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REGULATING HEDGE FUNDS AND OTHER PRIVATE INVESTMENT POOLS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

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

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE REGULATION OF HEDGE FUNDS AND OTHER PRIVATE INVESTMENT POOLS TO ASSIST REGULATORS IN ADDRESSING FRAUD AND PREVENTING SYSTEMIC RISK IN OUR CAPITAL MARKETS

JULY 15, 2009

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REGULATING HEDGE FUNDS AND OTHER PRIVATE INVESTMENT POOLS

WEDNESDAY, JULY 15, 2009

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:35 p.m., in room SD–538, Dirksen Senate Office Building, Senator Jack Reed (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Senator REED. Let me call the hearing to order. I want to thank Senator Bunning for participating today and contributing to the hearing. I also want to welcome all the witnesses—Mr. Donohue and the succeeding panel.

As we continue the important work of modernizing our outdated financial regulatory system, I have called this hearing to explore a key aspect of these reforms: The regulation of hedge funds and other private investment pools, such as private equity funds and venture capital funds.

The current financial crisis has reinvigorated my long-held concern—and I am not alone—that the regulation of hedge funds and other pooled investment vehicles should be improved to provide more information to regulators to help them address fraud and prevent systemic risk in our capital markets.

These private pools of capital are responsible for huge transfers of capital and risk, and so examining these industries and potential regulation are extremely important to this Subcommittee.

Hedge funds and other private investment funds generally operate under exemptions in Federal securities laws that recognize that not all investment pools require the same close scrutiny demand of retail investment products, like mutual funds. Hedge funds generally cater to more sophisticated and wealthy investors who are responsible for ensuring the integrity of their own investments and, as a result, are permitted to pursue somewhat riskier investment strategies. Indeed, these funds play an important role in enhancing liquidity and efficiency in the market, and subjecting them to fewer limitations on their activities has been and continues to be a policy choice that has been made by previous Administrations and previous Congresses.

However, these funds have often operated outside the framework of the financial regulatory system even as they have become in-

creasingly interwoven with the rest of the country's financial markets. As a result, there is no data on the number and nature of these firms or any regulatory ability to actual calculate the risks they present to the broader economy.

Over the past decade, the SEC has recognized there are risks to our capital markets posed by some of these entities, and it has attempted to require at a minimum that advisers to these funds register under the Investment Advisers Act so the FCC staff can collect basic information from and examine these private pools of capital. The SEC's rule making in this area, however, was rejected by a Federal court in 2006. As a result, without statutory changes, the SEC is currently unable to examine private funds, books, and records, or to take sufficient action when the SEC suspects fraud. In addition, no regulator is currently able to collect information on the size and nature of hedge funds or other funds to identify an act on systemic risk that may be created by these pools of capital.

To address this regulatory gap, I recently introduced the Private Fund Transparency Act of 2009, which would require investment advisers to private funds, including hedge funds, private equity funds, venture capital funds, and others, to register with the SEC.

Let me make the specific point that I chose a comprehensive approach so that we could begin to consider all of these different types of arrangements and make changes based upon not presumptions but hearings, evidence, and a detailed discussion of the range of regulatory authority. And this is the beginning of that process today.

The bill that I introduced would provide the SEC with the authority to collect information from these entities, including information about the risks they may pose to the financial system. In addition, it would authorize the SEC to require hedge funds and other investment pools to maintain and share with other Federal agencies on a confidential basis any information necessary for the identification and mitigation of systemic risk.

I hope today's hearing provides an opportunity to discuss my proposal and other proposals so that we can consider ways to determine the best approach in this area. The financial crisis is a stark reminder that transparency and disclosure are essential in today's marketplace. Improving oversight of hedge funds and other private funds is vital to their sustainability and to our economy's stability.

I welcome today's witnesses and look forward to the testimony, and now I would like to recognize the Ranking Member, Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

In some ways, the structure and incentives of these private pools of capital are what we should be hoping for in the rest of the financial system. Success is rewarded and failure is punished. Pay is based on performance over time and not just in the short run. And managers have skin in the game with their own funds at risk. It seems obvious to me that firms and traders will act more responsibly when they know they will face the consequences of their actions, which is why bailouts breed more bailouts.

I do have some concerns about the risk that these firms could post to our system. Hedge funds in particular use leverage, which can lead to outsize losses and panic selling. Losses in one part of a portfolio can force the sale of other assets, which spreads the losses to a normal, unrelated investment. Just look at last fall for an example.

I am also concerned about the potential for market manipulation and fraud. When firms can seek profit by any strategy they dream up, there will be a great temptation to cheat. I am not saying all or even most firms are dishonest. But the temptation will be there, and that cheating is harder to detect because of the secrecy of portfolios and strategies.

Huge risk in the system could build up out of the sight of regulators and other market participants as well. How we address these concerns is not an easy question, and I do not know the answer. I am skeptical of the idea of a Government regulator being smart enough to recognize concentration of risk and act to reduce it. Instead, it may make more sense to limit how much risk these firms can take on and, thus, how much risk they pose to others by imposing leverage restrictions. However, I am not sure if it is better to put restrictions on the firms themselves or limit the dealings of banks and other regulated institutions with these firms.

These are by no means all the issues to consider, but I hope to get some thoughts on them here today.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Bunning.

Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman. I am here to listen and learn and will reserve comment accordingly.

Senator REED. You also have the best opening statement, so thank you.

[Laughter.]

Senator REED. It is now my pleasure to introduce Mr. Andrew J. Donohue, who is the Director of the Division of Investment Management at the Securities and Exchange Commission. Serving in this role since 2006, Mr. Donohue has been responsible for developing regulatory policy and administering the Federal securities laws applicable to mutual funds investment advisers, and others. Prior to joining the SEC, Mr. Donohue was global general counsel for Merrill Lynch Investment Managers, overseeing the firm's legal and regulatory compliance functions for over $500 billion in assets, including mutual funds, fixed-income funds, hedge funds, private equities, managed futures, and exchange funds.

Mr. Donohue, I appreciate your appearing before the Subcommittee this afternoon, and I look forward to your testimony. Welcome.

STATEMENT OF ANDREW J. DONOHUE, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION

Mr. DONOHUE. Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee, thank you for the opportunity to testify before you today. My name is Andrew Donohue, and I am

the Director of the Division of Investment Management at the Securities and Exchange Commission.

Over the past two decades, private funds, including hedge, private equity, and venture capital funds, have grown to play an increasingly significant role in our capital markets. The securities laws, however, have not kept pace, and as a result, the Commission has very limited oversight authority over these vehicles and their advisers. We do not conduct compliance examinations of them. They do not file registration forms with us. We have incomplete information about these funds and their advisers. We sometimes discover them first in the midst of an investigation by our Enforcement Division.

This presents a significant regulatory gap in need of closing. The Commission tried to close the gap in 2004—at least partially—by adopting a rule requiring all hedge fund advisers to register under the Investment Advisers Act. That rule making was overturned by an appellate court in the *Goldstein* decision in 2006. Since then, the Commission has continued to bring enforcement action against private funds that violate the Federal securities laws, and we have continued to conduct compliance examinations of the hedge fund advisers that remain registered under the Advisers Act. But we only see a slice of the private fund industry, and the Commission strongly believes that legislative action is needed at this time to enhance regulation in this area.

You can close the regulatory gap by closing one or more of the exemptions on which private funds and their advisers rely to avoid registration. Registration under the Investment Company Act provides a number of important protections for retail fund investors. But many of those protections may not be necessary for private fund investors. Moreover, the application of the Investment Company Act would prohibit or curtail many of the legitimate investment strategies of private funds.

Investment advisers to private funds often avoid registration by claiming an exemption from the registration under the Advisers Act, available only to an adviser that has fewer than 15 clients. This small-adviser exemption was originally designed to exempt advisers that were too small to warrant Federal attention. But, today, advisers to private funds investing billions of dollars of client assets rely on this exemption to keep off of our radar scope. They are able to do this because under the exemption an adviser can count each private fund as a single client.

The small-adviser exemption is part of the original act, which was enacted before the modern hedge, private equity, and venture capital funds were even invented and is today quite an anachronism. An advisory firm with 15 individual clients and $30 million of assets under management must register with the Commission. But an adviser providing the same advisory services to the same individuals through a private fund could entirely avoid registering with the Commission. Investment adviser registration, in our view, is appropriate for any investment adviser managing $30 million or more, regardless of the form or number of its clients.

The Private Fund Transparency Act of 2009, which Chairman Reed recently introduced, would eliminate the small-adviser exemption from the Advisers Act and, thus, require advisers to pri-

vate funds to register. Registration would impose no impediments on legitimate business activities of private funds. Indeed, many advisers to all kinds of private funds are currently registered under the Advisers Act.

The Commission believes that the registration of these private fund advisers would be beneficial to investors and our markets in several important ways.

First, registration would allow the Commission to identify advisers and private funds that participate in our markets and to collect basic data from them. In addition, the Private Fund Transparency Act would permit us to keep confidential proprietary information we collect and to collect information related to systemic risk to be shared with other regulators.

Second, it would provide us with the authority to examine the activities of private fund advisers, in particular, compliance with fiduciary duties advisers owe to private funds they manage. We would be able to examine, for example, whether the advisers are keeping fund assets safe, accurately reporting fund performance, and managing the fund consistent with disclosures fund investors receive.

Third, registration of private fund advisers under the Advisers Act would permit us to oversee adviser trading activities to prevent market abuses such as insider trading and market manipulation, including improper short selling.

We believe that legislation should not exclude any advisers from registration with the Commission based on the type of private fund they manage. The lines which may have once separated the hedge funds from private equity and venture capital funds have blurred, and the distinctions are often unclear. Such an exclusion would likely create market inefficiencyt and exacerbate conflicts between advisers and their clients if, as is likely, advisers alter their investment strategies or investment terms to fit an exemption.

I would be happy to answer any questions you might have.

Senator REED. Well, thank you very much, Mr. Donohue.

You pointed out that the SEC has sought for many years to be able to monitor the full range of investment, hedge funds particularly, and now you have a regulatory gap because essentially it is a private system after the court ruling. Is there anything you would like to add to the necessity of this broad approach that you could see all the data?

Mr. DONOHUE. There are a couple of points I would like to make. One is investment advisers are managing other people's money. That is what the Investment Advisers Act was intended to cover. It does not make a distinction between whether you are managing money on behalf of wealthy clients or average clients. And this is a gap that exists out there that I think is one that should be filled.

A corollary benefit from filling that gap would be the ability to obtain information with respect to private funds, information that would be helpful to us and information that would also, I believe, be helpful to any systemic regulator that might be empowered.

Senator REED. As Senator Bunning alluded to in his comments, and as you also indicated, there are basically three approaches: one is to regulate the fund; two is to regulate the advisers; or three is

to give the SEC the authority by regulation to set up rules for exempt entities under both statutes.

I appreciate the fact you seem to speak favorably of the approach of investment advisers, but are there any strengths or weaknesses that you want to point out vis-a-vis the adviser approach or the fund approach or a separate approach?

Mr. DONOHUE. Well, I think the adviser approach is an essential approach, and so I would say that is a minimum that is necessary, that the advisers that are managing these pools are brought within the adviser statute and the protections that are there.

The potential to bring private funds within the ambit of the Investment Company Act can have its challenges. The Investment Company Act provides two exclusions from its coverage intended to carve out really the private funds, the 3(c)(1) exception for funds that have less than—a hundred or fewer investors, and 3(c)(7) where the fund is limited to qualified purchasers, those that really have $5 million or more invested.

So I think, you know, to try and fit some of the private funds within the investment company statute that really is intended for retail investors would be a challenge for us, and so if there is an alternative approach that is less intrusive that achieves the goal, that is something that deserves consideration.

An alternative approach is one that would provide the Commission with the ability to condition those two exclusions that I just mentioned on certain conditions that the Commission could determine from time to time. That would, in effect, keep private funds outside of the Investment Company Act but give us the tools that we might need to be able to impose conditions that.

Those are different approaches that I think all merit consideration.

Senator REED. And we are very fortunate because our second panel has provided excellent testimony from the vantage point and experience of market participants. Some have pointed out—in particular, with respect to venture capital—that the Investment Advisers Act might pose restraints that would fundamentally change their business model, compensation, others. In that spirit, are there some areas where you would see the Investment Advisers Act as being inconsistent with the appropriate functioning of the markets?

Mr. DONOHUE. I do not. I would like to point out that we currently have over 1,800 investment advisers that are registered with us out of our 11,000-plus that indicate that they manage private funds, and those include, you know, hedge funds, private equity funds, and venture capital funds. And we do have available to us at the Commission exemptive authority within which we could address particular issues that might exist.

And I also would like to point out that of the advisers that are registered with us, almost 70 percent of those advisers are small advisers that have 10 or fewer employees. So the Advisers Act itself and the regulatory regime that we have is certainly scalable to deal with both the largest and the smallest of the advisers.

Senator REED. Let me ask a final question. Given these new responsibilities, it would, I presume, require additional resources not only in terms of personnel but technology. As you point out, one of the potential advantages of registration is to be able to collect on

a confidential basis the systemic information not only for your use but also a potential systemic regulator. And that I think would require additional technology and resources. Is that a fair assessment?

Mr. DONOHUE. It is fair and is true that additional resources would be necessary for us to be able to do this and do it effectively. And I would point out, if we are going to do it, we should do it well.

Senator REED. Well, I concur with that thought. Thank you very much, Mr. Donohue.

Senator Bunning.

Senator BUNNING. Thank you for being here. Who in the Federal Government knows the markets well enough to effectively regulate and understand what hedge funds and other firms are doing and the risks they might be creating?

Mr. DONOHUE. That is an excellent question. I think the ability to oversee the activities of investment advisers and hedge funds is one that is within the ambit of the responsibility of the Securities and Exchange Commission. We——

Senator BUNNING. I did not ask that question. Who in the Securities and Exchange Commission has enough smarts to know what exactly is going on with hedge funds and other private firms that are doing—what risks they might create for the rest of them? You know, we have had AIG and all these things go on, and we haven't had anybody that knew what was happening.

Mr. DONOHUE. A couple of points that I would make, Senator Bunning. I think it is a challenge. I do think that having the ability to have the right people with the right skill set is extraordinarily important, and the Commission has reached out to get people with some of the skill sets that we would need to do this effectively. But in order to be able to do that with the people with the right skill sets, we also need access to the right information, and we need access to the ability to go in and to conduct inspections and examinations of the folks, and——

Senator BUNNING. But then you have to have someone who knows to ask the right questions and get the right information. The fear I have is a group of hedge funds or investment advisers getting together, colluding, shorting individual stocks for their own purpose, and at the end of the line, they profit by somebody going into bankruptcy. You know, is there anyone at the SEC that can get a handle on that kind of thing?

Mr. DONOHUE. Well, I would point out that if that form of collusion was going on——

Senator BUNNING. Somebody could find out if it was.

Mr. DONOHUE. Well, if it was going on, it would be more likely to be detected if we had the opportunity to go in and do examinations, if, in fact, they were required to keep certain books and records. And, you know, that would increase that likelihood. Chairman Schapiro has also advocated the possibility of having a whistleblower-type program in place that would, you know, enable us to benefit from whistleblowers in that type of area.

There is always the possibility for collusion inside of our markets.

Senator BUNNING. Yes, we found that out.

Should we put leverage restrictions on hedge funds and other firms?

Mr. DONOHUE. The first thing on that, Senator Bunning, is that the marketplace does place restrictions on the ability of hedge funds and others to use leverage. They are subject to the margin requirements. The counterparties that, in fact, lend to them apply their own market discipline to that. In fact, after the financial crisis, we saw a degree of deleveraging that occurred that wasn't the result of any regulatory action but, rather, was the market itself responding.

So I think leverage restrictions is one of those areas that you might want to consider, but I do think that there are market disciplines out there that help achieve that goal.

Senator BUNNING. To address systemic risk and fraud, do you think the SEC is better off focusing on resources on constant supervision and examination or kind of after-the-fact enforcement?

Mr. DONOHUE. Those two activities are very complementary. The Office of Compliance, Inspections, and Examinations and its program is there to help us determine things that are going on and to help catch things early if we can. Enforcement is there, works hand in glove with Office of Compliance, Inspections, and Examinations, complements that when, in fact, we do find that there are violations out there and to bring and hold people accountable for those. So I think they work hand in glove.

Senator BUNNING. OK. To limit the potential harm that could be done by private investment firms to the system and counterparties, do you think it is better to place limits on the firms themselves or to limit the exposure of counterparties like banks to the investment firms like they have?

Mr. DONOHUE. The approach that was and has been taken by the President's Working Group was to work with the counterparties that were providing leverage to hedge funds and to approach it from a risk-based approach at that level. I think that is a meaningful approach to take.

Senator BUNNING. You, in other words, would insist that that would be in any kind of legislation that Jack or myself would——

Mr. DONOHUE. Not necessarily. I think that is something that is occurring and has occurred——

Senator BUNNING. Oh, you think it is occurring already?

Mr. DONOHUE. Yes. Yes, I do believe, and——

Senator BUNNING. Some of us have serious doubts about that.

Mr. DONOHUE. Oh, well, but I do think it is in the best interests of those counterparties to manage that risk effectively and, you know, to the extent that——

Senator BUNNING. Do you think the counterparties should be reimbursed dollar for dollar in case there is a systemic failure with one of the hedge funds or one of the other types of investment firms? That have insurance, of course, obviously, like the AIG insurance on the credit default swaps. They got dollar for dollar. They didn't get 20 cents on the dollar.

Mr. DONOHUE. My personal perspective on that is that market discipline is a good discipline to have out there to the extent that private parties have arranged for protection for themselves, and they should get the benefit of their bargain.

Senator BUNNING. But do you think that it should be on the Standard & Poor's and Moody's and those who rate risk, if they lower their risk on a certain entity? That is the thing that started the spiraling downward of AIG, as you well know, when their credit got lowered. They then became responsible for the full value of what they had insured.

Mr. DONOHUE. Senator Bunning, you had asked before if there were folks inside the Commission that might have the smarts to answer all these questions, and with respect to that question, I would have to say inside the Commission I am not that person.

Senator BUNNING. Thank you.

Senator REED. Thank you, Senator Bunning.

Senator Bayh.

Senator BAYH. We have an honest man with us here today, Mr. Chairman.

Mr. Donohue, thank you for your service. I know one of the reasons we are here is so that we can better answer this question in the future, but I would be interested in your assessment, as best as you can based upon what we do know, about what level of systemic risk has been posed to the economy by these sorts of entities here in the recent past? I gather that there was—some of the genesis of the trouble at Bear Stearns involved some funds that related to that company. I am not familiar with the circumstances at Lehman, but there was Long-Term Capital years ago. But can you give us any sort of opinion about the nature of the systemic risk that was posed to the economy during this crisis by these kinds of firms?

Mr. DONOHUE. The hedge funds represent—based on information that I have—about $1.4 trillion of assets. I am not aware that they have been implicated in the financial crisis that we are currently in and certainly I don't have any particular information, but they are significant players in our capital markets. They represent from between 18 to 22 percent of the trading volume that occurs on the New York Stock Exchange. They employ leverage. They——

Senator BAYH. What percentage of trading involvement did you say?

Mr. DONOHUE. My understanding is it is between 18 and 22 percent of the trading volume. Now once again, this information we get from third parties as we don't have the data——

Senator BAYH. No evidence of historical unwinding of positions that imperiled perhaps counterparties, other institutions, nothing like that?

Mr. DONOHUE. Well, I would point out, I don't think that private funds have been without their challenges during this period of time. We have witnessed many private funds have had to institute gates or suspend redemptions during this period of time because of the nature of the investments that they had.

Senator BAYH. So I take your answer that we really don't know. There might be some. But one of the reasons for a proposal like this is so that we can assess in the future the level of systemic risk that might exist?

Mr. DONOHUE. Well, they are important players that currently are not—the information is not available.

Senator BAYH. Let me ask you, hedge funds, venture capital, private equity, I mean, there are some differences between these types of vehicles. Do they all deserve the same treatment?

Mr. DONOHUE. I think with respect to the advisers, the advisers are all managing—handling other people's money and I think that, they all have in common. That is what the Advisers Act was intended to address. I think with respect to the information that we may be able to collect with respect to them, that we might very well differentiate between the type of information we are collecting based on either the size or the nature of the private pool with respect to which the information is being provided.

Senator BAYH. I have seen some suggestions, for example, that venture capital investments in firms are for the most part quite different than hedge funds and that systemic risk might be different between those two types of vehicles.

Mr. DONOHUE. I do think that, you know, as folks would describe the different types of private funds, there is a distinct difference between them. On the other hand, many advisers manage several of those and several of the vehicles are less clear with respect to which category they might fall into. So there has been kind of a blurring that has occurred over time.

Senator BAYH. Some of them take kind of a hybrid approach, neither fish nor foul?

Mr. DONOHUE. Well, at times, and one of the things that we observed when we had done our previous attempt with respect to hedge fund advisers was we tried to describe and to come up with the characteristics of what a hedge fund was. Thereafter, many were able to change some of their characteristics to fall outside of the manner in which we tried to describe them. So I would not try and necessarily come up with a definitional approach with respect to private funds.

Senator BAYH. My last question, Mr. Donohue, I understand the EU has proposed a somewhat more stringent approach than has been recommended by the Administration, including barring non-EU—barring entities from doing business within their jurisdiction if they don't meet their standards. Do you have a reaction to that, and is there an effort being made for some convergence between our approach and their approach?

Mr. DONOHUE. Well, they have it out for comment and I am sure that many are currently providing and will be providing their assessment of that approach. I don't see the need for our system to necessarily converge with theirs. You know, the large proportion of private funds are managed in the United States by United States managers.

Senator BAYH. You don't see a potential for regulatory arbitrage, that sort of thing, if these standards are substantially different?

Mr. DONOHUE. Well, I think we have observed regulatory arbitrage that has occurred in the past and that is always a challenge for us and I think—that doesn't mean we need to come up with the same regulatory regime, as much as we should be mindful of that and deal cooperatively with our counterparts in Europe.

Senator BAYH. And if U.S. entities are barred from doing business if they don't meet European standards, should the reverse also apply?

Mr. DONOHUE. I would not—personally, I would not be an advocate of taking that particular approach. We have a system that works very well. We let competition reign in our country and I think that is what we should do.

Senator BAYH. Thank you very much.

Senator REED. Thank you, Senator Bayh.

Just let me ask one question, then Senator Bunning has additional questions, and that one question follows on Senator Bayh's. Are there ongoing efforts, for example, collaborations with the FSA and others, to also deal with the issue of hedge funds and private pools of capital?

Mr. DONOHUE. We are very—first, I would say we are very active members of the IOSCO and Standing Committee 5, which is the standing committee that deals with those, is one that particularly my division provides a lot of support to. We have been in discussions with our counterparts about the proposal that is out there and so there is active discussion that does take place.

Senator REED. Thank you, Mr. Donohue.

Senator Bunning.

Senator BUNNING. I just am curious, aside from the Madoff fraud, what kinds of manipulation or conspiracies have you seen regarding private investment firms, and are the laws against that kind of activity strong enough?

Mr. DONOHUE. I think we have the tools to deal with those, Senator Bunning. We have seen overstatement of performance for—in private funds——

Senator BUNNING. This was pretty sophisticated, I mean, to give out printed statements and totally and completely false statements. I mean, he had it set up—it was pretty sophisticated.

Mr. DONOHUE. It was.

Senator BUNNING. Fifty billion dollars is a lot of money, or whatever amount it was.

Mr. DONOHUE. I don't—we certainly had the tools to deal with it when it was found.

Senator BUNNING. Fifteen years, though, it got away.

Mr. DONOHUE. Well, that is, you know, and that certainly is something that we are redoubling our efforts, Senator, to look at what we can do in our agency to hire the right people, to train them properly, to use technology to help come up with likely candidates for this, to use risk-based approach and to do any number of things that would increase the likelihood that, in fact, we would be able to detect that early on and take appropriate action.

Senator BUNNING. Do you think becoming publicly traded changes the nature, the natural incentives private investment partnerships have to be responsible, when the partners have their own funds at risk?

Mr. DONOHUE. I think that when folks have their own money at risk, I do think that that may certainly increase the focus that one has with respect to managing and to the risks that one does take. I do think that having your own money invested has with it some of your own conflicts that exist. So you get certain advantages and disadvantages from having significant investment of a manager in a particular pool.

Senator BUNNING. My problem is, I don't know if we can afford to find the brains that we need to hire to get a hold of this problem, if you see it as a major problem. I know that you just said $1.2 trillion, 20 percent of the daily activity on the New York Stock Exchange. That is pretty substantial when you are talking about these type of entities. So if I were an investment adviser or somebody who was a hedge fund manager, I sure wouldn't want to work for the SEC. I would want to do my own thing, and where are you going to find somebody with that kind of expertise?

Mr. DONOHUE. Senator, I would first start off by saying that I am not sure we can afford not to find these people, and——

Senator BUNNING. I agree. Now where are we going to find them?

Mr. DONOHUE. Well, I think we have been fortunate in being able to attract people to public service——

Senator BUNNING. Not for $150,000 a year, you are not.

Mr. DONOHUE. Well, we have had some success, and I don't want to understate the challenges that we have when we are trying to do that, but we need to get those people and we need to get the ability to do this effectively.

Senator BUNNING. I wish you good luck.

Senator REED. Well, we all wish you good luck because your luck will influence greatly the economy, and it is also persistence and hard work and we thank you for that, Mr. Donohue. Thank you very much for your testimony, and now I will call the second panel forward.

Mr. DONOHUE. Thank you.

Senator REED. Let me introduce our second panel and then recognize them for their testimony.

Our first witness is Mr. Dinakar Singh, founder and Chief Executive Officer of TPG-Axon Capital, a leading global investment firm. He was previously a partner at Goldman Sachs, where he was cohead of the Principal Strategies Department, a key proprietary investing franchise of the firm. During his 14 years at Goldman Sachs, he served on a number of the firm's key leadership committees, including the Operating Committee, Risk Committee, Partnership Committee, and Asia Management Committee. Mr. Singh's company is also a member of the Managed Fund Association, which represents the hedge fund industry.

Our next witness is Mr. James S. Chanos. He is the founder and Managing Partner of Kynikos Associates, which is the largest exclusive short-selling investment firm, providing investment management services for both domestic and offshore clients. He is also Chairman of the Coalition of Private Investment Companies, which represents a coalition of private investment companies whose members and associates are diverse in both size and investment strategies, managing or advising an aggregate of over $100 billion in assets.

Our next witness is Mr. Trevor R. Loy. He is the founder and General Partner at Flywheel Ventures, a venture capital firm with approximately $40 million under management. Flywheel Ventures focuses on investments in digital services, physical infrastructure, energy, and water. Mr. Loy is also a Board member of the National Venture Capital Association, which is the premier trade association

that represents the U.S. venture capital industry, comprised of more than 450 member firms.

Our next witness is Mr. Mark B. Tresnowski. He is the Managing Director and General Counsel at Madison Dearborn Partners, a large private equity firm. Prior to joining Madison Dearborn, Mr. Tresnowski was a partner at Kirkland and Ellis, a firm he had been with from 1986 through 1999 and rejoined in August 2004 after having served as Executive Vice President and General Counsel of Allegiance Telecom, Inc. Mr. Tresnowski's company is also a member of the Private Equity Council, which is an advocacy, communications, and research organization and resource center established to develop, analyze, and distribute information about the private equity industry and its contributions to the national and global economy.

Our next witness, in order, is Mr. Richard Bookstaber, a former investment executive and author of four books and scores of articles on finance topics ranging from option theory to risk management. Mr. Bookstaber has worked in some of the largest buy side and sell side firms in capacities ranging from risk management to portfolio management to derivatives research and has worked at a number of hedge funds, including More Capital Management and Bridgewater Associates. He was previously the Managing Director in charge of firmwide risk management at Solomon Brothers, overseeing the client and proprietary risk taking activities of the firm, and prior to that spent 10 years at Morgan Stanley.

Our final witness is Mr. Joseph Dear. He is the Chief Investment Officer for the California Public Employees' Retirement System, CalPERS. At CalPERS, Mr. Dear oversees all investments, including, among many other asset classes, venture capital, leveraged buy-outs, and hedge funds. Mr. Dear joined CalPERS in March 2009 after previously serving as the Executive Director for the Washington State Investment Board and he has also served as Chief of Staff for Washington State Governor Gary Locke and in the Clinton administration as Assistant Secretary of Labor at the Occupational Safety and Health Administration. Mr. Dear also serves as the Chairman of the Council of Institutional Investors.

Thank you all, gentlemen. Your testimony has been extraordinarily helpful to me and to the Committee. If you could please make your comments 5 minutes or less, that would also be helpful to the Committee and to me and to Senator Bunning. But I want to thank you for the obvious effort and preparation. We have a full spectrum representing, we think, all of the parties that have an interest in equity in this process.

Mr. Singh, if you would begin, please.

STATEMENT OF DINAKAR SINGH, FOUNDER AND CHIEF EXECUTIVE OFFICER, TPG-AXON CAPITAL, ON BEHALF OF MANAGED FUNDS ASSOCIATION

Mr. SINGH. Chairman Reed, Ranking Member Bunning, my name is Dinakar Singh. I am the founding partner of TPG-Axon Capital, a leading global investment firm, and we are a member of the Managed Funds Association, the MFA. The MFA, as you know, represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry

growth for hedge funds, funded funds, and managed futures funds, as well as industry service providers.

Now, I would note that the opinions I will talk about today do not represent the individual position of TPG-Axon or any individual firm, for that matter. They represent the collected consensus of MFA members on key issues.

Now, over the past two decades, the markets have changed in two particular and very dramatic ways. They are much more globally interconnected than they have ever been, and the velocity of moves has increased dramatically. What happens in one corner of the world gets transmitted everywhere, and transmitted at a speed that really was unimaginable once upon a time. These are simply facts of life in an age of globalization and technology. The growth of the hedge fund industry is a reflection of these changes.

