HEDGE FUNDS AND SYSTEMIC RISK IN THE FINANCIAL MARKETS

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BEFORE THE

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HEDGE FUNDS AND SYSTEMIC RISK IN THE FINANCIAL MARKETS

Tuesday, March 13, 2007

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

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

Present: Representatives Frank, Maloney, Watt, Moore of Kansas, Capuano, Clay, Lynch, Scott, Green, Cleaver, Sires, Ellison, Klein, Murphy, Wexler, Marshall; Bachus, Baker, Pryce, Lucas, Gillmor, Manzullo, Jones, Shays, Feeney, Hensarling, Garrett, Neugebauer, Davis of Kentucky, Campbell, Bachmann, and Roskam.

The CHAIRMAN. This hearing of the Committee on Financial Services will come to order.

This is the first in a series of hearings we will be having on hedge funds and systemic risks in the financial markets. I do want to make a point that may encounter some skepticism, but it will not be the first time I have encountered skepticism. Sometimes congressional committees have hearings because they want to find things out, but I acknowledge that is not the normal reason for having hearings. Usually, we have hearings to make a point, to embarrass somebody, or to reinforce a position, but there are times when there is a genuine acknowledgment on our part that we need to know more about things.

We are now going to have a series of hearings on the linked topics of hedge funds, private equity, and the role of derivatives. Those are conceptually separate things; they get merged. One of the things I hope we will do as a result of these hearings is to help people to understand that these topics are not all the same thing, and we will unbundle conceptually some issues.

We will have two hearings with people from the private sector. The last hearing we are currently scheduled to have will be with the members of the Presidential Working Group. We thought it made sense, they having made their report, to then have some discussion of that, and then have them come back and respond to the conversation. We will at that point, too, be talking to some of the regulators, particularly in the bank area, who are given certain responsibilities under the approach of the President's Working Group.

I just have some preliminary comments to make here. First, I believe there is strong support on the committee—it may not be

unanimous and people can obviously speak for themselves—for the efforts the SEC has recently made in the area of investor protection. Among things we want to sort out is the question of investor protection versus the question of systemic risk. This hearing is called, "Hedge Funds and Systemic Risks," not because we are assuming that there is a systemic risk, but because that is the question we intend to look at. This series of hearings is not going to be primarily about investor protection. The SEC has moved in that direction, I think, with some appropriateness.

There is one sub-set of the investor protection issue, though, that we do plan to look at and that is the interaction between pension funds and the hedge funds. That one is not entirely within our jurisdiction, in fact, that became an issue last year when the pension bill was being voted on and that bill, of course, did not come to our committee at all, I believe, certainly not in any major way. There is interest in that in the Education and Labor Committee, which has jurisdiction over ERISA, and the Ways and Means Committee.

Now, I will confess, and I have asked people to be looking into this, one of the concerns I have is the extent to which public pension funds get involved in hedge funds. It was not clear to any of us who exactly had jurisdiction over public pension funds. That may become an issue now because you have some of the States concerned about their GASB requirements regarding the accounting but there is some concern about public pension funds and hedge funds. Once you have that concern, of course even if you had it, it is not clear if you are going to put any protections in there, restrictions, on whom do they go? Do they go on the fund which receives the investment? Do they go on their investor? These are all questions that we will be examining.

I will say from the systemic risk standpoint, it does seem to me that the form in which investments are made is less important by far than the type of investments. In particular, I think it is time for us to look into the question of derivatives.

Now, I said that sometimes Members of Congress have hearings to try to find things out and not because there is a strong position. I am very proud of the level of the discussion that goes on in this committee. In fact, I think if people had been at the mark-up we recently had on the question of how to respond to the hurricane, they would have been very impressed with the degree of knowledge. I am not prepared to argue that if we got into a serious discussion of derivatives, that we would dazzle anybody with the depth of our knowledge and understanding. I have previously expressed the view, particularly with regard to accounting for derivatives when that has become an issue from time to time with Fannie Mae or elsewhere, that the current state of that appeared to me to be somewhere between alchemy and astrology. I undoubtedly do a lot of people an injustice when I say that, and I am prepared to be further educated.

I just want to stress again that these are hearings that we are going to have because there is a new development in the American financial world to some extent, in the hedge funds, and there is also private equity. I should have added, I ask for just 30 more seconds. With regard to private equity, the concern here is not so much systemic risk as what the social implications are. In fact, our

colleague from Florida, Mr. Feeney, commented the other day when we were having the executive compensation hearing that he worries about people going private because constituents that he represents could lose the opportunity to make good investments. That was an issue that the gentleman from Florida raised in terms of the implications of private equity.

Many of us are also very concerned about the implications for private equity on the workers, and on employers. If you have in fact an increase in debt and the takeover of companies, what is the impact, short term and long term? Those are the questions that we want to look at. And, as I said, I personally have no pre-conceptions about this. Indeed, to be honest, in some cases I barely have conceptions much less pre-conceptions. It is a very important set of questions and it is the job of this committee to help I think both ourselves and our colleagues in Congress, and indeed many in the country to understand it.

The gentleman from Alabama is now recognized for 5 minutes.

Mr. BACHUS. I thank the chairman. And let me reiterate what the chairman said: the purpose of this hearing is informational; the purpose of the hearing is not to legislate. I think it speaks well that in reading your testimony, it seems that all of the witnesses are pretty much in agreement, although I noticed that two of them want a greater level of maybe more disclosure and transparency and that is even a controversial subject. In executive compensation, one of the reasons I believe that executive compensation has grown as fast as it has is the SEC requirement that you disclose CEO pay.

Warren Buffett, speaking last night, said that it was not greed that was driving executive compensation, it was envy. They see what each other makes and that actually that disclosure, which everybody thought was a good thing, may actually be the cause of a lot of the growth in executive compensation.

One reason it is very important for the committee to understand the hedge fund industry and other alternative investment vehicles like private equity and venture capital is because of the tremendous growth we have seen in hedge funds and these other alternatives. There are over 9,000 hedge funds today. That is an explosive growth. They manage over 400 percent more assets than they did in just 1999—$1.4 trillion of assets under management, 60 percent of that is just in the 100 largest hedge funds.

They also are generating an increased amount of trading volume. Some experts have represented that up to 50 percent of the trading in our markets in certain circumstances is hedge funds. The strategies employed by hedge funds vary significantly, although most of them hedge against down-turns in markets, which I think is good.

The primary goal of many hedge funds is to reduce volatility and risk and simultaneously provide liquidity, preserve capital and deliver positive returns under all market conditions. We found that during our hurricanes in the past few years that it was hedge funds that actually provided the liquidity for insurance, property insurance coverage, a very positive benefit of our hedge funds.

We all know hedge funds use complex, sophisticated strategies to achieve their investment goals. I suppose the first time most Americans heard of hedge funds, and many Members of Congress as

well, was with the implosion of long-term capital management in 1998. And you will recall that resulted in a bail out orchestrated by the Federal Reserve and the Treasury Department and other regulatory bodies, although it was a private bail out. And since that time the subject of systemic risks posed by the operation of large hedge funds has been a concern of financial regulators and members of this committee, and rightly so.

Systemic risk is not theoretical, and if not properly contained and managed, it can threaten the stability and soundness of our financial markets. There is always the potential for a single event, such as a massive loss at a large complex financial institution to trigger a cascading effect that could impact the broader financial markets and ultimately the global economy.

For this reason, and I think this is the right approach and I know that the witnesses have said this, last month's announcement by the President's Working Group on Financial Markets of the Principles and Guidelines of Private Pools of Capital is a welcome development. The President's Working Group appropriately focused on systemic risks to investor protection. Private pools of capital are a sophisticated investment used by sophisticated market participants. I am confident that these market participants, hedge funds and others, understand they must engage in constant due diligence and ongoing evaluation of market exposure and risks created by their relationship with hedge funds.

