address the problems with traditional diversification just cited. The fact that the potential for achieving a satisfactory long-term return generally requires a large equity position is addressed by some hedge funds by rebalancing risk (say, 50% equity, 50% bonds) and using leverage to return the total portfolio to the original target return. In addition, the ability to identify and combine uncorrelated alphas, while difficult, is virtually unlimited. The desired result by most large institutions is to use hedge funds as a new source of return that is largely uncorrelated with either stocks or bonds.

Describe the dialogue that occurs between investors and hedge fund managers and the due diligence you conduct in selecting asset managers.
At TRS, each hedge fund investment is viewed as a relationship and maintaining an open dialogue with a manager is vital to the success of the program. Formal calls and meetings are held monthly/quarterly, but the informal calls are every bit as important.

Hedge funds are viewed as a "head light" system in order to help TRS navigate towards opportunity and away from risks. TRS conducts extensive due diligence prior to making an investment in any hedge fund. This is called the Certification Process and consists of thorough documentation, on-site visits, operations checks and background analysis. Additional due diligence is conducted by our consultants, who sign-off on each hedge fund manager in which TRS invests.

The types of questions that regulators should be asking hedge fund managers to better understand their trading strategies.
The primary role of regulators is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Stated differently, they prevent fraud, protect against systematic risks and encourage trust in the system. The questions regulators ask should help them achieve those objectives.

The following areas of inquiry, as recommended by the President's Working Group (Investors Committee) would be relevant to regulators in their oversight capacity. They address systematic risks (leverage, liquidity, counterparty risk) and ensuring the integrity of the system (reporting and transparency)

Managing Liquidity and Leverage Risk

- Definition of leverage, as well as which investment strategies and instruments utilized by the hedge fund will generate levered exposure.
- Plans for reducing leverage if limits are exceeded.
- Source of leverage capital in any investment strategy
- Financing arrangements of the fund and constraints those arrangements place on the fund in terms of leverage, liquidity, operations, or otherwise
- Risks to the continued availability of financing and alternatives available to replace existing leverage financing in case of market dislocation or problems with an existing leverage provider.
- How frequently managers conduct liquidity stress - testing and scenario analysis, and understand its scope.
- Liquidity terms of their investment in the context of the fund's underlying asset liquidity and redemption policy
- Circumstances in which a fund can suspend redemptions and measures that managers employ to mitigate the risk of such suspensions.

Counterparty Risk

- Prime broker(s) and other material credit or trading counterparties of the fund and the manager's process for analyzing and diversifying prime broker and counterparty risk.
- Frequency the manager trades over-the-counter instruments, and what portion of the hedge fund's portfolio is exposed to the risks of over-the-counter markets.
- Stress-testing of counterparty arrangements to understand the circumstances in which a trading relationship can be unwound or margin/collateral requirements increased.

Reporting and Transparency

- Scope and timeliness of a fund's transparency and disclosure.
- Sample reports and the firm's commitment to providing these metrics on an ongoing basis.
- Information regarding a hedge fund's strategies, terms, conditions and risk management.
- Critical disclosures and metrics on a consistent and timely basis including:
    - General asset classes to which the portfolio is allocated.
    - Individual holdings to evaluate the associated risk exposures, (i.e. types of securities the fund holds, broken down by sector, duration, credit quality, geographic region, and exposures related to derivative positions.)
    - Percentage of hedge fund portfolio that managers classify as "illiquid."
- Disclosure of conflicts of interests
- Audit procedures and histories

What kinds of information hedge fund managers should voluntarily provide to investors and regulators.

Hedge fund managers should voluntarily provide sufficient transparency to enable investors to comply with the PWG Investors' Committee's principles and best practices. This would include:

- Description of strategy
- AUM at the fund, strategy and firm level
- Returns/performance of the fund (monthly, ideally daily/weekly)
- Pending redemption profile (e.g. what is gated, when do gates roll off)
- Service Providers, in particular changes to service providers
- Aggregated risk information, including leverage usage or gross and net exposures (this may include position level data)
- Liquidity profile
- Large position concentration
- Hard to price assets and methodology used
- Key personnel and changes to them
- Counterparties and exposures to them
- General market and fund specific updates (e.g. monthly newsletter)
- Prospectus, DDQ, financial statements, incorporation certificate

Your views on the recent publicized attempts by some pension funds to increase hedge fund transparency on their own and to re-negotiate the standard fee structure funds charge.

Recent conditions have highlighted the need to increasingly implement a system organized around the phrase "trust but verify". No longer should investors readily accept statements from managers such as "we don't disclose" or "that is proprietary". However, with that said, it should not be concluded that infinitesimal transparency is always

preferred and worthwhile. Reports are needed that effectively describe the overall portfolio and reveal its most important position and its most significant risks. This may, or may not, mean that position level reporting is required. In fact, position level reporting can sometimes be both a distraction for the investor and a competitive disadvantage for the manager.

In addition, transparency should presumably be separated into two categories. The first category would be the risk issues that could significantly disrupt the investment process and create an outcome that was both negative and largely unanticipated. These risks are described above but will be repeated here for convenience. They are (i) assets under management, (ii) leverage, (iii) liquidity, (iv) concentration, (v) counterparty exposure, trends in these factors, (vi) fat tail risks and (vi) and changes in the opportunity set specified for the manager.

The second category would be risk compliance and more oriented to policy guidelines and less likely to produce large and unanticipated losses. These kinds of risks are what is usually reported and can be a distraction if the objective is to monitor for "catastrophic" risks.

The second major category of risk – fraud – is somewhat more difficult to capture after the fact. Thankfully, it also seems rare – at least in the high end institutional world. Nonetheless, there are certainly notable exceptions and whatever reasonable steps that can be taken to reduce its occurrence should be considered. There is little that can be done to prevent a determined "swindler" from initiating a fraud. However, here is a list of items that can be helpful: use of segregated accounts, limitations on self dealing, use of a properly qualified accounting and performance firm, use of a high quality custodian, and the monitoring of unusually lengthy settlements. It is also helpful to have direct and personal long-term relationships with key personnel in both the trading and the custodial world. Finally, detecting fraud often requires the use of common sense and the willingness to question things that seem "to good to be true".

TRS has adopted the recent recommendations established by the President's Working Group. Thus far, 35 of our 44 hedge fund relationships have stated that they are fully compliant. The majority of the remainder has indicated that they will be appropriately compliant no later than year end.