Our ultimate investors are pension funds, endowments, foundations, families. Our job is to help them navigate a complex and fast-moving world and generate solid returns for their missions with less volatility than they would have otherwise.

By definition, we must be flexible, creative, and nimble to deliver the results our investors expect and depend upon. However, beyond that, the hedge fund industry is diverse, both in terms of what we do and how we do it. Yet we have common goals: To generate high quality and quantity of return to our investors while upholding high standards and ensuring that we don't negatively impact others in our attempts to do our job for our investors. Fairness and integrity are critical for our investors, for us, and for markets. Therefore, all leading hedge funds have a joint responsibility to ensure that high standards are upheld and best practices followed across the industry.

Now, in reflecting on events of the past few years, it would seem clear that sensible, balanced, importantly cohesive regulation—in short, smart regulation—of all major market participants is critical to ensuring fair and orderly markets. We support efforts as an industry to create a thoughtful and unified regulatory framework.

Now, I appreciate the opportunity to set the record straight about what hedge funds are and aren't, particularly in regard to size and leverage. Hedge funds manage nearly $1.5 trillion in global assets. This compares to over $9 trillion in just U.S. mutual fund assets and over $14 trillion in just U.S. banking assets. We are a meaningful participant in markets, but we are not the dominant one.

Regarding leverage, yes, hedge funds generally employ leverage, but it is far less than is employed in other parts of the financial services industry. Typical hedge fund leverage is two-to-one to four-to-one for every dollar of equity, and a large portion of those balance sheets are used to hedge and reduce volatility. Some hedge funds don't employ leverage at all since they hold much riskier assets than others.

Now, overall, these are far less levels of leverage than the high levels of leverage employed at banks, securities firms, and insurance companies. As a result, losses at hedge funds last year didn't pose the same systemic risk that losses at larger and more highly leveraged institutions did.

Mr. Chairman, hedge funds are not the root cause of the ongoing difficulties in our financial markets and our broader economy. Despite the challenges of the past year, the relatively modest size and low leverage of the industry meant that we haven't been the cause of problems to the average American investor or to the taxpayer. However, the unprecedented collapse in global markets has caused severe damage to our investors and consequently to the hedge fund industry, as well. As such, hedge funds have a shared interest with all market participants and policy makers in reestablishing stability and confidence in financial markets.

Now, smart regulation means improving the overall functioning of the financial system through appropriate, effective, and efficient regulation. We believe that established best practices are an important component of a smart regulatory framework as they promote efficient capital markets, market integrity, investor protection, and they reduce systemic risk.

Obviously, mandatory SEC registration for all advisers is one of the key regulatory reform proposals being considered by policy makers. We believe this approach, registering advisers to all private funds under the Investment Advisers Act, is the right approach. I note that your proposal, Mr. Chairman, and the Administration's proposal for regulation of private funds both take this approach. I would note that over half of FMA members are already registered under the Advisers Act.

Now, the Advisers Act provides a meaningful regulatory regime for registered investment advisers with significant disclosure and compliance requirements, including publicly available disclosure with SEC regarding the adviser's business; detailed disclosure with the clients on appropriate matters; clear policies and procedures to prevent insider trading in particular, but in addition to other factors; maintaining extensive books and records; and periodic inspections and examinations by SEC staff on a required basis.

We welcome sensible efforts to improve the health and efficiency of our financial system and to ensure that the very American principles of fairness and opportunity are represented in our capital markets, as well.

On behalf of MFA and its members, I appreciate the opportunity to testify here and would be happy to answer any questions that you have.

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

Mr. Chanos, please.

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

Mr. CHANOS. Good afternoon, Chairman Reed, Senator Bunning, and Members of the Subcommittee. My name is Jim Chanos. I am testifying today as Chairman of the Coalition of Private Investment Companies. Thank you for this opportunity.

We share the Subcommittee's commitment to restoring investor trust and confidence as a key step in helping our economy grow again. As part of your effort, we believe legislation to regulate private investment companies should be designed to protect investors and prevent fraud while fostering responsible innovation by private

investment companies who are often in the forefront of such innovation.

As this Subcommittee is aware, hedge funds and other private pools of capital were not the source of the near meltdown in our financial markets. In fact, as we learned over the past year, the greatest dangers to the world economy lay within large, highly regulated, diversified investment and commercial banks, insurance companies, and GSEs. Even so, CPIC supports appropriate regulation of private funds as an element of the regulatory improvements under consideration today.

The benefits of private funds to investors and the economy are well known. As Mr. Singh said, venture capital and private equity funds provide funding to startups, growing businesses, turn-around ventures. Hedge funds improve liquidity, price discovery, and efficiency in financial markets.

The main risks associated with private funds are those associated with the relationship between fund managers, investors, and individual counterparties. These risks center on, one, the level of transparency for investors and counterparties; two, the types of safeguards for investors' assets; and three, the opportunities for fraud and conflicts of interest. In rare cases, like Long-Term Capital Management in 1998, a fund may go to a size and level of leverage and interconnectedness that then presents a systemic risk.

Chairman Reed's bill, S. 1276, offers a creative and flexible approach to regulating private fund managers. It requires that private fund advisers register with the SEC under the Advisers Act and makes both the fund manager and the fund subject to SEC inspection. The bill also enhances the SEC's rule making authority to write different rules for different classes of advisers.

CPIC supports registration and has for a while, and SEC oversight of private fund advisers and supports these elements of S. 1276. We also suggest that you consider providing additional statutory direction to the SEC for rules it writes for private funds and their advisers. This type of direction could be achieved in a new Private Investment Company Act, a statute tailored specifically to address the unique nature of private funds, or through amendments to the pending legislation.

Some of the key elements of such a statute, in addition to SEC registration, should be, first, provisions to reduce the risks of Ponzi schemes and theft by requiring managers to keep all client assets with qualified custodians and requiring audits by independent public accounting firms overseen by the PCAOB.

Second, provisions to protect investors through specific disclosures, including a fund's valuation methodologies, the types of assets it holds, the existence of side arrangements, and the manager's trade allocation policies, and by requiring the delivery of audited financial statements.

Third, requirements that large funds establish plans to control operational counterparty leverage liquidity and portfolio risks, as well as plans for orderly wind-downs that assure investor parity.

Fourth, requirements to address counterparty risk by requiring funds to provide key information to their lenders and counterparties.

And finally, provisions to mandate customer identification and antimoney laundering programs for both market and national security reasons.

We believe these provisions will benefit investors by enhancing regulators' ability to prevent fraud and other abuse while also reducing systemic risk. Whether the Subcommittee elects to create a separate act as we suggest or to bring private fund managers under the Advisers Act, CPIC is committed to working with you to help provide a better regulatory framework.

Thank you for this opportunity.

Senator REED. Thank you, Mr. Chanos.

Mr. Loy, please.

STATEMENT OF TREVOR R. LOY, FOUNDER AND GENERAL PARTNER, FLYWHEEL VENTURES

Mr. LOY. Thank you, Chairman Reed, Ranking Member Bunning, and Members of the Committee. We very much appreciate the opportunity to be part of the discussion today.

I would like to begin today by talking about risk, because we all understand that is the reason we are here and we are all very concerned about it. That is what is on everyone's mind.

Risk is something that as venture capitalists we are very familiar with. In fact, we deal with it every day, although the risk we deal with is entrepreneurial and technological risk, not financial risk. And so I would like to give you some background on our industry and talk a bit about that.

Indeed, the fact that the U.S. actually proactively embraces entrepreneurial risk is one of the things that sets our economy apart from other countries and has allowed us as the venture industry to do what we do best: Translate brand new ideas, new entrepreneurs into new companies, millions of jobs, and countless innovations that otherwise would not have gotten into society.

As Congress and the Administration work to mitigate the kind of risk that led to the recent financial crisis, we urge you to continue to embrace entrepreneurial risk because it is what will help ultimately meet all the other critical goals for our Nation, including creating the new jobs and industries that will be part of pulling us out of this recession.

Given the recent financial meltdown, we obviously support the efforts to increase transparency and protect investors of all kinds. However, we do not believe that the venture industry is in the position to contribute to any systemic financial risk, and we urge caution when considering imposing one-size-fits-all layers of regulation on the venture community. Let me explain a little bit more our thinking.

The venture capital industry is very, very simple. We invest in startup companies run by entrepreneurs using capital from ourselves and outside investors, known as our limited partners, or LPs. Now, structurally, this is the same as most of the other asset classes you are considering, but otherwise I want to emphasize we are fundamentally different, as Director Donohue even acknowledged in his testimony. And I will suggest to you today that this one-size-fits-all approach will not accomplish the goals that we share of reducing systemic risk.

Going a bit more into how we invest, we invest cash to purchase equity shares, and we hold that equity typically for 5 to 10 years until the company is sold or goes public. The LPs' cash remains in their control until the VC identifies specific companies in which to invest. We then work closely with the entrepreneurs after we have invested in their companies alongside of them to grow their companies. Most of the folks in our industry are experienced company builders and technologists, not financial engineers.

When a company has grown enough that it has access to the public markets through an IPO or it can be acquired, the VC exits the company, and the liquidity from that transaction is immediately distributed back to our limited partners.

Of course, when we are not successful, which in our industry is a lot of the time, we lose all of our money invested. In fact, we expect to lose 40 percent—all of our money on up to 40 percent of the investments we make. But the loss doesn't extend anywhere beyond the venture ecosystem.

For over 40 years, this model has been a tremendous force in U.S. economic growth, building industries like the biotechnology, semiconductor, and now increasingly the clean technology industries. In fact, companies that were started with venture capital since 1970 today account for 12.1 million private sector jobs in the U.S.—that is nearly 10 percent—and $2.9 trillion in revenues in the United States, which is nearly 20 percent of the GDP.

We did this, however, without using leverage at all. It is not part of our equation. We work simply with cash and equity. As I like to say, we invest in real engineering and not financial engineering. We do not use debt to make investments or increase the capacity of our funds, and without debt, derivatives, or other complex financial instruments, we do not expose any party to losses in excess of their committed capital.

Nor are venture firms interdependent with the world financial system. We do not trade in the public markets, and our limited partners cannot withdraw capital during the entire 10-year or more life of the fund, nor can they publicly trade their partnership interest.

While some limited partners are public pension funds—and one of our esteemed colleagues on the panel today is an expert in that—under many State laws those public pension funds themselves are even limited to the amount of money that they dedicate to venture activity, typically even less than 5 percent of their entire asset portfolio.

The venture capital industry is also very small in size, despite the outsize impact we have on the economy. In 2008, U.S. venture capital funds held approximately $197 billion in aggregate assets raised over the last 10 years, and we invested just $28 billion into startup companies, which equates to less than 0.2 percent of the GDP.

In our world, in fact, the total potential loss from a $1 million investment is just that: It is limited to $1 million. There is no multiplier effect because there are no side best, no unmonitored securities, no swaps, no counterparties, and no derivatives traded based on our transactions.

Now, we do recognize the need for transparency into our activities, and today VCs already provide information to the SEC that is publicly available when we raise a fund. That information, submitted on what is known as a Form D, includes the nature, the size, the terms of the offering, critical dates and duration data, investment amounts, and the names and places of business for the fund. We are also subject, I should point out, to the same antifraud and other securities laws as regulated funds.

This information should already allow the Government to assess any systemic risk without the need for additional regulation. And I would also point out that we are open to dialogue about changing what is submitted on those forms to better provide information that is requested. But, in contrast, the formal requirements of registering as investment advisers under the current Advisers Act contain additional significant burdens without providing you any additional relevant information about our industry or systemic risk in the economy.

From preparing for SEC examinations to establishing complex compliance programs, overseen by a dedicated full-time compliance officer, which most of us would have to hire as a new staff member, SEC registration will demand significant resources which promise to be costly from both a financial and a human resources perspective.

Adding these significant administrative burdens in addition in exchange for information that is neither relevant nor useful for measuring and managing systemic risk seems counterproductive to us, at best.

While larger asset classes may be able to absorb the proposed regulatory costs, I am here to say that the venture industry—and also the startup entrepreneurial economy—will not go unscathed by the contemplated regulation.

When the Treasury designed new anti- money-laundering rules under the PATRIOT Act, they already recognized that not all investment vehicles posed risks that were worth regulating with the same one-size-fits-all approach, and they exempted industries that were not relevant to the money-laundering threat, including venture capital. In doing so, Treasury has successfully balanced the support for economic growth with the transparency required, and we hope that Congress and the Administration will work with our industry to ensure a similar outcome now.

Thank you.

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

Mr. Tresnowski, please.

STATEMENT OF MARK B. TRESNOWSKI, MANAGING DIRECTOR AND GENERAL COUNSEL, MADISON DEARBORN PARTNERS, LLC, ON BEHALF OF THE PRIVATE EQUITY COUNCIL

Mr. TRESNOWSKI. Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee, I am Mark Tresnowski, Managing Director and General Counsel for Madison Dearborn Partners. MDP is a Chicago-based private equity firm with $18 billion of assets under management. I appear today on behalf of the Private Equity Council, a 2-year-old trade association representing 12 of the largest private equity firms operating in the United States.

Between 1980 and 2005, the top-quartile PE firms delivered roughly $1.2 trillion of profits to public and private pension plans, university endowments, and other investors, and we did this by helping companies grow, create jobs, and become more competitive. The question today is whether we created this value by posing systemic risk to the financial system.

In laying out its financial regulatory reform program, the Obama administration articulated three fundamental factors that trigger systemic risk concerns: one, the impact a firm's failure on the financial system and economy; two, the firm's combination of size, leverage—including off-balance-sheet exposures—and degree of reliance on short-term funding; and, three, the firm's criticality as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the financial system. Private equity contains none of these systemic risk factors.

Specifically, PE firms have limited or no leverage at the fund level. As I mentioned, our firm is a firm that manages $18 billion in assets. We have only two lines of credit, each for $50 million, and they are both short-time lines that have to be repaid in 60 day.

Now, we often do have leverage in our portfolio companies, and this level of leverage can vary anywhere from zero in an all-equity transaction to 60 or 65 percent in the leveraged buyout. That compares to companies like Lehman Brothers which was leveraged 32:1 when it failed.

Total PE company borrowing represents a small portion of the overall credit market. Moreover, a World Economic Forum study of PE investing over 20 years demonstrates that PE company default rates are substantially below the default rates for U.S. companies that issue bonds generally during this period.

In addition, private equity investors are patient and commit their capital for 10 years or more, with no right to redeem your investment during that period. We are just this summer in the process of closing down our first MDP fund that was formed in 1992, so it had a 17-year life.

Private equity does not invest in short-term tradable securities like derivatives, swaps, or public equities, and private equity firms are not deeply interconnected with other financial market participants. When Lehman Brothers failed, we immediately did an assessment of our entire firm and our portfolio companies, and the exposure was minimal. We did the same thing with AIG and other companies that raised concern.

Private equity investments are also not cross-collateralized. Each fund stands alone, and each investment within a fund stands alone. If one fails, we do not borrow from the successful investments to cover that failure.

Let me turn to some of the specific proposals that the Subcommittee is considering. We support the creation of an overall systemic risk regulator which has the ability to obtain the information it needs, is capable of acting decisively in a crisis, and possesses the appropriate powers needed to carry out its mission.

Regarding private equity specifically, the Administration's plan calls for private equity firms to register as investment advisers with the SEC. Subcommittee Chairman Reed has introduced S.

1276, the Private Fund Transparency Act of 2009, which has a similar goal. We support these registration requirements.

To be clear, registration will result in regulatory oversight of many private equity firms, and there are considerable administrative and financial burdens associated with being a registered investment adviser. These could be especially problematic for smaller firms—firms smaller than ours. That said, we support strong regulation requirements to restore confidence in the financial markets and in each of its participants.

We do believe Congress should direct regulators to be precise in how new regulatory requirements are calibrated, so the burdens are tailored to the nature and size of the individual firm and the actual nature and degree of systemic risk posed.

In this regard, we are pleased that the Administration's white paper explicitly acknowledged that some requirements created by the SEC may vary across different types of private pools. We commend Chairman Reed for his sensitivity to this issue as well, and we think the emphasis on strong confidentiality of the information provided is also important.

We stand ready to work with you, Mr. Chairman, Members of your Committee, and the Administration in this important effort. I would be pleased to answer questions at the appropriate time.

Senator REED. Thank you very much.

Mr. Bookstaber, please.

STATEMENT OF RICHARD BOOKSTABER, AUTHOR OF "A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION"

Mr. BOOKSTABER. Mr. Chairman, Ranking Member Bunning, and other Members of the Committee, I thank you for the opportunity to testify today.

I will discuss the need for hedge fund regulation, specifically required to measure and monitor systemic risk. I will argue that regulators must obtain detailed position and leverage data from major hedge funds in order to successfully execute this task.

To understand why such data are necessary, let us look at one of the key sources of systemic risk, namely, the leverage. Leverage amplifies risk in a meltdown. When a market drops, highly leveraged hedge funds with positions in that market are to sell to meet their margin requirements, and this selling pushes prices down further. This in turn leads to more forced selling, and the result is a cascading liquidity crisis.

And it can get worse from there. Those hedge funds that are under pressure discover there is no longer liquidity in the stressed market, so they start to liquidate their positions in other markets. If many of the funds that are in the first market also have high exposure in a second one, the downward spiral propagates to this second market. This phenomenon explains why a systemic crisis can spread in surprising and unpredictable ways. The contagion is driven primarily by what other securities are owned by the hedge funds that need to sell.

To control this dynamic, we must be able to measure the crowding of the hedge funds to know how much leverage and exposure there is in the aggregate. This means knowing the positions of the

individual hedge funds and then being able to aggregate those positions.

Now, the data acquisition and analysis must be done by the regulator in a secure fashion. I would like to make two observations related to the feasibility of achieving an acceptable level of data security.

First, hedge funds already allow these data to be held by various agents in the private sector, such as their prime brokers and clearing corporations. Second, the Government successfully secures data in areas that are far more sensitive than position data such as in the military and the intelligence community where a failure can cost lives and where there are concerted efforts by adversaries to root out the data.

Let me briefly discuss the institutions that should be monitored for hedge fund-related systemic risk regulation.

For purposes of systemic regulation, hedge fund oversight should be extended to include the large proprietary trading operations within banks. From the standpoint of leverage and the ability to short, these operations act in the same way as do other hedge funds. However, venture capital firms and private equity funds can be excluded. Venture capital and private equity funds operate outside the publicly traded markets, they do not short; and, because of the nature of their collateral, they do not employ the degree of leverage of the hedge funds that operate in the public markets.

In conclusion, obtaining the position and leverage data required to measure and monitor this risk need not be invasive to the hedge funds. It does not affect day-to-day operations of the funds, and once the systems for transferring these data to the regulator are in place, it will be an essentially costless adjunct to the funds' already existing daily risk analysis. This sort of data management task has already been accomplished in other settings.

For example, when salmonella was found in a peanut factory in Georgia, the Food and Drug Administration identified the contaminated products across the Nation and tracked them all the way to the store shelves. This was possible because consumer products are tagged with a bar code. We should do the same for financial products. We should have the equivalent of bar codes so that regulators know what financial products exist and where they are being held.

My testimony does not address the next critical component of hedge fund regulation, the component that can be invasive, namely, what to do if the analysis of the health information technology data shows systemic risk working on the horizon. Who bears the responsibility for having the hedge funds reduce their exposure or leverage? Such regulatory authority must exist for hedge funds, just as it must exist for banks and other financial institutions of systemic import. However, the task of acquiring and analyzing data can be separated from the task of taking action based on that data. And acquiring the data is the first task to address, because we cannot manage what we cannot measure.

Thank you for the opportunity to testify today, and I look forward to your questions.

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

Mr. Dear, please.

STATEMENT OF JOSEPH A. DEAR, CHIEF INVESTMENT OFFICER, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Mr. DEAR. Thank you, Chairman Reed, Ranking Member Bunning, Members of the Subcommittee. My name is Joe Dear. I am Chief Investment Officer of CalPERS. We invest over $180 billion on behalf of 1.6 million active and retired State and local government employees in California. We are a broadly diversified investor, essentially investing in all asset classes and all geographies, including hedge funds, pew, and venture capital.

We are a long-horizon investor supplying patient capital with a decades-long investment horizon. Therefore, we have a vital interest in the quality of regulation of financial services in the United States and around the world.

Private equity and hedge funds play an important role in our portfolio. We have been investing in private equity since 1990 and in hedge funds since 2002; $20 billion of our assets are invested in private equity vehicles and $6 billion of our assets are invested in hedge funds, or about 14 percent of our total assets.

Our hedge fund return over the past 5 years has been 3.89 percent, considerably above what we earn in public markets, and our private equity return over 10 years is 6 percentage points, 600 basis points, above what we would earn in public markets. These assets, these investments are extremely important to the success of our investment program.

You have asked about risk, and you have heard from this whole panel about risk in the system. I would say basically the fundamental risk posed by private pools of capital is their ability to choose not to be regulated, to operate in the shadows of the financial system, depriving regulators of information about risks, leverage ratios, counterparties, and other information necessary to ascertain the overall level of risk in the system and whether that level of risk is excessive or not.

We have learned that the individual regulation of entities and activities is insufficient when the risk in the system builds up to a point where there is a catastrophic event.

Now, the question before you is: What action can Congress take? Your hearing today coincides with the release of a report by the Investors Working Group, an entity created by the Council of Institutional Investors, which I chair, and the CFA Institute. This is a bipartisan or nonpartisan group of experts in investment trying to present the investor's voice in this regulatory reform debate. We have identified four flaws in the regulatory system exposed by the credit crisis:

First, Federal regulators need to be strengthened and revitalized.

Second, we need to close gaps in the regulatory system, and you have heard a lot about that today.

Third, we need to strengthen corporate governance.

And, fourth, there needs to be the designation of a systemic risk regulator.

I want to highlight the recommendations of the Investor Working Group report that addressed hedge funds and private equity in the markets and instruments in which they invest.

With respect to closing gaps, as you have heard, hedge funds, private equity, and other private pools of capital should be required to register with the Securities and Exchange Commission. In addition, they should be required to make regular disclosures in real time for regulators, particularly to the systemic risk regulator, and on a delayed basis to markets and investors.

In particular, with respect to some instruments that are traded, standardized and standardizable OTC derivatives should be traded on regulated exchanges, and one party in the transaction should have an economic interest in the transaction, an insurable interest in the transaction.

The SEC and the Commodity Futures Trading Commission should, as they have tried to do, establish who is responsible for what in the regulation of OTC derivatives.

With respect to securitized products, like asset-backed securities and mortgage securities, new accounting standards are required so that the risks posed by these potentially off-balance-sheet items are visible to investors.

The SEC should also require sponsors of asset-backed securities to improve the timeliness and quality of disclosures. There are many instances of shelf registrations being used to present to investors opportunities which if at the time an offering statement is not available, and you have to choose whether to invest or not without adequate information. That practice needs to be brought to an end.

And, of course, issuers should have skin in the game.

With respect to strengthening Federal regulators, they need support to carry out their mission. They need the resources to do that, and they need the skill and training to keep up with the rapidly evolving markets in which they are responsible for regulating.

The SEC mission has grown. The size of its staff has not. That is true for other regulatory entities. So some kind of stable, long-term funding for these entities needs to be found.

Finally, with respect to systemic risk, an entity should be created which has the authority to gather all the relevant information about what is happening in the market and to be able to get that on a real-time basis. This entity needs to be independent and well staffed. It needs the ability to compel action by other regulators, specific regulatory agencies, or those agencies need to explain why they are not taking the recommended action. And, finally, great attention needs to be paid to the adequacy of capital standards and the adequacy of capital in financial institutions, since that is one of the principal sources of risk.

Mr. Chairman, we applaud your leadership in this effort, and we look forward to working with you and others so that we all get this right. Thank you.

Senator REED. Thank you very much, Mr. Dear, and I want to thank all the panelists for very thoughtful and very helpful testimony. I am going to try to address a question to each of the panelists. If my time expires, I will stop and then we will start a second round.

Mr. Singh, you point out in your testimony that you and your organization feel that the best approach is to use the Investment Ad-

visers Act. Are there any particular changes or specific modifications that you would suggest also with respect to the Advisers Act?

Mr. SINGH. Chairman Reed, I think so, here representing the MFA, I think there are, I would say, a variety of views on this. From my perspective and from our perspective, the Advisers Act has sufficient strength and teeth in it to take the important first step forward.

Second, I think taking that step and getting to a point at which there is a thoughtful regulatory system, a cohesive regulatory system, and data is helpful. If in time it seems clear that the tools are not sufficient, more can be added. But there is a balance to be struck here.

Generally speaking, investors in most private investment firms, certainly hedge funds, are large and they are sophisticated. And, second, by definition, what we do requires creativity, nimbleness, and flexibility. And so I think the critical point is to get to a point at which the systemic risk is clearly addressed, stability in the system is clearly improved and enhanced; and yet we also do not go so far as to actually start detracting from the markets themselves.

And so from my perspective, we think the Advisers Act has the sufficient tools, though it certainly does not prevent modifications or enhancements down the road.

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

Mr. Chanos, your testimony made some, I think, valuable suggestions about information and authority that the regulators should have. This is a common issue that has come up, which is basically—and Mr. Loy did a very good job of laying out the one-size-fits-all approach. And Mr. Tresnowski also suggested a variation in sort of approaches.

Can you comment on that sort of issue?

Mr. CHANOS. Well, I would echo some of Mr. Donohue's comments in that we are looking at bringing the managers under these statutes or possible statutes, or within enhanced versions of the act, not the funds themselves. So I think there are a number of things that managers who are fiduciaries of both pension funds and wealthy individuals and others share in common, that we feel enhanced legislation would best suit or strengthening of existing legislation. Some of that would be the ability to give specific direction to the SEC, for example, as opposed to just leaving it to a more vague rule making process.

Enhanced disclosure is easier with specific mandates, I think. More modern concerns like anti- money-laundering I mentioned, which doesn't get the attention I think it deserves, could be specifically tailored through legislation embodying all aspects of the private investment world.

And, finally, I think you lessen the risk of judicial review if you give clear, broad mandates via legislation as opposed to rule making. We saw that with the SEC's attempt to register hedge funds a couple years ago.

So I think all these things are easier if done proactively as opposed to by exemption.

Senator REED. Thank you.

Mr. Loy, you have made a very thoughtful and strong case in the venture community about your suitability for, necessity for regula-

tion. You also pointed out that in Regulation D, you make a presentation to the SEC, and I appreciate the fact that the industry were willing to work for improvements or more information along those lines.

But let me just raise a question that Mr. Donohue suggested, which is the ingenuity of people to sort of reform or recalculate themselves to take advantage of an exemption. Is that something that we should be concerned about in terms of the venture community? Or, alternatively stated, if there is a total exemption, will people find ways to exploit that venture exemption, if it exists?

Mr. LOY. Well, most people want to be venture capitalists, so——

[Laughter.]

Mr. LOY. Just kidding. I think that is an excellent question, Mr. Chairman. I do think—and I think our industry understands—and I want to emphasize, we are not arguing that the structure or name or nomenclature or semantics should be the basis of the regulation. What we are arguing is that there are certain types of investment activities in which our activities do not pose any systemic risk, and we would certainly be comfortable, I believe, in some sort of disclosure in which we, you know, certified that we were not engaging in any of the types of activities. And if one was engaging in those activities, then that would require sort of a subsequent additional amount to become registered, *et cetera.*

So I want to be clear. We are happy to provide information, transparency, and certify about the kinds of things we are doing or not doing and allow the SEC to then choose—or not choose but, you know, to be instructed as to only follow up on those kinds of firms engaging in the behaviors that they believe could potentially contribute to systemic risk.

Senator REED. Thank you, Mr. Loy.

Mr. Tresnowski, your approach is—I think you suggested that it would be the flexibility, which the Administration has talked about and we have tried to talk about, to tailor investment adviser regulations to the appropriate model. Any comments that you would like to make?

Mr. TRESNOWSKI. Yes, I think it is important because I think that—you know, you hear the terms "hedge fund," "private equity fund," "venture capital fund," and it is sometimes very difficult to understand what the differences are. There clearly are differences. But where you draw the line, for example, between venture capital and private equity has always been a mystery to me. We do investments in startup companies. We also do leveraged buyouts.

I think if you focus on activities, therefore, you are going to get the kind of information that you need. And I agree with the suggestion that if there is—you could have a single set of regulations that elicit information. Do you cross-collateralize your investments? And in our cases, the answer would be, no, we don't, and so we wouldn't answer the rest of the questions on that form.

Do you have leverage at your portfolio companies? We would answer yes. You would answer no.

So I think there is a way to do it where—and, again, if the focus is on trying to get the information that allows the systemic risk regulator to make decisions and monitor risk, I think that is the right way to go.

Senator REED. Well, thank you very much.

Mr. Bookstaber, thank you for your testimony. I think you provided some critical insights about the potential systemic consequences of some hedge funds' behavior. I was also struck by your explanation in the testimony, your written testimony, about Long Term Capital, that it really was not the Russian ruble collapse; it was the Danish mortgage market. And so that was an insight that I had not heard, but it was compelling because it suggests that things are connected together and that what happens in one market, through what you have described, can happen in other markets.

You left sort of the—maybe the $64 trillion question, which is we collect all this information, and what do we do with it? Do you have any ideas along those lines?

Mr. BOOKSTABER. I think that is a difficult question and I think I was smart enough to know where to stop——

Senator REED. OK.

Mr. BOOKSTABER. ——because I don't know from a political standpoint what way would be the most palatable. But Senator Bunning did mention—ask the question, do you limit the leverage only if there is crisis? Do you limit the leverage at the hedge fund level? Do you limit it through the banks? I believe that if you try to control leverage by just having a limit on leverage, whether it is from the banks or in the hedge funds, you will be using a very blunt instrument to get at the issues of the systemic risk, because there are plenty of times where you can take leverage without it leading to systemic risk. Systemic risk will occur if there is leverage plus crowding.