I applaud Secretary Paulson, Chairman Cox, and other regulators who developed this guidance, and I am glad to hear the chairman also say that he thinks that this is the way to approach this, and that relies on market discipline and sound risk management techniques rather than the heavy hand of government regulation to achieve the desired objective.

This is how I will sum up. The bottom line is that I believe an overly prescriptive rules-based approach to regulating these private pools of capital could stifle innovation and drive hedge funds and their capital offshore. Such an approach would not benefit the competitive standing of our capital markets, something we are very concerned about.

So I thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. I would just like to make it clear that in regard to hedge funds, I have come to no conclusion. My mind is pretty open on this.

Next, we will hear from the gentlewoman from Ohio for 2 minutes.

Ms. PRYCE. Thank you very much, Mr. Chairman, for holding this hearing today and for the promise of continued hearings on private pools of capital.

I want to take a moment to thank the panel, also. This is very important information for us. These are very complicated issues that you can help shed some light on as we start today and continue down this series of hearings. There is really no doubt that the hedge funds provide significant economic benefits to the market and the Federal Reserve Chairman has cautioned against any heavy-handed regulation of the $1 trillion industry. We all know that the President's proactive Working Group recently took steps to issue guidelines for hedge fund participants. I agree with the

Working Group that the regulators' continued role must be to promote market discipline on hedge funds and to ensure that proper risk management is being followed.

I think in this committee it is important that we closely examine why hedge funds do fail on occasion and why some failures are different than others. Why was the collapse last September of Amaranth advisors, which lost $6 billion in a matter of weeks, different from the failure of long term capital management in 1998 that sent shockwaves through the system? Is there systemic risk posed to our economic system today? And, if so, what are those risks? Are the protections that are in place adequate to provide market actors and regulators with the information needed to make informed decisions? Should we be doing more to protect unsophisticated investors? All are important questions that I hope we will begin to answer today and in future hearings.

Just once again, Mr. Chairman, and our ranking member, Mr. Bachus, thank you for holding these hearings, I will look forward to all of the testimony, and I yield back.

The CHAIRMAN. I thank the gentlewoman again, working off the list that the ranking member gave me, the gentleman from Delaware is recognized for 2 minutes. Is he here? Well, the gentleman was not recognized. Someone was posing as him. The gentleman from Connecticut is recognized for 2 minutes.

Mr. SHAYS. Thank you very much, Mr. Chairman, for holding this hearing. I also thank my ranking member. I live in a district, in the greater New York area—we say that about 60 percent of the hedge funds exist and in my district there is a claim that one-fourth to one-third of all assets under management are in actually the district I represent. I tell people that if you are from Iowa, you want to get on the Agriculture Committee, and if you are from Fairfield, Connecticut, you want to get on the Financial Services Committee.

I would like to welcome all of our witnesses, but in particular a personal friend, Jeff Matthews, and also his wife is here, Nancy. Nancy is the chancellor of the diocese of Bridgeport. They are quite a force. Jeff is an accomplished hedge fund manager. He is an active member of his community, having served in Fairfield, Connecticut, not the county, on the board of finance and on the board of education. I love him for his good nature, his sharp, insightful mind, his candor, and his honesty. He is just a very welcome guest on this panel. Jeff, thank you for being here.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. Next, the gentleman from New Jersey, Mr. Garrett, is recognized for 1 minute.

Mr. GARRETT. Thank you, Mr. Chairman, and thank you for holding this hearing. Thank you to the witnesses for being with us today. For those I have met previously, good to see you again. Also, I would like to thank my colleague who is not here, the gentleman, Congressman Castle, for his work and focus on this issue in the past term as well. Hedge funds, as you all know, are now at $1.2 trillion, truly a high stakes, high-risk investment. It originally started out for, I guess, the super wealthy or the very wealthy and have now extended to the pension funds, as the chairman says, both public and private. And it is for that reason that it is impor-

tant, it impacts more on the middle class, millions of middle class Americans as well, that we have this involvement here today.

I also would like to point out, just as a more personal point of view from us coming from New Jersey. My friend from the other side of the aisle and I, Albio and I, represent districts that have a strong nexus to the financial markets and so just as the gentleman behind us from Connecticut has that connection, I know we do as well and take this from both perspectives of our constituents here at home and across America as well. And, as the ranking member had indicated, I think it is important that we are able to have the benefit of the President's Working Group on this, that goes all the way back I guess to 1987, the stock market crash when that was created to try to take a look at the financial markets and try to gather up all the information that they can. And since that time, obviously I don't think you were talking about hedge funds that much back in 1987 but now we have, and they have grown in importance. And like the chairman, I am still trying to get my mind around all the issues involved, so I very much appreciate the testimony at this hearing today. Thank you, and I yield back.

The CHAIRMAN. I thank the gentleman and now I will ask unanimous consent since 10 minutes has been consumed on the minority side to extend the time for opening statements for an additional 3 minutes. Is there any objection? Hearing none, we will go forward. And the final recognition is for the gentleman from Louisiana, Mr. Baker, for 3 minutes.

Mr. BAKER. Thank you, Mr. Chairman, for the courtesy. I think it important to recognize why we are actually here. Few people would trouble themselves if really wealthy people lose or make money, and so as long as this phenomena was relegated to a handful of sophisticated Wall Street types, there was no need for the Congress to be involved in this discussion.

However, that has changed. As innovation has caused your reach of scope, economically and otherwise, to broaden, we are now concerned about the inadvertent consequence of a systemic-like event which causes pensioners, who have no idea their manager has invested in a derivatives currency arbitrage, to lose money as a result of a Russian currency crisis. I think it is not quite clear to me what really constitutes a hedge fund. Is that necessarily to the exclusion of private equity or venture capital or does it go more to the aggregation of large sums of capital, which are deployed in a sophisticated manner, which is not subject to the same rules as a public operating company, for which there could be adverse financial systemic consequences. So, one, I think we have to define who is it we are trying to constrain, why are we trying to do it, or what is it we are trying to find out about them.

In reading through testimony, it became clear there are certain best practices that each of you may have suggested would be appropriate, and I think that is highly desirable as opposed to a governmentally-driven remedy for the industry to come to some conclusion as to how we should define those who are engaging in this practice in a professional manner.

Beyond that, I think the valuation issue that has been referenced and how do we know from an investor perspective that there is consistency between Fund A and Fund B and the values associated

with your position in that particular exposure, that is not clear to me either.

Finally, the manner in which the disclosure occurs cannot be paper-based because by the time you get it on a piece of paper, it is out of date. There has to be some net-based disclosure, electronic disclosure, of the essentials that are determined by the industry to the regulator of importance and not public disclosure and certainly nothing proprietary.

I only make these comments because as the chairman was talking about having reached no resolution thereon, this Congress will come to resolution thereon if there is an adverse event that drives a number of pensioners into bankruptcy because a hedge fund guy was fast and loose with his investment protocol. You will then get a "Sarb-Ox" like response, applicable to whatever is defined as the hedge fund industry, and you do not want us to do that. I think this is a window in which there is great opportunity for the industry to coalesce, to produce a document which is defensible, and give the appropriate regulator the insightful information you know he should have to help throw the circuit breaker when things go bad. Absent that, we are going to get into a policy arena that I think will be very difficult for the industry and not helpful to our world economy.

Thank you.

The CHAIRMAN. I thank the gentleman, and we will now begin with the witnesses. And our first, just in the order in which somebody sat them, is Gerald Corrigan, formerly a very distinguished leader of the Federal Reserve system and someone who has been working closely on this issue. He is now managing director at Goldman Sachs. Mr. Corrigan, please.

Let me say that without objection, the written statements of all of the witnesses will be included in the record. Mr. Corrigan, please go ahead.