Regarding fees, there are two significant considerations. First, performance related fees should be properly aligned between investors and managers thereby creating productive incentives for long-term performance. Second, hedge fund fees should generally be paid solely for alpha (market outperformance) and should be largely independent of market performance. The production of "alpha" is often exceedingly difficult and "zero sum". However, when it is achieved it can be particularly helpful in creating long-term returns. New arrangements should now be considered that reduce the typical hedge fund management fees while continuing to allow for mutually acceptable arrangements regarding performance fees.

What the Congress should do—besides mandating registration- to increase transparency of hedge funds and better protect investors.
Congress should look at encouraging investors to take responsibility for their own due diligence and risk monitoring because this becomes a powerful catalyst for improving the standards within the hedge fund industry. In some circumstances, such as when a hedge fund blow-up turns out to be a fraud, investors can actually be effectively penalized for actively getting out of the fund because it failed to meet its due diligence standards as opposed to claiming it was just redeeming in the regular course of that investors activities. This sends a perversely mixed message to the investor community. "Buyer beware" should augment the law, not contradict it.

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House of Representatives

For Release on Delivery
Expected at 11:00 a.m. EDT
Thursday, May 7, 2009

HEDGE FUNDS

Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges

Statement of Orice M. Williams, Director
Financial Markets and Community Investment

GAO-09-677T

May 7, 2009

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-09-677T, a testimony to Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

HEDGE FUNDS

Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges

Why GAO Did This Study

In 2008, GAO issued two reports on hedge funds—pooled investment vehicles that are privately managed and often engage in active trading of various types of securities and commodity futures and options contracts—highlighting the need for continued regulatory attention and for guidance to better inform pension plans on the risks and challenges of hedge fund investments. Hedge funds generally qualified for exemption from certain securities laws and regulations, including the requirement to register as an investment company. Hedge funds have been deeply affected by the recent financial turmoil. But an industry survey of institutional investors suggests that these investors are still committed to investing in hedge funds in the long term. For the first time hedge funds are allowed to borrow from the Federal Reserve under the Term-Asset Backed Loan Facility. As such, the regulatory oversight issues and investment challenges raised by the 2008 reports still remain relevant.

This testimony discusses: (1) federal regulators' oversight of hedge fund-related activities; (2) potential benefits, risks, and challenges pension plans face in investing in hedge funds; (3) the measures investors, creditors, and counterparties have taken to impose market discipline on hedge funds; and (4) the potential for systemic risk from hedge fund-related activities. To do this work we relied upon our issued reports and updated data where possible.

View GAO-09-677T or key components. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

Under the existing regulatory structure, the Securities and Exchange Commission and Commodity Futures Trading Commission can provide direct oversight of registered hedge fund advisers, and along with federal bank regulators, they monitor hedge fund-related activities conducted at their regulated entities. Although some examinations found that banks generally have strengthened practices for managing risk exposures to hedge funds, regulators recommended that they enhance firmwide risk management systems and practices, including expanded stress testing. The federal government does not specifically limit or monitor private sector plan investment in hedge funds. Under federal law, fiduciaries must comply with a standard of prudence, but no explicit restrictions on hedge funds exist.

Pension plans invest in hedge funds to obtain a number of potential benefits, such as returns greater than the stock market and stable returns on investment. However, hedge funds also pose challenges and risks beyond those posed by traditional investments. For example, some investors may have little information on funds' underlying assets and their values, which limits the opportunity for oversight. Plan representatives said they take steps to mitigate these and other challenges, but doing so requires resources beyond the means of some plans.

According to market participants, hedge fund advisers have improved disclosures and transparency about their operations as a result of industry guidance issued and pressure from investors and creditors and counterparties. Regulators and market participants said that creditors and counterparties have generally conducted more due diligence and tightened their credit standards for hedge funds. However, several factors may limit the effectiveness of market discipline or illustrate failures to properly exercise it. Further, if the risk controls of creditors and counterparties are inadequate, their actions may not prevent hedge funds from taking excessive risk and can contribute to conditions that create systemic risk if breakdowns in market discipline and risk controls are sufficiently severe that losses by hedge funds in turn cause significant losses at key intermediaries or in financial markets.

Financial regulators and industry observers remain concerned about the adequacy of counterparty credit risk management at major financial institutions because it is a key factor in controlling the potential for hedge funds to become a source of systemic risk. Although hedge funds generally add liquidity to many markets, including distressed asset markets, in some circumstances hedge funds' activities can strain liquidity and contribute to financial distress. In response to their concerns regarding the adequacy of counterparty credit risk, a group of regulators had collaborated to examine particular hedge fund-related activities across entities they regulate, and the President's Working Group on Financial Markets (PWG). The PWG also established two private sector committees that recently released guidelines to address systemic risk and investor protection.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to participate in today's hearing on hedge funds. A hedge fund is a pooled investment vehicle that is privately managed and often engages in active trading of various types of securities and commodity futures and options. In general, hedge funds qualify for exemption from certain securities laws and regulations, including the requirement to register as an investment company.[1] When we conducted the two studies on hedge funds in 2007, the hedge fund sector was growing in importance and continuing to evolve within the financial system. Hedge funds, largely driven by investments from institutional investors, such as endowments, foundations, insurance companies, and pension plans, seeking to diversify their risks and increase returns, have grown dramatically over the last decade. From 1998 to early 2007, the estimated number of funds grew from more than 3,000 to more than 9,000 and assets under management from $200 billion to more than $2 trillion globally.[2] An estimated $1.5 trillion of these assets is managed by U.S. hedge fund advisers. Hedge funds have significant business relationships with the largest regulated banking organizations. Hedge funds act as trading counterparties for a wide range of over-the-counter derivatives and other financing transactions. They also act as clients through their purchase of clearing and other services and as borrowers through their use of margin loans from prime brokers.

Much has happened in the financial markets since we issued our reports. Hedge funds have been deeply affected in the financial turmoil. According to an industry survey, most hedge fund strategies produced double-digit losses in 2008 and hedge funds saw approximately $70 billion in redemptions between June and November 2008.[3] Some observers blamed hedge funds for dramatic volatility in the stock and commodity markets last year and some funds of hedge funds were heavily invested in the

[1]To avoid being required to register as an investment company under the Investment Company Act of 1940 (Investment Company Act), hedge funds typically rely on sections 3(c)(1) or 3(c)(7) of that act. Hedge fund advisers also typically satisfy the "private manager" exemption from registration under section 203(b)(3) of the Investments Advisers Act of 1940 (Advisers Act).

[2]By comparison, assets under management in the mutual fund industry grew from about $5.5 trillion in 1998 to about $10.4 trillion in 2006.