So to be more precise in controlling the systemic risk that comes from leverage, I think the way that you want to do it is to use the data to try to discern the times where there are a wad of people on the same side of the boat, where there is this crowding. At that point, the tools for dealing with it, the lever that you use is really a matter of who ends up with the authority. Is it done through haircuts at the banking level or is there authority who can go directly to the hedge funds? You know, that remains to be seen.

Senator REED. The one other point I think that you made in your written testimony was that hedge funds can operate against themselves in these markets. They are not aware of what the other hedge fund is doing.

Mr. BOOKSTABER. Right.

Senator REED. They have a strategy based upon everybody else sort of being straight equity investors and they might be shorting. But if there are two or three funds shorting, then the whole system——

Mr. BOOKSTABER. Yes.

Senator REED. So I think just a comment. I think this approach of getting the information might also ultimately be beneficial to some hedge fund participants.

Mr. BOOKSTABER. Yes, I think that is true. The analogy I used in my written testimony was it is as if you are sitting in a darkened theater and you don't know whether there are just four people there or it is stuffed to the gills. So a hedge fund, although they can't know who else is in the market, might want to have some in-

formation, or at least have somebody who has sufficient oversight to know if there is enough crowding at the very time that there is an exotic shock that forces them to go out of the market, there are ten other people doing the same thing.

Senator REED. Thank you very much.

And Mr. Dear, thank you for your testimony and also for your leadership. I thought the report issued today will be very helpful to us going forward. We are going to go ahead, I think, and pursue an issue of investment registration, adviser registration. As one of the premier investors in the country, is there a danger that just simply giving the SEC label of "registered investment adviser" would take away from due diligence, would undermine what the investor himself has to do? Is that something we should be worried about?

Mr. DEAR. I think it could, but I think if it did, it would involve a breach of fiduciary duty on the part of the pension funds and endowments who are making those kinds of investments. Part of the lesson of 2008 is you can't simply rely on a rating agency or other entity for the information you need to decide whether the investment makes sense for your portfolio given your objectives, your risk appetite, and whether the investor that you are going to put your money with has the degree of integrity that you demand from a partner.

Registration simply makes it possible for the information to be out there and for steps to be taken if somebody gets outside—gets out of bounds. I think you have to look at the whole system in terms of information requirements, registration requirements, better scrutiny, better accounting of the instruments which are traded, and if we don't do all of those things, then we are going to leave the system vulnerable again to another crisis.

Senator REED. Thank you very much.

Senator Bunning.

Senator BUNNING. Thank you.

For all the firms, if we had a systemic risk regulator and that regulator came to you and told you to get out of some positions, how would you react?

Mr. LOY. I would just say that in venture capital, we would like to be able to get out of more of our positions right now, so——

[Laughter.]

Senator BUNNING. But if you were told to get out by a regulator——

Mr. LOY. In all seriousness?

Senator BUNNING. Yes, in all seriousness.

Mr. LOY. Senator, we do not trade in public markets, so there often is for 5 to 7 years no market at all for the companies we are building until they have reached a point of maturity.

Senator BUNNING. You are not answering my question.

Mr. LOY. The answer is, we would have to shut our investments down. There is no market on a dime for selling our companies.

Senator BUNNING. Your company or the investments——

Mr. LOY. The companies in which we invest in. If you told me that I had——

Senator BUNNING. There is no market?

Mr. LOY. There is no market. We would shut them down.

Mr. TRESNOWSKI. I would——

Senator BUNNING. Let me ask, did you have to get a rating from a rating company before you bought?

Mr. LOY. No, sir. We only invest in private companies——

Senator BUNNING. Private companies——

Mr. LOY. ——started from scratch——

Senator BUNNING. Well, sometimes those private companies have to go get rated before your firm would buy any part of that company.

Mr. LOY. In the case of venture capital, that is not the case.

Senator BUNNING. I can give you chapter and verse on when it did. It got a triple-B rating and it cost $250,000 and they borrowed $200,000 and your risk capital, or venture capital or whatever you want to call yourself, put in the rest of the capital and bought the firm.

Mr. LOY. I think, Senator, you may be talking more about a model that is associated with my colleague here from private equity. In the case of venture capital, often, particularly in my case, we are seed-stage investors. The companies often do not exist when we first invest.

Senator BUNNING. Oh. What about ones that do exist?

Mr. LOY. The ones that do exist are still so fledgling, often just one or two employees that have been funded entirely on those employees' credits or second mortgage.

Senator BUNNING. OK. Let us have the next man answer the same question.

Mr. TRESNOWSKI. Well, it is—we would have difficulty, as well. I would say, in general terms, we have two types of investments. We have investments in private companies, and if the regulator came to us and said, you have to get rid of that investment——

Senator BUNNING. In other words, it is systemically going to hurt the market.

Mr. TRESNOWSKI. Right. That would be very difficult for us to respond to because the only way we can sell a private company is to take it public or to sell it to somebody else——

Senator BUNNING. That is correct.

Mr. TRESNOWSKI. ——and if there is a market to do that, we would probably be looking at it anyway. And if we are not looking at it and there is a market for it, it is because the valuation is far below what we as investment managers think the value is.

The other type of company we have is a company that we have invested in that has gone public, and there the problem is our positions in those companies, because we at one time owned them, can be 50 to 60 percent of the stock of the company. So if the regulator came to us and said, you need to get out of this company, it would be catastrophic to that company because we would dump the stock on the market.

Senator BUNNING. OK. How about the hedge funds?

Mr. CHANOS. I was going to say, I think you want to be looking more toward our end of the table on this question.

Senator BUNNING. OK. I look to anybody who had answered the question. I just happened to get two people that didn't have the answer.

Mr. CHANOS. A few years ago, my firm—speaking for my firm specifically and not the coalition I represent—we had a very celebrated short position in the shares of Enron Corporation. So if the Government regulator came to us and said, we want you to cover that short position for whatever reason, I think my first responsibility, quite frankly, Senator, is to my clients as a fiduciary. So I would have to call my attorneys and say, well, can the Government force me to do this, because I think in this particular case, I would want to be short the shares of Enron because I thought it was a fraud. So it really——

Senator BUNNING. You happened to be right, but that is beside the point.

Mr. CHANOS. Well, it would, again, depend. My first responsibility as a fiduciary, as a money manager, is to my clients, and I would have to look at it through that prism, get advice from legal counsel, and if counsel advised me that in their business judgment it made a lot of sense to unwind the position because Uncle Sam was asking me to, I would probably do it.

Senator BUNNING. Mr. Singh.

Mr. SINGH. Senator, I think there are a host of challenges and complexities. I think we would all say the obvious, which is that as you noted in the comments with the previous panel, the complexity involved with an individual person, institution, agency in deciding—in understanding complex risks and deciding when a line has gone too far is enormous. We would note that over the last decade or so, there have been three crises. The 1998 crisis was a function of a number of things, Long-Term Capital——

Senator BUNNING. I have a question on that.

Mr. SINGH. ——was one of them. The tech crisis, if you will, and the things that trigger it, I think was a second one. And this last one was a banking and a finance problem. I think it is probably true that the next one will be different and I think the ability for anyone to go and predict the future is difficult.

Senator BUNNING. I don't want to predict the future. I want to prevent it from——

Mr. SINGH. Understood. I think, look, from our perspective, I would say first if something was needed to be done and it was clear that we had to do it, of course, we would do it. I think, as my colleague said, presumably we had a sensible reason to do it in the first place. Our investors clearly presumably would have asked us questions about something that was an extraordinary risk. And third, people that lend us money clearly see our balance sheet and interrogate and investigate things all the time that are of concern to them. We have lots of folks asking questions.

So ultimately, it would be surprising to us, because our first instinct would be, gosh, if we thought it made sense, we thought it was a sensible, responsible investment to make, if we thought it made sense to our investors and to our lenders, it would be surprising to us that the Government would say that this was a very bad thing to do. So if it were a voluntary question, we would want to learn more and understand why, because we all have a responsibility not to get ourselves in trouble or the country in trouble. Of course, ultimately, if it is a required decision, then you can ask those questions, but it is after the fact.

Senator BUNNING. This has something to do with what Mr. Bookstaber suggested. He suggested giving the regulator the power to collect information on the firm's position and strategies. How do we protect that information? Specifically, how do we prevent someone at the regulator from either sharing that information or leaving the agency with that information in his head and then profiting from it? Go ahead.

Mr. BOOKSTABER. As I mentioned in my testimony, you know, that is a critical question, and certainly from the industry standpoint, if they want to object to this information being brought in, that would be the first line of defense is to—but I would say that, given that we—I am repeating my testimony to some extent, but I think that, number one, there already are in the private sector agents who have the position information of the firms. And number two, the Government does a very good job of securing information of far more value.

So I could try to posit different safeguards one way or the other, but I think there is a precedent that exists both on the private and the public sector that there is the capacity to protect and safeguard this type of information.

Senator BUNNING. Last question, and anybody can answer, the hedge funds, particularly. What do you think caused the failure of Long-Term Capital Management in 1998? What do you think caused it?

Mr. SINGH. Senator, I think, sure, there are many factors, but I think ultimately the one similarity with Long-Term Capital Management and, frankly, the crisis in the past year is that when people believe something to be very safe and believe it can only move modestly and they count on that and it turns out that is not true, very bad things happen. The difference in bond movements in 1998 was, in fact, the thing that could never have happened and it was not contemplated by Long-Term Capital Management and their balance sheet and structure against it simply wasn't sensible.

I think the lesson of this last year, as well, of course, there was an assumption by many that home prices could never go down and people lent against it assuming they could never go down. That fundamentally is at the core of this and that has been shown to be not true, and, of course, anything that people are certain is true, eventually markets turn out to have a way of turning around on its head.

I think the lesson of all this, frankly, and this is the problem with crises, is that we have to make sure that when there is too much conviction and belief in any one thing, that there is a responsibility to assess whether or not people are taking it too far.

Senator BUNNING. How do we stop talking heads from telling us that, then?

Mr. SINGH. Senator, I think in some ways this ties to your last question. I think the reality is, the industry position and theory is that systemic risk share leaders are a sensible step forward. I would note two things. With apprehension, because these are complicated and very difficult things and the notion that one thing or person can get it right and make calls, balls and strikes, if you will, in that sense, is a difficult one.

On the other hand, I think we also know that it has been a terrible year and environment for many Americans and people around the world, enormous pain inflicted on people, and so it may well be that it is worth trying something that is difficult and complicated in the hope and the attempt to go and at least see whether we can try to reduce the odds of something like this happening again.

Senator BUNNING. In so doing, we may just double and triple the problem, so I want you to be aware that that is why we are hesitant, or at least some of us are, in trying to get our hands on this market that not a lot of us are fully aware of the risks that are involved in each and everyone's firm or the market itself. I mean, the expertise up here is not as good as the expertise sitting at that table, and to think that we can go out and hire people for $150,000 a year to do that, I think is a little foolish, to say the least. Thank you.

Senator REED. I guess we will have to bring back the draft, Jim.

Senator BUNNING. OK.

[Laughter.]

Senator REED. I want to thank you all. This has been extremely helpful. I want to thank Senator Bunning for his contribution. I thought it was very useful to begin to explore these issues. This is not the last time we will have to deal with them.

There seems to be a recognition by all that further transparency is important, to get the data, to get the information, to at least be able to gauge the systemic risk. But I think the question that we have to address is how do you do it, how do you deal with it, what tools must the systemic regulator have to step in.

In terms of my recollection of Long-Term Capital, it was bringing all the significant banks together and saying, pony up the money. They did that. That worked. So there are maybe other tools than sort of just going in and telling you, stop.

And I think the other point I would say, and I think this has been recognized, is that there is a value to have this information and we just have to be smart about how we collect it, how we protect it, and then how we use it, which might be the most challenging issue.

But I want to thank you. This has been a very helpful session. Thank you.

Senator BUNNING. Thank you all.

Senator REED. The hearing is adjourned.

[Whereupon, at 4:18 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN JACK REED

I want to welcome everyone, and thank Mr. Donahue and our other witnesses for appearing today.

As we continue the important work of modernizing an outdated financial regulatory system, I have called this hearing to explore another key aspect of such reforms, the regulation of hedge funds and other private investment pools, such as private equity funds and venture capital funds.

The current financial crisis has reinvigorated my long-held concern that the regulation of hedge funds and other pooled investment vehicles should be improved to provide more information to regulators to help them address fraud and prevent systemic risk in our capital markets. These private pools of capital are responsible for huge transfers of capital and risk, and so examining these industries and potential regulation are extremely important to this Subcommittee.

Hedge funds and other private investment funds generally operate under exemptions in Federal securities laws that recognize that not all investment pools require the same close scrutiny demanded of retail investment products, like mutual funds. Hedge funds generally cater to more sophisticated and wealthy investors who are responsible for ensuring the integrity of their own investments, and as a result are permitted to pursue somewhat riskier investment strategies. Indeed, these funds play an important role in enhancing liquidity and efficiency in the market, and subjecting them to fewer limitations on their activities has been, and continues to be, a reasonable policy choice.

However, these funds have often operated outside the framework of the financial regulatory system, even as they have become increasingly interwoven with the rest of the country's financial markets. As a result, there is no data on the number and nature of these firms or any regulatory ability to actually calculate the risks they pose to the broader economy.

Over the past decade the SEC has recognized there are risks to our capital markets posed by some of these entities, and it has attempted to require at a minimum that advisers to these funds register under the Investment Advisers Act so that SEC staff can collect basic information from and examine these private pools of capital. The SEC's rule making in this area, however, was rejected by a Federal court in 2006. As a result, without statutory changes, the SEC is currently unable to examine private funds' books and records, or to take sufficient action when the SEC suspects fraud. In addition, no regulator is currently able to collect information on the size and nature of hedge funds or other funds to identify and act on systemic risks that may be created by these pools of capital.

To address this regulatory gap, I recently introduced the Private Fund Transparency Act of 2009, which would require investment advisers to private funds, including hedge funds, private equity funds, venture capital funds, and others, to register with the SEC. The bill would provide the SEC with the authority to collect information from these entities, including information about the risks they may pose to the financial system. In addition, it would authorize the SEC to require hedge funds and other investment pools to maintain and share with other Federal agencies, on a confidential basis, any information necessary for the identification and mitigation of systemic risk.

I hope today's hearing provides an opportunity to discuss my proposal and others, so that we can consider ways to determine the best approach in this area. The financial crisis is a stark reminder that transparency and disclosure are essential in today's marketplace. Improving oversight of hedge funds and other private funds is vital to their sustainability and to our economy's stability.

PREPARED STATEMENT OF SENATOR JIM BUNNING

Thank you, Mr. Chairman.

In some ways, the structure and incentives of these private pools of capital are what we should be hoping for in the rest of the financial system. Success is rewarded and failure is punished. Pay is based on performance over time, and not just in the short term. And managers have skin in the game, with their own funds at risk. It seems obvious to me that firms and traders will act more responsibly when they know they will face the consequences of their actions, which is why bailouts breed more bailouts.

I do have some concerns about the risks that these firms could pose to our system. Hedge funds in particular use leverage, which can lead to out-sized losses and panic selling. Losses in one part of a portfolio can force the sale of other assets, which spreads the losses to a normally unrelated investment. Just look at last fall for an example.

I am also concerned about the potential for market manipulation and fraud. When firms can seek profit by any strategy they dream up, there will be great temptation to cheat. I am not saying all or even most firms are dishonest, but the temptation will be there. And that cheating is harder to detect because of the secrecy of portfolios and strategies. Huge risks to the system could build up out of sight of the regulators and other market participants as well.

How we address these concerns is not an easy question, and I do not yet know the answer. I am skeptical of the idea of a Government regulator being smart enough to recognize concentration of risk and act to reduce it. Instead, it may make more sense to limit how much risk these firms can take on, and thus how much risk they pose to others, by imposing leverage restrictions. However, I am not sure if it is better to put restrictions on the firms themselves, or limit the dealings of banks and other regulated institutions with these firms.

These are by no means all the issues to consider, but I hope to get some thoughts on them here today. Thank you, Mr. Chairman.

PREPARED STATEMENT OF ANDREW J. DONOHUE

DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT,
SECURITIES AND EXCHANGE COMMISSION

JULY 15, 2009

I. Introduction

Thank you for the opportunity to testify before you today. My name is Andrew Donohue, and I am the Director of the Division of Investment Management at the Securities and Exchange Commission. I am pleased to testify on behalf of the Commission about regulating hedge funds and other private investment pools.[1]

Over the past two decades, private funds, including hedge, private equity, and venture capital funds, have grown to play an increasingly significant role in our capital markets both as a source of capital and the investment vehicle of choice for many institutional investors. We estimate that advisers to hedge funds have almost $1.4 trillion under management. Since many hedge funds are very active and often leveraged traders, this amount understates their impact on our trading markets. Hedge funds reportedly account for 18–22 percent of all trading on the New York Stock Exchange. Venture capital funds manage about $257 billion of assets,[2] and private equity funds raised about $256 billion last year.[3]

The securities laws have not kept pace with the growth and market significance of hedge funds and other private funds and, as a result, the Commission has very limited oversight authority over these vehicles. Sponsors of private funds—typically investment advisers—are able to organize their affairs in such a way as to avoid registration under the Federal securities laws. The Commission only has authority to conduct compliance examinations of those funds and advisers that are registered under one of the statutes we administer. Consequently, advisers to private funds can "opt out" of Commission oversight.

Moreover, the Commission has incomplete information about the advisers and private funds that are participating in our markets. It is not uncommon that our first contact with a manager of a significant amount of assets is during an investigation by our Enforcement Division. The data that we are often requested to provide members of Congress (including the data we provide above) or other Federal regulators are based on industry sources, which have proven over the years to be unreliable and inconsistent because neither the private funds nor their advisers are required to report even basic census-type information.

This presents a significant regulatory gap in need of closing. The Commission tried to close the gap in 2004—at least partially—by adopting a rule requiring all hedge fund advisers to register under the Investment Advisers Act of 1940 (Advisers Act).[4] That rule making was overturned by an appellate court in the *Goldstein* deci-

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[1] Commissioner Paredes does not endorse this testimony.

[2] The National Venture Capital Association (NVCA) estimates that 741 venture capital firms and 1,549 venture capital funds were in existence in 2007, with $257.1 billion in capital under management. NVCA, Yearbook 2008 at 9 (2008). In 2008, venture capital funds raised $28.2 billion, down from $35.6 billion in 2007. Thomson Reuters & NVCA, News Release (Apr. 13 2009). In 2007, the average fund size was $166 million and the average firm size was $347 million. *Id.* at 9.

[3] U.S. private equity funds raised $256.9 billion in 2008 (down from $325.2 billion in 2007). Private Equity Analyst, 2008 Review and 2009 Outlook at 9 (2009) (reporting Dow Jones LP Source data), available at *http://fis.dowjones.com/products/privateequityanalyst.html.*

[4] Investment Advisers Act Release No. 2333 (Dec. 2, 2004).

sion in 2006.[5] Since then, the Commission has continued to bring enforcement actions vigorously against private funds that violate the Federal securities laws, and we have continued to conduct compliance examinations of the hedge fund advisers that remain registered under the Advisers Act. But we only see a slice of the private fund industry, and the Commission strongly believes that legislative action is needed at this time to enhance regulation in this area.

The Private Fund Transparency Act of 2009, which Chairman Reed recently introduced, would require advisers to private funds to register under the Advisers Act if they have at least $30 million of assets under management.[6] This approach would provide the Commission with needed tools to provide oversight of this important industry in order to protect investors and the securities markets. Today, I wish to discuss how registration of advisers to private funds under the Advisers Act would greatly enhance the Commission's ability to properly oversee the activities of private funds and their advisers. Although the Commission supports this approach, there are additional approaches available that also would close the regulatory gap and provide the Commission with tools to better protect both investors and the health of our markets.

II. The Importance and Structure of Private Funds

Private funds are generally considered to be professionally managed pools of assets that are not subject to regulation under the Investment Company Act of 1940 (Investment Company Act). Private funds include, but are not limited to, hedge funds, private equity funds, and venture capital funds.

Hedge funds pursue a wide variety of strategies that typically involve the active management of a liquid portfolio, and often utilize short selling and leverage.

Private equity funds generally invest in companies to which their advisers provide management or restructuring assistance and utilize strategies that include leveraged buyouts, mezzanine finance, and distressed debt. Venture capital funds typically invest in earlier stage and start-up companies with the goal of either taking the company public or privately selling the company. Each type of private fund plays an important role in the capital markets. Hedge funds are thought to be active traders that contribute to market efficiency and enhance liquidity, while private equity and venture capital funds are seen as helping create new businesses, fostering innovation, and assisting businesses in need of restructuring. Moreover, investing in these funds can serve to provide investors with portfolio diversification and returns that may be uncorrelated or less correlated to traditional securities indices.

Any regulatory reform should acknowledge the differences in the business models pursued by different types of private fund advisers and should address in a proportionate manner the risks to investors and the markets raised by each.

III. Current Regulatory Exemptions

Although hedge funds, private equity funds and venture capital funds reflect different approaches to investing, legally they are indistinguishable. They are all pools of investment capital organized to take advantage of various exemptions from registration. All but one of these exemptions were designed to achieve some purpose other than permitting private funds to avoid oversight.

A. Securities Act of 1933

Private funds typically avoid registration of their securities under the Securities Act of 1933 (Securities Act) by conducting private placements under section 4(2) and Regulation D.[7] As a consequence, these funds are sold primarily to "accredited investors," the investors typically receive a "private placement memorandum" rather than a statutory prospectus, and the funds do not file periodic reports with the Commission. In other words, they lack the same degree of transparency required of publicly offered issuers.

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[5] See *Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006).

[6] Section 203A(a)(1) of the Act prohibits a State-regulated adviser to register under the Act if it has less than $25 million of assets under management. The Commission has adopted a rule increasing the $25 million threshold to $30 million. See Rule 203A-1 under the Advisers Act. The threshold does not apply to foreign advisers. Section 3 of the Private Fund Transparency Act would establish a parallel registration threshold for foreign advisers, which would prevent numerous smaller foreign advisers that today rely on the *de minimis* exception, which the Act would repeal, from being required to register with the Commission.

[7] Section 4(2) of the Securities Act of 1933 provides an exemption from registration for transactions by the issuer of a security not involving a public offering. Rule 506 of Regulation D provides a voluntary "safe harbor" for transactions that are considered to come within the general statutory language of section 4(2).

B. Investment Company Act of 1940

Private funds seek to qualify for one of two exceptions from regulation under the Investment Company Act of 1940 (Investment Company Act). They either limit themselves to 100 total investors (as provided in section 3(c)(1)) or permit only "qualified purchasers" to invest (as provided in section 3(c)(7)).[8] As a result, the traditional safeguards designed to protect retail investors in the Investment Company Act are the subject of private contracts for investors in private funds. These safeguards include investor redemption rights, application of auditing standards, asset valuation, portfolio transparency, and fund governance. They are typically included in private fund partnership documents, but are not required and vary significantly among funds.

C. Investment Advisers Act of 1940

The investment activities of a private fund are directed by its investment adviser, which is typically the fund's general partner.[9] Investment advisers to private funds often claim an exemption from registration under section 203(b)(3) of the Advisers Act, which is available to an adviser that has fewer than 15 clients and does not hold itself out generally to the public as an investment adviser.

Section 203(b)(3) of the Advisers Act contains a *de minimis* provision that we believe originally was designed to cover advisers that were too small to warrant Federal attention. This exemption now covers advisers with billions of dollars under management because each adviser is permitted to count a single fund as a "client." The Commission recognized the incongruity of the purpose of the exemption with the counting rule, and adopted a new rule in 2004 that required hedge fund advisers to "look through" the fund to count the number of investors in the fund as clients for purposes of determining whether the adviser met the *de minimis* exemption. This was the rule overturned by the appellate court in the *Goldstein* decision. As a consequence, approximately 800 hedge fund advisers that had registered with the Commission under its 2004 rule subsequently withdrew their registration.

All advisers to private funds are subject to the antifraud provisions of the Investment Advisers Act, including an antifraud rule the Commission adopted in response to the *Goldstein* decision that prohibits advisers from defrauding investors in pooled investment vehicles.[10] Registered advisers, however, are also subject to periodic examination by Commission staff. They are required to submit (and keep current) registration statements providing the Commission with basic information, maintain business records for our examination, and comply with certain rules designed to prevent fraud or overreaching by advisers. For example, registered advisers are required to maintain compliance programs administered by a chief compliance officer.

IV. Options To Address the Private Funds Regulatory Gap[11]

As discussed below, though there are different regulatory approaches to private funds available to Congress, or a combination of approaches, no type of private fund should be excluded from any new oversight authority any particular type of private fund. The Commission's 2004 rule making was limited to hedge fund advisers. However, since that time, the lines which may have once separated hedge funds from private equity and venture capital funds have blurred, and the distinctions are often unclear. The same adviser often manages funds pursuing different strategies and even individual private funds often defy precise categorization. Moreover, we are concerned that in order to escape Commission oversight, advisers may alter fund investment strategies or investment terms in ways that will create market inefficiencies.

A. Registration of Private Fund Investment Advisers

The Private Funds Transparency Act of 2009 would address the regulatory gap discussed above by eliminating Section 203(b)(3)'s *de minimis* exemption from the Advisers Act, resulting in investment advisers to private funds being required to register with the Commission. Investment adviser registration would be beneficial to investors and our markets in a several important ways.

Accurate, Reliable, and Complete Information: Registration of private fund advisers would provide the Commission with the ability to collect data from advisers about their business operations and the private funds they manage. The Commis-

[8] "Qualified purchasers" generally are individuals or family partnerships with at least $5 million in investable assets and companies with at least $25 million. The section 3(c)(7) exception was added in 1996 and specifically anticipated use by private funds.

[9] Private funds often are organized as limited partnerships with the fund's investment adviser serving as the fund's general partner. The fund's investors are limited partners of the fund.

[10] See Rule 206(4)-8 under the Advisers Act.

[11] Commissioner Casey does not endorse the approaches discussed in sections IV. B and C.

sion and Congress would thereby, for the first time have accurate, reliable, and complete information about the sizable and important private fund industry which could be used to better protect investors and market integrity. Significantly, the information collected could include systemic risk data, which could then be shared with other regulators.[12]

Enforcement of Fiduciary Responsibilities: Advisers are fiduciaries to their clients. Advisers' fiduciary duties are enforceable under the antifraud provisions of the Advisers Act. They require advisers to avoid conflicts of interest with their clients, or fully disclose the conflicts to their clients. Registration under the Advisers Act gives the Commission authority to conduct on-site compliance examinations of advisers designed, among other things, to identify conflicts of interest and determine whether the adviser has properly disclosed them. In the case of private funds, it gives us an opportunity to determine facts that most investors in private funds cannot discern for themselves. For example, investors often cannot determine whether fund assets are subject to appropriate safekeeping or whether the performance represented to them in an account statement is accurate. In this way, registration may also have a deterrent effect because it would increase an unscrupulous adviser's risk of being discovered.

A grant of additional authority to obtain information from and perform on-site examinations of private fund advisers should be accompanied with additional resources so that the Commission can bring to bear the appropriate expertise and technological support to be effective.

Prevention of Market Abuses: Registration of private fund advisers under the Advisers Act would permit oversight of adviser trading activities to prevent market abuses such as insider trading and market manipulation, including improper short-selling.

Compliance Programs: Private fund advisers registered with the Commission are required to develop internal compliance programs administered by a chief compliance officer. Chief compliance officers help advisers manage conflicts of interest the adviser has with private funds. Our examination staff resources are limited, and we cannot be at the office of every adviser at all times. Compliance officers serve as the front-line watch for violations of securities laws, and provide protection against conflicts of interests.

Keeping Unfit Persons From Using Private Funds To Perpetrate Frauds: Registration with the Commission permits us to screen individuals associated with the adviser, and to deny registration if they have been convicted of a felony or engaged in securities fraud.

Scalable Regulation: In addition, many private fund advisers have small to medium size businesses, so it is important that any regulation take into account the resources available to those types of businesses. Fortunately, the Advisers Act has long been used to regulate both small and large businesses, so the existing rules and regulations already account for those considerations. In fact, roughly 69 percent of the investment advisers registered with the Commission have 10 or fewer employees.

Equal Treatment of Advisers Providing Same Services: Under the current law, an investment adviser with 15 or more individual clients and at least $30 million in assets under management must register with the Commission, while an adviser providing the same advisory services to the same individuals through a limited partnership could avoid registering with the Commission. Investment adviser registration in our view is appropriate for any investment adviser managing $30 million regardless of the form of its clients or the types of securities in which they invest.

B. Private Fund Registration

Another option to address the private fund regulatory gap might be to register the funds themselves under the Investment Company Act (in addition to registering their advisers under the Advisers Act). Alternatively, the Commission could be given stand-alone authority to impose requirements on unregistered funds. Through direct regulation of the funds, the Commission could impose, as appropriate, investment restrictions or diversification requirements designed to protect investors. The Commission could also regulate the structure of private funds to protect investors (such as requiring an independent board of directors) and could also regulate investment terms (such as protecting redemption rights).

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[12] The Private Fund Transparency Act includes some important although technical amendments to the Advisers Act that are critical to the Commission's ability to collect information from advisers about private funds, including amendments to Section 204 of the Act permitting the Commission to keep information collected confidential, and amendments to Section 210 preventing advisers from keeping the identity of private fund clients from our examiners.

C. Regulatory Flexibility Through Rule-making Authority

Finally, there is a third option that in conjunction with advisers' registration may be necessary to address the regulatory gap in this area. Because it is difficult, if not impossible, to predict today what rules will be required in the future to protect investors and obtain sufficient transparency, especially in an industry as dynamic and creative as private funds, an additional option might be to provide the Commission with the authority that allows for additional regulatory flexibility to act in this area. This could be done by providing rule-making authority to condition the use by a private fund of the exceptions provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act. These conditions could impose those requirements that the Commission believes are necessary or appropriate to protect investors and enhance transparency.[13] In many situations, it may be appropriate for these requirements to vary depending upon the type of fund involved. This would enable the Commission to better discharge its responsibilities and adapt to future market conditions without necessarily subjecting private funds to Investment Company Act registration and regulation.