STATEMENT OF E. GERALD CORRIGAN, MANAGING DIRECTOR, GOLDMAN SACHS & COMPANY, AND FORMER PRESIDENT OF THE FEDERAL RESERVE BANK OF NEW YORK

Mr. CORRIGAN. Mr. Chairman and members of the committee, I, and I think all of us, appreciate your calling this hearing and the timeliness with which you have done it. My statement, as the others, will be accepted into the record.

In the interest of time, let me just highlight several of the major points that I tried to make in my written statement. The first part of the statement essentially tries to quickly trace and highlight the evolution of the hedge fund industry since long term capital in 1998, and I think that is quite straightforward. The only thing I would want to emphasize, Mr. Chairman, is that I think it is entirely fair to say, as I do in my statement, that over recent years there have been very substantial improvements in business practices in the hedge fund industry in such areas as corporate governance, risk management, disclosures to investors, and operational infrastructure improvements. And in many cases, certainly not all, but in many cases, I think the capabilities in those areas within segments of the hedge fund community now has much in common with best practices across the financial system as a whole.

The statement also does a little idle speculation about the future evolution of the hedge fund industry, which I will not go into except to say that, at least in my judgment, there is some prospect that the forces of competition probably will induce over time some further pressures on fees and therefore in my judgment the prospect of some further consolidation in the industry over time.

I think it is very important for the committee to recognize that as the premium on performance intensifies what I will call the orderly attrition of under-performing funds may accelerate and inevitably a few funds will encounter serious financial problems. Such developments, as I see them, are a natural and healthy market-driven phenomenon, which need not have material adverse consequences for the stability of the financial system.

The second part of my statement traces the relationship between hedge funds and large integrated financial intermediaries. The substance of that discussion, while obviously summarized, I think is indeed very important to this whole question about systemic risk. And what I try to illustrate is that the relationship between large financial intermediaries, which are typically major banks and securities firms, all of whom are subject to some form of consolidated supervision, it involves two separate but related phenomena, the first is the so-called prime brokerage phenomenon and that essentially involves a whole range of services, including providing credit by prime brokers to their hedge fund clients. And I do make the point that a well-managed framework within which prime brokers provide credit to hedge funds that is secured, following the procedures that I have outlined in my statement, is a relatively, I emphasize relatively, low-risk activity.

The second class of activities that characterize the relationships between hedge funds and major financial institutions is the totality of what I call their counter-party relationships and those counter-party relationships are very, very complex and involve a whole range of activities and risk taking on both the part of the intermediary and the hedge fund. I take that discussion into a little sidebar discussion about risk management. And I think the fundamental point that I want to stress in terms of risk management, whether it is at a major intermediary or at a hedge fund, is that the foundation for effective risk management rests on what I like to call a “culture” of sound corporate governance, collective analysis and decisionmaking, and above all, sound judgments by experienced business leaders. And it is in this sense, Mr. Chairman, that I believe that risk management is much more an art than it is a science. And I go on to illustrate in my statement some of the reasons why I think that is true.

The next part of my statement talks about systemic risk. And I think that what I have tried to do here is in a very summary fashion try to help ensure that the committee realistically understands what systemic risk is and what it is not. And the characterization that I have used for years and years to describe systemic risk of a financial nature is to call it a financial shock that brings with it the reality or the clear and present danger of inflicting significant damage on the financial system and the real economy. And I draw a sharp distinction, as I have for years, between what I call

"financial shocks" and "financial disturbances," the latter of which occur with some regularity.

I stress the point when I began the work of the Counter-Party Risk Management Policy Group a year-and-a-half ago, that the whole effort was shaped around three threshold conclusions about systemic financial risk. The first was that over time the already low statistical probabilities of the occurrence of systemic financial shocks had declined further but they were still well short of zero. The second, and this is the one that worries me, is that while the probabilities of shocks are lower, the potential damage that could result from such shocks is greater due to the increased speed, complexity, and tighter linkages to characterized a global financial system.

And then finally, that our collective capacity to anticipate the specific timing and triggers of future financial shocks is extremely low, if not nil. Indeed, I argue that if we could anticipate these things, they would not happen.

Now in those circumstances—

The CHAIRMAN. Mr. Corrigan, we need you to get to a conclusion.

Mr. CORRIGAN. The last thought, Mr. Chairman, that I have put emphasis on, strengthening what I call the shock absorbers of the system, and I do think that the President's Working Group exercise on hedge funds and private pools of capital is a very constructive move in that direction.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Corrigan can be found on page 97 of the appendix.]

The CHAIRMAN. Thank you. Our next witness is one who has appeared before us in other capacities when he was the head of the Export-Import Bank, over which this committee has jurisdiction, and he is now with Taconic Capital Advisors, Mr. Kenneth Brody.

STATEMENT OF KENNETH D. BRODY, CO-FOUNDER AND PRINCIPAL, TACONIC CAPITAL ADVISORS, LLC, AND CHAIRMAN, INVESTMENT COMMITTEE, UNIVERSITY OF MARYLAND

Mr. BRODY. I thank Chairman Frank and Ranking Member Bachus for the opportunity to testify. In my former life as a public servant, under the jurisdiction of this committee and Chairman Frank, I have learned to be brief, to the point, and succinct, so let's go. I wish to address two issues, systemic risk and investor protection. The President's Working Group and virtually all knowledgeable professionals agree that systemic risk is best controlled by regulators overseeing the providers of credit. These providers of credit are primarily the large financial institutions, commercial banks and investment banks.

Turning to investor protection, I believe it is another story. I am going to take a very unusual view for an industry participant. I believe that mandatory registration is good policy. It provides for better investor protection, and I think it should come about because the nature of the investors have changed. It is not just wealthy individuals but it is institutions of all stripes, including pension funds, who are getting more and more into investing in hedge funds. And with pension funds, the ultimate beneficiaries are regular working people.

What registration primarily provides is a self-discipline and a self-policing because that comes with the threat of SEC examination. In my testimony, I have included many of the elements of such protections that are provided by registration with the SEC. Having said that, a better way to do registration is to introduce a principles approach instead of a "tick the box" regime. A principle approach will provide better investor protection and with greater efficiency.

We are registered and a substantial number of hedge fund managers are registered. We think it is good policy for all. I thank you again for the opportunity to testify, and I welcome the opportunity to answer any questions.

[The prepared statement of Mr. Brody can be found on page 57 of the appendix.]

The CHAIRMAN. Thank you very much, Mr. Brody, for your testimony and your example of how to testify.

[Laughter]

The CHAIRMAN. Next, we have James Chanos, who is chairman of the Coalition of Private Investment Companies. And, Mr. Chanos, please proceed.

STATEMENT OF JAMES CHANOS, FOUNDER AND PRESIDENT, KYNIKOS ASSOCIATES, LP, ON BEHALF OF THE COALITION OF PRIVATE INVESTMENT COMPANIES

Mr. CHANOS. Chairman Frank, Ranking Member Bachus, and members of the committee, my name is Jim Chanos, and I am president of Kynikos Associates, an SEC-registered New York private investment management company I founded in 1985. I am appearing today on behalf of the Coalition of Private Investment Companies, whose members and associate managers advise more than $60 billion in assets. I would like to thank the chairman and ranking member for inviting us to participate today.

The Coalition welcomes the attention of this committee on our industry. Rapid growth in all alternative investment funds, whether they call themselves hedge funds, private equity, or venture capital, has brought significant rewards to investors and the financial markets. But to paraphrase the great Stan Lee, "With great growth comes great responsibility." This responsibility derives from the industry's more prominent roles in various parts of the financial markets and perhaps most importantly the trust placed on our managers to properly invest the assets of pension funds and endowments, institutions whose ultimate beneficiaries are not themselves wealth individuals. Consequently, hearings such as this present a unique opportunity for our industry to explain the way it works, dispel some of the myths and misconceptions that surround it, and make clear our commitment to work with policymakers in the Congress and in the financial regulatory agencies in order to improve those areas where the system of oversight may not be keeping pace with the growth of the sector.