[3]Greenwich Associates and SEI Knowledge Partnership, *Hedge Funds Under the Microscope: Examining Institutional Commitment in Challenging Times* (January 2009).

alleged Madoff fraud. Nevertheless, an industry survey of institutional investors suggests that these investors are still committed to investing in hedge funds in the long term.[4] Financial regulators' views on hedge funds appear to be shifting as well, perhaps signaling recognition that hedge funds have become an integral part of the financial markets. For example, hedge funds are allowed to borrow from the Federal Reserve for the first time under the Term Asset-Backed Securities Loan Facility (TALF) intended to support consumer credit. While the Federal Reserve Chairman and Treasury Secretary have supported the position of enhanced market discipline over stricter regulation of hedge funds in 2007, Treasury has recently called for greater regulatory oversight of hedge funds. Despite changes surrounding the hedge fund sector, the issues and concerns related to regulatory oversight of hedge funds and challenges posed by hedge fund investing that were raised in our 2008 reports remain relevant today.

This statement is based on our January 24, 2008 and August 14, 2008 reports.[5] Specifically, I will discuss: (1) the oversight of hedge fund-related activities provided by federal financial regulators under their existing authorities; (2) the potential benefits, risks, and challenges pension plans face in investing in hedge funds; (3) the measures investors, creditors, and counterparties have taken to impose market discipline on hedge funds; and (4) the potential for systemic risk from hedge fund-related activities and actions regulators have taken to address this risk.

To do this work, we reviewed and analyzed relevant regulatory examination documentation and enforcement cases from federal financial regulators. We also analyzed relevant laws and regulations, survey data, speeches, testimonies, studies, and industry protocols and guidelines about private pools of capital. In addition, we interviewed officials representing various U.S. regulators, as well as representatives from market participants such as commercial and investment banks, large hedge funds, pension industry participants, credit rating agencies, a risk management firm, trade groups representing hedge funds and institutional

[4]SEI Knowledge Partnership and Greenwich Associates, *Hedge Funds Under the Microscope.*

[5]GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed,* GAO-08-200 (Washington, D.C. Jan. 24, 2008) and *Defined Benefit Pension Plans: Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity,* GAO-08-692 (Washington, D.C. Aug. 14, 2008)

investors, and academics. We conducted these performance audits from September 2006 to August 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Summary

Under the existing regulatory structure, the Securities and Exchange Commission's (SEC) ability to directly oversee hedge fund advisers is limited to those that are required to register or voluntarily register with SEC as an investment advisor. Examinations of registered advisers raised concerns in areas such as disclosure, reporting and filing, personal trading, and asset valuation. SEC also oversees some of the securities firms that engage in significant hedge fund-related activities. The Commodity Futures Trading Commission (CFTC) regulates those hedge fund advisers who are registered as registered as commodity pool operators (CPO) or commodity trading advisors (CTA). Federal banking regulators monitor hedge fund-related activities conducted at their regulated entities.[6] Although some examinations found that banks generally have strengthened practices for managing risk exposures to hedge funds since the 1998 near collapse of Long-Term Capital Management (LTCM), a large highly leveraged hedge fund, regulators recommended that they enhance firmwide risk management systems and practices, including expanded stress testing.[7] Regulated entities have the responsibility to practice prudent risk management standards, but prudent standards do not guarantee prudent practices. As such, it will be important for regulators to show continued vigilance in overseeing the hedge fund-related activities of regulated institutions. The federal government does not specifically limit or monitor private sector plan investment in hedge funds, and state approaches to public plans vary. Under federal law, fiduciaries must comply with a standard of prudence, but no explicit restrictions on hedge funds exist.

[6]Banking regulators include the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Federal Reserve), and Federal Deposit Insurance Corporation (FDIC).

[7]Inadequate market discipline is often cited as a contributing factor to the near collapse in 1998 of LTCM.

Pension plans invest in hedge funds in order to achieve one or more of several goals, including steadier, less volatile returns, obtaining returns greater than those expected in the stock market, or diversification of portfolio investments. Nonetheless, hedge fund investments pose investment challenges beyond those posed by traditional investments in stocks and bonds. For example, some investors may have little information on funds' underlying assets and their values, which limits the opportunity for oversight. Plan officials and others described steps plans can take to address these challenges. However, they said that some of these steps require considerably greater effort and expertise from fiduciaries than is required for more traditional investments, and such steps may be beyond the capabilities of some pension plans, particularly smaller ones.

According to market participants, hedge fund advisers had improved disclosures and transparency about their operations since LTCM as a result of industry guidance issued and pressure from investors and creditors and counterparties (such as prime brokers), but noted limitations. Regulators and market participants also said that creditors and counterparties had generally conducted more due diligence and tightened their credit standards for hedge funds. However, several factors may limit the effectiveness of market discipline or illustrate failures to properly exercise it. For example, because most large hedge funds use multiple prime brokers as service providers, no one broker may have all the data necessary to assess the total leverage of a hedge fund client. Further, if the risk controls of creditors and counterparties are inadequate, their actions may not prevent hedge funds from taking excessive risk. These factors can contribute to conditions that create systemic risk if breakdowns in market discipline and risk controls are sufficiently severe that losses by hedge funds in turn cause significant losses at key intermediaries or instability in financial markets.

Financial regulators and industry observers remained concerned about the adequacy of counterparty credit risk management at major financial institutions because it is a key factor in controlling the potential for hedge funds to become a source of systemic risk. Although hedge funds generally add liquidity to many markets, including distressed asset markets, in some circumstances hedge funds' activities can strain liquidity and contribute to financial distress. For example, the concentration created by numerous market participants establishing large positions on the same side of a trade, especially in combination with a high degree of leverage, can contribute to a liquidity crisis if market conditions compel traders to simultaneously unwind their positions. In response to their concerns

regarding the adequacy of counterparty credit risk, a group of regulators had collaborated to examine particular hedge fund-related activities across entities they regulate, mainly through international multilateral efforts and the President's Working Group on Financial Markets (PWG).[8] The PWG also has established two private sector committees to identify best practices to address systemic risk and investor protection, which released reports for comments in 2008 and issued final reports in 2009 respectively.

[8]The PWG was established by Executive Order 12631, signed on March 18, 1988. The Secretary of the Treasury chairs the PWG, the other members of which are the chairpersons of the Board of Governors of the Federal Reserve System, Securities and Exchange Commission, and Commodity Futures Trading Commission. The group was formed in 1988 to enhance the integrity, efficiency, orderliness, and competitiveness of the U.S. financial markets and maintain the public's confidence in those markets.