V. Conclusion

The registration and oversight of private fund advisers would provide transparency and enhance Commission oversight of the capital markets. It would give regulators and Congress, for the first time, reliable and complete data about the impact of private funds on our securities markets. It would give the Commission access to information about the operation of hedge funds and other private funds through their advisers. It would permit private funds—which play an important role in our capital markets—to retain the current flexibility in their investment strategies.

The Commission supports the registration of private fund advisers under the Advisers Act. The other legislative options I discussed above, namely registration of private funds under the Investment Company Act and/or providing the Commission with rule-making authority in the Investment Company Act exemptions on which private funds rely, should also be weighed and considered as the Subcommittee considers approaches to filling the gaps in regulation of pooled investment vehicles.

I would be happy to answer any questions you may have.

PREPARED STATEMENT OF DINAKAR SINGH

FOUNDER AND CHIEF EXECUTIVE OFFICER, TPG-AXON CAPITAL,
ON BEHALF OF MANAGED FUNDS ASSOCIATION

JULY 15, 2009

Chairman Reed, Ranking Member Bunning, Members of the Subcommittee—My name is Dinakar Singh, and I am the founding partner of TPG-Axon Capital, a leading global investment firm. As with many leading hedge funds, we are headquartered in the U.S., though we oversee investments around the world, for investors from across the world, and with employees and offices in three continents. I am here today to speak on behalf of the Managed Funds Association (MFA) and its members. On their behalf, I am pleased to provide this statement in connection with the Senate Subcommittee on Securities, Insurance, and Investment hearing, "Regulating Hedge Funds and Other Private Investment Pools" held on July 15, 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.

On behalf of MFA and its members, I appreciate the opportunity to express the industry's views on regulation for managers of private pools of capital, including hedge fund managers. The opinions presented today do not represent the individual position of TPG-Axon, or any individual firm, but rather represent the collected consensus of our (MFA) members on key issues.

The hedge fund industry is diverse, both in terms of what we do and how we do it. And yet there are clear issues that all leading hedge funds have in common, and common goals that we all ought to try to achieve. We manage money for pension funds, endowments, foundations, and families. The money they invest with us, and the returns they hope to receive, are critical to fulfilling their individual missions:

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[13] For example, private funds might be required to provide information directly to the Commission. These conditions could be included in an amendment to the Investment Company Act or could be in a separate statute.

scholarships for students, retirement benefits for workers, supporting arts and sciences, providing healthcare to communities.

Our mission? To generate high quality and quantity of returns for our investors, while upholding high standards, and ensuring that we do not negatively impact others in our attempts to do our job for our investors. Our investors depend upon us to deliver results for them—and if we cannot, their ability to serve their communities and constituencies is damaged. However, fairness and integrity are also critical, for them, for us, and for markets. Therefore, all leading hedge funds have a joint responsibility to ensure that high standards are upheld, and best practices followed, across the industry.

While acknowledging that "one size does not fit all" for hedge funds, or their investors, it is worth noting the primary reasons why our investors choose to invest with us. Simplistically, institutions historically found that portfolios invested only in stocks and bonds delivered suboptimal performance over the long term. Stocks have historically been highly volatile and correlated to each other, while bonds have not provided enough return relative to the safety and diversification they provided. As a result, institutional investors have broadened their portfolio scope over time to include a broader array of investments, in the hope that diversification will enhance return, while diminishing the volatility of that return. For the most part, hedge funds have accomplished their mission, and helped improve the quality and quantity of returns of their investors. In turn, this has led to tremendous growth in the industry, and increased the influence of hedge fund activity in financial markets. Therefore, as important and responsible participants in markets, we welcome systematic and thoughtful dialogue about ways to enhance the stability and quality of our financial markets.

In our view, any 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 assumptions.

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 with the 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 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 percent 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

MFA and its members support a smart approach to regulation, which includes appropriate, effective, and efficient regulation and industry best practices that (i) promote efficient capital markets, market integrity, and investor protection and; (ii) better monitor and reduce systemic risk. Smart regulation 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. 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).[1] As part of its commitment to ensuring that Sound Practices remains at the forefront of setting standards of excellence for the industry, MFA and its members have 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 and other industry groups have also created global, unified principles of best practices for hedge fund managers.

Because of the complexity of our financial system, an ongoing dialogue among 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.

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.

MFA and its members recognize that the framework for the registration and regulation of managers to private pools of capital is part of the broader discussion regarding regulatory reform, which includes regulatory proposals regarding systemic risk, over-the-counter markets and consumer protection. We are committed to continuing to be an active and constructive participant in the broader regulatory reform

[1] MFA's Sound Practices is available at: *http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf.*

discussion. My testimony today will focus on the primary topic of today's hearing, regulation of managers to private pools of capital.

II. Hedge Fund Manager Registration and Regulation

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. The Obama administration, in its release "Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation" (the "Administration Proposal"),[2] is supportive of this approach, calling for the registration of advisers of hedge funds and other private pools of capital with the SEC. MFA and its members support the Administration's proposal to require the registration of investment advisers to all private pools of capital, subject to a limited exemption for the smallest investment advisers with a *de minimis* amount of assets under management. We believe that a registration framework under the Advisers Act is the smart approach to registration and regulation of managers to private pools of capital.

MFA and its members have publicly supported this comprehensive approach to adviser registration over the past several months, even when the Administration called for a narrower registration requirement only for advisers to the largest and most systemically relevant private pools of capital. We strongly encourage policy makers also to consider the issue of registration 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 U.S. 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 set out in the Administration Proposal of registering investment advisers, including advisers to private pools of capital, under the Investment Advisers Act of 1940 (the "Advisers Act") is the right approach in considering this issue. In fact, more than half of MFA member firms already are registered with the Securities and Exchange Commission (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 15 clients would be an effective way to achieve this result.[3] 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:

- 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;[4]
- 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

[2] Available at: *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.*

[3] We note that this approach is consistent with the approach taken by H.R. 711 and S. 1276.

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

- Adopting and implementing written proxy voting policies.

Though the Advisers Act already provides a meaningful regulatory framework for investment advisers, MFA and its members have been working with policy makers to explore ideas for possible enhancements to the Act. These enhancements are designed to ensure that regulators have appropriate authority to conduct meaningful oversight over and regulation of investment advisers to private pools of capital and the pools (funds) that those advisers manage. In particular, MFA and its members have been working to develop proposals that will ensure regulators have appropriate transparency regarding private funds and have the authority and tools necessary to prevent fraud. We believe that an enhanced Advisers Act regulatory framework is the most effective means to achieve those goals, and we are committed to working with policy makers on developing that framework.

In addition to registration and regulation of advisers through the Advisers Act, 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.[5] 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 SEC, which is the existing regulator with oversight of investment advisers, has acknowledged that its examination and enforcement resources are already seriously constrained.[6] This raises the question whether the SEC 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.[7] 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 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:

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[5] 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.

[6] 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.*

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

- The goal of any reform efforts should be to develop a more intelligent and effective regulatory framework, which makes our financial system stronger for the benefit of consumers, businesses, and investors.
- 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 rule making 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 regulators keep confidential any sensitive, proprietary information that market participants report. 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.[8] Regulations should not force market participants publicly to reveal information that would be tantamount to revealing their trade secrets to competitors.
- 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.
- 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. Hedge Fund Best Practices

MFA and its members recognize the importance of a smart regulatory framework designed to protect investors, prevent systemic risk, and ensure appropriate over-

[8] MFA and its members also believe that regulators should also ensure that they share information with foreign regulators only under circumstances that protect the confidentiality of that information. For example, the SEC has adopted Rule 24c-1 under the Exchange Act (17 CFR §24c-1), which allows the SEC in its discretion to share nonpublic information with a foreign financial authority if the authority receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate. MFA believe that U.S. regulators should employ this type of approach when sharing information with foreign regulators.

sight by regulators. In addition to regulation, it is important for market participants to promote investor protection and limit systemic risk through high standards of business conduct, as reflected in industry best practices.

As mentioned earlier, MFA and its members have been at the forefront of developing and promoting industry best practices through the recommendations in its Sound Practices. Over the past 10 years, MFA and its members have regularly updated and enhanced Sound Practices to ensure that the recommendations in that document are at the forefront of best practices for the hedge fund industry. Most recently, MFA and other industry groups have developed global, unified principles of best practice for the hedge fund industry. These unified principles are designed to be applicable to hedge fund managers in all jurisdictions. MFA's Sound Practices contains robust recommendations that address, among other things, important investor protection considerations such as robust disclosure from managers as well as risk management, which can help guard against systemic risk concerns. Adoption of these recommendations by hedge fund managers will help managers develop strong business practices. Strong business practices are an important complement to regulation to achieve the goals of investor protection and prevent systemic risk.[9]

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.

On behalf of MFA and its members, I appreciate the opportunity to testify before the Subcommittee. I would be happy to answer any questions that you may have.

PREPARED STATEMENT OF JAMES S. CHANOS

CHAIRMAN,

COALITION OF PRIVATE INVESTMENT COMPANIES

JULY 15, 2009

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee. 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 private investment companies that are diverse in size and in the investment strategies they pursue, with a wide range of clients that include pension funds, asset managers, foundations, other institutional investors, and qualified wealthy individuals.

I want to thank you for the opportunity to testify on the regulation of hedge funds and other private investment pools. Among other subjects, my testimony discusses pending legislative proposals for private investment funds, including the bill introduced by Chairman Reed, S. 1276, which I believe offers a creative and flexible approach to regulating managers of private investment funds under the Investment Advisers Act of 1940 (Advisers Act). I also suggest for your consideration an approach that may be more difficult to achieve legislatively, but which would be more comprehensive and less reliant upon expansive rule making by the Securities and Exchange Commission to achieve effective regulation of private investment companies and their managers. In short, I recommend that you consider drafting a special

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[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.*

[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.

"Private Investment Company" statute, specifically tailored for SEC regulation of private investment funds.

Private investment company legislation should require registration of private funds with the SEC; provide that each such fund and its investment manager be subject to SEC inspection and enforcement authority, just as mutual funds and registered investment advisers are; require custody and audit protections to prevent theft, Ponzi schemes and fraud; require robust disclosures to investors, counterparties and lenders; require that private funds provide basic census data in an online publicly available form; require that they implement antimoney laundering programs, just as broker-dealers, banks and open-end investment companies must do; and, for larger funds, require the adoption of risk management plans to identify and control material risks, as well as plans to address orderly wind-downs. CPIC believes that these statutory requirements would benefit investors by putting into place a comprehensive regulatory framework that enhances the ability of regulators to monitor and address systemic risks while providing clearer authority to prevent fraud and other illegal actions. Our approach strives for the highest standards of prevention without eliminating the beneficial effects of responsible innovation.

Whatever approach this Subcommittee chooses, either through robust amendments to the Advisers Act or by creating a new Private Investment Company Act, I look forward to working with you and your staff as you consider legislation in this area.

Benefits of Private Pools of Capital

Your letter of invitation requests that witnesses discuss the benefits of private pools of capital to investors and to the broader economy. Our financial markets benefit from the wide diversity of market participants—investment bankers and broker-dealers, commercial banks and savings institutions, mutual funds, commodity futures traders, exchanges and markets of all types, traders of all sizes, and a variety of managed pools of capital, including venture funds, private equity funds, commodity pools, and hedge funds, among others.

Private investment companies play significant, diverse roles in the financial markets and in the economy as a whole. For example, venture capital funds are an important source of funding for start-up companies or turnaround ventures. Other private equity funds provide growth capital to established small-sized companies, while still others pursue "buyout" strategies by investing in underperforming companies and providing them with capital and/or expertise to improve results. These types of funds may focus on providing capital in particular sectors, for example, energy, real estate, and infrastructure, among others.

Hedge funds invest in or trade a variety of financial instruments on a global level, including stocks, bonds, currencies, futures, options, other derivatives and physical commodities. Some invest in securities and hold long term positions, such as some long-short funds and short-only funds. Some are strictly traders. Many serve as important counterparties to other participants in the market who wish to offset risk. Others may become "activists" and use a large equity position in a company to encourage management to make changes to increase shareholder value. Hedge funds, as a group, add to the depth, liquidity, and vibrancy of the markets in which they participate. The individuals who run them bring their research and insight to bear on the value of various assets, thereby adding to the price discovery and efficiency of the markets as a whole. The important role of hedge funds and other private investment funds in the U.S. and global markets has been widely acknowledged over many years by Government and private sector groups, including the President's Working Group on Financial Markets, the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the Federal Reserve Board.[2]

In addition to the benefits provided by these flexibly structured pools of capital to investors and to the markets more broadly in terms of liquidity, efficiency, and price discovery, private investment funds are a potential source of private invest-

[2] See, *e.g.,* remarks of Bernard Bernanke, who called hedge funds a "positive force in the American financial system." Hearing on the Nomination of Bernard S. Bernanke to be Member and Chairman of the Federal Reserve Board, S. Comm. on Banking, Housing, and Urban Affairs; (Nov. 15, 2005) (statement of Bernard Bernanke) (unpublished transcript). Other financial regulators also view hedge funds as a positive force. For example, the United Kingdom's Financial Services Authority, releasing a March 2006 report on hedge funds, reiterated its view that hedge funds are "a vital segment of the financial services industry. In particular they play a fundamental role in the efficient reallocation of capital and risk, and remain an important source of liquidity and innovation in today's markets." Press Release, FSA (Mar. 23, 2006) available at *www.fsa.gov.uk/pages/Library/Communication/PR/2006/026.shtml.*

ment to participate with the Government in addressing the current financial crisis.[3] It therefore is in the interests of investors, U.S. markets, and the broader economy that private investment funds continue to participate in our financial markets and have the flexibility to perform their unique roles.

Risks Posed by Private Pools of Capital

In recent years, prior to the current economic downturn, some market observers believed that hedge funds and other private pools of capital would be the source of the next financial crisis. Of course, as we have all painfully learned, the greatest danger to world economies came not from those entities subject to indirect regulation, such as hedge funds, but from institutions such as banks, insurance companies, broker-dealers, and Government-sponsored enterprises operating with charters and licenses granted by State and Federal regulators and under direct regulatory supervision, examination, and enforcement. Indeed, 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. The Stanford group of companies used an SEC-registered broker-dealer and SEC-registered investment adviser to market, among other products, certificates of deposit of an affiliated offshore bank.

Nonetheless, those of us who are in the private investment fund industry recognize that a modernized financial regulatory system—one that addresses overall risk to the financial system and that regulates market participants performing the same functions in a consistent manner—will include appropriate regulation of hedge funds and other private pools of capital.

To address the specific question posed by your letter of invitation regarding the risks posed by private investment funds, it is fair to say that the types of risks they pose are different from those posed by other financial institutions. Private investment funds are not part of the governmental "safety net," as are insured depository institutions—no Federal guarantees are provided to their investors. Moreover, while some hedge funds are large, they are dwarfed by the sizes of financial institutions such as commercial and investment banks, the Government-sponsored enterprises, and others. Despite the rapid growth and size of hedge funds ($1.33 trillion), their relative size within the financial sector is small, accounting for less than one percent of the approximately $196 trillion invested in the world's financial assets—including equities, Government and private debt, and deposits.[4] Nor do private investment funds participate as intermediaries in payment and settlement systems. Finally, because they are not relying on a Federal safety net or supervision, the counterparties to transactions with hedge funds and other private investment funds typically require them to have higher levels of capital and liquidity and to post strong collateral, as compared to more heavily regulated financial institutions. For all these reasons, when a private fund fails, it is not as likely to set off a chain reaction, such as we saw when Lehman Brothers collapsed.

In a rare case, such as that involving the super-leveraged Long Term Capital Management in 1998, it is possible that a private fund could grow to a level of size, leverage, and interconnectedness that it might pose systemic risk. Yet, in our experience, the most prominent risks associated with hedge funds relate to the relationship between funds, their managers, their investors, and discrete counterparties. In a nutshell, these are the risks of unfair dealing with clients, lack of transparency, certain custody issues, potential fraud, and conflicts of interest.

Congress has sought to ensure that hedge funds and other private funds deal appropriately with their investors by imposing conditions on the exemptions from registration under the Securities Act of 1933, the Investment Company Act of 1940 (Investment Company Act), and in some cases the Commodity Exchange Act (CEA),

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[3] United States Department of the Treasury, "Fact Sheet: Public–Private Investment Program" (Mar. 23, 2009) (available at *http://www.treas.gov/press/releases/reports/ppip_fact_sheet.pdf*).

[4] Total hedge fund industry capital stood at $1.33 trillion as of the first quarter 2009, with 9,284 funds in operation at year-end 2008, according to Hedge Fund Research, Inc. See "Positive Hedge Fund Performance Fails To Offset Record Fund of Funds Withdrawals in Q1", (Apr. 21, 2009) (available at *http://www.hedgefundresearch.com/pdf/pr_20090421.pdf*); Hedge Fund Research, Inc., "Record Number of Hedge Funds Liquidate in 2008", (Mar. 18, 2009) (available at *http://www.hedgefundresearch.com/pdf/pr_20090318.pdf*). The total value of the world's financial assets—including equities, Government and private debt, and deposits—was $196 trillion in 2007. See McKinsey Global Institute, "Mapping Global Capital Markets: Fifth Annual Report" (Oct. 2008) (available at *http://www.mckinsey.com/mgi/reports/pdfs/fifth_annual_report/fifth_annual_report.pdf*).

under which they operate.[5] To meet these exemptions, the laws require hedge funds to limit their offerings to private placements with high net worth sophisticated investors, who are able to understand and bear the risks of the investment. A private fund must either limit its beneficial owners to not more than 100 persons and entities (typically all or most of whom are "accredited investors"), or limit its investors to super-accredited "qualified purchasers," such as individuals with more than $5 million in investments and institutions with more than $25 million in investments. Private funds typically file exemptive notices with the SEC and State securities commissioners under Regulation D of the Securities Act of 1933. Many also file notices with the National Futures Association under the CEA exemptions by which they operate (which impose their own additional restrictions on sophistication and qualifications of investors).

Moreover, the SEC and criminal prosecutors have significant regulatory and enforcement authority to address a number of potential risks posed by private funds—both risks to their clients and risks to other market participants. For example, private investment funds are subject to the same restrictions on their investment and portfolio trading activities as most other securities investors, including such requirements as the margin rules[6] (which limit the use of leverage to purchase and carry publicly traded securities and options); SEC Regulation SHO[7] (which regulates short-selling); the Williams Act amendments to the Securities Exchange Act of 1934 (Exchange Act)[8] and related SEC rules (which require public reporting of the acquisition of blocks of securities and regulate other activities in connection with takeovers); and FINRA's "new issues" Rule 5130 (which governs allocations of IPOs). Private investment funds must also abide by the rules and regulations of the markets in which they seek to buy or sell financial products. And, perhaps most important, they are subject to antifraud and antimanipulation requirements, such as Section 10(b) of the Securities Exchange Act of 1934[9] and Rule 10b-5,[10] as well as insider trading prohibitions, both in the funds' investment and portfolio trading activities, and in the funds' offers and sales of units to their own investors. Private fund advisers also are subject to the antifraud provisions in Section 206 of the Advisers Act, which applies to both registered and unregistered investment advisers.[11]

However, regulators' lack of detailed information about private investment funds—the absence of a registration requirement and the inability of a regulator to subject private funds to periodic reporting and examination—may handicap the SEC in meeting its investor protection mandate, and may handicap financial regulators generally in addressing potential systemic risks. Therefore, CPIC for many years has advocated that the SEC, at a minimum, be able to collect certain "census" data regarding all private investment funds; we further have advocated basic protections for investors in private funds, including disclosure requirements (particularly with respect to valuation of fund assets) and custody requirements, as well as audits by accounting firms registered with the Public Company Accounting Oversight Board (PCAOB).

Approaches by Market Participants and Regulators To Limit Risks Without Unduly Limiting Benefits

Private sector groups, often working with regulators, have developed best practices for hedge funds over the years, and the industry continues to improve in the areas of risk management and client protection. For example, for a number of years the Managed Funds Association has published and updated a "Sound Practices" guide for hedge funds.[12] Institutional investors have strengthened their "due diligence" processes and have demanded more information and stronger risk management approaches from the funds in which they invest. As a report by the Govern-

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[5] See "Implications of the Growth of Hedge Funds", Staff Report to the United States Securities and Exchange Commission, at 11-17, 23-25 (Sept. 2003), available at *http://www.sec.gov/news/studies/hedgefunds0903.pdf* (Staff Report).

[6] 12 C.F.R. §§220, 221.

[7] 17 C.F.R. §§242.200–203.

[8] The Williams Act added 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) in 1968. Related legislation added Section 13(g), §78m(g), in 1977.

[9] 15 U.S.C. §78j.

[10] 17 C.F.R. §240.10b-5.

[11] 15 U.S.C. §80b-6.

[12] "Sound Practices for Hedge Fund Managers 2009", Managed Funds Association (available at *http://www.managedfunds.org/mfas-sound-practices-for-hedge-fund-managers.asp*).

ment Accountability Office (GAO) in May 2009 noted, "hedge fund advisers have improved disclosure and become more transparent about their operations . . . ."[13]

The President's Working Group on Financial Markets since its formation in 1999 has shared information regarding private investment funds among regulators and also has launched initiatives with the private sector, including the PWG's appointment in 2007 of an Asset Managers' Committee, on which I served, and an Investors' Committee, each of which issued reports earlier this year on best practices for private fund managers and investors, respectively.[14]

In my view, one of the most important recommendations of the report of the Asset Managers' Committee (AMC Best Practices) is that managers should disclose more details—going beyond Generally Accepted Accounting Principles—regarding how their funds derive income and losses from Financial Accounting Standard (FAS) 157 Level 1, 2, and 3 assets.[15] 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 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 may wish to give legal effect to many of these recommendations; in fact, I believe any private investment company legislation should do just that. But, I would urge that Congress carefully tailor legislation in this area, in order to preserve the flexibility of private funds and their capacity for innovation that has benefited investors and the capital markets over the years.

What Legislative Changes Are Needed?

Current Advisers Act and Investment Company Act Framework

As this Subcommittee is aware, private investment companies and their advisers are not required to register with the SEC if they comply with the conditions of certain exemptions from registration under the Investment Company Act and the Advisers Act.[16] Congress created exemptions under these laws, because it determined

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[13] "Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges." GAO-09677T (May 7, 2009) (available at *http://www.gao.gov/products/GAO-09-677T*).

[14] See, *e.g.,* "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*).

[15] 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.

[16] *Section 3(c)(1) of the Investment Company Act* excludes a company from the definition of an "investment company" if it has 100 or fewer beneficial owners of its securities and does not offer its securities to the public. Under the Securities Act of 1933 and SEC rules, an offering is not "public" if it is not made through any general solicitation or advertising to retail investors, but is made only to certain high-net-worth individuals and institutions known as "accredited investors." "Accredited investors" include banks, broker-dealers, and insurance companies. The term also includes natural persons whose individual net worth or joint net worth with a spouse exceeds $1 million, and natural persons whose individual income in each of the past 2 years exceeds $200,0000, or whose joint income with a spouse in each of the past 3 years exceeds $300,000, and who reasonably expect to reach the same income level in the current year.

Section 3(c)(7) of the Investment Company Act excludes a company from the definition of an "investment company" if all of its securities are owned by persons who are "qualified purchasers" at the time of acquisition and if the Company does not offer its securities to the public. Congress added this section to the Investment Company Act in 1996 after determining that there should be no limit on the number of investors in a private investment fund, provided that all of such investors are "qualified purchasers." In brief, "qualified purchasers" must have even greater financial assets than accredited investors. Generally, individuals that own not less than $5 million in investments and entities that own not less than $25 million in investments are qualified purchasers.

Section 203(b)(3) of the Advisers Act exempts from registration any investment adviser that, during the course of the preceding 12 months has had fewer than 15 clients and that does not

that highly restrictive requirements applicable to publicly offered mutual funds and advisers to retail investors were not appropriate for funds designed primarily for institutions and wealthy investors.

To date, legislative proposals to regulate private investment companies have focused on limiting the exemptions from regulation of private investment companies under the Investment Company Act or removing an exemption under the Advisers Act and thus subjecting private investment companies or their advisers to the requirements of one of those Acts.[17] Although I agree that private investment companies and their managers should be subject to additional regulatory requirements to protect investors and counterparties, I believe simply eliminating the exemptions in either or both of these statutes will prove unsatisfactory.[18]

The first lesson we all learned in shop class was to use the right tool for the job. Neither the Investment Company Act nor the Advisers Act in its current form is the right tool for the job of regulating hedge funds and other private investment companies. They do not contain the provisions needed to address the potential risks posed by the largest large private investment companies, the types of investments they hold, and the contracts into which they enter. At the same time, those laws each contain provisions designed for the types of businesses they are intended to regulate—laws that would either be irrelevant to oversight of private investment companies or would unduly restrict their operation.

The Advisers Act and the Investment Company Act (which applies primarily to the retail mutual fund sector), are both designed primarily for retail investor protection in individual accounts that invest in publicly traded stocks and bonds. Neither has specific provisions designed to protect funds' counterparties or control systemic

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hold itself out as an investment adviser nor act as an investment adviser to any investment company. Advisers to hedge funds and other private investment companies are generally excepted from registration under the Advisers Act by relying upon Section 203(b)(3), because a fund counts as one client.

In some cases, where these companies and their advisers engage in trading commodity futures, they also comply with exemptions from registration under the "commodity pool operator" and "commodity trading advisor" provisions of the CEA. These exemptions generally parallel the exemptions from registration under the securities laws.

[17] For example, a bill introduced in the House, H.R. 711, simply strikes the "private adviser" exemption under Section 203(b)(3) of the Advisers Act and makes private funds subject to the Advisers Act in its entirety. Another bill introduced in the Senate, S. 344, attempts a more tailored approach by altering the current private fund exemptions under the Investment Company Act to make them conditional exemptions, available only where a fund registers with the SEC and provides specified disclosures.

[18] In my testimony before the SEC's public roundtable on hedge funds in 2003, I recommended that, as a further condition to exemption under the Advisers Act, hedge funds should be subject to specific standards relating to investor qualifications, custody of fund assets (an issue on which there now is significant focus as a result of the Madoff scandal), annual audits and quarterly unaudited reports to investors, clear disclosure of financial arrangements with interested parties (such as the investment manager, custodian, prime broker, and others—in order to address conflicts issues), clear disclosure of investment allocation policies, and objective and transparent standards for valuation of fund assets that are clearly disclosed, not stale, and subject to audit. 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*).

When I testified before this Committee in 2004, I expanded upon these points and recommended that the SEC require, as a condition to a hedge fund's exemption under the Advisers Act, that hedge funds file basic information with the SEC and certify that they met the standards outlined above. Testimony 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=79b80b77-9855-47d4a514-840725ad912c*). See also Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) (available at *http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf*). This would have provided the SEC with hedge fund "census" data it has long said it needs; it also would have provided a basis for SEC enforcement action against any fund failing to meet the above standards. Had the SEC adopted this recommendation, the agency would have avoided the legal challenge to the rule it adopted later that year to change its interpretation of the term "client" under the Advisers Act in order to require hedge fund managers to register. See *Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006).

As this Subcommittee knows, the SEC's hedge fund adviser registration rule was struck down in 2006, (*id.*) and the SEC decided not to appeal. Some hedge fund managers that had registered with the SEC under the rule withdrew their registrations. I decided that my firm should remain registered as an investment adviser (which we are still today), but, as I testified in 2006 before this Committee, the Advisers Act is "an awkward statute for providing the SEC with the information it seeks . . . and for dealing with the broader issues that are outside the Act's purposes." Testimony of James Chanos, CPIC, before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities and Investment; Hearing on the Hedge Fund Industry, at 7 (available at *http://banking.senate.gov/public/_files/ACF82BA.pdf*).

risk. Many requirements of the Advisers Act are irrelevant, or would be counterproductive, if applied to private investment companies. For example, Advisers Act restrictions on transactions with affiliates conducted as principal that require client consent on a transaction-by-transaction basis may work against investors' needs by impinging on a fund's ability to seize rapidly emerging opportunities, particularly in the cases of private equity and venture capital funds. Such funds routinely conduct transactions as principal or as a coinvestor alongside affiliated funds, and transaction-by-transaction consents from large numbers of private fund investors are, as a practical matter, not possible to collect.

In addition, the SEC's custody rules under the Advisers Act are insufficient to protect private investment fund assets from theft or prevent other forms of fraud. Although the SEC recently proposed amendments to these rules, even as proposed to be amended, the rules do not fully protect the assets of private investment funds. For example, the rules exclude from custody requirements 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 custodian provides.[19] Access control requirements under the rules are rudimentary at best, particularly for assets other than publicly traded securities. Detailed formal requirements on the means by which private investment fund assets enter and exit the custodian's control are needed to assure that the fund's assets really exist and cannot easily be stolen.[20]

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 today's investment structures, strategies, and qualified investors' needs.

Neither is the Investment Company Act suited for regulation of private funds. As an 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 select groups of high net worth and institutional investors. Similarly, the Investment Company Act generally provides for either daily liquidity (mutual funds for which investors can redeem shares every business day), or no liquidity (closed-end funds for which investors can rarely be redeemed out), while private investment funds are able to adopt a flexible range of redemption dates to address the liquidity of the assets in which the particular fund invests.

Scope of S. 1276

The Chairman's bill, S. 1276, would require registration under the Advisers Act for those private fund managers that have $30 million or more under management. It would also provide that records of the adviser's related private funds (those exempted under sections 3(c)(1) and 3(c)(7) of the Investment Company Act) are deemed to be records of the adviser and subject to SEC inspection. Thus, under the bill, the SEC would have full authority under the Advisers Act over all private fund managers (other than foreign advisers) meeting the specified threshold, and would have broad inspection authority over all records of private funds, even though the funds themselves would not be registered.

The legislation further amends existing section 211 of the Advisers Act to enhance the SEC's authority to adopt different sets of rules to address different types of advisers. Under this authority, the SEC could, for example, write a set of rules under

[19] These instruments are privately issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, as well as shares of mutual funds, which, under current law, can simply be titled in the name of the private investment fund care of the manager, 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 for the benefit of the private fund 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.