The Coalition would like to suggest a few ideas that may be useful in thinking about the issues associated with private pooled investment vehicles. First, almost all private investment pools, whether a hedge fund, a venture capital fund, or private equity fund, share many common characteristics in terms of their disclo-

sures to their investors and counter-parties without detailed government mandates. Consequently, we would suggest that policymakers, instead of creating distinctions between these types of entities, treat all private pool investment vehicles similarly, regardless of their underlying investment strategies. Even though we may all use the term “hedge fund” in the context of today’s hearing, the most accurate phrase is not “hedge fund” but “private investment company.

Second, in terms of investment activity, the buying or selling of securities or commodities or derivatives, hedge funds are but one type of many market participants engaged in the same activity. Again, in order to gain the most complete understanding of the subprime mortgage market, to use a recent example, one should not focus solely on a single segment of the market but should look at all participants engaged in that activity. Looking at mortgage securitizations solely through the prism of hedge funds without looking at banks, investment banks, insurance companies, and other types of dealers and investors will create a distorted picture of how and why that market operates as it does.

This is not to say that hedge funds should not be included at all in such a distinction, quite to the contrary, we are an important part of the equation. But hedge funds are not nearly so significant in and of themselves that they should be the focus of attention to the exclusion of other market participants doing the same thing. A focus on the activity, not the actor, is more likely to yield the information desired by policymakers in assessing the appropriate level of oversight and regulation.

Third, the phrase, “lightly regulated,” which typically is applied to hedge funds and other alternative investment vehicles, is somewhat misleading as it really only applies to governmental regulation of the relationship between the fund and its investors. In this area, sophisticated or institutional investors are deemed by the government to have the capacity and equal footing to obtain the requisite information from fund managers on their own instead of relying on standardized government-mandated disclosures. In almost all other aspects of the U.S. financial system, hedge funds are subject to the same web of statutory and regulatory requirements as all other institutional market participants engaged in the same activity.

And even with the interaction of the fund, the manager and the fund investors, despite lack of regulation, does not yield a lack of transparency, either to investors or to the counter-parties providing credit and other financial support. In the case of my funds, for example, investors or their financial managers generally require us to provide answers to detailed questions regarding our background, strategies and research, personnel, returns, compliance programs, risk profile, and accounting and valuation practices. Prospective investors also review terms such as liquidity restrictions, management performance fees, and any applicable lock-up periods for their capital. Depending upon the nature of the investor, a person may meet an institution’s portfolio managers or compliance officers.

Some investors also ask to speak to our lawyers, auditors, and prime brokers for references. The process usually also includes any number of on-site visits by the potential investor or their represent-

atives. The right to on-site visits continues after the investment is made as well as continued oral and written communication on a regular basis so that the investor can assure himself or herself that the representations that we made at the outset are being followed.

Fourth, much of the secrecy surrounding hedge funds is frequently a consequence of both the proprietary nature of the investment strategies employed and of the mandates of the SEC itself. The Commission's restrictions on general solicitation and public offerings, under which all hedge funds operate, prohibit fund managers from discussing their strategies and performance in any venue or in any way that could be construed as a solicitation or investment from the general public. Certainly, it means that fund managers must limit the content of or access to their Web site and limit public interviews about their funds and investment strategies that could be viewed as designed to attract the interest of the general public to invest in the funds. Accordingly, most fund managers prefer to err on the side of less public discussion rather than risk running afoul of the SEC.

Fifth, if there are gaps in the system of regulatory oversight, then there should be ways to address them consistent with the principles and guidelines recently issued by the President's Working Group. Such deficiencies are best addressed without trying to shoe-horn the institutional business and the statutes that were designed primarily for the interaction of investment professionals and the general public. In this regard, we have some suggestions for consideration that may provide some commonsense approaches to answering at least some of these concerns without re-engaging in the unproductive debate from 2 years ago surrounding mandatory registration requirements.

Mr. Chairman, do I have another minute to give that suggestion?

The CHAIRMAN. Yes.

Mr. CHANOS. As an example, the SEC in proposing the Hedge Fund Advisor Registration Rule hoped to gather census information about hedge funds. The SEC could, however, without mandatory registration obtain much of the information it seeks by amending Form D, a basic document used by issuers of private placement of securities to acquire some additional information if the issuer is a pooled investment vehicle. The form could include a variety of basic information that I set out further in my written testimony. The SEC could also require that the form be kept current or updated annually. With this kind of information, the Commission, and policymakers generally, would be in a better position to answer the question, "Who is out there?"

With respect to best practices, we believe that most investors already demand practices of their funds that are equal to or exceed the requirements of the Investment Advisors Act. Fundamentally, we believe the institutional investors operate on a fairly equal footing with hedge funds and by simply taking steps to protect their own assets and investments produce the desired effect. However, if there is a belief that certain practices are so commonsense, such as third-party custodianship of client funds or annual outside audits, that they deserve the added strength of SEC authority behind them, we believe the Commission could consider using its antifraud authority under the Advisors Act to require certain measures

to be taken by both registered and unregistered votes in order to protect fraud.

And with that, I will make the rest of my comments in the written testimony.

[The prepared statement of Mr. Chanos can be found on page 73 of the appendix.]

The CHAIRMAN. Thank you, Mr. Chanos. We have that and of course, there will be questions from the members.

Next, we have Mr. George Hall, who is testifying on behalf of the Managed Fund Association. Mr. Hall?

STATEMENT OF GEORGE HALL, FOUNDER AND CEO, CLINTON GROUP, ON BEHALF OF THE MANAGED FUNDS ASSOCIATION

Mr. HALL. Mr. Chairman, and members of the committee, thank you for the opportunity to testify here today. I am here on behalf of the Managed Funds Association, the largest U.S.-based association representing the hedge fund industry with more than 1,300 members in the United States and around the world. In addition to being a director of MFA, I am the founder and chief investment officer of Clinton Group, an investment advisor for a diverse group of institutional and high net worth individual investors. We greatly appreciate the interest of this committee in considering public policy issues relevant to our industry and the opportunity to share our views with the committee.

Hedge funds have been closely monitored and reviewed by Congress and Federal regulators in the recent years. This intense review has led to a clear recognition that hedge funds play a critical role in the success story of the U.S. capital markets. Hedge funds have helped to disburse risks, enhance market liquidity and resilience, and increase overall financial stability. With this vital market role comes important responsibilities. We agree with the President's Working Group on Financial Markets that the hedge fund industry and other market participants, along with financial regulators, have a shared responsibility for maintaining the vitality, stability, and integrity of our capital markets.

I would like to briefly address four points. First, the President's Working Group on Financial Markets. MFA fully supports the recent agreement of the President's Working Group issued in late February. The Working Group addressed both systemic risk and investor protection concerns in its agreement and concluded that, and I quote, "Market discipline most effectively addresses systemic risks posed by private pools of capital." The agreement stated that a combination of market discipline and regulatory policies that limit direct investment in private pools of capital to more sophisticated investors would be the most effective way to address this issue.

MFA not only agrees with the Working Group's conclusions, but has been working with its members to address these issues for a number of years. We are committed to working closely with regulators, counter-parties, investors, and our own industry to do our part to remain ever vigilant.

Second, systemic risk. MFA has worked proactively with its members to develop very specific risk management and internal control guidance set forth in Sound Practices for Hedge Fund Man-

agers first published in 2000. Our sound practice guidance has been revised and enhanced to take into account market developments and is currently undergoing its third revision to be issued later this year. The President's Working Group principles will be a guiding blueprint for this effort. MFA members have also worked extensively with the major derivatives dealer firms and Federal Reserve Bank of New York to improve market practices for credit derivatives and other derivatives in order to reduce systemic risk concerns.