Hedge Funds Generally Are Subject to Limited Direct Oversight and the Federal Government Does Not Specifically Limit or Monitor Private Sector Plans' Investments in Hedge Funds

SEC's ability to directly oversee hedge fund advisers is limited to those that are required to register or voluntarily register with SEC as investment advisers. Registered hedge fund advisers are subject to the same disclosure requirements as all other registered investment advisers. These advisers must provide current information to both SEC and investors about their business practices and disciplinary history. Advisers also must maintain required books and records, and are subject to periodic examinations by SEC staff. Meanwhile, hedge funds, like other investors in publicly traded securities, are subject to various regulatory reporting requirements. For example, upon acquiring a 5 percent beneficial ownership position of a particular publicly traded security, a hedge fund may be required to file a report disclosing its holdings with SEC.[9]

In December 2004, SEC adopted an amendment to Rule 203(b)(3)-1, which had the effect of requiring certain hedge fund advisers that previously enjoyed the private adviser exemption from registration to register with SEC as investment advisers. In June 2006, a federal court vacated the 2004 amendment to Rule 203(b)(3)-1.[10] According to SEC, when the rule was in effect (from February 1, 2006, through August 21, 2006), SEC was better able to identify hedge fund advisers. In August 2006, SEC estimated that 2,534 advisers that sponsored at least one hedge fund were registered with the agency. Since August 2006, SEC's ability to identify an adviser that manages a hedge fund has been further limited due to changes in filing

[9]Under the Securities Act of 1933, a public offering or sale of securities must be registered with SEC, unless otherwise exempted. In order to exempt an offering or sale of hedge fund shares (ownership interests) to investors from registration under the Securities Act of 1933, most hedge funds restrict their sales to accredited investors in compliance with the safe harbor requirements of Rule 506 of Regulation D. See 15 U.S.C. § 77d and § 77e; 17 C.F.R. § 230.506 (2007). Such investors must meet certain wealth and income thresholds. SEC generally has proposed a rule that would raise the accredited investor qualification standards for individual investors (natural persons) from $1 million in net worth to $2.5 million in investments. See *Revisions to Limited Offering Exemptions in Regulation D*, 72 Fed. Reg. 45116 (Aug. 10, 2007) (proposed rules and request for additional comments). In addition, hedge funds typically limit the number of investors to fewer than 500, so as not to fall within the purview of Section 12(g) of the Securities Exchange Act of 1934, which requires the registration of any class of equity securities (other than exempted securities) held of record by 500 or more persons. 15 U.S.C. § 78l(g).

[10]See *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006). In Goldstein, the U.S. Circuit Court of Appeals for the District of Columbia held that SEC's hedge fund rule was arbitrary because it departed, without reasonable justification, from SEC's long-standing interpretation of the term "client" in the private adviser exemption as referring to the hedge fund itself, and not to the individual investors in the fund. See footnote 19, supra, for a description of the private adviser exemption from registration under the Advisers Act.

requirements and to advisers that chose to retain registered status. As of April 2007, 488, or about 19 percent of the 2,534 advisers, had withdrawn their registrations. At the same time, 76 new registrants were added and some others changed their filing status, leaving an estimated 1,991 hedge fund advisers registered. While the list of registered hedge fund advisers is not all-inclusive, many of the largest hedge fund advisers—including 49 of the largest 78 U.S. hedge fund advisers—are registered. These 49 hedge fund advisers account for approximately $492 billion of assets under management, or about 33 percent of the estimated $1.5 trillion in hedge fund assets under management in the United States. In an April 2009 speech, Chairman Schapiro stated that there are approximately150 active hedge fund investigations at SEC, some of which include possible Ponzi schemes, misappropriations, and performance smoothing. In a separate speech in April, Chairman Schapiro renewed SEC's call for greater oversight of hedge funds, including the registration of hedge fund advisers and potentially the hedge funds themselves.

SEC uses a risk-based examination approach to select investment advisers for inspections. Under this approach, higher-risk investment advisers are examined every 3 years. One of the variables in determining risk level is the amount of assets under management. SEC officials told us that most hedge funds, even the larger ones, do not meet the dollar threshold to be automatically considered higher-risk. In fiscal year 2006, SEC examined 321 hedge fund advisers and identified issues (such as information disclosure, reporting and filing, personal trading, and asset valuation) that are not exclusive to hedge funds. Also, from 2004 to 2008, SEC oversaw the large internationally active securities firms on a consolidated basis.[11] These securities firms have significant interaction with hedge funds through affiliates previously not overseen by SEC. One aspect of this program was to examine how the securities firms manage various risk exposures, including those from hedge fund-related activities such as providing prime brokerage services and acting as creditors and counterparties. SEC found areas where capital computation methodology and risk management practices can be improved.

[11]In September 2008, SEC ended the Consolidated Supervised Entities program, created in 2004 as a way for global investment bank conglomerates that lack a supervisor under law to voluntarily submit to regulation. The agency plans for enhancing SEC oversight of the broker-dealer subsidiaries of bank holding companies regulated by the Federal Reserve, based on a Memorandum of Understanding between the two agencies.

Similarly, CFTC regulates those hedge fund advisers registered as CPOs or CTAs. CFTC has authorized the National Futures Association (NFA), a self-regulatory organization for the U.S. futures industry, to conduct day-to-day monitoring of registered CPOs and CTAs. In fiscal year 2006, NFA examinations of CPOs included six of the largest U.S. hedge fund advisers. In addition, SEC, CFTC, and bank regulators can use their existing authorities—to establish capital standards and reporting requirements, conduct risk-based examinations, and take enforcement actions—to oversee activities, including those involving hedge funds, of broker-dealers, of futures commission merchants, and of banks, respectively.

While none of the regulators we interviewed specifically monitored hedge fund activities on an ongoing basis, generally regulators had increased reviews—by such means as targeted examinations—of systems and policies to mitigate counterparty credit risk at the large regulated entities. For instance, from 2004 to 2007, the Federal Reserve Bank of New York (FRBNY) had conducted various reviews—including horizontal reviews—of credit risk management practices that involved hedge fund-related activities at several large banks.[12] On the basis of the results, FRBNY noted that the banks generally had strengthened practices for managing risk exposures to hedge funds, but the banks could further enhance firmwide risk management systems and practices, including expanded stress testing.