[20] CPIC is separately filing a comment letter with the SEC in connection with its pending rule making, in which we advocate a further strengthening of the custody rules.

the Advisers Act applicable only to advisers to private funds and tailored for those advisers. The bill, therefore, offers a creative and flexible approach to regulation of private investment fund managers and oversight of the funds themselves.

However, you may wish to consider whether the bill, as drafted, provides too little direction from Congress—both as to what elements of the Advisers Act should be modified or omitted with respect to private funds, and what additional requirements, going beyond those currently applicable to registered investment advisers, should be added for advisers to private funds and for the funds themselves. Indeed, the legislation, as currently drafted, could leave some doubt as to how broadly Congress intends the SEC to act in this area.

We therefore recommend that Congress consider developing a Private Investment Company Act, which would contain targeted controls and safeguards needed for oversight of private funds, while preserving their operational flexibility. More detailed requirements could be considered for 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. If you choose not to develop a separate act for private funds and use the approach of S. 1276 regulating private investment funds under the Advisers Act, we suggest that the legislation further direct the SEC to use its authority under Section 211 and tailor the requirements of the Advisers Act to impose appropriate requirements on private investment funds. We believe the legislation should specify those requirements.

Below, we discuss provisions relating to systemic risk and investor protection that we believe should be included in any Private Investment Company Act or, alternatively, addressed under the Advisers Act in further amendments to S. 1276.

Consideration of a Private Investment Company Act

We have given some thought to what the elements of a special "Private Investment Company Act" statute should contain. Many of the elements of such a statute should be similar to provisions currently in the Advisers Act or Investment Company Act, but others would be tailored to private investment funds. Such a new statute could be codified as new Section 80c of Title 15 of the U.S. Code (Section 80a is the Investment Company Act, while Section 80b is the Investment Advisers Act) and should apply to private investment funds of all kinds with assets under management of more than $30 million, no matter whether a fund is called a "hedge," "venture capital," "private equity" or other type of fund; and should include all foreign investment companies that conduct U.S. private offerings, so that a fund would gain no benefit by organizing or operating as an "offshore" entity. Private funds subject to the new statute would not be subject to registration under the Investment Company Act if they continue to meet the standards for exclusion under Sections 3(c)(1) or 3(c)(7)[21] or other relevant exemption, nor would they be subject to registration under the Advisers Act if they continue to meet the requirements for exemptions under that Act. They would, however, be required to register under the new Private Investment Company Act and be subject to its provisions. The following are key elements of any private fund legislation.

Registration Requirements/SEC Examination and Inspection Authority. As stated above, private funds (or their advisers) should be required to register with the SEC. Registration—whether under the Advisers Act or under a new Private Investment Company Act—should entail requirements for the filing of basic census data in an online publicly available form. Registration will bring with it the ability of the SEC to conduct examinations and bring administrative proceedings against registered advisers, funds, and their personnel. The SEC also will have the ability to bring civil enforcement actions and to levy fines and penalties for violations.

Prevention of Theft, Ponzi Schemes, and Fraud. Any new private fund legislation should include provisions to reduce the risks of Ponzi schemes and theft by requiring money managers to keep client assets at a qualified custodian, and by requiring investment funds to be audited by independent public accounting firms that are overseen by the PCAOB.[22] Custody requirements should be extended to all investments held by covered funds. Fund assets should be held in the custody of a bank, registered securities broker-dealer, or (for futures contracts), a futures commission merchant. While the SEC has adopted custody rules for registered advisers pursu-

[21] Certain family owned companies that are deemed "qualified purchasers" pursuant to Section 2(a)(51)(A)(ii) or (iii) of the Investment Company Act should not be covered by the new requirements, however. Companies, trusts, and estates, *etc.*, that are owned by members of one family and that own investments should not be deemed to be investment companies or regulated like other private investment funds.

[22] This requirement is consistent with the AMC Best Practices, and would close the above-described gaps in the protections provided by the Advisers Act custody rule.

ant to its antifraud authority under the Advisers Act (and recently proposed amendments to those rules), we believe Congress should provide specific statutory direction to the SEC to adopt enhanced custody requirements for all advisers.

Transparency for Investors. Private investment fund legislation should require funds or their managers to provide potential investors with specific disclosures before accepting any investment, and provide existing investors with ongoing disclosures.[23] Among other things, a private fund should be required to disclose in detail its methodologies for valuation of assets and liabilities, the portion of income and losses that it derives from Financial Accounting Standard (FAS) 157 Level 1, 2, and 3 assets,[24] and any and all investor side-letters and side-arrangements. Likewise, private funds should have to disclose the policies of the fund and its investment manager as to investment and trade allocations. They should also disclose conflicts of interest and financial arrangements with interested parties, such as their investment managers, custodians, portfolio brokers, and placement agents. Funds should also be transparent with respect to their fees and expense structures, including the use of soft dollars. Investors should receive audited annual financial statements and quarterly unaudited financial statements.

Reduction of Risks Through Transparency for Counterparties and Lenders. Consistent with recent recommendations from the Administration, we believe Congress should focus on particular points where private funds could have an impact on the financial system, such as counterparty risk and lender risk. Thus, private fund legislation should include requirements that lenders and counterparties be provided with certain information by a private fund, such as the company's audited annual financial statements, current private placement memorandum, information as to the fund's valuation methodology, the existence of side-letters and side-arrangements and any material conflicts of interest or financial arrangements.

Implementation of Antimoney Laundering Measures. Private investment companies should have to implement customer identification and antimoney laundering programs, and file suspicious activity reports and currency transaction reports, just as securities broker-dealers, banks, and open-end investment companies are required to do.[25] Currently, neither registered investment advisers nor registered closed-end investment companies are subject to customer identification or other formal antimoney laundering rules.

Special Requirements for Large Private Investment Funds. Consideration should be given to establishing requirements for a fund (or a family of funds and/or its manager) that controls gross assets in excess of a specified amount that would not apply to smaller private investment companies. For example, larger funds should be required to implement disaster recovery, business continuity, and risk management plans to identify and control material operational, counterparty, liquidity, leverage, and portfolio risks.[26] In addition, such a fund should be required to adopt a detailed plan to address liquidity and for conducting an orderly wind-down that assures parity of treatment of investors in the event of a major liquidity event.

Conclusion

Private investment companies have operated remarkably well in the absence of direct Government oversight and subject to the due diligence of large and sophisticated investors. CPIC nonetheless supports the call for enhanced oversight, with the SEC as the primary functional regulator. But, 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. Moreover, simply requiring registration under the Advisers Act or Investment Company Act could degrade investor due diligence by causing undue reliance upon SEC regulation under statutes that are insufficiently robust to address the unique characteristics of private funds. We believe that the twin goals of improved investor protection and enhanced systemic oversight could be better achieved with a stand-alone statute, tailored for private investment funds. If this Subcommittee determines, however, to bring private funds under SEC oversight by requiring fund managers to register under the Advisers Act, we believe that any such legislation should include the key provisions discussed above.

We appreciate the work that this Subcommittee is doing in crafting legislation in this area, and we stand ready to work with you in the days ahead. Thank you for giving CPIC the opportunity to testify on this important subject.

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

[24] See n. 15 *supra.*

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

[26] These requirements are consistent with the AMC Best Practices.

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:

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[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.

(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

(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.

(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.

(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:

(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

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

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).

PREPARED STATEMENT OF TREVOR R. LOY

FOUNDER AND GENERAL PARTNER,
FLYWHEEL VENTURES

JULY 15, 2009

Introduction

Chairman Reed, Ranking Member Bunning, and Members of the Committee, my name is Trevor Loy and I am the founder and a general partner of Flywheel Ventures, a venture capital firm based in Santa Fe, New Mexico, with offices in Albuquerque and San Francisco. Flywheel invests in seed and early stage companies based on innovations in information technology and the physical sciences. We invest primarily in the Southwest and Rocky Mountain regions of the U.S. in companies targeting global markets in digital services, physical infrastructure, energy and water. Since raising our first fund in 2002, we have grown to a staff of seven with approximately $40 million dollars under management in three active funds. Our firm targets initial investments of $100,000 to $1 million into private, start-up companies which are often built around innovations coming out of the region's research universities, R&D organizations, and national laboratories. Our goal is for these companies to one day become viable, market-leading public companies or be acquired by larger corporations so that their technologies can reach millions of people.

In addition to my responsibilities as a venture investor, I am also a member of the Board of Directors of the National Venture Capital Association (the NVCA) based in Arlington, Virginia. The NVCA represents the interests of approximately 460 venture capital firms in the United States which comprise more than 90 percent of the venture industry's capital under management.

It is my privilege to be here today to share with you, on behalf of the industry, the role of venture capital investment in the financial system, particularly as it relates to systemic risk. Our asset class is unique in many ways, with a critical distinction being that while the companies we have funded have had a proven and profound positive impact on the U.S. economy in terms of job creation and innovation, our specific asset class remains a small cottage industry that poses little, if any, risk to the overall financial system.

As Congress and the Administration examine the forces that led to the financial markets crisis, including regulatory weaknesses that may have slowed an earlier response by the Government, we appreciate the opportunity to be part of the discussion. Our goal is that the role of the venture capital industry in the economy be clearly understood. We also appreciate the opportunity to offer recommendations on how regulators can meet transparency needs by using information already disclosed by venture firms, while also protecting the continued ability of venture firms to create companies and grow jobs for the U.S. economy.

The Fundamentals of Venture Capital Investment

I would like to begin with a brief overview of the structure and dynamics of venture capital investing. Venture capital funds typically are organized as private limited partnerships. Generally, 95 to 99 percent of capital for the venture fund is provided by qualified institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net-worth individuals. These investors, referred to as the limited partners (LPs), generally seek the high risk/high reward exposure afforded by venture capital as a relatively small component of a diversified investment portfolio. The venture capitalists that make investment decisions on behalf of the fund form the general partner (the GP), and we supply the rest of the capital for the fund from our own personal assets. Importantly, the capital supplied to a venture capital fund consists entirely of equity commitments provided as cash from investors in installments on an as-needed basis. Although venture capital funds may occasionally borrow on a short-term basis immediately preceding the time when the cash installments are due, they do not use debt to make investments in excess of the partner's capital commitments or "lever up" the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the Government.

A venture fund is typically structured with a fixed term of at least 10 years, sometimes extending to 12 or more years. At the outset, a limited partner commits a fixed dollar amount to the fund. Pending the draw down of the limited partner's cash when the venture capitalist has identified a company or idea in which to invest, the cash remains in the LPs' control. The "capital calls" for investments generally happen in cycles over the full life of the fund on an "as needed" basis as investments are identified by the general partners and then as further rounds of in-

vestment are made into the portfolio companies. As portfolio company investments are sold in the later years of the fund—when the company has grown so that it can access the public markets through an initial public offering (an IPO) or when it is an attractive target to be bought—the liquidity from these "exits" is distributed back to the limited partners. The timing of these distributions is subject to the discretion of the general partner, and limited partners may not otherwise withdraw capital during the life of the venture fund.

Once the venture fund is formed, our job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment. Often these companies are formed from ideas and entrepreneurs that come out of university and Government laboratories—or even someone's garage. Typically, the venture industry has focused on high technology areas such as information technology, life sciences, and more recently, clean technology. Some of our recent investments at Flywheel include MIOX Corporation and Tred Displays both based in Albuquerque, New Mexico. MIOX solves one of the world's most pressing problems, the need for clean and safe water. MIOX's patented technology purifies water beyond EPA standards in over 1,300 installations around the world. The advantage of MIOX's solution, which was originally developed with funding from Los Alamos National Laboratory, is eliminating chlorine and all other dangerous and costly chemicals from the water purification process. Tred Displays is another company in Flywheel's portfolio. Much of the world's printed signage is now changing to digital technologies such as LED or LCD displays, both of which are expensive and consume tremendous energy. The Tred sign provides similar digital capability with its proprietary innovative technology that uses batteries or solar cell energy to power digital content, cutting the energy consumption of a digital sign by more than 95 percent.

Once we have identified a promising opportunity, we vet the management team and conduct due diligence research on the company, the market, the financial projections, and other areas. For those companies who clear this investigation, we make an investment in exchange for equity ownership in the business. Importantly, investments into start-up companies are structured as cash in return for an equity share of the company's stock. Leverage is not part of the equation because start-ups do not typically have the ability to sustain debt interest payments and often do not have collateral that lenders desire. We also generally take a seat on the company's board of directors. We expect to hold a typical venture capital investment for 5–10 years, often longer and, since the technology bubble burst, rarely much less. During that time, we continue to invest additional capital into those companies that are performing well; we cease follow-on investments into companies that do not reach their agreed upon milestones. Our ultimate goal is what we refer to as an exit—which is when the company is strong enough to either go public on a stock market exchange or become acquired by a strategic buyer at a price that ideally exceeds our investment. At that juncture, the venture capitalist "exits" the investment, though the business continues to grow. Essentially we make way for new investors who may be the public (when the company issues an IPO) or a new corporate owner (when there is an acquisition). The nature of our industry is that many companies do not survive, yet a few companies are able to generate very significant returns.

Our industry is no stranger to technological and entrepreneurial risk. At least one third of our companies ultimately fail, and those that succeed usually take 5–10 years to do so. In many ways, our industry is one of the only asset classes with the long-term patience and fortitude to withstand the high rates of failure among start-up businesses. This high tolerance for risk, however, is limited entirely to the operational success or failure of the start-ups in which we are owners. This risk is very different from the systemic risk that is the basis for the recent SEC registration proposals. Because there is typically no leverage component between the VC fund and its outside investors or between the VC fund and the companies in which we invest, venture capital investment risk is contained and measured. Those portfolio companies that succeed do so in significant ways, counterbalancing the losses elsewhere in the portfolio, while losses do not compound beyond the amount of capital committed by each partner. The venture industry has operated under this risk-reward model for the last 40 years.

The Economic Contribution of Venture Capital

Historically, venture capital has differentiated the U.S. economy from all others across the globe. Since the 1970s, the venture capital community has served as a builder of companies, a creator of jobs, and a catalyst for innovation in the United States. According to a 2009 study conducted by econometrics firm IHS Global Insight, companies that were started with venture capital since 1970 accounted in

2008 for 12.1 million jobs (or 11 percent of private sector employment) and $2.9 trillion in revenues in the United States in 2008. Such companies include historic innovators such as Genentech, Intel, FedEx, Microsoft, Google, Amgen, and Apple. Our asset class has been recognized for building entire industries including the biotechnology, semiconductor, online retailing, and software sectors. Within the last year, the venture industry has also committed itself to funding companies in the clean technology arena which includes renewable energy, power management, recycling, water purification, and conservation. My partners and I are extremely proud of the work that we do each day because we are creating long-term value for our investors, our companies, their employees, and the communities in which our companies operate. In fact, a 2007 study by the NVCA found that New Mexico was the fastest growing venture capital economy in the country in the past decade. We are also dedicated to playing an important role in our country's economic recovery.

Venture Capital and Lack of Systemic Risk

In light of the financial meltdowns of the past year, we believe that Congress has a right and duty to examine regulatory policy to protect investors from systemic risk. However, the venture capital industry's activities are not interwoven with U.S. financial markets. We believe an examination of any of the measures of size, complexity, or interconnection reveals that venture capital investment does not qualify as posing such risk for the following reasons:

Venture capital firms are not interdependent with the world financial system. We do not trade in the public markets. Most venture capital funds restrict or prohibit: (i) investments in publicly traded securities; (ii) investor redemptions prior to the end of the fund's term (which, in most cases, is 10 to 12 years); and (iii) short selling or other high risk trading strategies. Moreover, our firm stakeholders are contained to a defined set of limited partners and their interests in the funds are not publicly traded. LPs make their investment in a venture fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to "lock-up" their money for the life of the fund, generally 10 or more years as I stated earlier. This long-term commitment is critical to ensure that funds are available not just for the initial investment into a start-up, but also for the follow-on rounds of investment which provide the company continued resources to grow. LPs agree to this lack of liquidity because the venture industry has historically achieved higher returns than the public markets. However, the length and risk profile of the investment also means that LPs typically limit the amount of money that is dedicated to venture activity. A pension fund, for example, typically will only invest 5–15 percent of its investable assets in what are called alternative assets—the broad category of hedge fund, private equity, real estate, and venture capital investments. The percentage or component of that allocation that is then committed to venture investing is often quite small.

Whereas a hedge fund in distress may leave a chain of unsettled transactions and other liabilities, a venture capital fund in distress would generally only have consequences limited to the investors' returns, the fund sponsor's inability to raise a subsequent fund, and the fund's portfolio companies potentially losing access to additional equity capital. With its relatively small allocation to venture, the totality of the capital at risk is known and transparent, bounded by the level of capital initially committed.

The venture capital industry is small in size. While certain pooled investment funds may present a systemic risk due in part to their size, the same cannot be said about venture capital funds, as the collective venture industry equates to a fraction of other alternative asset classes. In 2008, U.S. venture capital funds held approximately $197.3 billion in aggregate assets. That same year, U.S. hedge funds held, in the aggregate, approximately $1.3 trillion in assets.[1] From the period 2004 to 2008, only 13 U.S. venture capital funds had $1 billion or more in commitments. In comparison, approximately 218 U.S. hedge funds held over $1 billion in assets in 2008 alone. In 2008, venture capitalists invested just $28 billion into start-up companies which equates to less than 0.2 percent of U.S. GDP. The average size of a venture capital fund in 2008 was $144 million dollars, although areas such as cleantech and biotech investing are very capital intensive and often require larger funds.

Venture capital firms do not use long-term leverage or rely on short-term funding. Borrowing at the venture capital fund level, if done at all, typically is only used for short-term capital needs (pending draw down of capital from its partners) and does

[1] See Hedge Fund Intelligence Ltd., "United States: The End of an Era?" Global Review 2009, GLOBAL REVIEW 2009 (January 2009) (available at *http://www.hedgefundintelligence.com/Article.aspx?Task=Report&IssueID=71697&ArticleID=2186589*).

not exceed 90 days. In fact, many venture capital funds significantly limit borrowing such that all outstanding capital borrowed by the fund, together with guarantees of portfolio company indebtedness, does not exceed the lesser of (i) 10–15 percent of total limited partner commitments to the fund and (ii) undrawn limited partner commitments. Additionally, venture capital firms do not generally rely on short-term funding. In fact, quite the opposite is true. Our firms gradually call down equity capital commitments from investors over a period of approximately 10 years on a "just-in-time basis," with initial investments in a company typically made within the first 3 to 5 years.

All risk is contained within the venture ecosystem of limited partners, venture capital funds, and portfolio companies. This ecosystem differs significantly from others where leverage, securitization or derivatives are used. For example, a million dollar mortgage can create a multiple of asset flows—perhaps $100 million—because of derivatives and bets regarding interest rates for that mortgage pool. In our world, a million dollar investment is just that—a million dollars. There is no multiplier effect because there are no side bets or other unmonitored securities based on our transaction. When one of our companies fails, the jobs may go away and our million dollars is gone but the losses end there. Even when certain industries broadly collapsed in the past—such as the optical equipment industry—the failure and losses remained contained to that industry and those investments. Although entrepreneurs and their companies were impacted, the impact remained a very isolated, nonsystemic exposure. Without the layer of securities or use of derivatives that were at the heart of the many problematic transactions that catalyzed the recent financial crisis, the financial pain of failure remains self contained. No outside parties are betting on the success or failure of the venture industry and therefore they can not be impacted.

Risk is very much at the heart of the venture industry but it is entrepreneurial and technological risk not systemic financial risk. Indeed, it is critical that our country proactively support this entrepreneurial risk as it has translated into new companies, millions of jobs, and countless innovations that would otherwise never be brought to life. As the fundamentals of our industry are expected to remain unchanged, we do not believe that we will find ourselves in a position to contribute to any systemic risk going forward.

Meeting the Need for Transparency

As I stated at the outset, we do recognize the need for transparency into our activities and, in that spirit, venture firms have provided information to the SEC for decades. We believe this information remains sufficient to meet the need for transparency without burdening our firms with additional regulations that do not further the understanding of systemic risk. I would like to take a moment to review our current disclosure activities.

As limited partnership interests are securities, venture capital fund offerings must either be registered with the SEC or meet an exemption from registration proscribed by the Securities Act of 1933 (the Securities Act). Venture capital funds typically rely on the Rule 506 "safe harbor" of Regulation D, as an exemption from publicly registering their securities with the Securities and Exchange Commission (the SEC).

To comply with the Rule 506 safe harbor, most venture capital funds file a "Form D" disclosure document with the SEC during or shortly after their offering has commenced. The Form D requires disclosure of significant information about the private offering.

An initial Form D must be filed with the SEC no later than 15 calendar days after the "date of first sale" of securities in the venture capital fund's offering. Any information contained in a Form D filing is publicly available. As part of the current Form D filing requirements, venture capital funds are required to disclose many aspects of their business that can assist the Government in assessing whether or not the venture capital fund imposes any systemic risk to the financial system.

Form D currently requires venture capital funds to disclose information about the fund, including (i) the fund's name, (ii) principal place of business, (iii) year and jurisdiction of organization, and (iv) the form of legal entity. Form D also requires venture capital funds to disclose material information regarding the size and terms of the offering. This information includes (i) the date of first sale of the fund's securities, (ii) the intended duration of the fund's private offering, (iii) the minimum investment amount accepted from a third party investor, and (iv) the total number of accredited and nonaccredited investors to which the fund has sold securities (a Form D amendment is required if the total number of nonaccredited investors increases to more than 35). This information also discloses the relevant Securities Act

and Investment Company Act of 1940 exemptions that the fund relies upon in privately offering its securities.

A venture capital fund must also disclose the total dollar amount of securities the fund is offering. In contrast to hedge funds and some other types of pooled investment funds, a venture capital fund offering is generally neither continuous nor for an indefinite amount of interests. The stated offering amount is also often disclosed in the venture capital fund's offering memorandum or in the limited partnership agreement among the limited partners and general partner of the fund.

Additional SEC Registration Requirements Could Hamper Venture Activity

The SEC previously used the Investment Advisers Act of 1940 (the Advisers Act) as a mechanism to attempt to regulate hedge fund activity. It is important to note that the SEC also explicitly exempted venture capital activity from that regulatory push. We strongly believe that the Government's need to understand the venture industry's financial commitments can be met with current disclosure. Using the Advisers Act brings layers of additional regulatory requirements that can prevent us from focusing our time and financial resources on helping to start and grow new companies, does not provide the Government with meaningful insight into systemic risk assessment and will divert Government resources.

A venture capital firm employs a small administrative staff to handle firm operations. Often an investing partner will take on the role of Chief Administrative Officer and in that capacity will manage a Chief Financial Officer. The CFO is fully engaged in the financial operations of the firm, including portfolio company reporting, and all investor relations activities. At Flywheel, we have a single full-time Director of Finance and Operations. This individual, who I proudly note has been honored as one of the top CFO's in our region, manages all aspects of our quarterly and annual financial reporting, our portfolio company reporting, our relationships with our tax, audit, accounting and legal service providers, our investor relations, our capital management, and other miscellaneous financial activities. In addition, as a small firm, her responsibilities also encompass general management and office management duties, including seemingly mundane activities such as booking travel, filing expense reports, and coordinating team logistics. By requiring venture funds to register with the SEC under the Advisers Act, the administrative burden on the firm and the CFO would grow exponentially. In addition to filing information regarding the identification of the firm, its partners and assets under management, the Advisers Act establishes a number of substantive requirements that would change the operation of a venture fund and the relationship between the venture fund and its limited partners. Many of these requirements, which are summarized below, would demand significant resources and overhead which sophisticated investors have not requested and venture funds currently do not have in place.

SEC Examinations: The SEC can and does conduct periodic examinations of registered investment advisers. The SEC inspection staff looks closely at, among other things, the firm's internal controls, compliance policies and procedures, annual review documentation, and books and records. SEC examinations may last anywhere from a few days to a few months. The intent of these inspections is to evaluate the firm's compliance with various policies and procedures imposed on registered advisers. We do not believe that requiring periodic inspections of venture capital firms would provide meaningful insight for the Government's assessment of systemic risk; however, we do believe it would further divert the SEC's resources from inspection of firms that do present systemic risk. Moreover, the costs and administrative burdens associated with preparing for an examination can be substantial.

Performance Fees: The Advisers Act prohibits contracts that provide for compensation based on a percentage of the capital gains or capital appreciation in a client's account, subject to certain exceptions, including a provision that permits a performance fee to be charged to certain "qualified clients" of the adviser that have a minimum net worth or a minimum amount of assets under management with the adviser. This limitation was designed to preclude advisers from subjecting client funds and securities to unnecessary speculation in order to increase fees to the adviser. However, venture firms are intentionally structured to make investments in companies that may fail and requiring venture firms to register could unintentionally prohibit carried interest payments for certain investors, thereby denying them access to a high-growth alternative asset class. In particular, it would require significant restructuring issues for existing funds formed in reliance on existing exemptions. More fundamentally this restriction alters the long-standing practice of LPs providing increased incentives for the GP to demonstrate long-term commitment to company growth. Doing so could change the dynamics of the industry unnecessarily.

The following administrative requirements, while not controversial, would require venture firms to dedicate resources beyond those which their investors have asked them to devote:

Compliance Programs and Appointment of Chief Compliance Officer: The Advisers Act would require venture firms to implement written policies and procedures designed to prevent violations of the Federal securities laws, to review the policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer (a "CCO") to be responsible for administering the policies and procedures. The CCO selected by the venture firm must be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. The SEC has indicated that it expects that written policies and procedures would address, at a minimum (i) portfolio management processes; (ii) trading practices; (iii) proprietary trading of the adviser and personal trading by the adviser's supervised persons; (iv) accuracy of disclosures made to clients, investors, and regulators; (v) safeguarding of client assets; (vi) accurate creation and maintenance of required books and records; (vii) advertising and marketing practices; (viii) processes to value client holdings and assess fees based on those valuations; (ix) safeguards for the privacy protection of client records and information; (x) disaster recovery and business continuity plans; (xi) insider trading safeguards; and (xii) antimoney laundering efforts.

Codes of Ethics: The Advisers Act would require venture firms to adopt a code of ethics (a "Code") which must set forth, among other things, (i) standards of conduct expected of personnel; (ii) a system of preclearance for investments in initial public offerings and private placements, (iii) a requirement that all violations of the Code be promptly reported to the CCO or his or her designee; and (iv) a requirement that certain advisory personnel periodically report their personal securities transactions and holdings in securities. As venture capital funds do not typically trade in the public markets and generally limit advisory activities to the purchase and sale of securities of private operating companies in private transactions, the latter requirement is of limited relevance to venture capital funds, yet would still apply.

Reports in relation to securities holdings must be submitted to the CCO on an annual basis; reports in relation to securities transactions must be submitted on a quarterly basis. The adviser must provide each supervised person with a copy of its Code and must obtain each supervised person's written acknowledgment of receipt of the Code, as well as any amendments.

Form ADV and Periodic Filing: The Advisers Act would require a venture firm to file Form ADV Part I with the SEC in order to become registered under the Advisers Act. In addition, all registered venture firms would need to furnish each limited partner or prospective limited partner with a written disclosure statement that provides information concerning the venture firm, its operations, and its principals. This would need to be done on at least an annual basis.

Custody: The Advisers Act would require a venture firm that has custody of limited partner funds or securities to maintain such funds or securities with a qualified custodian. If a venture firm has custody of the limited partner funds or securities, then the firm must send quarterly account statements directly to each limited partner, member, or other beneficial owner. However, the venture fund need not send these quarterly account statements if such entity is subject to audit at least annually and distributes audited financial statements to all limited partners. In the alternative, a venture firm possessing custody may also have an independent public accountant verify the assets held by the firm at least once a year. This auditing procedure must be conducted on a surprise, rather than a scheduled, basis.

Recordkeeping: The Advisers Act sets forth the books and records investment advisers must maintain. The CCO and at least one member of the professional staff of a venture firm would have to be fully familiar with this rule, which lists approximately 20 categories of records to be maintained, and with all operating procedures for complying with the recordkeeping rule. Generally, a registered investment adviser's books and records must be kept for a total period of 5 years (and longer in some cases).

All of these compliance elements promise to be costly from both a financial and human resources perspective. They also promise to change the way venture capital firms operate, adding significant administrative burden in exchange for information that is neither relevant nor useful for measuring and managing systemic risk.

We have been in this place before. In 2001, then President Bush signed into law the USA Patriot Act, broad legislation intended to combat terrorism and money laundering activity. The legislation imposed antimoney laundering (AML) compliance obligations on "financial institutions," including broker-dealers, commodity trading advisors, commodity pool operators, and investment companies. While the

term "investment companies" was not specifically defined, most legal opinions concluded that the term was intended to encompass both registered investment companies (*e.g.,* mutual funds) and private investment funds (*e.g.,* U.S. and offshore unregistered hedge funds, funds-of-funds, commodity pools, private equity funds, and venture capital funds).

In addition to complying with existing AML requirements such as reporting currency transactions and complying with the economic sanctions imposed by the U.S. through the Office of Foreign Assets Control (OFAC), the new statute imposed significant new obligations, including designating a compliance officer, establishing ongoing training programs and arranging independent audits to ensure compliance.

However, as the regulatory process unfolded, the Treasury Department ultimately recognized that venture activity did not meet the criteria for money laundering risk. The Treasury concluded that funds which do not permit investors to redeem investments within 2 years of their purchase would not be required to comply with the USA Patriot Act's AML compliance program obligations. In this instance the regulations were tailored to meet the need for information and transparency while not affecting activity ultimately unrelated. We hope that the Congress and the Administration will work together with our industry to ensure a similar outcome in the current regulatory overhaul.