Third, investor protection. MFA supports increasing the accredited standard. We applaud the SEC for considering this issue and for its recent proposed rule. Based on all available data, hedge funds remain chiefly an investment vehicle for institutional investors and high net worth individuals. We support a significant increase in the financial thresholds for entry into hedge funds.

Finally, pension plans. MFA endorses efforts to increase the understanding of hedge funds among pension plan fiduciaries and trustees and is committed to helping promote investor financial literacy through the development of due diligence materials.

In conclusion, hedge funds have proven to be attractive investment vehicles for institutional investors seeking to diversify risk and enhance portfolio strength. They also play a key role in our capital markets. To assure that these benefits continue, and that any associated risks are fully addressed, MFA believes that the proactive efforts of its members to enhance market practices are vital. MFA pledges to continue these efforts and to work with all market participants, financial regulators and Congress.

Thank you.

[The prepared statement of Mr. Hall can be found on page 119 of the appendix.]

The CHAIRMAN. Thank you.

Next we have Jeffrey Matthews, previously introduced by the gentleman from Connecticut. Mr. Matthews is general partner at Ram Partners.

STATEMENT OF JEFFREY L. MATTHEWS, GENERAL PARTNER, RAM PARTNERS, LP

Mr. MATTHEWS. Mr. Chairman and members of the committee, good morning, and thank you for inviting me to speak. My name is Jeff Matthews, and I am general partner of Ram Partners, a hedge fund I formed in 1994 after working at another hedge fund for 4 years and starting my career at Merrill Lynch in 1979. My fund is small relative to the others represented here and rather old-fashioned. We buy stocks for the long term, we hedge against short term market fluctuations, and we do not do any derivatives. Nevertheless, 18 years in the hedge fund world does make me something of an old timer, and I do have views on the issues that you have raised.

To understand the growth in hedge funds you might ask, why do people start them in the first place? The answer is quite simple: Hedge funds are private partnerships whose investors are wealthy individuals and large institutions. That private structure and more sophisticated investor base gives us flexibility to pursue alternative investments, take greater risks, and reap greater rewards than a

more strictly regulated mutual fund. Furthermore, as a private partnership, hedge fund managers can charge what their investors are willing to pay, including a share of the profits the business generates.

So a successful multi-billion dollar hedge fund manager can earn hundreds of millions of dollars while her mutual fund counterpart could not. And that is why people start hedge funds and that is why this industry has exploded. In fact, the single biggest change I have witnessed since I started is size. In 1994, the biggest hedge fund I knew about had $6 billion in assets; $6 billion today would not rank in the top 50 hedge funds, and the three largest U.S. hedge funds now have over $30 billion each.

Along with that explosive growth has come diversity. Hedge funds no longer focus mainly on stocks, bonds, and currencies but have branched into subprime debt, distressed securities, real estate, uranium ore, and even grain silos. In fact, there are hedge funds that do nothing but invest in other hedge funds.

The flood of money has also caused many so-called hedge funds to no longer actively hedge against market declines because hedging has been a drag on returns during the bull market. It has been like paying a premium for an insurance policy you never needed.

However, the most significant change I have witnessed in 18 years in this business is the increased use of leverage, meaning borrowed money to start new hedge funds. A $400 million hedge fund today, for example, might actually have only $100 million of equity. The rest, the other $300 million, might come from a bank that sells a preferred class of equity that looks, acts, and smells like debt. That structure works fine if the value of the whole thing goes up, everyone makes money, and the bank gets paid back. But if it goes down, that equity gets wiped out, much like a house bought with no money down.

What type of risks might this pose? Could the graded leverage cause another long term capital type catastrophe that brings the markets? Well, we had just such a catastrophe last year. Amaranth was a $10 billion hedge fund with sophisticated investors, run by intelligent people using computerized trading systems, and it collapsed in just 20 days after a huge complex bet on natural gas went wrong.

What does that tell us? Number one, that hedge fund managers can do stupid things just like any money manager only in much bigger size.

Number two, even sophisticated investors do not necessarily mind this kind of risk taking until it goes wrong and when it does, they pull the plug very quickly. Number three, the more exotic the investments, the harder it is for any outsider to know what is going on inside a hedge fund. After all, if Amaranth's general partner did not realize his business was at risk, how would the Fed or SEC have seen what was coming and act to stop it?

There is, however, a fourth and more positive lesson from Amaranth, which was not foreseen by many observers at the time, it is this, a $10 billion fund could evaporate in a matter of months and yet aside from a couple of wild weeks in the natural gas pits, the system did not blink. Unlike long term capital in 1998, which had to be bailed out by the Fed, other hedge funds stepped in,

bought Amaranth's positions at a deep discount and the firm was liquidated. It is true that Amaranth's investors included public sector pension funds, and they lost a great deal of money, but the people who manage those funds should have known the risks they were taking.

As I said, I run a smaller, old-fashioned fund, we do not do derivatives, and I am not defending my own business model generally represented here but these are my real-world observations, nor am I acting as a cheerleader for all hedge funds. There will be failures again, and they could get ugly.

However, the presence of so many large hedge funds today, specializing in so many aspects of the world markets, means in my view that the systemic risk of broad failure is probably much lower than I have ever seen it in the last 18 years. I was there when long term capital blew up, I was there when Amaranth blew up, and luckily for us Amaranth turned out to be no long term capital.

Thank you for inviting me to speak.

[The prepared statement of Mr. Matthews can be found on page 135 of the appendix.]

The CHAIRMAN. Thank you, Mr. Matthews.

Next, we have Andrew Golden, who is president of the Princeton University Investment Company.

STATEMENT OF ANDREW K. GOLDEN, PRESIDENT, PRINCETON UNIVERSITY INVESTMENT COMPANY

Mr. GOLDEN. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to share my perspective today as someone who has been an institutional investor in hedge funds for almost 2 decades. For the past 12 years, I have been the president of Princeton University Investment Company, the university office that has responsibility for investing Princeton's $14 billion endowment. With a staff of 25, we develop asset allocation plans, and select and monitor a roster of 140 external managers. We essentially act as a large fund of funds.

Princeton's hedge fund investment approach illustrates that taken by a number of sensible investors for whom hedge funds need not entail great risk. Indeed, for us hedge funds can be an important tool for reducing risk. Princeton has enjoyed success as an investor with annual returns during the past 10 fiscal years of 15.7 percent versus 8.3 percent for the S&P 500.

We have enjoyed particular success as an investor in hedge funds, but before going any further, let me say that all my comments today are complicated by the fact that hedge funds do not represent a distinctive asset class like real estate or venture capital. Rather, hedge funds are a relationship format defined by the nature of the contractual arrangement between an investment manager and his or her clients. At Princeton, we use the hedge fund format to pursue a broad variety of strategies across a spectrum of markets. Roughly 45 percent of the endowment is invested via the hedge fund format. One-third of that amount is invested in 14 funds that pursue traditional, unleveraged, long-only investment strategies. These funds tend to walk and quack like mutual funds, albeit ones managed very, very, very well with superior track records.

The hedge fund format entails a higher fee schedule than that of traditional institutional accounts, yet it better aligns the manager's interest with their own, creating an environment for superior returns net of fees. Notably, Princeton's hedge fund managers are dis-incentivized from taking inappropriate risks as all have a significant share, typically the vast majority of their personal net worth, invested side by side with us.

Approximately 30 percent of the endowment is invested in 16 hedge funds that do pursue less traditional strategies, including for example selling short and investing in bankrupt companies. We categorize these managers as independent return managers. They seek returns that are equity-like but with correlation to most broad market moves. This low correlation means that our independent return program has been particularly effective at reducing the endowment's total risk. We do not invest with managers pursuing inherently opaque strategies. Our managers do not employ significant leverage, yet our low octane independent return program has generated a very strong 16.4 percent 10 year annualized return with half the volatility of the stock market.