The federal government does not specifically limit or monitor private sector pension investment in hedge funds and, while some states do so for public plans, their approaches vary. Although the Employee Retirement and Income Security Act (ERISA) governs the investment practices of private sector pension plans, neither federal law nor regulation specifically limit pension investment in hedge funds or private equity. Instead, ERISA requires that plan fiduciaries apply a "prudent man" standard, including diversifying assets and minimizing the risk of large losses. The prudent man standard does not explicitly prohibit investment in any specific category of investment. The standard focuses on the process for making investment decisions, requiring documentation of the investment decisions, due diligence, and ongoing monitoring of any managers hired to invest plan assets. Plan fiduciaries are expected to meet general standards of prudent investing and no specific restrictions on investments in hedge funds or private equity have been established. The Department of Labor is

[12]A horizontal review is a coordinated supervisory review of a specific activity, business line, or risk management practice conducted across a group of peer institutions.

tasked with helping to ensure plan sponsors meet their fiduciary duties; however, it does not currently provide any guidance specific to pension plan investments in hedge funds or private equity.

Conversely, some states specifically regulate and monitor public sector pension investment in hedge funds, but these approaches vary from state to state. While states generally have adopted a "prudent man" standard similar to that in ERISA, some states also explicitly restrict or prohibit pension plan investment in hedge funds or private equity. For instance, in Massachusetts, the agency overseeing public plans will not permit plans with less than $250 million in total assets to invest directly in hedge funds. Some states have detailed lists of authorized investments that exclude hedge funds and/or private equity. Other states may limit investment in certain investment vehicles or trading strategies employed by hedge fund or private equity fund managers. While some guidance exists for hedge fund investors, specific guidance aimed at pension plans could serve as an additional tool for plan fiduciaries when assessing whether and to what degree hedge funds would be a prudent investment.

Pension Plans Seek Various Investment Objectives through Hedge Funds, and Such Investments Pose Challenges That Require Considerable Effort and Expertise to Address

According to several 2006 and 2007 surveys of private and public sector plans, investments in hedge funds are typically a small portion of total plan assets—about 4 to 5 percent on average—but a considerable and growing number of plans invest in them.[13] Updates to the surveys indicated that institutional investors plan to continue to invest in hedge funds. One 2008 survey reported that nearly half of over 200 plans surveyed had hedge funds and hedge-fund-type strategies. This was a large increase when compared to the previous survey when 80 percent of the funds had no hedge fund exposure.[14] Pension plans' investments in hedge funds n part were a response to stock market declines and disenchantment with traditional investment management in recent years. Officials with most of the plans we contacted indicated that they invested in hedge funds, at least in part, to reduce the volatility of returns. Several pension plan officials told us that they sought to obtain returns greater than the returns of the overall stock market through at least some of their hedge fund investments. Officials of pension plans that we contacted also stated that hedge funds are used to help diversify their overall portfolio and provide a vehicle that will, to some degree, be uncorrelated with the other investments in their portfolio. This reduced correlation was viewed as having a number of benefits, including reduction in overall portfolio volatility and risk.

While any plan investment may fail to deliver expected returns over time, hedge fund investments pose investment challenges beyond those posed by traditional investments in stocks and bonds. These include the reliance on the skill of hedge fund managers, who often have broad latitude to engage in complex investment techniques that can involve various financial instruments in various financial markets; use of leverage, which amplifies both potential gains and losses; and higher fees, which require a plan to earn a higher gross return to achieve a higher net return. In addition to investment challenges, hedge funds pose additional challenges,

[13]We reviewed data from surveys of defined benefit pension plans conducted by three organizations—Greenwich Associates (covering mid- to large-size pension plans, with $250 million or more in total assets), Pyramis Global Advisors (covering mid- to large-size pension plans, with $200 million or more in total assets), and *Pensions & Investments* (limited to large plans, which generally had $1 billion or more in total assets). Greenwich Associates is an institutional financial services consulting and research firm; Pyramis Global Advisors, a division of Fidelity Investments, is an institutional asset management firm; and *Pensions & Investments* is a money management industry publication. These data cannot be generalized to all plans.

[14]Pyramis Global Advisers. *Pyramis Defined Benefit Survey Shows Institutional Investors Seek Balance in a Volatile World*, October, 2008

including: (1) limited information on a hedge fund's underlying assets and valuation (limited transparency); (2) contract provisions which limit an investor's ability to redeem an investment in a hedge fund for a defined period of time (limited liquidity); and (3) the possibility that a hedge fund's active or risky trading activity will result in losses due to operational failure such as trading errors or outright fraud (operational risk).

Pension plans that invest in hedge funds take various steps to mitigate the risks and challenges posed by hedge fund investing, including developing a specific investment purpose and strategy, negotiating important investment terms, conducting due diligence, and investing through funds of funds. Such steps require greater effort, expertise and expense than required for more traditional investments. As a result, according to plan officials, state and federal regulators, and others, some pension plans, especially smaller plans, may not be equipped to address the various demands of hedge fund investing.

Investors, Creditors, and Counterparties Have Increased Efforts to Impose Discipline on Hedge Fund Advisers, but Some Limitations Remain

Investors, creditors, and counterparties have the power to impose market discipline—rewarding well-managed hedge funds and reducing their exposure to risky, poorly managed hedge funds—during due diligence exercises and through ongoing monitoring. Creditors and counterparties also can impose market discipline through ongoing management of credit terms (such as collateral requirements). According to market participants doing business with larger hedge funds, hedge fund advisers have improved disclosure and become more transparent about their operations, including risk management practices, partly as a result of recent increases in investments by institutional investors with fiduciary responsibilities, such as pension plans, and guidance provided by regulators and industry groups.

Despite the requirement that fund investors be sophisticated, some market participants suggested that not all prospective investors have the capacity or retain the expertise to analyze the information they receive from hedge funds, and some may choose to invest in a hedge fund largely as a result of its prior returns and may fail to fully evaluate its risks. Since the near collapse of LTCM in 1998, investors, creditors, and counterparties have increased their efforts to impose market discipline on hedge funds. Regulators and market participants also said creditors and counterparties have been conducting more extensive due diligence and monitoring risk exposures to their hedge fund clients since LTCM. The creditors and counterparties we interviewed said that they have exercised market

discipline by tightening their credit standards for hedge funds and demanding greater disclosure.

However, regulators and market participants also identified issues that limit the effectiveness of market discipline or illustrate failures to properly exercise it. For example, most large hedge funds use multiple prime brokers as service providers. Thus, no one broker may have all the data necessary to assess the total leverage used by a hedge fund client. In addition, the actions of creditors and counterparties may not fully prevent hedge funds from taking excessive risk if these creditors' and counterparties' risk controls are inadequate. For example, the risk controls may not keep pace with the increasing complexity of financial instruments and investment strategies that hedge funds employ. Similarly, regulators have been concerned that in competing for hedge fund clients, creditors sometimes relaxed credit standards. These factors can contribute to conditions that create the potential for systemic risk if breakdowns in market discipline and the risk controls of creditors and counterparties are sufficiently severe that losses by hedge funds in turn cause significant losses at key intermediaries or instability in financial markets.