Summary

We understand that the implosion which occurred in the financial system in the last year—and the economic strife which ensued—is a just reason to examine how to better protect investors and the overall market. We agree that those entities and industries which could cause financial system failure should be better monitored so that the events of 2008 are never repeated. However, venture capital is not one of those industries. Our size and operations within the private market do not pose broader financial risk. Venture capital played no role in the recent financial meltdown and does not have the fundamental investing principles to cause a future financial system failure. By requiring the venture industry to comply with the requirements of the Advisers Act, Congress would be unnecessarily weighing down an asset class that should be focused on building companies and creating jobs, rather than redirecting our resources and time toward administrative functions that our investors did not request and that do not help the entrepreneurs that we fund to create valuable businesses and the jobs that follow.

For innovation and entrepreneurship to continue to succeed in the U.S., the venture capital industry needs a supportive public policy environment. In many areas we acknowledge and are thankful for a public policy framework in the U.S. that not only supports our industry and our entrepreneurs but remains the envy of the rest of the world. As a small and dynamic industry, however, we remain highly susceptible to seemingly minor changes in our ecosystem. While some larger asset classes may be able to absorb the proposed regulatory costs and requirements, I am here today to say that the venture industry—and subsequently the start-up economy—will not go unscathed by the contemplated regulatory changes. We ask that you please examine each asset class that will be impacted by this legislation and make your policy decision based upon the systemic risk posed by each as well as the implications of regulation, and focus the Government's resources where it can have the most impact. We believe you will come to the same conclusion: venture capital does not belong in this mix. I thank you for your consideration today and I am happy to answer any questions.

PREPARED STATEMENT OF MARK B. TRESNOWSKI

MANAGING DIRECTOR AND GENERAL COUNSEL,
MADISON DEARBORN PARTNERS, LLC,
ON BEHALF OF THE PRIVATE EQUITY COUNCIL

JULY 15, 2009

Introduction

Mr. Chairman and Members of the Committee, thank you for giving me the opportunity to present the Private Equity Council's views on creating a forward looking approach to regulating the financial services sector in the aftermath of the systemwide financial crisis that has shaken so many investors, consumers, and institutions.

The Private Equity Council is a 2-year-old trade association representing 12 of the largest private equity firms operating in the United States.[1] Our mission is to educate public policy makers on the positive role private equity investments have played in both strengthening hundreds of companies of all sizes and from all sectors of the economy, and in generating above average returns for scores of public and private pension funds and other investors that have allocated a portion of their portfolios to private equity funds. While PEC members are among the most visible and well known in private equity, each with more than $10 billion in assets under management, the Committee should bear in mind that there are more than 2,000 PE firms doing business in the U.S. The overwhelming majority of these are local firms doing small transactions that rarely attract much attention and yet help power local, State, and the national economies.

The Business of Private Equity

Before directly addressing the policy issues before the Committee, it is useful to describe briefly the private equity industry, how it works, and how it fits contextually into the financial marketplace.

A private equity firm, regardless of its size, creates funds in which it invests its own capital, along with larger amounts of capital raised from third-party investors. In these partnerships, the private equity firm acts as the general partner, or GP, and the third-party investors are the limited partners, or LPs. In fact, highly sophisticated investors such as large public and private pension funds, endowments and foundations account for 70 percent of the funds invested with the top 100 PE firms since 2005. The 20 largest public pension funds for which data is available (including the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund, and the Florida State Board of Administration) have invested nearly $140 billion in private equity.

The PE firm (or GP) uses the partnership's capital, along with funds borrowed from banks and other lenders, to buy or invest in companies that it believes could be significantly more successful with the right infusion of capital, talent, and strategy. Historically, PE-owned funds carry virtually no debt at the fund level. Private equity firms do use debt to acquire portfolio companies, but this debt is maintained at the portfolio company level. The typical capital structure of the companies acquired by a private equity fund is approximately 60 percent debt and 40 percent equity (though this proportion can vary based on the cost of credit, the economic outlook, and the nature of the business).

A key to the success of private equity investments is the requirement that both the PE firm (the owners/shareholders) and the senior managers invest their own money into the sponsored business. By definition, when you have your skin in the game, when your equity is at risk, you are highly incented to make decisions that will grow the value of your investment. Failure to do so means you lose your own money—not just the investment of a faceless shareholder. In short, the PE model ensures that the interests of the shareholders (GPs and LPs) and the interests of management are fully aligned. In contrast to publicly owned companies, PE owned companies can operate without the pressures imposed by public equity markets' focus on quarterly earnings and short-term gains. As a result, they make management decisions focused entirely on what is required to improve long-term performance and value.

In seeking companies to purchase or invest in, PE firms have focused on a number of broad categories, including: struggling and underperforming businesses such as Toys 'R Us or J Crew; unwanted divisions of large conglomerates, such as Dunkin Donuts or Burger King; promising or strong companies in need of venture or growth capital, such as NASDAQ or the online video service Hulu; and family businesses where the founders are seeking to transition beyond family ownership.

Regardless of the type of firm acquired, the objective is the same: increase the value of the business during the time that it is owned by a private equity fund. PE firms accomplish this by adding managerial expertise, making capital and R&D expenditures, expanding into new markets and developing new products, and making strategic acquisitions to create the scale required to compete and become market leaders. Importantly, the PE firms do not share in any profits unless and until they have paid an 8–10 percent *per annum* return to their investors.

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[1] Apax Partners; Apollo Global Management LLC; Bain Capital Partners; the Blackstone Group; the Carlyle Group; Hellman & Friedman LLC; Kohlberg Kravis Roberts & Co.; Madison Dearborn Partners; Permira; Providence Equity Partners; Silver Lake Partners, and TPG-Capital.

PE and Jobs

Private equity funds have a proven track record of creating jobs. The World Economic Forum reported that before they were acquired, private equity-owned companies on average were losing jobs at existing facilities faster than their competitors. But by the fourth year of private equity ownership, employment levels at those companies had increased to above the industry average. It also reported that in the first 2 years of private equity ownership, private equity portfolio companies increased the rate of job growth at new U.S. facilities to 6 percent above the industry average.[2]

Ernst & Young (E&Y) reported that at eight out of ten private equity portfolio company's employment is sustained or increased over time.[3] And economists Dr. Robert Shapiro and Dr. Nam Pham found that large companies acquired by major U.S. private equity firms increased domestic employment by 13 percent between 2002 and 2005, a period when employment at all large U.S. businesses grew by only three percent, and manufacturing companies owned by private equity investors grew employment by 1.4 percent during the same 4-year period, while employment in the overall manufacturing sector declined by 7.7 percent.[4]

PE and Performance and Value

According to E&Y, the value of U.S. businesses owned by private equity grew 83 percent during the years they were owned by PE firms, three times faster than their equivalents in the public sector.[5] E&Y also found that more than half of the earnings growth (before taxes, interest, and capital expense) at PE-owned portfolio companies came from business expansion, not cost-cutting or new acquisitions.[6] And Shapiro and Pham reported that 85 percent of PE firms studied increased capital expenditures in the 3 years after the PE investment.[7]

PE Returns to Investors

Improving the performance of portfolio companies has enabled private equity firms to deliver above average returns for the pension funds and other limited partners that invest in their funds. Between 1980 and 2005, the top-quartile PE firms delivered average annualized net returns of 39 percent,[8] significantly beating the S&P 500 and other indices. The overwhelming majority of these returns—80 percent typically—is returned to investors in the form of profit. That 80 percent translates into real dollars—$1.2 trillion to be exact—the total profits distributed to pension funds and other investors worldwide from their PE investments between the early 1980s and 2008.[9] This massive infusion to public and private pensions serving teachers, firefighters, policemen, and other retired public employees strengthens the solvency of the pension system.

On a mark-to-market basis, PE investors have seen the current value of their investments decline due to the financial crisis. But since PE firms hold investments for the long term, the current valuation snapshot is of marginal utility in assessing the eventual returns likely to flow to investors. Many investments now marked down as a result of the recession are likely to recover and be profitable for LPs, though perhaps not as profitable as was the case in more robust economic cycles.

But despite lower valuations now, on a relative basis, private equity performance through the third quarter of 2008 still surpassed the performance of public equity markets. One year performance for private equity in the period ending September 30, 2008, was -8.2 percent, compared to -21.4 percent for the NASDAQ and -22 percent for the Standard and Poor's 500 index.[10] Importantly, as noted, these results do not reflect "returns" as these investments are still owned and as the economy improves and their value recovers, many will be sold at a profit.

The investment report of an actual LP is illustrative. In its just released Comprehensive Annual Financial Report, the Pennsylvania State Employees' Retirement System reported that in 2008 its PE investments declined 6.8 percent while its investment in domestic, global, and international equities fell from 37.5 percent to

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[2] The Global Economic Impact of Private Equity Report 2008, "Private Equity and Employment", World Economic Forum, January 2008.

[3] Ernst & Young, "How Do Private Equity Investors Create Value? A Study of 2006 Exits in the U.S. and Western Europe", 2007.

[4] Robert Shapiro and Nam Pham, "American Jobs and the Impact of Private Equity Transactions", Private Equity Council, January 2008.

[5] Ernst & Young, 2007.

[6] Ernst & Young, "Beyond the Credit Crunch: How Do Private Equity Investors Create Value?" A Global Study of 2007 Exits—2008.

[7] Robert Shapiro and Nam Pham.

[8] PEC analysis of data from Venture Economics and Bloomberg.

[9] Preqin 2008 Global Private Equity Review.

[10] Thomson Reuters Private Equity Performance Index (PEPI).

52.4 percent. Over the last 3 years, total returns from PE have been 17 percent compared to -10.5 percent for U.S. stocks and -11.0 for non-U.S. stocks.

PE Today

Like other financial institutions, the private equity sector has been adversely impacted by the recession and credit crisis. Restricted credit markets have effectively shut down the market for financing new acquisitions, and many portfolio companies are under stress as they manage through this recession. In this regard, the challenges private equity faces are similar to those that virtually every public and private business in the U.S. is addressing. The good news, if there is any, is that over the last decade top private equity firms have made a major commitment to adding very sophisticated management resources to their portfolio companies, thus allowing them to provide hands-on guidance both from an operational and capital structure perspective, especially in such perilous economic times. The combination of operational expertise and favorable financing terms should enable most portfolio companies in viable sectors of the economy to ride out the economic downturn without violating debt covenants that could force them into default.

To be sure, some portfolio companies will not survive this deep recession, just as is the case with dozens of public companies with household names like GM and AIG. Nonetheless, bankruptcies associated with PE investments made in the 2005–7 period will create hardships on workers, communities, and investors, not to mention the PE firms that will lose tens or hundreds of millions of their own equity.[11] But the critical takeaway for the Members of this Subcommittee is that the failures of individual PE-owned companies, while hardly trivial, do not give rise to the kind of systemic risk relevant to policy makers seeking to prevent global financial shocks.

Despite the challenges facing the industry, private equity is poised to play a constructive role in the economic recovery. Today, private equity firms have more than $450 billion in committed capital to invest. But that capital is mostly sidelined due to the credit crisis and the recession. This industry is poised to be part of the solution, whether it is helping to recapitalize the banking system or investing in companies that desperately need growth capital and management expertise. We will continue to support traditional U.S. industries like steel and manufacturing, while also providing capital for new companies that are developing green technologies and energy efficient products.

PE and Systemic Risk

As Congress evaluates issues relating to systemic risk, we think it is important that policy makers distinguish among different types of private capital. Private equity is just one form of private capital. Other private investment vehicles include hedge funds, real estate partnerships, and venture capital funds, among others. All these pools of capital have features in common. But there are also important distinctions between them. Accordingly, we believe Congress should focus on regulating activities, not what businesses call themselves.

In laying out its Financial Regulatory Reform program, the Obama Administration articulated three fundamental factors that trigger systemic risk concerns: (i) the impact a firm's failure would have on the financial system and economy; (ii) the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and (iii) the firm's criticality as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the financial system. Private equity contains none of these systemic risk factors and thus should pose little concern for policy makers seeking to develop a new regime to guard against catastrophic, cascading financial shocks. Specifically:

- PE firms have limited or no leverage at the fund level (as distinct from leverage maintained a the portfolio company level for a particular acquisition). Thus, PE funds are not subject to unsustainable debt or creditor margin calls.
- Private equity funds typically use 3:1 leverage for acquisitions compared to companies like Lehman Brothers, which was levered at 32:1 when it failed. Further, Lehman's leverage was maintained at the parent company level, thus exposing the entire firm to collateral calls.
- PE funds do not rely on short-term funding. Rather, private equity investors are patient and commit their capital for 10–12 years (or more) with no redemption

[11] That said, according to a World Economic Forum study of PE investing over 20 years, private equity-owned companies defaulted on debt obligations at a rate substantially lower than all U.S. companies that issued bonds—and much lower than companies that issued high-yield debt.

rights. Therefore, investors cannot withdraw their money on short notice, triggering "asset fire sales" to find cash to make the repayments.

- PE firms are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures or prime brokerage relationships.
- Private equity investments are not cross-collateralized, which means that neither investors nor debt holders can force a fund to sell unrelated assets to repay a debt. In a sense, private equity investments are firewalled from one another so that any nonperforming investment does not negatively affect another investment. Losses are limited to the underlying value of the original investment.
- Private equity funds invest in long-term illiquid assets that are typically operating companies. Private equity does not invest in short-term traceable securities, like derivatives, swaps, or equities.
- Private equity investments are diversified across multiple industries and there is no over-exposure to any single sector.
- PE firms are not a source of credit to households, businesses, or Governments, nor do they act as a primary source of liquidity for the financial system.
- PE companies' borrowing is still a small portion of the overall credit market, well under 5 percent of all U.S. credit market obligations outstanding. The total value of all private equity holdings is equivalent to just 2.6 percent to 4.3 percent of corporate stocks and 3.1 percent to 5.3 percent of GDP.

In short, when applying the Administration's systemic risk factors to private equity, it is hard to see how any particular private equity fund could be considered a systemic risk.

Financial Services Reform Issues

The goals of financial regulatory reform should be to restore confidence in financial markets generally and the credit markets in particular, and to protect our financial system from the kind of meltdown that has devastated the global economy. We believe the Obama Administration's plan can accomplish these objectives. Although we do not have a direct stake in many specifics of the plan, we do feel very strongly that Congress should take deliberative action to provide clarity to market participants.

More specifically, we support creation of an overall systemic risk regulator capable of acting decisively in a crisis, empowered to implement needed policies, and possessing sufficient international credibility to instill confidence in global markets. If the systemic risk regulator finds that an activity, an institution, or a class of institutions is systemically significant it should be empowered to examine and require reports, and promulgate rules on capital adequacy, operational controls, information and audit systems, and credit risk or other significant risk exposure. Further, the systemic regulator should be granted enforcement authority powers to take actions deemed necessary to protect the financial system.

Regarding private equity specifically, as I said PE does not have the potential to create the kind of systemic shocks that contributed to the financial crisis. Therefore we do not believe this form of investment poses significant concerns in the context of the financial regulation debate. As the Committee knows, the Administration's plan calls for private equity firms to register as investment advisers with the Securities and Exchange Commission. Subcommittee Chairman Reed has introduced S. 1276, the Private Fund Transparency Act of 2009 which has a similar goal. We generally support the registration requirements contemplated by the Administration and S. 1276.

Registration will result in new regulatory oversight for many private equity firms. There are considerable administrative and financial burdens associated with record keeping and audits as registered investment advisors. These could be especially problematic for smaller firms. Given the fact that PE firms are not a cause of systemic risk, these additional regulatory requirements are arguably unnecessary. That said, we are mindful of the fact that excluding any asset class from the new regulatory regime could contribute in some way to diminishing confidence in the effectiveness of new regulatory regime and therefore we support the casting of a wide net.

While supporting the concept of registration and data collection from market participants including PE firms, we do believe Congress should direct regulators to be precise in how new regulatory requirements are calibrated so the burdens are tailored to the nature and size of the individual firm and the actual nature and degree of systemic risk it may pose. In this regard, we were pleased that the Administration's White Paper explicitly acknowledges that some of the requirements created

by the SEC "may vary across the different types of private pools." We commend Chairman Reed for his sensitivity to this point in his own bill. Further, it is absolutely vital that any information provided to the SEC pursuant to a new registration requirement be subject to strong confidentiality protections so as not to expose highly sensitive business and financial information beyond that required to carry out the systemic risk oversight function. We stand ready to work with Chairman Reed on these and other provisions in S. 1276.

Conclusion

Mr. Chairman, according to research by Dr. Robert Shapiro, private investments typically rise during recessions and continue to rise during the initial years of recovery. Further, Shapiro reports that total private equity investments grow much faster during the initial year of recovery than overall business investment and there is some evidence suggesting that private equity-held firms create jobs during the initial stages of recoveries while employment across the economy continues to contract.[12]

Today, private equity firms have more than $450 billion in committed capital to invest. This industry is poised to be part of the solution. That is our business, it's what we've done in the past, and it is what we will do in the future.

As Dr. Shapiro wrote, "In good and bad times, the core business of private equity funds is to identify firms with long-term potential for higher productivity, sales, and profits; secure the capital to purchase these firms; and inject additional capital, improve their strategies, and reorganize their operations, to achieve higher returns. Public policy should support these activities, especially during the current crisis, and refrain from imposing additional burdens that could hamper these activities or redirect them to other economies."[13] We believe the Administration's financial reform plan strikes a good balance between regulating PE while still allowing it to play its historically valuable role in making American companies stronger and more competitive.

Thank you.

PREPARED STATEMENT OF RICHARD BOOKSTABER

AUTHOR,

"A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION"

JULY 15, 2009

Mr. Chairman and Members of the Committee, I thank you for the opportunity to testify today. My name is Richard Bookstaber. Over the past decade I have worked as the risk manager in two of the world's largest hedge funds, Moore Capital Management and, most recently, Bridgewater Associates, and I have run my own hedge fund, the FrontPoint Quantitative Fund. In the 1990s I oversaw firmwide risk at Salomon Brothers, which had a large internal proprietary trading operation. From my vantage point at Salomon I was familiar with the trading approach of some of the dominant hedge funds of the time, such as Long Term Capital Management.

I am the author of "A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation." Published in April, 2007, this book warned of the potential for financial crisis resulting from the growth of leverage and the proliferation of derivatives and other innovative products.

Although I have extensive experience on both the buy-side and sell-side, I left my position at Bridgewater Associates at the end of 2008, and come before the Committee in an unaffiliated capacity, representing no industry interests.

My testimony will discuss the need for hedge fund regulation. I will limit my testimony specifically to the hedge fund regulation required to address systemic risk. I will argue that regulators must obtain detailed position and leverage data from major hedge funds in order to successfully monitor systemic risk.

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[12] Robert Shapiro, "The Role of the Private Equity Sector Promoting Economic Recovery", Private Equity Council, March 2009.

[13] *Ibid.*

The Benefits and Risks of Hedge Funds

Two characteristics that differentiate hedge funds from other investment funds are their ability to lever and to take short positions.[1] These tools give hedge funds more freedom than their traditional counterparts in executing investment ideas. If a hedge fund manager finds a trade that is particularly attractive, leverage allows him to borrow fund in order to put more exposure into that trade than can a traditional fund manager who is not permitted to lever. If a hedge fund manager wants to express a negative view, he can short a security, while the long-only fund manager's expression of such a view is limited to excluding the security from the portfolio. The ability to short also allows the hedge fund manager to eliminate exposures that are unavoidable for the traditional manager. For example, an equity hedge fund manager can construct a portfolio that has little market exposure by holding an equal weighting in long and short positions.[2]

Because hedge funds have more tools at their disposal, they have the potential to generate higher returns. Put another way, because hedge funds do not have some of the constraints of traditional investment funds, they can construct superior portfolios—portfolios that more precisely match the fund manager's intentions—when these constraints are binding.

But this freedom also means that hedge funds can take on more risk in more dimensions, and thus lose more money if things go wrong. And the risk posture of hedge funds is more difficult to assess, because the leverage and short positions give hedge funds a measure of complexity beyond that of traditional, long-only funds.[3] On the face of it, it is noteworthy that the most free-ranging, risky, and opaque type of investment fund has been so lightly regulated.

Systemic Risk From Hedge Funds

The first task in managing systemic risk is aggregating position and leverage data. To understand why, let's look at the sources of systemic risk.

One source of systemic risk is leverage. Leverage amplifies risk in a meltdown. When a market drops, highly leveraged investment funds with positions in that market are forced to sell to meet their margin requirements, and their selling pushes prices down further. This in turn leads to more forced selling. The result is a cascading liquidity crisis.

And it can get worse from there. Those funds that are under pressure discover there is no longer liquidity in the stressed market, so they start to liquidate their positions in other markets. If many of the funds that are in the first market also have high exposure in a second one, the downward spiral propagates to this second market. This phenomenon explains why a systemic crisis can spread in surprising and unpredictable ways. The contagion is driven primarily by what other securities are owned by the funds that need to sell.[4] For example, when the silver bubble burst in 1980, the silver market became closely linked to the market for cattle. Why? Because when the Hunt family had to meet margin calls on their silver positions, they sold whatever else they could. And they happened also to be invested in cattle.

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[1] Another characteristic that can be argued to differentiate hedge funds from traditional funds is their fee structure. Hedge funds typically have a performance incentive fee. The fund manager receives a percentage of any positive returns. The manager does not, however, similarly share in losses. This leads to an incentive to take on risk, especially if the fund is "under water."

[2] The ability to reduce exposure to the market leads to the broadly applied differentiation between portfolios with "beta" and "alpha" exposure. Beta refers to exposure to the market. A traditional equity fund has unavoidable beta exposure, because it holds nothing but long positions in equities. Its return will tend to move up and down with the overall equity market. Alpha refers to exposure that is unrelated to the underlying market. A hedge fund can largely eliminate its beta exposure by holding equal positions long and short. Its return is then alpha-based, because it will not be correlated with the underlying market.

[3] The leverage and short positions also lead to a greater demand for opacity, because if a leveraged or short position becomes known, others can trade against it to force the fund to cover its shorts or to reduce its leverage.

[4] As an illustration, the proximate cause of Long Term Capital Management's (LTCM's) demise was the Russian default in August, 1998. But LTCM was not highly exposed to Russia. A reasonable risk manager, aware of the Russian risks, might not have viewed it as critical to LTCM. But the Russian default hurt LTCM because many of those who did have high leverage in Russia also had positions in other markets where LTCM was leveraged. When the Russian debt markets failed and these investors had to come up with capital, they sold their more liquid positions in, among other things, Danish mortgage bonds. So the Danish mortgage bond market and these other markets went into a tail spin, and because LTCM was heavily exposed in these markets, the contagion took LTCM with it.

Another source of systemic risk from hedge funds can come from the potential for widespread manipulation of critical markets.[5] When it comes to market manipulation, the ability of hedge funds to lever multiplies the impact of their capital base, and their ability to short means that they can take actions to depress prices. The potential for this risk can be appreciated by reflecting on the markets in the weeks surrounding the failure of Lehman Brothers in September, 2008. During that period short-selling contributed to a spectacular decline in equity prices, and there was huge pressure on the credit default swaps of the major financial institutions. The credit default swap spreads widened to a level that had previously been all but unimaginable. Because the spreads were viewed as indications of creditworthiness, and indeed were used in various loan covenants, the extreme widening of the spreads threatened the viability of these institutions.[6] The role of hedge funds in precipitating these market events remains to be studied, but given the history of this crisis it is not difficult to imagine the potential for a coordinated assault on the credit default swap market or on some other critical market precipitating a crisis in the future.

Regulating Hedge Funds for Systemic Risk

To control the systemic risk posed by hedge funds we must be able to measure crowding, the unintentional concentration of separate funds in the same trade. This means knowing the positions of the individual hedge funds and then being able to aggregate those positions. Whatever their own risk management capabilities, the individual funds—and regulators that might be providing oversight on an institution-by-institution basis—cannot keep systemic risk in check because they do not have this aggregate information.[7] It is as if each fund is sitting in a darkened theater unaware of how many others might run for the exit. To regulate and monitor the systemic risk arising from manipulation, the first task again is for the regulator to know the positions of the hedge funds that are capable of such manipulation, and know those positions on a frequently updated basis.

Thus an essential task for the regulation of hedge funds is to get data on leverage and positions from the institutions. We must be able to track the concentration of hedge funds by assets and by strategies to understand how the failure of one firm might propagate out to affect others. This is missing in the current regulatory structure, and is at the core of systemic risk.

Position data must be reported in a standardized form so that similar positions can be aggregated across the various hedge funds. This sort of data management task has been accomplished in other settings. For example, when salmonella was found in a peanut factory in Georgia, the Food and Drug Administration identified the contaminated products across the Nation and tracked them all the way to the store shelf. This was possible because consumer products are tagged with a bar code. We should do the same for financial products; have the equivalent of bar codes so that regulators know what financial products exist and where they are being held. This will help us anticipate the course of a systemic shock. It will identify cases where many investors may be acting prudently, but where their aggregate positions still lead to a level of risk which they themselves cannot see. It also will give us the means to evaluate crises after the fact. Just as the National Transportation Safety Board can use "black box" flight recorders to help improve airline safety by determining the causes of an airline accident, this position and leverage data will

[5] Manipulation is the intentional concentration of positions in a market with the objective of distorting the market price. This distortion can be intended to convey the impression of information, or to trigger actions that are price-dependent.

[6] The SEC issued a temporary ban on short sales in the wake of the Lehman crisis. But the SEC had no control over hedge fund trading in the credit default swap market. Indeed, regulators did not have transparency into the activities of that market.

[7] For example, over a few days in August, 2007 a number of large, quantitatively oriented long-short equity hedge funds saw their value plummet by 20 to 40 percent. Among these were highly regarded funds, including Greenwich, Connecticut-based AQR Capital and Goldman Sachs's flagship Global Alpha Fund. These funds all used high leverage; after the debacle hit, Goldman reported its fund was leveraged six to one. These hedge funds had strategies in common, indeed they shared common lineage: The principals of AQR came from Global Alpha, and the principals of Tykhe Capital came from DE Shaw, both other funds embroiled in the crisis. An exogenous shock initiated a drop in their primary strategies, and due to their high leverage they were forced to reduce their positions. With many funds running for the door at the same time, this precipitated a leverage-induced liquidity crisis. These funds had substantial investments in risk management talent and systems. But what they did not appreciate—and would have had difficulty knowing given the secrecy with which the quantitative portion of the hedge fund industry operates—was the potential crowding from having many large competitors in the same strategies.

act as the black box data to help us understand how a crisis started, and help us understand what we need to do to improve the safety of the markets.

I believe this is a regulatory task that can be readily accomplished. Initially the task need only focus on the largest hedge funds, and those funds already amass the required position data as part of their daily risk management process. And the task can bear fruit even if it does not exhaustively pull in and tag every position. The exhaustive reporting of all positions for all hedge funds would be difficult, but it is not necessary, because what matters for evaluating systemic risk is getting a critical mass of positions that reflects the biases and interdependencies that can lead to a crisis.[8]

The data acquisition and analysis must be done by the regulator in a secure fashion. I am not an expert in such security issues, but I can make two observations related to the feasibility of achieving an acceptable level of data security. First, an acceptable standard for position security already exists, because hedge funds allow these data to be held by various agents in the private sector, such as their prime brokers and clearing corporations. Second, the Government successfully secures data in areas that are far more sensitive than position data such as the military and the intelligence community where a failure can cost lives and where there are concerted efforts by adversaries to root out the data.

Hedge Funds That Should Be Monitored for Systemic Risk Regulation

For purposes of systemic regulation, hedge fund oversight should be extended to include the large proprietary trading operations within banks. From the standpoint of leverage and the ability to short, these operations act the same as hedge funds.[9] They too can contribute to liquidity crisis events, and can participate in systemically relevant market manipulation. However, venture capital firms and private equity funds can be excluded. Venture capital and private equity funds operate outside the publicly traded markets, they do not short, and, because of the nature of their collateral, they do not employ the degree of leverage of the hedge funds that operate in the public markets. They also have long-term holding periods with positions that they recognize as being illiquid from the outset. Their business model is more that of creating a conglomerate of embryonic businesses than it is of trading like a hedge fund. The so-called 130-30 types of investments funds also can be excluded.[10] These funds can employ leverage and can short, but only within tight limits.

Conclusion

My testimony has focused narrowly on what is required to regulate hedge funds, looking specifically at the issue of systemic risk, and within that at the data required to measure and monitor this risk.

Systemic risk regulation is seen by some as the key to averting market and economic crises like those we have faced over the past 2 years. But while systemic risk is fresh on our minds given recent events, it is just one of many risks that require regulatory oversight. And it is not that difficult to address. Granted we failed to do so this time around, and that failure exacted a huge toll. But if we make the effort to look, systemic risk is more visible than many other risks. Compared to risks from insider trading or fraud, where the whole objective is to remain hidden, it is hard to be stealthy when there are hundreds of billion of dollars of assets and multiple financial institutions involved. And that is the scale for a risk to build to systemic proportions.

Obtaining the position and leverage data is not invasive to a hedge fund. It does not affect day-to-day business, and once the systems for transferring these data to the regulator are in place it will be an essentially costless adjunct to the funds' daily risk analysis. But I have not addressed the next critical component of hedge fund regulation, the component that can be invasive: What to do if the analysis of the hedge fund data shows a systemic risk lurking on the horizon. Who pulls the emergency brake? Who bears the responsibility for having the hedge funds reduce their

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[8] There are many thousands of hedge fund, most small and inconsequential for systemic risk. And there are a range of customized and complex financial products—which with regulatory pressure might move over time into increasingly standardized forms—that will be time consuming to identify and tag. However, if we do get to the point where position information is provided on an exhaustive basis, then this process can also be used as a tool to detect fraud. The regulator can cross-check the reported positions against the fund's registered prime broker or clearing corporation for verification. Once verified, the returns from the reported positions can be cross-checked against the hedge fund's reported returns.

[9] Also, compensation within proprietary trading groups is generally incentive-based, similar to that of hedge funds.

[10] The 130-30 type of funds add a limited degree of leverage and ability to short to a traditional long-only structure.

exposure or leverage? Such regulatory authority must exist for hedge funds, just as it must exist for banks and other financial institutions of systemic import.[11] However, the task of acquiring and analyzing data can be separated from that of taking action; indeed, I believe there are advantages to such a separation. And acquiring the data is the first task to address, because we cannot manage what we cannot measure.