While we have some natural advantages of the hedge fund investor, our success largely reflects hard work. We spend at least 400 person hours in our due diligence process before investing in a hedge fund. Post-hire we spend for each manager 70 person hours per year monitoring activities.

The single most important factor behind our success, however, has been that we have always been guided by a simple over-arching rule: we will not invest in something we do not understand. Princeton requires that our hedge funds provide substantial transparency. No one has ever been forced to invest in any particular hedge fund. I do not believe that sophisticated investors who willingly invest in anything without assuring that they have adequate information and understanding deserve any sympathy, let alone any additional regulatory safeguards. Indeed, I believe that fiduciaries who fail to assure their own understanding of investments may deserve to be sued or prosecuted.

Understanding investment, however, does not guarantee happy results. It is a certainty that at least some investors will suffer significant losses in their hedge fund investments. However, for perspective, it should be remembered that when the tech bubble burst, U.S. stock investors collectively lost almost $7 trillion. Among the losers were sophisticated and unsophisticated investors. The losses were suffered through the entire spectrum of relationship formats including mutual funds. The $7 trillion losses give interesting context to worries about the hedge fund industry, to which we have all been estimating total investor exposure is between $1- and $2 trillion.

I suspect that there are some hedge funds using imprudent leverage with likely unpleasant consequences for their investors at some point in the future. However, when I think about the important systemic risk facing markets today, hedge fund leverage is less of a concern than say mortgage or Federal debt levels. The markets for institutional client money provides some discipline with regard to what a particular hedge fund manager will flourish but then

again not so much to prevent an Amaranth. However, as others have noted today, the resolution of Amaranth was quite orderly.

The Chair asked that I comment on current levels of risks in the markets, and actually could I have one more minute to deal with that?

The CHAIRMAN. Yes.

Mr. GOLDEN. And I think you cannot refer to risk without referring to price. If prices are high, likely investors are not getting compensated for the risk present today but who knows if the resolution of that will be a sharp down draft or more prolonged periods of mediocre results?

I was also asked to comment on market practices since the issuance of the CRMPG II report, and I can echo others' comments that market practices have matured with much greater discipline in trade documentation.

Finally, let me give my views on the appropriate role of government with regard to hedge funds, their activities and markets. And, basically, the bottom line there is I think the President's Working Group essentially has it right. I would wonder whether or not the minimum wealth test should be set even higher than what has been anticipated.

With respect to the regulation of hedge fund activity in the markets, I think the PWG again has it right, to assure fair markets and control systemic risks, it makes most sense to focus regulatory and private oversight bandwidth on large financial institutions that act as counter-parties and lenders. Perhaps we should accept guidance from the bank—and direct our activities to where they keep the money.

Thank you.

[The prepared statement of Mr. Golden can be found on page 111 of the appendix.]

The CHAIRMAN. Thank you.

Our final witness is Stephen J. Brown, who is a David S. Loeb professor of finance at the NYU Stern School of Business.

We have appropriately thanked all the donors here, the Loebs and the Sterns. They all have their names in it.

Please go ahead, Mr. Brown.

By the way, the business schools practice what they preach. Most medical schools and law schools are not named for people. Every business school is. They do understand marketing and put it into practice.

[Laughter]

STATEMENT OF STEPHEN J. BROWN, DAVID S. LOEB PROFESSOR OF FINANCE, STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

Mr. BROWN. Absolutely. I agree 100 percent.

It is a very distinct honor to be invited to testify before this committee, and I really thank Chairman Frank and Ranking Member Bachus for this honor.

The President's Working Group on Financial Markets tells us that private pools of capital bring significant benefits to the financial markets.

What are these benefits? Some would tell us that their only objective is to enrich themselves and their rich clients.

The industry needs to show that these benefits outweigh any problems they might cause. A premise of the PWG is that hedge funds do not pose a systemic risk for the financial markets.

What is a "hedge fund?" The term actually comes from Carol Loomis, a Fortune journalist writing in 1966 about the strategy of AW Jones who invested in under valued companies financed in part by short positions in companies he felt were over valued. In this sense, the investment was "hedged" against general market movements.

The term "hedge fund" was a stretch even for AW Jones, as his short positions never equalled in size or economic significance of his long positions. Subsequent funds adopted the regulatory form of AW Jones but not his investment philosophy. Indeed, the term "hedge fund" belies their considerable risk.

Sophisticated investors ought to be allowed to do as they please, provided they not hurt innocent bystanders. Unfortunately, the industry interprets the general solicitation ban as limiting all kinds of public disclosure. Indeed, some view the lack of transparency as part of the business model the very reason for their success.

I argue that it is this lack of information, this lack of transparency, at an industry level, that is of greatest concern. Absent industry-wide disclosure, the only reliable information we have is a purely voluntary disclosure to data vendors, such as Lipper TASS.

According to their numbers, U.S. domiciled funds have grown from close to $20 billion under management in December 1995 to $131 billion today, although the growth has leveled off recently.

I should add that the trillion dollar number that people cite includes both domestic and foreign funds.

The data show remarkable diversity of styles of management under the "hedge fund" banner. The AW Jones long/short strategy captures about 30 to 40 percent of the business.

The style mix has been fairly stable, although there has been a dramatic rise in assets managed by funds of funds. These diversified portfolios of hedge funds are attractive to an ever increasing institutional clientele, which a decade ago did not exist, but now is about 52 percent of the total.

Event driven funds focusing on private equity, mergers and acquisitions and such, have risen in market share from 19 to 25 percent over the past decade, while the global macro style popularized by Soros has actually fallen from 19 to 3 percent.

There is a concern of the committee about the role of hedge funds in the credit derivatives and CDO markets. How big is this issue? We do not know since the industry is not required to tell us, but based on TASS, fixed income arbitrage, which involves these kinds of strategies, is just 4 percent of the business.

I think the industry should make the case that entering this market, their "rich clients" are taking on significant risk, which would otherwise fall on the banking system. They are thus reducing systemic risk, not increasing it.

What about leverage? According to TASS, the fraction of funds that use leverage has fallen from 69 percent in 2002 to 57 percent today. In addition, there are vast differences in degree of leverage

across funds. Strategies that report the highest degree of leverage have quite small market share.

More information would certainly help. Does this detract from due diligence of sophisticated investors? With colleagues, I studied the recent controversial and ultimately unsuccessful SEC attempt to increase hedge fund disclosure.

We examined disclosures filed by many hedge funds in February 2006. Leverage and ownership structures as of the previous December suggest that lenders and hedge fund equity investors were already aware of hedge fund operational risk revealed in these forms.

However, operational risk does not mediate the naive tendency of investors to chase past returns. Investors either lack this information or regard it as immaterial.

What is the role of government? Perhaps Congress needs to revisit the 1940 Act. The "sophisticated investor" exemption seems quaint these days.

Industry argues that the ban on direct solicitation inhibits disclosure, and perhaps it does. However, Congress can mandate any level of selective disclosure necessary for 3C1 or 3C7 exemption. There is no need to know proprietary trading information.

However, by being just a little bit more forthcoming, the industry could allay public concern about systemic risk and operational risk.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Brown can be found on page 71 of the appendix.]

The CHAIRMAN. Thank you. I thank all the witnesses. I think many of us will be reading in detail particularly what you have submitted.

Let me begin with Mr. Corrigan. Obviously, our job is to think about whether or not there is any public policy implications.

You talked about the need or the desirability of increasing the shock absorbers. What would they be and would we have any role in trying to do that? That would seem to me to be what we ought to be focusing on to the extent that there was something for us to do.