Regulators View Hedge Fund Activities as Potential Sources of Systemic Risk and Are Taking Measures to Enhance Market Discipline and Prepare for Financial Disruptions

Although financial regulators and market participants recognize that the enhanced efforts by investors, creditors, and counterparties since LTCM impose greater market discipline on hedge funds, some remain concerned that hedge funds' activities are a potential source of systemic risk. Counterparty credit risk arises when hedge funds enter into transactions, including derivatives contracts, with regulated financial institutions.[15] Some regulators regard counterparty credit risk as the primary channel for potentially creating systemic risk. At the time of our work in 2007, financial regulators said that the market discipline imposed by investors, creditors, and counterparties is the most effective mechanism for limiting the systemic risk from the activities of hedge funds (and other private pools of capital). The most important providers of market discipline are the large, global commercial and investment banks that are hedge funds' principal creditors and counterparties. As part of the credit extension process, creditors and counterparties typically require hedge funds to post collateral that can be sold in the event of default. OCC officials told us that

[15]Counterparty credit risk is the risk that a loss will be incurred if a counterparty to a transaction does not fulfill its financial obligations in a timely manner.

losses at their supervised banks due to the extension of credit to hedge funds were rare. Similarly, several prime brokers told us that losses from hedge fund clients were extremely rare due to the asset-based lending they provided such funds. While regulators and others recognize that counterparty credit risk management has improved since LTCM, the ability of financial institutions to maintain the adequacy of these management processes in light of the dramatic growth in hedge fund activities remained a particular focus of concern.

In addition to counterparty credit risk, other factors such as trading behavior can create conditions that contribute to systemic risk. Given certain market conditions, the simultaneous liquidation of similar positions by hedge funds that hold large positions on the same side of a trade could lead to losses or a liquidity crisis that might aggravate financial distress. Recognizing that market discipline cannot eliminate the potential systemic risk posed by hedge funds and others, regulators have been taking steps to better understand the potential for systemic risk and respond more effectively to financial disruptions that can spread across markets. For instance, they have examined particular hedge fund activities across regulated entities, mainly through international multilateral efforts. The PWG has issued guidelines that provide a framework for addressing risks associated with hedge funds and implemented protocols to respond to market turmoil. Finally, in September 2007, the PWG formed two private sector committees comprising hedge fund advisers and investors to address investor protection and systemic risk concerns, including counterparty credit risk management issues. On January 15, 2009, these two committees, the Asset Managers' Committee and the Investors' Committee, released their final best practices reports to hedge fund managers and investors. The final best practices for the asset managers establishes a framework on five aspects of the hedge fund business—disclosure, valuation of assets, risk management, business operations, compliance and conflicts of interest—to help hedge fund managers take a comprehensive approach to adopting best practices and serve as the foundation upon which those best practices are established. The final best practices for investors include a Fiduciary's Guide, which provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio, and an Investor's Guide, which provides recommendations to those charged with executing and administering a hedge fund program if one is added to the investment portfolio.

In closing, I would like to include a final thought. It is likely that hedge funds will continue to be a source of capital and liquidity in financial

markets, by providing financing to new companies, industries and markets, as well as a source of investments for institutional investors. Given our recent experience with the financial crisis, it is important that regulators have the information to monitor the activities of market participants that play a prominent role in the financial system, such as hedge funds, to protect investors and manage systemic risk.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

GAO Contact

For further information on this testimony, please contact Orice M. Williams on (202) 512-8678 or at williamso@gao.gov.Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this statement.

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

GAO's Mission	The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.
Obtaining Copies of GAO Reports and Testimony	The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."
Order by Phone	The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, http://www.gao.gov/ordering.htm. Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537. Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.
To Report Fraud, Waste, and Abuse in Federal Programs	Contact: Web site: www.gao.gov/fraudnet/fraudnet.htm E-mail: fraudnet@gao.gov Automated answering system: (800) 424-5454 or (202) 512-7470
Congressional Relations	Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400 U.S. Government Accountability Office, 441 G Street NW, Room 7125 Washington, DC 20548
Public Affairs	Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800 U.S. Government Accountability Office, 441 G Street NW, Room 7149 Washington, DC 20548

Please Print on Recycled Paper

IBDeditorials.com

- Turn $1K to $16,940 in less than 30 days click here

Don't Demonize Chrysler's Debt Holders For Standing Up For Their Shareholders

By STEVE STANEK | Posted Monday, May 04, 2009 4:20 PM PT

President Obama last Thursday gave us reason to wonder what he believes is more important: respect for rule of law or his desire for more government control over the economy.

"A small group of speculators" is how Obama disparaged holders of Chrysler debt who resisted government pressure to accept a small fraction of what they are owed as Chrysler filed for bankruptcy Thursday.

The money managers at these firms — including Oppenheimer Fund, Perella Weinberg Partners and Stairway Capital Management — rightly stood up for their shareholders and investors, who include government pension funds, school endowments, and corporate and individual retirement investors.

Government Heat

A government task force has been pushing a restructuring of America's auto industry, and was pressuring holders of Chrysler debt to forgive most of it to keep the company out of bankruptcy.

Chrysler's largest lenders, who hold about 70% of Chrysler's nearly $7 billion in debt, agreed to accept $2.2 billion of the money they are owed. The smaller lenders hold about $1 billion of Chrysler debt. Their refusal to give up a similar percentage of what they are owed forced the company's bankruptcy restructuring.

"In particular, a group of investment firms and hedge funds decided to hold out for the prospect of an unjustified taxpayer bailout," Obama misleadingly complained. "They were hoping that everybody else would make sacrifices and they would have to make none."

And what of those other lenders?

They include Goldman Sachs, Morgan Stanley, JPMorgan Chase and Citibank, some of the nation's largest financial firms and recipients of tens of billions of dollars of taxpayer bailouts. The smaller lenders whom Obama falsely attacked as wanting a taxpayer bailout have taken no taxpayer bailout money.

It's not much of a sacrifice for companies that have received tens of billions of taxpayer dollars apiece to give up less than $5 billion among them, especially when doing so will make the government that has smiled on them smile even more.

The president in his demagoguery also neglected to note that the United Auto Workers, who gave him overwhelming support in the last election, were asked to "sacrifice" far less than the lenders, even though the UAW's lavish pay, health and retirement benefits are major reasons the Big Three automakers are in such trouble. The Obama-supporting UAW will actually end up as Chrysler's majority owner.