PREPARED STATEMENT OF JOSEPH A. DEAR

CHIEF INVESTMENT OFFICER,
CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

JULY 15, 2009

Chairman Reed and Members of the U.S. Senate Banking Subcommittee on Securities, Insurance, and Investment, it is an honor and pleasure to provide this statement on behalf of the California Public Employees' Retirement System (CalPERS). Our mission is to advance the financial and health security for over 1.6 million public employees, retirees, and their families. CalPERS is the largest public pension system in the United States with a total fund market value of approximately $180 billion and annual payout obligations of over $10 billion to California pensioners.

Acting as fiduciaries first and foremost, the goal of the CalPERS investment program is to achieve the highest possible long-term, sustainable, risk-adjusted returns. To discharge that responsibility, we are inherently long-term investors in the capital markets, providing patient capital with a decades-long investment time horizon. Because of the sheer size of our fund and the need to diversify to provide sound investment returns, we are broadly invested throughout the capital markets in most asset class investment strategies including hedge funds and private equity funds.

We are vitally interested in the quality of regulation of financial services since effective investor protection is essential to creating and maintaining the trust necessary for investors to put their capital to work.

We applaud the Committee's leadership in holding this hearing to address options for regulating hedge funds and other private pools of capital. You have asked about the benefits of investing in these vehicles, the risks they pose to financial markets and the broader economy, how market participants and regulators can reduce these risks, without unduly limiting their benefits and what legislative changes are needed to assure that regulators have the tools they need to prevent fraud and reduce risks posed to the financial system.

1. What benefits do private pools of capital—including hedge funds, private equity funds, and venture capital funds—provide to financial markets, investors, and the broader economy? In particular, what benefits are not available through other financial structures?

As the Nation's largest public pension fund, CalPERS investments span domestic and international markets. The CalPERS Board of Administration has investment authority and sole fiduciary responsibility for the management of the System's assets. Our goal is to efficiently and effectively manage investments to achieve the highest possible return at an acceptable level of risk. In doing so, CalPERS has generated strong long-term returns. The CalPERS investment portfolio is diversified into several asset classes, so that over the long run any weaknesses in one area can be offset by gains in another. The CalPERS Board follows a strategic asset allocation policy that targets the percentage of funds to be invested across a broad array of asset classes and strategies, such as U.S. equity, international developed and emerging equity, fixed income securities including U.S. Treasury bonds, corporate bonds, mortgages, sovereign bonds, and high yield bonds, private equity, venture capital, real estate, hedge funds, and infrastructure.

Our target rate of return over the long term is 7.75 percent. The return enhancement attributes of private equity and the risk management characteristics of hedge funds make them indispensable elements of our investment program. CalPERS invests in private equity and hedge fund investment structures with the objective of diversifying its investment portfolio, managing risk, and adding value to the total fund. For example, private equity is an important asset class for CalPERS and other public pension funds because top-performing private equity funds consistently outperform other classes of investments, invest for the long term, and align their inter-

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[11] This means that the task of data aggregation also must extend to these other institutions, as must the ability to control leverage. For banks, the regulatory authority already is in place to obtain these data.

ests and incentives with those of their investors. Part of the above market return expected by private equity investors is compensation for the risk of holding illiquid securities. Public pension funds, by virtue of their long investment horizon are ideally suited to invest in private equity vehicles. The value of patient capital invested for the long term and not obsessed with short term performance is important to the health of the national economy.

Important benefits to CalPERS provided by investing in private equity and hedge funds include effective risk management and investment value creation through allowance for the diversification of our portfolio across a broad array of asset classes. We have been investing in private equity since 1990 and in hedge funds since 2002. Today, we have approximately $20 billion invested in private equity strategies and $6 billion invested in hedge fund investment strategies that combined represent just over 14 percent of CalPERS' total asset allocation. The 5-year hedge fund program annualized return is +3.89 percent versus +1.32 percent for all of Global Equity giving value added of 2.57 percent annually over the same period after expenses. As of March 31, 2009, the private equity portfolio at CalPERS has outperformed the public stock market index by over 1,000 basis points over a 10-year period.

This performance translates into substantial value added to the pension fund over a sustained time period. It makes realization of our target rate of return feasible. The consequences to our beneficiaries, their Government employers and taxpayers of our not meeting this objective are substantial and real: lower wages, higher contribution rates and higher taxes. Can these performance benefits be delivered through other investment products? No. Sure, investors can boost returns from investing in publicly listed equities by borrowing to enhance returns, but that does not necessarily bring with it the long term focus of a partnership with an expected duration of 10 to 12 years. Some hedge fund returns can be duplicated with lower cost replication strategies, but, by definition, they only work for existing strategies, not the innovations that competitive markets constantly call forth.

In summary, hedge funds, private equity, and other pools of private capital provide:

- Useful components of a diversified investment portfolio to enhance returns and add effective risk management tools.
- The ability to bring together like minded investors that have been committing long term capital to a number of investment areas.
- More flexibility to invest in accordance with opportunities in contrast to being limited to a particular category or "style."
- Benefits to the larger financial system including innovation, gains in growth and employment and the provision of capital for economic and technological advancement.

2. What risks do private pools of capital pose to financial markets and the broader economy?

The fundamental risk posed by private pools of capital is that they can choose to operate outside the regulatory structure of the United States. When these entities operate in the shadows of the financial system, regulatory authorities lack basic information about exposures, leverage ratios, counterparty risks and other information necessary to assure that overall risk levels in the financial system are reasonable. Moreover, without the disclosure, reporting and licensing requirements that accompany registration, investors may be deprived of the timely and accurate information they need to ascertain the suitability of an investment fund given their financial objectives and risk tolerance.

Clearly, the buildup of massively leveraged positions was enabled by the absence of any effective regulatory oversight. Combined with misaligned compensation practices that, among other things, encouraged excessive risk taking by rewarding short term success without penalty for subsequent losses, the result was an unprecedented degree of risk in the system. The harm that has ensued as overleveraged investors have had to unwind their positions extends far beyond them and their investors, to other market participants and ultimately to the national economy as a whole.

3. What approaches by market participants and regulators can best reduce these risks, without unduly limiting the benefits of such funds?

Policy makers, investors, regulators, and the public need to accept that risk is inevitable and necessary; return without risk is like love without heartache—they go together. If risk cannot be avoided then it has to be managed.

One of the powerful lessons of the crash for us was the limited value of many quantitative risk management tools. So an obvious imperative for us is to improve

our quantitative and qualitative comprehension of the risks in our portfolio. In addition to better risk management, investors can improve the depth and detail of their due diligence, adhere scrupulously to best practices in decision making, and make timely disclosures of their investment policies, holdings and performance.

Regulators need new tools and authority to deal effectively with the gaps exposed by the crash. But not all of the regulatory shortcomings we see so clearly now are the product of gaps and omissions. Regulators also failed to use the authority they possessed to protect investors and assure the integrity of markets, exchanges and investment providers. Enforcement is not the only tool of effective regulatory systems, but its absence can dangerously weaken the credibility of those systems. Regulatory agencies need resources, support and leadership to make the most of the authority granted to them so they can fulfill their mission.

Institutional investors also need the flexibility to invest, consistent with their fiduciary responsibilities, in an unconstrained investment opportunity set. This is critical to enable public pension funds to meet our obligations. Limitations on the universe of available investments will potentially reduce our ability to generate the needed returns and may increase the risk of the plan.

4. What possible legislative changes are needed to ensure that activities of private pools of capital are sufficiently transparent, and that regulators have the tools they need to prevent fraud and reduce risks posed to the financial system?

Today's hearing coincides with the release of a report by the Investors' Working Group on U.S. Financial Regulatory Reform: The Investors' Perspective. I was a member of the group which was formed by the Council of Institutional Investors and the CFA Institute Centre for Financial Market Integrity. The IWG report focuses on four major areas that the credit crisis has revealed to be fundamentally flawed:

- Strengthening and reinvigorating existing Federal agencies responsible for policing financial institutions and markets and protecting investors and consumers.
- Filling the gaps in the regulatory architecture and in authority over certain investment firms, institutions, and products.
- Improving corporate governance at U.S. financial companies.
- Designating a systemic risk regulator, with appropriate scope and powers.

A number of the recommendations of the IWG are relevant to the issues posed by private pools of capital. These include:

A. Strengthening Existing Federal Regulators

- Congress and the Administration should nurture and protect regulators' commitment to fully exercising their authority.
- Regulators should have enhanced independence through stable, long-term funding that meets their needs.
- Regulators should acquire deeper knowledge and expertise.

B. Closing the Gaps for Products, Players, and Gatekeepers

OTC Derivatives

- Standardized derivatives should trade on regulated exchanges and clear centrally.
- OTC trading in derivatives should be strictly limited and subject to robust Federal regulation.
- The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should improve accounting for derivatives.
- The SEC and the CFTC should have primary regulatory responsibility for derivatives trading.
- The United States should lead a global effort to strengthen and harmonize derivatives regulation.

Securitized Products

- New accounting standards for off-balance sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted.
- Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance sheet asset-backed securities.

- The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products.
- Asset-backed securities sponsors should be required to retain a meaningful residual interest in their securitized products.

Hedge Funds, Private Equity and Investment Companies, Advisers, and Brokers

- All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight.
- Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction.
- Investment managers should have to make regular disclosures to regulators on a real-time basis, and to their investors and the market on a delayed basis.
- Investment advisers and brokers who provide investment advice to customers should adhere to fiduciary standards of care and loyalty. Their compensation practices should be reformed, and their disclosures should be improved.
- Institutional investors—including pension funds, hedge funds, and private equity firms—should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance.

Nonbank Financial Institutions

- Congress should give regulators resolution authority, analogous to the FDIC's authority for failed banks, to wind down or restructure troubled, systemically significant nonbanks.

Mortgage Originators

- Congress should create a new agency to regulate consumer financial products, including mortgages.
- Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements.
- Mortgage regulators should develop suitability standards and require lenders to comply with them.
- Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines.

C. Corporate Governance

- In uncontested elections, directors should be elected by a majority of votes cast.
- Shareowners should have the right to place director nominees on the company's proxy.
- Boards of directors should be encouraged to separate the role of chair and CEO, or explain why they have adopted another method to assure independent leadership of the board.
- Exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management.
- Companies should give shareowners an annual, advisory vote on executive compensation.
- Federal clawback provisions on unearned executive pay should be strengthened.

D. Systemic Risk Oversight Board

- Congress should create an independent governmental Systemic Risk Oversight Board.
- The board's budget should ensure its independence from the firms it examines.
- All board members should be full-time and independent of Government agencies and financial institutions.
- The board should have a dedicated, highly skilled staff.
- The board should have the authority to gather all information it deems relevant to systemic risk.
- The board should report to regulators any findings that require prompt action to relieve systemic pressures, and should make periodic reports to Congress and the public on the status of systemic risks.
- The board should strive to offer regulators unbiased, substantive recommendations on appropriate action.

- Regulators should have wide latitude to implement the oversight board's recommendations on a "comply or explain" basis.

In closing, we appreciate your consideration of CalPERS' perspective as a large public plan, institutional investor, and fiduciary to the financial interests of hard working pensioners and their families. Independent robust regulatory and enforcement authority over hedge funds and other unregulated investment pools that emphasizes transparency and accountability is vitally important to CalPERS as a long-term participant in the capital markets. We encourage you to move forward with care and skill to bring about comprehensive financial regulatory reform.

Thank you.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ANDREW J. DONOHUE

Q.1. Mr. Donohue, your testimony was not endorsed by Commissioner Paredes. Please transmit to us an explanation authored by Commissioner Paredes of why he did not endorse the testimony.

A.1. Commissioner Paredes' response follows:

I appreciate the opportunity to explain why I did not endorse the July 15, 2009, testimony of Andrew J. Donohue, Director of the Division of Investment Management at the U.S. Securities and Exchange Commission (SEC), before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Testimony). The Testimony addresses regulating hedge funds and other private investment pools, including venture capital funds and private equity funds.

Introduction

Although I agree with aspects of the Testimony, I did not endorse the Testimony for four primary reasons.

First, the Testimony understates the extent to which private investment pools are subject to existing regulation and market discipline that constrain how the funds are managed.

Second, to the extent private investment pools fall within limited statutory exemptions from certain regulatory obligations, the Testimony does not adequately account for the important interests these exemptions advance.

Third, the Testimony does not properly recognize the potential cost to our financial markets and our economy more generally if private investment pools are subject to additional regulation beyond the regulatory demands that hedge funds, venture capital funds, and private equity funds already must satisfy. The Testimony obscures the rigorous analysis that is needed to determine the appropriate oversight of private investment pools by framing their regulation in terms of closing a "regulatory gap," suggesting that the decision to regulate funds more is straightforward when, in fact, it is not. The desirability of closing any such "gap" is not self-evident but depends on a number of considerations, some of which recommend against subjecting the funds to more regulation.

Fourth, although the Testimony correctly explains that, in some instances, it can be difficult to distinguish among hedge funds, venture capital funds, and private equity funds, the Testimony too readily concludes that regulatory distinctions should not be made among different types of funds. To the contrary, funds can and should be distinguished and, when appropriate, subject to different regulatory treatment. Indeed, Federal securities regulation is replete with instances of regulatory line-drawing designed to refine regulation to avoid unduly burdening investment funds, investors, and businesses. If private investment pools are to be regulated more, such regulation should be focused on those funds that present the most serious systemic risk instead of subjecting qualitatively different funds to an ill-fitting one-size-fits-all regulatory regime.

The Current Regulatory Framework

Calls for more regulation should begin by assessing current regulation. As the Testimony summarizes, private investment pools are structured to benefit from certain regulatory exemptions. The Testimony's characterization of the regulatory regime, while technically accurate insofar as it goes, is incomplete and thus imbalanced. For example, the Testimony recognizes that the Investment Advisers Act (Advisers Act) imposes certain fiduciary obligations on an adviser to a hedge fund, venture capital fund, or private equity fund, even if the adviser is not required to register under the Advisers Act. However, the Testimony neglects to explain that private investment pools must comply with a host of other regulatory requirements, including prohibitions against fraud, insider trading, and manipulation and obligations to make various disclosures.

In addition, it is important to recognize that private investment pools are subject to market discipline that holds funds and their managers accountable. Consider, for example, that funds issue securities to their investors in private offerings. Even though not statutorily required, most funds nonetheless provide extensive disclosures to their investors—both when investors initially invest in the fund and periodically throughout the life of the fund—because investors demand information. Concerning the Advisers Act, many managers of private investment pools have chosen to register with the SEC, despite no regulatory mandate to do so.

These two examples illustrate how funds and their advisers organize their affairs to meet investor demands. Put differently, market discipline can fill so-called "gaps" in the regulatory regime and should be part of analyzing what additional regulation may be warranted and for what purpose. The Testimony does not acknowledge the influence of market discipline as it should.

The Benefits of Existing Statutory Exemptions

The Testimony identifies regulatory requirements that are scaled back as a result of certain exemptions from the Federal securities laws but does not equally stress the benefits that follow when funds and investors are allowed additional flexibility to privately order their affairs and transact more freely. By emphasizing the regulatory mandates that are scaled back as a result of the exemptions without fully crediting how more tailored regulation can benefit the U.S. economy, the Testimony's tone is biased toward more regulation because the value of the exemptions is understated.

The Testimony's use of the term "regulatory gap" to characterize well-established statutory exemptions under the Federal securities laws is problematic. The term "regulatory gap" has taken on a negative meaning, connoting that there is an inherent flaw in the regulatory regime. When a "gap" is identified, it seems to predetermine the outcome in favor of more regulation. Calling something a "regulatory gap," however, should not distract from a rigorous analysis of the pros and cons of a regulatory initiative. Many so-called "gaps" are purposeful, reflecting an informed determination that the net consequence of closing the "gap" is adverse to the interests of investors and our economy overall. In many instances, a "regulatory gap" affords the latitude needed for private sector innovation and entrepreneurism to prosper, unbridled by unjustified regu-

latory constraints. The beneficial activities of private investment pools—which promote economic growth by facilitating capital formation, spurring research and development, creating jobs, and contributing to efficient, liquid securities markets—would be impeded if the funds were subject to the full measure of the Federal securities laws.

In addition, the tailoring of regulation through statutory exemptions can allow the SEC to allocate its resources more efficiently and effectively. A determination that sophisticated and institutional investors are able to protect their own interests—such as by negotiating for disclosures, pressuring a fund manager to register as an adviser, or simply refusing to invest if investor demands are unmet—argues in favor of certain regulatory exemptions, the effect of which is to empower the SEC to dedicate its resources to other goals, including protecting retail investors. Even if the SEC enjoys additional resources, the agency's resources still will be limited. As a result, there is an inevitable opportunity cost associated with overseeing private investment pools. More resources spent overseeing private investment pools means fewer resources spent on other priorities.

Considerations in Assessing Additional Regulation

Whether or not to impose additional regulation on private investment pools requires a careful balancing of interests. It is always possible to take another regulatory step, but is the cost of the additional regulation warranted? The answer may differ for different types of funds under different circumstances. Given that the Testimony emphasizes the potential benefits of more regulation, the following is a nonexclusive set of other considerations that inform the analysis but that the Testimony does not adequately address.

First, moral hazard is a potential cost of regulation. One should consider the extent to which subjecting private investment pools to more regulation could foster moral hazard by promoting an undue sense of security that dissuades investors from taking steps to protect their own interests, such as engaging in demanding due diligence. In other words, more regulation may undercut market discipline. Active investor skepticism and due diligence may do more to deter and detect misconduct than particular regulatory demands.

Second, the additional steps that hedge funds, venture capital funds, and private equity funds would have to take to meet new regulatory requirements could take time and effort away from more productive matters that benefit investors and our markets as a whole. Time and effort that fund managers and other professionals otherwise could have spent analyzing investment opportunities, assessing trading strategies, or providing managerial guidance to start-up businesses likely would be redirected to tend to new administrative obligations.

Third, expanded regulatory demands may erect barriers that preclude entry by new funds and thus undercut competition. Similarly, well-established funds that are better positioned to incur the added cost may gain a competitive advantage over smaller, less-established competitors that struggle to meet the added burdens.

Fourth, additional regulation may jeopardize the benefits that private investment pools generate. As the Testimony summarizes,

hedge funds, venture capital funds, and private equity funds benefit investors, financial markets, and our economy. The Testimony explains:

> Private equity funds generally invest in companies to which their advisers provide management or restructuring assistance and utilize strategies that include leveraged buyouts, mezzanine finance and distressed debt. Venture capital funds typically invest in early stage and start-up companies with the goal of either taking the company public or privately selling the company. Each type of private fund plays an important role in the capital markets. Hedge funds are thought to be active traders that contribute to market efficiency and enhance liquidity, while private equity and venture capital funds are seen as helping create new businesses, fostering innovation and assisting businesses in need of restructuring. Moreover, investing in these funds can serve to provide investors with portfolio diversification and returns that may be uncorrelated or less correlated to traditional securities indices.

The Testimony, however, does not expressly recognize that subjecting private investment pools to more regulation runs the risk that these benefits will be lost, at least to some degree. Stated differently, the potential cost of more regulation of funds includes less efficient and less liquid securities markets, less commercialization of cutting-edge technologies and innovative products, fewer restructurings and control transactions that can lead to job preservation and job growth, and fewer investment opportunities for investors. That private investment pools—particularly venture capital funds and private equity funds—generally do not pose the type of systemic risk that regulatory reform has focused on is one important factor in determining whether more regulation is justified in light of the cost of further constraining fund activities.

Regulatory Options

The Testimony endorses subjecting investment advisers of private investment pools to registration under the Advisers Act. The Testimony also suggests the option of subjecting private investment pools to the Investment Company Act of 1940 (Investment Company Act) and suggests giving the SEC additional rule-making authority.

Registration of Private Fund Investment Advisers

In supporting Advisers Act registration, the Testimony argues for treating hedge funds, venture capital funds, and private equity funds alike on the grounds that it is too difficult to distinguish among them. The Testimony also explains that "[w]e [the SEC] are concerned that in order to escape Commission oversight, advisers may alter fund investment strategies or investment terms in ways that will create market inefficiencies."

If there is to be more regulation, regulatory distinctions should be made among funds. Economically different activities argue for different regulatory treatment. For example, funds that buy and hold stock present different regulatory considerations than funds that actively trade debt, equities, and derivatives. Funds of different sizes with different leverage ratios also raise different concerns. By way of illustration, subjecting the manager of a venture capital fund to investment adviser registration does not seem to be cost-justified when the fund does not present a systemic risk because it is not leveraged or interconnected with the rest of the financial system. Even if hedge fund managers are required to reg-

ister under the Advisers Act, it does not necessarily follow that the manager of a private equity fund that takes long-term controlling stakes in companies should be required to register. Indeed, depending on their size, leverage, and trading activities, different hedge funds may present different concerns arguing for different regulatory treatment.

Drawing regulatory distinctions is central to balanced regulation. The failure to draw appropriate regulatory lines when it comes to private investment pools will mean that new regulatory requirements will be overinclusive—burdening funds that do not present the kinds of concerns that may justify more costly regulation.

B. Private Fund Registration

Subjecting private investment pools to the Investment Company Act would result in direct substantive regulation of the funds as opposed to their advisers. Direct regulation of hedge funds, venture capital funds, and private equity funds would unduly constrain their investment and trading activities. Pools of capital should not be homogenized into mutual funds. Private investment pools need flexibility to undertake different strategies that serve different functions in our economy.

C. Regulatory Flexibility Through Rule-Making Authority

The Testimony suggests that the SEC could be given additional rule-making authority, including the authority to impose conditions on the availability of the current section 3(c)(1) and section 3(c)(7) exceptions to the Investment Company Act. This option is objectionable because it again raises the specter that funds themselves, and not just their advisers, will be subject to direct regulation. A further objection is that the applicability of the Investment Company Act and the nature and scope of the regulation a fund might face would be uncertain and unpredictable. The lack of a stable regulatory regime risks frustrating valuable private sector enterprise by, for example, injecting undue regulatory uncertainty into commercial dealings. Regulatory predictability promotes business and investing.

Disclosure to Regulators

The SEC has a legitimate interest in ensuring that the agency has adequate information concerning private investment pools, particularly if funds of a certain character pose a systemic risk. To the extent the regulatory objective is to monitor and stem systemic risk, the SEC should consider the information that is required by it or other regulators to monitor our markets effectively and seek legislation, if needed, that would ensure that such disclosures are made to the Government, perhaps on a confidential basis. Neither the Advisers Act nor the Investment Company Act was crafted to address systemic risk. So it seems ill-fitting to unwind exemptions from these statutes in order to advance systemic risk regulation.

Conclusion

In this response, I have highlighted some of the considerations and tradeoffs that need to be accounted for in deciding the extent to which private investment pools should be subject to more regu-

latory burdens. Whatever may be the benefits of additional regulation, it is necessary to consider the attendant costs in assuring that any regulatory response is properly calibrated and tailored.

Thank you again for the opportunity to explain why I did not endorse the Testimony. My staff and I are available to expand upon this written response to your question and to answer any other questions you may have.

Q.2. Mr. Donohue, your testimony noted that Commissioner Casey does not endorse the approaches discussed in Sections IV. B and C. Please transmit to us an explanation authored by Commissioner Casey of why she does not endorse the approaches discussed in Sections IV. B and C.

A.2. Commissioner Casey's response follows:

Thank you for inviting me to explain why I did not endorse several components of SEC Division of Investment Management Director Andrew Donohue's July 15, 2009, testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs relating to the regulation of hedge funds and other private investment pools.

I agree generally with Mr. Donohue's testimony as to many of the benefits that would come of broadening the investment adviser registration requirement to include managers of private funds. Many regulatory issues touch upon investment advisers irrespective of the type of private pool at issue. Furthermore, it would be a perverse (but not an unexpected) result if investment advisers were to migrate to different products or services merely because they are seeking to avoid registration.

In evaluating whether to broaden investment adviser registration requirements, I believe Congress should begin by clearly identifying its objective. As part of a broader financial regulatory restructuring, I agree that appropriate regulation of private pools of capital is an important element in addressing overall risks to the financial system, enhancing market confidence, and strengthening investor protection. As a next step, I believe Congress should acknowledge that there are real differences among private funds (for instance, how they are managed, how they are structured, and the risks they present) and that it is important to ask serious questions from the outset about what standards investment advisers should operate under, what information regulators should obtain about them and the products and services they offer, and how that information should be used. For example, while it may make sense to have access to information about the use of leverage, position or sector concentration, or other factors relating to the operation of a $20 billion hedge fund, I do not believe such information is necessary for the SEC (or a systemic regulator) to obtain from the adviser to, say, a small VC fund or a family office. Likewise, we should think carefully about the nature of the inspection regime, recordkeeping, compliance policies and procedures, and other requirements we impose on registrants.

In any mandatory registration scheme, I believe Congress should encourage the SEC to tailor the standards and information requirements to suit the size and nature of the adviser. As Mr. Donohue's

testimony suggests, it is critical that Congress establish a regulatory approach that does not unnecessarily impede capital formation or stifle innovation: "Any regulatory reform should acknowledge the differences in the business models pursued by different types of private fund advisers and should address in a proportionate manner the risks to investors and the markets raised by each." Moreover, I believe Congress's regulatory approach should not engender false confidence that registration can serve as a panacea for all ills. Enhanced requirements are an important means of filling a regulatory gap, but will never be a substitute for care and due diligence on the part of private fund investors in choosing an investment adviser.

Where I depart more substantially from Mr. Donohue's testimony is in its discussion of the potential regulatory option of requiring registration of private funds under the Investment Company Act of 1940. I do not believe there is a sufficient rationale for endorsing such an approach (and, indeed, I believe it would be unadvisable) for several reasons.

First, private funds—especially those relying on section 3(c)(7) of the Investment Company Act—have been excepted from the registration requirements of the Act primarily on the theory that investors are sophisticated enough to evaluate their investment decisions without the regulatory intervention of fund registration. While it may be appropriate to rethink (and perhaps to reconcile) the thresholds we associate with who should be deemed a sophisticated investor, I believe the underlying concept is still valid. Whereas the regulation of investment advisers can be designed to prevent and detect fraud in areas such as trade allocations, where even sophisticated investors lack the means to protect themselves, in other areas, such as investment risks, fund structure, and other particular terms of a private fund, I believe that these are still areas where sophisticated investors can protect themselves adequately. I think that if Congress or the SEC were to regulate the structure of or redemption rights associated with a private placement, we risk stifling innovation and capital formation.

Second (and in a similar vein), I believe that private fund registration is not advisable for much the same reason that broadening the investment adviser registration requirement is a good idea. Namely, mandatory registration of private funds may prompt a migration away from such structures into other products and services, such as separately managed accounts. As a result, this option is likely to substitute one method of regulatory arbitrage for another. Another way of putting this point is that I believe we can get the essential information we need and exercise sufficiently comprehensive oversight by obtaining jurisdiction over and setting sensible requirements for advisers rather than focusing on the private funds they manage. Moreover, we are less likely to obtain duplicative or inaccurate information if we focus on the lead (the investment adviser and the assets it manages) rather than on the supporting cast of characters (the various funds, series of funds, or other products organized in various jurisdictions and along different lines for a host of different reasons).

Finally, I note that there may be significant costs that would come of private fund registration that would be borne by funds,

managers, investors, and the Commission. In thinking about how best to allocate resources to an effective registration and examination program, enhancing adviser regulation seems the better course than focusing on private fund registration.

I also have concerns about the testimony's discussion of the advisability of devolving broader authority for the Commission to condition the use by a private fund of the section 3(c)(1) and 3(c)(7) exceptions. In connection with establishing any new regulatory authority, Congress should clearly enunciate what it wants to do and why and not leave it in the purview of the Commission to rethink the purposes behind a mandate to impose new conditions. Otherwise, because the process of rule making is almost always accretive and rarely results in streamlining, I fear that too broad a delegation will lead in time to overlapping, cumbersome requirements that will handicap our thriving private fund market. While I appreciate the desire for our regulatory approach to be sufficiently flexible to adapt to evolving market conditions, I think this can be done in a way that more narrowly circumscribes the authority under which the Commission operates without the broad mandate that Mr. Donohue's testimony discusses.

I hope these points are responsive. My staff and I would be happy to provide a more detailed response to this or other questions you may have.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ANDREW J. DONOHUE

Q.1. If we create a systemic risk regulator and give that regulator the power to collect information on firms' positions and strategies, how do we protect that information? Specifically, how do we prevent someone at the regulator from either sharing that information or leaving the agency with that information in his head and then profiting from it?

A.1. Confidentiality is very important, especially with respect to information about lending and trading activities that are systemically significant. With respect to the SEC, the various Federal securities laws and SEC rules generally prohibit the disclosure of nonpublic information by members, officers and employees of the Commission, and prohibit the use of that information for personal gain. For example, section 24(b) of the Securities Exchange Act of 1934 makes unlawful the unauthorized disclosure or misuse for personal gain of any information contained in any application, statement, report, contract, correspondence, notice, or other document filed with the Commission.[1] A willful violation of this section is a crime. Similarly, the Commission's Conduct Regulation prohibits any use of confidential or nonpublic information for private gain.[2]

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[1] 15 U.S.C. 78x(b).
[2] 17 CFR 200.735-3(b)(1).

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM ANDREW J. DONOHUE

Q.1. The Administration's proposal only requires disclosure of information related to whether the fund poses systemic risk. Following the Madoff and Stanford fiascos, as well as countless other frauds that got fewer headlines but wreaked no less havoc on their victims, it seems obvious to me that closer attention needs to be paid to these funds to avoid future Ponzi schemes from flying under the radar for decades, sweeping up more and more victims while remaining unnoticed and unpunished. The Administration's proposal last week to require that broker-dealers observe the same fiduciary standards as investment advisors is an important step in this direction. But the simple fact is we need to empower the SEC to do more. This doesn't necessarily require new rules—after all, fraud is already illegal—but we need to make sure the SEC has the information and resources it needs to go after these sophisticated schemes. Shouldn't private investment funds be required to disclose information to the SEC for the purpose of investigating and enforcing antifraud rules, not just for systemic risk purposes?