Mr. CORRIGAN. Certainly, to answer your last question first, I think your oversight role is very important. As to the shock absorber concept that I have used, I have tended to put my favorite shock absorbers, if you will, into basically six categories.

One is corporate governance. I cannot begin to underscore how important the details of what corporate governance really means is for this purpose. It is a lot more than having a few independent directors. The second is risk management and risk monitoring. The third is what I call financial infrastructure, and these are some of the problems that we encounter with backlogs of derivatives and so on and so forth. The fourth is better understanding in managing these highly complex products. The fifth is a multiple four legged table of enhanced disclosure, and the sixth is what I like to call reputational risk management.

The CHAIRMAN. Let me go to the one that may potentially involve us, number five, the disclosure. Would you change the disclosure regime that we now have?

Mr. CORRIGAN. Most of the time when we talk about disclosure, we are thinking about public disclosure. One of the issues that I

raised in my statement in terms of suggesting some enhancements to the President's Working Group approach is to better recognize that in the context of financial stability issues.

Disclosure is a four legged table. The first has to do with disclosure of a bilateral confidential nature say between a hedge fund and its prime broker.

The second has to do with disclosures that are made by hedge funds or private equity funds to their investors or prospective investors.

The third has to do, and this is very important, with what I like to call voluntary informal exchanges of largely confidential information between hedge funds or private equity funds and regulated institutions with the regulatory community. The last is public disclosure.

I firmly believe, Mr. Chairman, that again, in the context of shock absorbers and financial stability, there is more pay dirt in those first three legs than there is the last, in part because public disclosure is suffering from a very chronic information overload problem.

The CHAIRMAN. I accept that. Is there a role for the government? Again, I ask this without any preconception.

"Public" can mean two things. It can mean public in that it is to some extent compelled by public agencies, and it can also mean that the actual information is made public.

Is there a role for the government in increasing the flow of information in the first three categories?

Mr. CORRIGAN. Yes, there is. Again, one of the suggestions in my statement, Mr. Chairman, was that in the context of the so-called systemic risk principles of the President's Working Group, I suggest in my statement that one thing I would like to see happen would be an effort to quickly develop best practices, make them public, so that we have benchmarks, including in this area of transparency—

The CHAIRMAN. Would you recommend that any public agency have the responsibility to monitor whether or not the best practices were being followed?

Mr. CORRIGAN. I would expect in this context that the supervisory authorities would indeed do that. I believe, if I take as a point of reference the recommendations of our risk management policy group, that has happened.

The CHAIRMAN. That would be the supervising authorities obviously for the depository institutions. Would that also mean by anybody for the hedge funds themselves? I understand on the counterparties.

Would you recommend there be any governmental responsibility to monitor whether best practices were being followed by the investment entities themselves?

Mr. CORRIGAN. I think that it is in the best interest of the hedge funds themselves to put themselves in a position in which they voluntarily make their practices public.

The CHAIRMAN. I understand. Every time people tell me something would be good if it was done voluntarily—if everybody did everything voluntarily, I would be out of a job. Maybe that would be a good thing. We are in the involuntary part of this.

If people do not do it, should somebody at least be checking to see who does and who does not do it voluntarily?

Mr. CORRIGAN. I think that will happen; yes.

The CHAIRMAN. Thank you. Mr. Bachus.

Mr. BACHUS. Thank you. Let me ask all the panelists. We have talked about the President's Working Group and they are going to come up with some recommendations.

Would your advice to us be to wait on their final recommendations before we considered any action?

I will start with Mr. Corrigan.

Mr. CORRIGAN. Yes. I would suggest, and I don't think that is going to take all that long. I think there is enough in the pipeline right now that the committee, in my judgment, should continue to exercise its oversight function as it is doing today.

I do not see the need for anything beyond the continued effective exercise of that oversight function.

Mr. BACHUS. Mr. Brody?

Mr. BRODY. I guess it would depend upon how long it takes. If it is done in a sensible and timely way, I think it is absolutely appropriate for the committee to wait.

If it takes an extensive period of time, then it is probably proper to move without it.

Mr. BACHUS. All right. Mr. Chanos?

Mr. CHANOS. I would echo Mr. Brody's comments on that. I think if we are looking at a long process, I think it would behoove the committee to keep moving at all due speed. I suspect the report will be out relatively soon.

Mr. BACHUS. Is 6 months a reasonable amount of time?

Mr. CHANOS. If there are no financial hiccups, I would say yes, 6 months seems reasonable.

Mr. BACHUS. We probably would not know until after the hiccup, I guess. By "hiccup," you do not mean a failure of a hedge fund. You mean?

Mr. CHANOS. A broader market problem that would include but not be exclusive to hedge funds, that would move things quicker.

Mr. BACHUS. Some of the things that have been advised still would not prevent that, would it?

Mr. CHANOS. Absolutely not. I am a realist as well as an idealist. I understand, as one of the members said earlier, that the industry will come under greater scrutiny should there be such a hiccup.

Mr. BACHUS. Mr. Hall?

Mr. HALL. I would agree with that, that the committee should wait for the President's Working Group. We believe they are on the right track. They have identified what we think are the important issues, and they have also identified what the potential failures could be of aggressive regulation.

I think, as Mr. Baker pointed out, overreaction based on a hiccup is in the long run not going to serve the industry or the economy as well either. We need to be very careful and hopefully they will move quickly and get it taken care of.

Mr. BACHUS. Mr. Matthews?

Mr. MATTHEWS. I agree with my colleagues.

Mr. BACHUS. To wait?

Mr. MATTHEWS. Yes.

Mr. BACHUS. A reasonable amount of time?

Mr. MATTHEWS. Yes.

Mr. BACHUS. Mr. Golden?

Mr. GOLDEN. There is a downside to being on this end of the table. It's all been said before.

Mr. BROWN. I agree also.

Mr. BACHUS. Thank you. Mr. Brody, you mentioned registration with the SEC. What does that mean? In your mind, what is registration with the SEC?

Mr. BRODY. It gives oversight by the SEC. Let me just tick off some of the things that are required in registration, realizing that I would have the SEC go to a principles-based approach.

Some of the things they do now is they require a chief compliance officer. They require a set of written compliance policies and procedures. They require a code of ethics. They require a filing of a public information form. They require independent custodian requirements, which leads to a financial audit, and they do on-site inspections and examinations, and they require retention of books and records.

There are obviously more things, but those are key elements of registration that give protection to the more unsophisticated investors.

Mr. BACHUS. Some of you mentioned the traditional hedge fund and then the ones that are private equity, and then the ones that are leveraged that are borrowing a lot of their money from financial institutions.

One thing that should be happening right now at the Federal Reserve, Mr. Corrigan, you were on it, is that the Federal Reserve should be looking at our financial institutions and seeing their investments. In that regard, that is already a regulated part of the process, is it not?

Mr. CORRIGAN. It is. That is correct.

One of the very constructive things that has happened just in the recent past that I might add is consistent with this whole notion of principles based oversight is that the Federal Reserve, in cooperation with the SEC, and interestingly with the U.K. FSA, went through an exercise, again, in a largely principles-based approach.

They spent a very substantial amount of time with each of the major banks and securities firms that have prime brokerage activities, in an effort to systematically review and understand the nature of those relationships, out of which they will be developing a statement of best practices to be used prospectively in order for them to be able to better judge how individual institutions perform this function.

This, to me, is a terrific example of adapting the approach to prudential oversight to the real world in which we live, and I think it is enormously constructive. I think it provides a framework for the future that can be applied in other areas as well.

Mr. BACHUS. My final question, if I can, Fortress Investment Group, which is the first IPO of a hedge fund, at the New York Stock Exchange, that is an example of a hedge fund that is being basically offered to anyone.

Should there be maybe a different rule for that, or would you depend on the New York Stock Exchange?