The people the president derisively called speculators are simply asking the government to follow long-established law to protect their clients and shareholders.

"To facilitate Chrysler's rehabilitation, we offered to take a 40% haircut even though some groups lower down in the legal priority chain in Chrysler debt were being given recoveries of up to 50% or more, and being allowed to take out billions of dollars," said a joint statement of the holdout lenders Obama demonized.

"In contrast, over at General Motors, senior secured lenders are being left unimpaired with 100% recoveries, while even GM's unsecured bondholders are receiving a far better recovery than we are as Chrysler's first lien secured lenders."

Bank On It

The holdouts note they were not allowed to negotiate directly, but instead had to go through "an obviously conflicted intermediary: a group of banks that have received billions of TARP funds."

They summarized the Obama administration's move well: "The government has risked overturning the rule of law and practices that have governed our world-leading bankruptcy code for decades."

Stanek is a research fellow at the Heartland Institute in Chicago.

© Copyright 2009 Investor's Business Daily. All Rights Reserved.

The Washington Post

Hedge Funds Get Tangled In Bad-Business Cycle

By Steven Pearlstein
Wednesday, October 19, 2005

Advertisement • Your Ad Here

It starts with a good idea that yields spectacular returns, attracts much money and generates great wealth for those at the top. With so many people doing the same thing, investment returns decline, as do ethics and the quality of financial reports. Then come the scandals, the lawsuits and the rush for the exits, followed at times by convictions or regulatory settlements.

We've seen it before with railroad stocks, junk bonds, third-world debt and tech stocks. Now it's happening again -- with hedge funds.

Start with Bayou Management, which used made-up financial statements to lure $450 million from investors. In fact, Bayou managed to lose money every year since 1997. Now all that's left is about $100 million, seized after bank employees inquired after suspicious wire transfers.

Then there's John Whittier, who raised several hundred million dollars for Wood River Capital even after informing investors he had no particular investment strategy. After promising not to put more than 10 percent of the fund in any one investment, Whittier poured two-thirds of it into two small wireless companies that -- surprise -- have since lost three-quarters of their value.

Next there's the former chief operating officer of Durus Capital Management who has pleaded guilty to charges that he artificially boosted returns by buying up two thinly traded stocks in an effort to inflate the share price and earn a big bonus. When word got out, the stock plunged, reducing the value of the fund by more than $300 million, according to the Securities and Exchange Commission.

The SEC is also looking into the collapse of Philadelphia Alternative Asset Management, run by Paul Eustace of Ontario, Canada. Eustace allegedly invented funds with fictitious returns, then mingled the investments with his personal funds. Regulators say he hid $175 million in losses from investors by stashing them in brokerage accounts run by another giant hedge fund, Man Group.

And finally there is Refco, a major commodities broker that profited by borrowing and lending securities for hedge funds. Prosecutors say one of those funds, Liberty Corner Capital, engaged in offsetting transactions at the end of each quarter, and the beginning of the next, allowing Refco chief executive Phil R. Bennett to keep up to $545 million in bad debt off the company's books. The shell game allegedly went on for years, eluding detection by auditors and overpaid bankers who peddled the company to investors. Now Refco has filed for bankruptcy protection, and Bennett faces criminal charges.

There's no coincidence that all this is emerging just when the returns from hedge funds are about to turn negative and the flow of funds into them has dramatically slowed.

Nor should it be surprising that such scams went undetected. Hedge funds are notoriously secretive, fending off regulations with the argument that they deal only with wealthy and sophisticated investors.

If you need more proof that the hedge fund bubble is about to burst, consider that last year, fund manager Eddie Lampert reportedly broke through the billion-dollar annual compensation mark -- apparently for his brilliant idea of combining Kmart and Sears into one giant retail failure.

Former SEC chairman William Donaldson could see this coming but was able to push through only modest regulatory oversight of hedge funds. His successor, Christopher Cox, must show his mettle.

At a minimum, hedge funds should be required to send audited, quarterly statements to investors and the SEC. With college endowments, insurance companies, pensions and mutual funds now so heavily invested in hedge funds, this has gone well beyond protecting rich investors.

With $1 trillion in assets, hedge funds have become a dominant force in capital markets, accounting for as much as half the daily trading on the stock market, hundreds of billions of dollars in bank loans and a healthy chunk of the profits of Wall Street brokerages. Federal regulators cannot guard against systemic risk to global markets if they don't know what hedge funds are doing.

This is not a case of a few rotten apples. It's a case of an industry that has become so rich and arrogant -- and so littered with charlatans and con men -- that government must step in to protect the public interest.

Steven Pearlstein will host an online discussion at 11 a.m. today athttp://washingtonpost.com. He can be reached atpearlsteins@washpost.com.

View all comments that have been posted about this article.

© 2005 The Washington Post Company

Ads by Google

Hedge Fund Directory
Stay Ahead Of The Market With Barclay's Hedge Fund Database!
www.BarclayHedge.com

Prime Broker
Gar Wood focuses on solultions for active traders and hedge funds
www.garwoodsecurities.net

Bernanke's Debt Solution
Central Banks To Change Value Of Money - What It Means For You.
UncommonWisdomDaily.com/Financial

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

June 22, 2009

The Honorable Bill Foster
United States House of Representatives
1339 Longworth House Office Building
Washington, D.C. 20515

Re: Response to Question at a Hearing Regarding "Perspectives on Hedge Fund Registration", Held Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, of the Committee on Financial Services, U.S. House of Representatives, on May 7, 2009

Dear Representative Foster:

Managed Funds Association ("MFA")[1] is pleased to submit this letter in response to the question that you asked me at the hearing on May 7, 2009, "Perspectives on Hedge Fund Registration" (the "Hearing"). During the Hearing, you asked that MFA provide an answer to your question regarding the total outstanding notional amount of swaps and off-balance sheet obligations traded by hedge funds.[2] Because detailed information is not readily available, we were not able to specifically determine the total outstanding notional amount of swaps traded by hedge funds. We were, however, able to determine the total outstanding notional amount of swaps traded by a broad category of financial institutions, within which hedge funds fall.

To obtain information on international OTC derivatives trading, we used materials published by the Bank for International Settlements (the "BIS").[3] The BIS researches, collects and publishes information on the international OTC derivatives market, including information on the types of financial institutions which trade them. The BIS collects and publishes information for the following three categories of OTC derivatives trading counterparties: (i) reporting dealers; (ii) other financial institutions; (iii) non-financial institutions. The BIS does not collect, research or publish specific information on the trading activity of hedge funds. The BIS collects aggregated information from reporting central banks in the same broad categories in which such information is published. Hedge funds generally fall within the category "other financial

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York, NY.