A.1. I agree that private fund advisers should be required to provide information to us about the private funds they manage not just for systemic risk monitoring but also for market integrity and investor protection purposes. Advisers Act registration is a vital step in obtaining this information.

Q.2. Also, the SEC currently has only about 450 examiners to oversee approximately 11,300 investment advisors plus 8,000 mutual funds. Requiring that all hedge funds, private equity funds and other similar private investment pools register with the SEC and that the SEC perform some level of oversight and enforcement of their activities, would result in those examiners being responsible for approximately 2,000 more investment advisors. Won't the SEC need significant additional resources to perform these oversight functions?

A.2. The SEC has already suffered declines in the examination staff overseeing existing registrants. Because of flat or declining budgets from FY2005 through FY2007, this fiscal year the SEC expects to have 8 percent fewer examination staff in this area than it did in FY2005, while the number of registrants has jumped by 32 percent.

As a result, the SEC has been able to maintain a regular examination cycle only for advisers that the agency believes are "high-risk." In recent years this relatively small group of firms has been inspected once every 3 years. The rest of the firm population, which represents approximately 89 percent of firms, is only inspected as resources allow, and as a result can go a decade or longer without a visit from the SEC's examination staff. Furthermore, the SEC's examinations are now taking longer to complete, because of the growing complexity of advisory firms and the need to determine compliance with new regulatory requirements. As a result, the agency may not be able to conduct regular inspections of all firms with higher risk profiles going forward and has even fewer resources to dedicate to non- high-risk firms.

If Congress were to require the registrations of private funds advisors, then the SEC would require a significant increase in its examination and rule-making staff. At a minimum, we would require approximately 100 additional staff members in order to maintain our current examination frequency levels and regulatory oversight functions and expand them to the 2,000 additional private fund advisers. It is likely, however, that more frequent examinations would be necessary, and that the need for resources would be greater, depending on the level of oversight expected under any bill that may be enacted.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM ANDREW J. DONOHUE

Q.1. In your testimony you say that "the registration and oversight of private fund advisers would provide transparency and enhance Commission oversight of capital markets. It would give regulators and Congress, for the first time, reliable and complete data about the impact of funds on our securities markets. It would give the commission access to information about the operation of hedge funds and other private funds through their advisors."

Please provide me, in detail, the role that private funds and private fund managers played in creating the turmoil in the U.S., and global, financial markets over the last 2 years.

A.1. Unfortunately, we have only an incomplete idea of the role that private funds and private fund managers played in creating the turmoil in the U.S., and global, financial markets over the last 2 years. Adviser registration and reporting requirements would help us understand better the role of these important market participants going forward.

We understand that certain private funds, as significant users of leverage, may well have contributed to the market turmoil as those leveraged private funds unwound highly leveraged positions. That being said, from what we can tell, private funds were not a direct cause of the market turmoil in the fall of 2008, and in many cases they were casualties of it.

Q.2. Why would private funds continue to operate in the United States if the Commission requires detailed information about their business practices which would dramatically increase the risk that those business practices would be made public? If that is not a concern, why not?

A.2. I am certainly concerned about maintaining the confidentiality and integrity of legitimate proprietary information. The SEC deals with extremely sensitive information everyday, and we protect the information provided to us. The Federal securities laws and SEC rules generally prohibit the disclosure of nonpublic information by members, officers and employees of the Commission, and prohibit the use of that information for personal gain. For example, section 24(b) of the Securities Exchange Act of 1934 makes unlawful the unauthorized disclosure or misuse for personal gain of any information contained in any application, statement, report, contract, cor-

respondence, notice, or other document filed with the Commission.[1] A willful violation of this section is a crime. Similarly, the Commission's Conduct Regulation prohibits any use of confidential or nonpublic information for private gain.[2]

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM DINAKAR SINGH

Q.1. Who in the Federal Government knows the markets enough to effectively regulate and understand what hedge funds and other firms are doing and the risks they might create?

A.1. Answer not received by time of publication.

Q.2. Should we put leverage limits on hedge funds and other firms?

A.2. Answer not received by time of publication.

Q.3. To limit the potential harm that could be done by private investment firms to the system and counterparties, do you think it is a better approach to place limits on the firms themselves, or limit the exposure of counterparties like banks to the investment firms?

A.3. Answer not received by time of publication.

Q.4. Do you think becoming publicly traded changes the natural incentives private investment partnerships have to be responsible when the partners have their own funds at risk?

A.4. Answer not received by time of publication.

Q.5. To address systemic risk and fraud, do you think the SEC is better off focusing its resources on constant supervision and examination, or on after-the-fact enforcement?

A.5. Answer not received by time of publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM DINAKAR SINGH

Q.1. Can you give me a good reason why we shouldn't require all hedge funds to register with the SEC or, assuming there are appropriate safeguards in place to ensure that confidential information remains confidential, disclose information to their regulators so the regulators can see if they pose systemic risk?

A.1. Answer not received by time of publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JAMES S. CHANOS

Q.1. Who in the Federal Government knows the markets enough to effectively regulate and understand what hedge funds and other firms are doing and the risk they might create?

A.1. The Securities and Exchange Commission is the Federal agency with the most knowledge regarding the markets, hedge fund and other investment vehicles to evaluate the riskiness of their activities.

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[1] 15 U.S.C. 78x(b).
[2] 17 CFR 200.735-3(b)(1).

Q.2. Should we put leverage limits on hedge funds and other firms?

A.2. In the context of the systemic risk legislation, firms that meet the legislation's criteria as systemically important should be subject to regulatory disclosure, as well as possible capital, leverage, and other requirements.

Q.3. To limit the potential harm that could be done by private investment firms to the system and counterparties, do you think it is a better approach to place limits on the firms themselves, or limit the exposure of counterparties like banks to the investment firms?

A.3. Regulators should consider both sides of a transaction where it involves regulated entities on each side.

Q.4. Do you think becoming publicly traded changes the natural incentives private investment partnerships have to be responsible when the partners have their own funds at risk?

A.4. Clearly the incentives are somewhat different. Of course, publicly traded companies have a host of regulatory requirements and potential liability that should operate to keep managers operating responsibly.

Q.5. To address systemic risk and fraud, do you think the SEC is better off focusing its resources on constant supervision and examination, or on after the fact enforcement?

A.5. Up-front supervision and examination is always better than after-the-fact-enforcement.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM JAMES S. CHANOS

Q.1. Can you give me a good reason why we shouldn't require all hedge funds to register with the SEC or, assuming there are appropriate safeguards in place to ensure that confidential information remains confidential, disclose information to their regulators so the regulators can see if they pose systemic risk?

A.1. As I testified, CPIC supports the registration of hedge funds (and other private investment funds) with the SEC. CPIC has also been supportive of confidential disclosure information necessary for regulators to assess the potential for systemic risk posed by private funds.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM TREVOR R. LOY

Q.1. Who in the Federal Government knows the markets enough to effectively regulate and understand what hedge funds and other firms are doing and the risks they might create?

A.1. In my experience, the Securities and Exchange Commission (SEC) has significant knowledge and expertise regarding privately offered pooled investment vehicles and the systemic risks related thereto. Venture capital firms already submit information to the SEC when they raise a fund. Venture firms are also already subject to antifraud rules under the SEC's purview. Although I can't speak directly to the SEC's knowledge of hedge funds since that is a dif-

ferent industry, I would assume that the SEC would have the knowledge and expertise to examine hedge funds given that the Commission in 2003 conducted an exhaustive study on the operations and practices of the hedge fund industry.

I would respectfully assert that the SEC should devote its time and attention to effectively regulating firms that may actually present systemic risk (*e.g.,* hedge funds) rather than diverting its limited resources to firms that present little to no systemic risk, such as venture capital firms. The SEC's Hedge Funds Study arrived at the same conclusion, citing that the SEC is "mindful that the Commission's resources available to examine advisers is limited" in arguing that venture capital funds should be distinguished from hedge funds for purposes of registration under the Advisers Act. [1]

Q.2. Should we put leverage limits on hedge funds and other firms?

A.2. Since venture capital firms use little or no leverage, it is difficult to respond to this question with regard to our industry. A typical venture capital fund limits its borrowing to short term capital needs (pending the draw down of capital commitments from its partners) which does not exceed 90 days and which does not exceed available equity commitments. As a result, placing a limitation on leverage would have very little impact on the activities of venture capital firms.

Q.3. To limit the potential harm that could be done by private investment firms to the system and counterparties, do you think it is a better approach to place limits on the firms themselves, or limit the exposure of counterparties like banks to the investment firms?

A.3. Venture capital firms generally do not act as borrowers from or lenders to counterparties. As a venture capitalist, I have only limited experience with counterparty risk and am not an expert.

Venture capital firms present an extremely limited universe of risk. Whereas a hedge fund in distress may leave a chain of unsettled transactions and other liabilities, a venture capital fund in distress generally would result in limited consequences. Because of the lack of leverage, in a worst-case scenario where a venture capital fund loses money, the venture capital partners and outside investors will lose their invested capital and/or will have limited investment returns, but there is no multiplier effect to increase the amount of the loss or trigger losses at other institutions or in other portfolios. When a venture capital fund loses money, the venture capitalist may be unable to raise a subsequent fund and portfolio companies may have to seek new sources of equity capital, but there is no spread of economic harm.

Q.4. Do you think becoming publicly traded changes the natural incentives private investment partnerships have to be responsible when the partners have their own funds at risk?

A.4. In my experience, venture capital firms do not become publicly traded entities. The economics of becoming publicly traded necessitate that any firm or partnership contemplating doing so have

[1] *Id.* at p. 96.

significant, growing revenues above a certain threshold. Because venture firms are relatively small, going public does not make sense.

Generally, venture capitalists (like managers/general partners of most private equity funds) are compensated with 20 percent of the fund's realized profits if successful, but their losses are limited to their own contributions if the fund is unsuccessful. This compensation scheme reflects the investors' desire to encourage long-term "high risk, high reward" investing (as a means of diversification to a larger portfolio), with the loss of committed capital acting as a governor on unwarranted or reckless risk taking. The general partners also receive, very generally, an annual management fee of approximately 2 percent of investors' capital commitments.

It is difficult to answer this question without knowing the particular proposed compensation scheme resulting from being publicly traded. For example, if the entity that becomes publicly traded owns only the annual management fee (but not any of the 20 percent profit share), the incentives might remain the same. That is, the general partners will have increased liquidity earlier, but that liquidity will be based on a relatively certain stream of income. If, however, the entity that becomes publicly traded also owns all or a portion of the 20 percent profit share, then the general partners can achieve liquidity based on unrealized profits rather than realized profits through a sale in the public market. In that instance, the incentives to bring about a liquidity event for the limited partners, through realization events involving the fund's underlying portfolio companies (for example, in the form of a public offering or a sale), may be different.

Furthermore, I would respectfully assert that the costs and administrative burdens of becoming publicly traded would result in significantly less entrepreneurial activity in the private investment fund industry and would create a substantial barrier to entry for most start-up venture capital fund managers.

Q.5. To address systemic risk and fraud, do you think the SEC is better off focusing its resources on constant supervision and examination, or on after-the-fact enforcement?

A.5. As the events surrounding Bernie Madoff, Allen Stanford, and others have shown, "after-the-fact enforcement" may accomplish little in the way of protecting investor assets or increasing investor confidence. Constant supervision and examination is expensive and fraudulent actors will seek to evade detection. A combination, therefore, seems warranted.

If constant supervision and examination is pursued, the SEC should focus on the market participants that present significant systemic risk to the economy and financial system, and should allocate its limited resources to closely supervising and inspecting these high-risk institutions. Requiring venture capital firms and other low-risk financial institutions to register with the SEC under the Advisers Act or similar Federal securities laws would significantly and unnecessarily dilute and divert the SEC's resources from where it can have the most impact, namely hedge funds and other financial industry participants that present much greater systemic risk.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM TREVOR R. LOY

Q.1. Can you give me a good reason why we shouldn't require all hedge funds to register with the SEC or, assuming there are appropriate safeguards in place to ensure that confidential information remains confidential, disclose information to their regulators so the regulators can see if they pose systemic risk?

A.1. While hedge fund managers may need to be subject to at least a limited form of regulation by the SEC, I respectfully assert that venture capital fund managers do not present the same systemic risks as hedge funds and therefore do not require equivalent regulation. The goal of venture capital funds is to identify and nurture young businesses and realize returns through a sale of those businesses at an appropriate time, generally 5–10 years in the future. Unlike hedge funds, venture capital funds (i) generally do not make investments in publicly traded securities, (ii) offer little, if any, opportunity for investors to redeem their investments in the fund prior to the end of its specified term (which is often 10 to 12 years), (iii) do not generally utilize short selling or other high risk trading strategies (investments are held long-term), and (iv) generally limit the use of leverage to short-term borrowing pending draw downs of capital. Accordingly, the systemic risks to the financial system that were well-publicized in connection with the financial distress of large hedge funds such as Long Term Capital Management (1998) and Amaranth Advisors (2006) are not applicable to venture capital funds.

Our venture capital asset class is unique in many ways, with a critical distinction being that—while the companies we have funded have had a proven and profound positive impact of significant magnitude on the U.S. economy in terms of job creation and innovation—our specific asset class remains a small cottage industry that poses little, if any, risk to the overall financial system. Our job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment. As a small and dynamic industry, however, we remain highly susceptible to seemingly minor changes in our ecosystem. While some larger asset classes may be able to absorb the proposed regulatory costs and requirements, using the Investment Advisers Act of 1940 to regulate venture capital firms brings layers of additional regulatory requirements that can prevent us from focusing our time and financial resources on helping to start and grow new companies and which may force some venture firms to close, thereby negatively impacting job creation activities.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM MARK B. TRESNOWSKI

Q.1. Who in the Federal Government knows the markets enough to effectively regulate and understand what hedge funds and other firms are doing and the risks they might create?

A.1. The last year and a half has been devastating for nearly every financial market participant and there is no question some regulatory deficiencies were exposed. But I believe the oversight from

your Committee and others has illuminated ways to strengthen the regulatory system. Accordingly, I believe the SEC, with access to more information from market participants, and through interaction with a new systemic risk regulator, is fully capable of providing appropriate oversight. I do believe that the new registration requirements will increase the number of registered investment advisers the SEC oversees significantly. I commend the leadership at the SEC for recognizing this and for renewed and increased focus on improving its risk assessment capabilities, hiring new, talented examiners and strengthening internal training all of which will ensure they are well suited to regulate the industry.

Q.2. Should we put leverage limits on hedge funds and other firms?

A.2. Since my firm engages in private equity activity I can speak to the validity of imposing leverage limits on private equity funds. In this regard, I would say there is no basis for any leverage limits on PE. In fact, private equity firms have limited or no leverage at the fund level (as distinct from leverage maintained at the portfolio company level for a particular acquisition). Thus, private equity funds are not subject to unsustainable debt or creditor margin calls. Private equity funds typically use 3:1 leverage for acquisitions compared to companies like Lehman Brothers, which was levered at 32:1 when it failed. Further, Lehman's leverage was maintained at the parent company level, thus exposing the entire firm to collateral calls.

Q.3. To limit the potential harm that could be done by private investment firms to the system and counterparties, do you think it is a better approach to place limits on the firms themselves, or limit the exposure of counterparties like banks to the investment firms?

A.3. The question is predicated on the belief that PE firms could create systemic risk. As I said in my testimony and as others, including the European Commission and the Committee on Capital Markets Regulation, have concluded, this is simply not the case. Systemic crises, such as the one we all witnessed last year, are caused by cascading effects across multiple financial institutions which ultimately produce "correlated defaults." This is when a major instance creates large losses for several highly leveraged investment banks or other financial institutions forcing them to sell assets to service debts and raise capital. A private equity held company that fails is very unlikely to be so interconnected financially to cause this type of cascading effect. In fact, PE firms are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures, or prime brokerage relationships. Therefore, I do not believe imposing limits on PE firms is necessary.

Q.4. Do you think becoming publicly traded changes the natural incentives private investment partnerships have to be responsible when the partners have their own funds at risk?

A.4. No. Even though firms are publicly traded, the fact remains that the partners in the PE firms still have their own equity invested in every transaction they complete. Thus, an alignment of interests between GPs and LPs remains in place.

Q.5. To address systemic risk and fraud, do you think the SEC is better off focusing its resources on constant supervision and examination, or on after-the-fact enforcement?

A.5. The SEC should have access to specific information from financial market participants based on the type of activity it performs to identify financial institutions that are systemically significant and consequently to monitor their activities through supervision and examination. However, the SEC also needs strong enforcement tools to deter fraudulent activities. Both functions are equally important for a world-class regulatory regime.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM MARK B. TRESNOWSKI

Q.1. Can you give me a good reason why we shouldn't require all hedge funds to register with the SEC or, assuming there are appropriate safeguards in place to ensure that confidential information remains confidential, disclose information to their regulators so the regulators can see if they pose systemic risk?

A.1. We do not think that any asset class—hedge fund, private equity, or venture capital—should be excluded from the new regulatory regime. Congress should direct regulators to be precise in how new regulatory requirements are calibrated so the burdens are tailored to the nature and size of the individual firm and the actual nature and degree of systemic risk it may pose. In this regard, we were pleased that the Administration's White Paper explicitly acknowledges that some of the requirements created by the SEC "may vary across the different types of private pools."

As I said in my testimony, it is important to recognize that registration will result in new regulatory oversight for all newly covered firms. There are considerable administrative and financial burdens associated with record keeping and audits as registered investment advisors. Registration could be especially problematic for smaller firms regardless of asset class and you should bear this in mind in establishing the threshold for regulation.

Finally, your question refers to the importance of confidentiality. I want to stress that in any regulatory regime, it is absolutely vital that any information provided to the SEC pursuant to a new registration requirement be subject to strong confidentiality protections so as not to expose highly sensitive business and financial information beyond that required to carry out the systemic risk oversight function.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM RICHARD BOOKSTABER

Q.1. Who in the Federal Government knows the markets enough to effectively regulate and understand what hedge funds and other firms are doing and the risks they might create?

A.1. I do not believe any agency has sufficient knowledge to effectively regulate and understand what hedge funds and other firms are doing and the risks they might create. The SEC is focused on the legal issues related to fraud and compliance, not on the issues of risk management and trading strategies. The Federal Reserve

has a stable of academics with strong analytical capability but with limited financial market experience, and is not focused on the practical, micro-market issues related to hedge funds.

Understanding the risks of hedge funds and other trading operations requires an infusion of experienced risk professionals from the industry. It also requires communication between these professionals and the financial institutions in order to learn quickly of new investment strategies and trading methods that might have systemic importance.

Q.2. Should we put leverage limits on hedge funds and other firms?

A.2. There should be limits on the leverage of hedge funds. Controls are needed because it is through leverage that liquidity crisis cycles begin. By liquidity crisis cycles, I mean the situations I discussed in my testimony where a drop in the market forces leveraged investors such as hedge funds to sell positions, which in turn leads to yet further drops in prices.

Hedge funds and other risk-taking firms already monitor leverage as part of their internal risk management. But hedge funds cannot self-regulate leverage because if some hedge funds elect to increase their leverage, they will outperform their competitors at times when adverse risks are not realized. And in some strategies, such as credit-related and certain derivative strategies, adverse risks are realized infrequently, though when they do occur, they are substantial. Therefore, to stay competitive, the other hedge funds will also have to increase their leverage.

A blanket leverage limit will be too blunt an instrument, however. The limits for leverage should vary by instrument and strategy. For example, short-term Treasuries can support more leverage than emerging market equities. The limits should also depend on the amount of crowding in a market. If many hedge funds are pursuing the same strategy, there is more of a chance that when it's time to unload, many hedge funds will be running for the door at the same time, hence the leverage limits should be tighter in this instance. Currently, data are not available to any regulators to assess the degree of crowding, however.

Q.3. To limit the potential harm that could be done by private investment firms to the system and counterparties, do you think it is a better approach to place limits on the firms themselves, or limit the exposure of counterparties like banks to the investment firms?

A.3. Limiting the leverage of the firms by way of the counterparties/banks is a more elegant solution than dealing with each of the many hedge funds, because there are fewer points of contact when dealing with the banks. And the banks—which are the main sources of leverage financing—already have regulatory controls and oversight in place.

There must be sharing of information across the leverage providers, either directly or by way of a regulator, in order for hedge fund leverage to be controlled at the source level. Otherwise a fund might be able to generate high leverage by borrowing across many banks, without each bank knowing the full scope of the fund's leverage. The leverage implications of derivatives must also be taken into account because it is possible to garner high leverage through

derivatives without it being readily apparent. For these reasons, if the banks are used as the control point, regulators must be involved to verify that hedge funds are not finding alternative routes to meet their leverage demands.

Q.4. Do you think becoming publicly traded changes the natural incentives private investment partnerships have to be responsible when the partners have their own funds at risk?

A.4. The pressure already exists for most hedge funds to perform well month by month. That is to say that they currently have the adverse incentives common to many public companies, which focus on the next quarter's earnings. However, there can be no denying that the incentives of the fund and the client are more closely aligned when the fund partners have a substantial portion of their wealth at risk.

Given the opacity of hedge funds and the many strategies and trading instruments at their disposal, it is difficult to be confident that a fund is not taking short-term risks that are opposed to the clients' interests. Having the principals invest a substantial portion of their wealth in the same strategies is one safeguard against such imprudent short-term risks.

Q.5. To address systemic risk and fraud, do you think the SEC is better off focusing its resources on constant supervision and examination, or on after-the-fact enforcement?

A.5. The answer to this question is different for systemic risk than it is for fraud. Fraud is by design hidden from ready observation and will usually affect only one firm, while systemic risk by its scale will be more evident before the fact and will have wider-ranging effects. Therefore, for systemic risk it is both more plausible and more important to have before-the-fact supervision.

But such supervision is not a matter of having lawyers walk in the door armed with a subpoena under one arm and a sixty page questionnaire under the other. As I stated in my testimony, the proper starting point is to require hedge funds and other financial institutions—especially those that are large enough to pose a systemic risk—to provide key position and leverage data in an aggregatable form. Regulators must then have the analytical capability and market experience to analyze the data to assess systemic risk. As I noted above, I believe this capability and experience is not yet in place within the Federal Government.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOSEPH A. DEAR

Q.1. Who in the Federal Government knows the markets enough to effectively regulate and understand what hedge funds and other firms are doing and the risks they might create?

A.1. Nobody does.

The SEC should understand the strategies deployed by hedge funds; the Fed should understand the explicit leverage being provided to them by member banks; the CFTC should understand the implicit leverage made available through derivative exposures. Ideally these functions would be better understood by all relevant

regulators and/or incorporated under fewer regulatory bodies to ensure consistency of supervision.

The patchwork of regulatory regimes means that various agencies have jurisdiction over related activities—in some cases, economically identical activities. It might help to think about insurance companies, banks, and investment managers (including hedge funds, investment bank proprietary trading operations, mutual funds, *etc.*) as one category of entity: underwriters of risk. These entities may operate in different environments, but at the end of the day they all do the same thing—underwriting and/or transferring risk.

Let's use MetLife as an example.

- MetLife's primary business is underwriting the risk of a person's death and is paid a premium to accept that risk.
- A MetLife stockholder provides equity capital and accepts the risk that the company's liabilities will exceed its assets (rendering the equity worthless) in exchange for a variable stream of dividends and capital gain or loss.
- A MetLife bondholder lends capital to MetLife (that is, provide leverage) and is paid interest to accept the risk the issuer will default on its obligation.
- An investment bank can enter into an interest-rate swap with MetLife and is paid a variable amount to accept the risk from fluctuations in interest rates.

These are all the same type of economic function—underwriting risk or paying another entity to accept those risks. Yet:

- MetLife's life insurance business is regulated by State insurance commissioners.
- The stockholder and bondholder may be regulated by the SEC, a State regulator, an overseas entity such as the UK's FSA, or (for unregistered hedge funds) virtually nobody.
- The investment bank may be regulated by the SEC, the Fed, FINRA, and myriad other entities.

The absence of a comprehensive means of regulating the underwriting of risk makes developing a full understanding of the system's risks nearly impossible.

A valuable first step would be requiring SEC registration of (and information from) hedge funds, private equity funds, and other risk-taking entities with sufficient capital and risk exposures to provide meaningful incremental information to regulators.

A valuable second step would be aggregating Congressional oversight of financial risk-underwriting activities under fewer committees. For example, does having the Senate Agriculture Committee oversee the CFTC and the Senate Finance Committee oversees the SEC result in uneven regulatory scrutiny being applied to risk-underwriting activities which are functionally equivalent?

Q.2. Should we put leverage limits on hedge funds and other firms?

A.2. Not unless those limits are necessary to avert systemic risks.

Leverage (which should be thought of as any risk exposure which exceeds the risk-taker's equity capital, or where the risk-taker can lose more than the amount initially invested) is not provided in a

vacuum; someone has to be bearing the credit risk associated with providing any investor leverage, and arbitrarily limiting leverage improperly usurps the role (and ability) of the risk-taker to determine how much leverage is appropriate.

The simplest everyday analogy is a home mortgage: everyone with a home mortgage is using leverage, often at levels much higher than "risky" hedge funds. Borrowers who put 5 percent down on their home purchases and borrow the remaining 95 percent are levered 20 to 1 on their equity investment. Even putting 20 percent down still requires leverage of 5 to 1. Is 20 to 1 "too much leverage"? Is 5 to 1? Should we simply eliminate subprime mortgages (thereby "putting leverage limits" on riskier homebuyers) because those borrowers are more likely to default? The answer is no—strict leverage limits do not take into account other risk factors that may mitigate or exacerbate the risks from the leverage itself. (The borrower putting 5 percent down may be Warren Buffett.)

Similarly, we should not eliminate or arbitrarily restrict the ability to provide leverage to investment strategies. The price of a risk-taking society is that, sometimes, risk-taking results in failure. Query whether the Government's powers are better oriented toward ensuring that the failure of any subset of risk-takers does not result in systemic failure, for example by better assessing the risks taken by providers of leverage both to "consumers" of leverage and to each other.

Q.3. To limit the potential harm that could be done by private investment firms to the system and counterparties, do you think it is a better approach to place limits on the firms themselves, or limit the exposure of counterparties like banks to the investment firms?

A.3. Counterparty risk exposure assessment and management is the better approach.

A key regulatory focus should be on ensuring that parties that take risk are capable of handling the consequences of their activities without resorting to the assets of unrelated parties (such as taxpayer bailouts).

It is almost certainly wiser, from a systemic-risk perspective, to exercise tighter controls over the providers of leverage (banks and derivative clearinghouses) than over the users of leverage. (It is also easier to engage the major providers of leverage than the users, as there are perhaps only a few dozen major counterparties but tens of millions of risk-taking entities. These are certainly more complex and interrelated entities, but it is these complexities and relationships that makes effective oversight of them that much more vital to the Nation's economic stability.)

Returning to the mortgage analogy, the problem was not that individual homeowners borrowed more than they could repay and ended up defaulting; that scenario happens to some degree in any economic environment. The problem was that the providers of leverage failed to properly assess the risks inherent in their lending practices on a broad scale, and the relationships between these providers were not adequately monitored.

The example most frequently cited for the "hedge funds as systemic risks" concept was Long-Term Capital Management (LTCM).

LTCM's equity capital was effectively levered over 100 to 1 because of their extensive use of derivative transactions. The danger to the system was not, however, from LTCM's deploying that leverage; it was from the counterparties' willingness to provide enormous amounts of leverage through over-the-counter transactions such as swaps.

The complexity of the major risk-underwriting institutions makes a well-financed, well-staffed, well-informed, and properly empowered regulator absolutely essential.

Q.4. Do you think becoming publicly traded changes the natural incentives private investment partnerships have to be responsible when the partners have their own funds at risk?

A.4. It can, but that probably isn't the right way to think about the alignment-of-incentives issue.

The shareowner structure of an investment vehicle or firm will always play a role in the alignment of interests and balance of incentives, and the private/public distinction, while important, is not by itself enough to fully assess interests and incentives. Some shareowner and compensation structures reward asset-gathering over performance; others reward excessive risk-taking in a "heads-I-win–tails-you-lose" manner. Finding the right balance of shareowner structure and compensation structure is critical for proper incentivization of investment risk-takers.

Typically a public structure encourages its managers to raise assets—the market values consistent revenues from management fees more highly than the irregular revenues from performance fees. That said, a manager of a privately held hedge fund firm with a "2 and 20" fee structure may also be quite content with mediocre performance as long as it can keep earning the 2 percent management fee.

And even a well-designed structure is not absolute protection against inappropriate risk-taking. Joseph Cassano's group at AIG appears to have had a very well-designed incentive structure, with long-term payouts and compensation in both cash and equity. That did not stop the group from destroying the firm and costing taxpayers billions of dollars.

Q.5. To address systemic risk and fraud, do you think the SEC is better off focusing its resources on constant supervision and examination, or on after-the-fact enforcement?

A.5. Without a doubt, the SEC is better off focusing its resources on supervision and examination.

Supervision and examination, if properly executed, should help avoid the excesses that give rise to the need for extraordinary levels of after-the-fact enforcement. For example, the SEC's mission to protect investors would have been much better carried out in the Madoff case by better supervision and quicker intervention; investors would have lost far less. Far better to close the barn door before the horse has left.

That being said, neither focus will succeed if the resources provided are insufficient. Far too often the fight between the SEC and a bad actor is an unfair one, with the SEC outgunned and outmanned. CalPERS believes existing SEC funding and staffing levels are insufficient to keep pace with the increasingly complex

and rapidly shifting securities markets. The SEC must maintain robust regulatory and enforcement authority over security market practices, transactions, the policing of market professionals and intermediaries, the maintenance of accounting standards, and the disclosure of relevant information. To carry out the mandate of investor protection, the SEC must be provided with resources adequate for this vital task.