[2] In responding to your question, we think it is important to note one point. Our response is limited to OTC swaps; we did not provide information regarding OTC options and forwards.

[3] According to its Web site, the BIS is an international organization that fosters international monetary and financial cooperation and serves as a bank for central banks. The BIS fulfils its mandate by acting as, among other things, a center for economic and monetary research.

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

Jun-23-09 02:48pm From-ASSOCIATION HEADQUARTERS + T-481 P.008/012 F-809

institutions", along with central banks, non-dealer banks, mutual funds, pension funds, currency funds, money market funds, building societies, leasing companies and insurance companies.

By using information reported in two recent BIS publications (both of which are referenced below), MFA was able to estimate the total outstanding gross notional amount of swaps traded by entities in the category "other financial institutions" is approximately U.S. $211 trillion. We believe that it is noteworthy that information in these publications reflects the gross notional value of all OTC derivatives deals. Gross notional value is not indicative the amounts that are truly at risk (*i.e.*, the net notional value). The net notional value of OTC derivatives is generally a fraction of the gross notional amount.[4]

In June 2009, the BIS released its Quarterly Review titled, "International banking and financial market developments" ("BIS Quarterly Review").[5] The BIS Quarterly Review contains semiannual over-the-counter ("OTC") derivatives statistics dated as of December 31, 2008.[6] Tables 20A, 21A and 22A of the BIS Quarterly Review provide the gross notional amounts outstanding in U.S. dollars of the global OTC derivatives market trading across foreign exchange, single-currency interest rate and equity-linked asset classes. The tables provide that total outstanding notional amount traded by other financial institutions across foreign exchange, single-currency interest rate and equity-linked asset classes is approximately U.S. $195 trillion.[7]

In May 2009, the Monetary and Economic Department of the BIS published a report titled, "OTC derivatives market activity in the second half of 2008" (the "Report"), which provides, among other things, the total outstanding notional amount of credit default swaps ("CDS") traded by other financial institutions. Table 4 of the Report provides that other financial institutions bought and sold CDS in the total notional amount of approximately U.S. $16 trillion.

****

MFA appreciates the opportunity to provide you with information on the hedge fund industry. As stated in my testimony at the Hearing, MFA and its members are committed to being constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets.

---

[4] To explain the gross versus net notional amounts, we think it might be helpful to look at other data sources for OTC derivatives. The International Swaps and Derivatives Association ("ISDA") published its 2008 Year-End Market Survey, which reported that the total outstanding gross notional amount of the CDS market was U.S. $38.6 trillion. This amount was approximately evenly divided between bought and sold protection: bought protection gross notional amount was U.S. $19.5 trillion and sold protection gross notional amount was U.S. $19.1 trillion. ISDA's survey reported that the total outstanding net notional amount at the end of 2008 was only U.S. $400 billion.

[5] The BIS Quarterly Review is available at: http://www.bis.org/publ/qtrpdf/r_qt0906.pdf

[6] The semiannual OTC statistics are available on the BIS's Web site at: http://www.bis.org/statistics/derdetailed.htm

[7] The total outstanding notional amount of U.S. $195 trillion was calculated by adding the total outstanding notional amounts of swaps contracts across asset classes in each of the three tables.

Jun-23-09 02:48pm From-ASSOCIATION HEADQUARTERS + T-481 P.009/012 F-809

MFA would welcome the opportunity to meet with you or members of your staff to respond to any further questions you may have. Please feel free to contact Roger Hollingsworth or me at (202) 367-1140 with any questions, or if you would like to arrange such a meeting.

Sincerely,

Richard H. Baker
President & C.E.O.

CC: The Honorable Chairman Paul E. Kanjorski, Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives

The Honorable Ranking Member Scott Garrett, Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

Jun-23-09 02:48pm From-ASSOCIATION HEADQUARTERS + T-481 P.010/012 F-809

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

June 22, 2009

The Honorable Jim Himes
United States House of Representatives
214 Cannon House Office Building
Washington, DC 20515

Re: Response to Question at a Hearing Regarding "Perspectives on Hedge Fund Registration", Held Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, of the Committee on Financial Services, U.S. House of Representatives, on May 7, 2009

Dear Representative Himes:

Managed Funds Association ("MFA")[1] is pleased to submit this letter in response to the question that you asked me at the hearing on May 7, 2009, "Perspectives on Hedge Fund Registration" (the "Hearing"). During the Hearing, you asked that MFA provide a list of financial products that can create synthetic debt or credit exposure.[2]

Hedge funds and other financial institutions invest in the synthetic credit market to gain several benefits, including credit protection, capital relief and exposure to an asset without having the obligation to retain ownership of the asset. There are a variety of products that can create such exposure, however, the following list, though not exhaustive, provides the primary products in this market:

- Credit derivatives: Credit default swaps ("CDS") on single issuers, indices and asset-backed securities ("ABS");
- Options on derivatives: options on CDS, and options and warrants on corporate debt;
- Swaps: Total return swaps on bonds, loans, collateralized debt obligations ("CDOs"), and other ABS; and
- Structured products: Synthetic CDOs, index tranches and other correlation trading, as well as credit-linked structured notes.

While we acknowledge the complexity of the synthetic credit market, we believe that the advent and trading of synthetic credit products is demonstrative of the innovation of our capital markets. It is also noteworthy that this market has been in a state of contraction since early 2008.

MFA appreciates the opportunity to provide you with this additional information following the Hearing. As stated in my testimony, MFA and its members are committed to being

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York, NY.

[2] In responding to your question, we note that synthetic debt and synthetic credit exposure are synonymous.

Jun-23-09 02:48pm From-ASSOCIATION HEADQUARTERS + T-481 P.011/012 F-809

constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets.

MFA would welcome the opportunity to meet with you or members of your staff to respond to any further questions you may have. Please feel free to contact Roger Hollingsworth or me at (202) 367-1140 with any questions, or if you would like to arrange such a meeting.

Sincerely,

Richard H. Baker
President & CEO

CC: The Honorable Chairman Paul E. Kanjorski, Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives

The Honorable Ranking Member Scott Garrett, Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives

2025 M Street, NW, Suite 610 | Washington, DC 20036 | 202.367.1140 | Fax 202.367.2140 | www.managedfunds.org

Jun-23-09 02:48pm From-ASSOCIATION HEADQUARTERS + T-481 P.012/012 F-809

O