Mr. CORRIGAN. Others, I am sure, will want to comment. It is important to keep in mind that in the Fortress case where there is an IPO, by definition, as part of the IPO process. Fortress and the new public entity is subject to a whole further raft of regulations that apply to listed companies in general.

Not only do they have the regulations that others talked about earlier, but in addition, they now are subject to all of those regulatory requirements as well.

Mr. BACHUS. Mr. Brody?

Mr. BRODY. There is an important distinction to make between a public offering of the fund and the public offering of the management company. In the Fortress case, it was a public offering of the management company. That is the entity that is responsible for advising the funds.

I think, so far in the United States, we have not had significant, or even any, public offerings of hedge funds. In Europe, there have been.

Mr. BACHUS. This was the management company, not the participating hedge fund.

Mrs. MALONEY. [presiding] The gentleman's time has expired. Thank you, and I thank all of the witnesses. Coming from New York, I certainly appreciate the significant role that hedge funds have come to play in our markets and our economy.

I want to thank the chairman for holding this hearing to review the growth in hedge fund activity and whether that growth needs additional transparency or constraints.

Certainly, hedge funds operate in a regulatory scheme that has not been adjusted much to reflect their new activity. Many of you testified to the tremendous growth in hedge funds, the change in leverage, and this may well be out of date.

The SEC is taking a few small steps to tweak the rules, such as raising the threshold for individual investors, but such investors are only a very small part of the hedge fund market, so these are very minor adjustments.

I would like to go back to Mr. Brody's statement and support of requiring all hedge funds to register as investment advisors. I would like to go down the panel and see if you support this idea, yes or no.

Would you support that, having Mr. Brody's strong statement in support of having them registered as investment advisors?

Mr. Corrigan, would you support that or not?

Mr. CORRIGAN. I would not. At this juncture, I would not.

Mrs. MALONEY. You would not. Why would you not support that?

Mr. CORRIGAN. Because I think that the central thrust of the approach suggested by the President's Working Group can achieve what we really need to achieve.

Many of the witnesses have suggested this idea that hedge funds are unregulated, and it is a bit misguided. There is a lot of regulation.

I do not see any need at this point to go that distance, and I would emphasize, Congresswoman Maloney, that I have debated this thing with myself for years. What always stops me from going there is the so-called moral hazard problem, the danger that by going to that place, we effectively encourage people to believe that

the government will protect these organizations, even in very dire circumstances. Philosophically, I am just not ready.

Mrs. MALONEY. Thank you. Mr. Chanos, yes or no?

Mr. CHANOS. No. I believe that through—

Mrs. MALONEY. Thank you. Mr. Hall, yes or no?

Mr. HALL. No.

Mrs. MALONEY. Mr. Matthews, yes or no?

Mr. MATTHEWS. I think if you take public pension money, you should. If you do not, why should you. You are no different than a partnership that invests in a shopping mall, and those are not regulated.

Mrs. MALONEY. Thank you. Mr. Golden?

Mr. GOLDEN. No, I would say no. I would note that we do the same extensive due diligence on registered advisors as non-registered's. It gives no real protection.

Mrs. MALONEY. Mr. Brown?

Mr. BROWN. I would say no in the current way the registration works because my research shows that sophisticated investors already understand what is in those forms. Unsophisticated investors either did not know or did not care.

Mrs. MALONEY. Thank you. I would like to ask anyone on the panel, starting with Mr. Brody, about the credit derivatives, the credit default swaps. They have been criticized as unduly risky and have raised issues of systemic risk, which regulators worked to resolve in the 2005 Novation Protocol.

Maybe these credit default swaps are the canaries in the mine of the subprime lending which we are reading about in the Tsunami Daily as it unravels.

A few months ago, the ABX Index that tracks the credit default swaps suggested that the subprime market was headed for a fall and now we have seen that is now taking place.

Do you think the CDS investments can soften the impact on the markets of events such as the subprime challenge or crisis that we are seeing today, or do they inherently aggravate market swings, or are they neutral in their impact?

Mr. BRODY. Let me first make a comment on derivatives, CDS' and hedge funds. The reality is that these instruments are used throughout the investment community. They are used substantially by investment banks. They are used substantially by commercial banks. In general, these instruments serve the laudable purpose of dispersing risk, putting risk in many hands.

However, that dispersion of risk does not prevent failure. We are seeing right now in the subprime market some degree of failure.

Mrs. MALONEY. Anyone else?

Mr. HALL. I would be happy to comment. I agree their purpose is to disperse risk. I think they are really no more risky than the underlying investment. If you can buy the underlying investment, the derivative is a more efficient way to take advantage of that.

It can be used as a hedging instrument and as you pointed out with the ABX Index, it can lead to price discovery that might not as readily be seen in the underlying prices of illiquid bonds.

I think they are an important risk mitigator in the system.

Mrs. MALONEY. Would anyone else like to comment?

Mr. BROWN. The hedge funds are actually taking the risk away from the financial system. They are giving it to the high net worth individuals who are in the best position of society to afford that risk.

The other thing is that they are such a small part of this business. There is a real problem, I think, in the public perception of seeing all the hedge funds as the same, that the danger is that the sins of the few will be visited upon the many, and if there is a problem in that little section of the market, it may affect public perception of the whole market.

No. The whole purpose is to take risk away from them.

Mrs. MALONEY. Mr. Chanos?

Mr. CHANOS. I would like to make two points on that. The derivative swap market, which has grown dramatically, has not only dispersed risk but it has given us new informational content.

Over and over again, we see the credit default swap market show us prices ahead of the rating agencies, pointing out risks that the market may not have completely understood.

I would also point out that hedge funds themselves, through their effort of shorting the ABX market, were sending an important signal back in the fall that the subprime market was headed for problems.

Again, this was more information, not less, for those who wanted to look at it and draw the proper conclusions.

Thank you.

Mrs. MALONEY. Thank you. Yes, sir?

Mr. CORRIGAN. One thing I would want to emphasize is that there have been several comments earlier about leverage. Most of those comments deal with what I think I would consider to be balance sheet leverage, equity to asset ratio's and things like that.

Credit default swaps are in the family of what I would consider to be fairly complex financial instruments. One of the reasons why they are complex is that depending upon market conditions, they can have the characteristics of what I like to call "embedded leverage." Embedded leverage is different than balance sheet leverage because it is a measure of how a given instrument, like a credit default swap, can change in value based on a shock.

When we talk about these complex instruments, we have to recognize the distinction between balance sheet leverage on the one hand and so-called embedded leverage on the other.

Having said that, I want to emphasize credit default swaps have been a tremendously constructive innovation for the financial markets generally.

The CHAIRMAN. The gentleman from Louisiana.

Mr. BAKER. Thank you, Mr. Chairman.

Mr. Hall, I am going to address my sort of series of questions to you, since you are representing an association.

Generally, what happens within a fund, and I am not even going to call it a "hedge," I am just going to say a private investment opportunity company, is of no concern to anyone as long as it is operating in an expected and anticipated way.

We are dealing with a circumstance where there is an unanticipated loss that brings about consequences that are adverse financially to other parties. That is the focus of what we are about.

If you limit those who participate in that activity, that is one way to stem the scope of adverse consequences. It has been mentioned by several that the current definition of sophisticated or qualified investors does seem inadequate.

My observation is that a dollar figure does not necessarily equal sophistication, as in a young person who is the beneficiary of a substantial trust. They will be relying upon a third party to make investment decisions on their behalf, whether hedge fund or otherwise.

The suitability of that person in conducting that financial or fiduciary responsibility is pivotal in this case. That goes to the pension fund question and whether the school bus driver ought to be exposed to some derivative transaction with embedded leverage.

Beyond the question of who gets in, it is the elements that constitute the organizational activity of that fund itself, going to the question of leverage defined broadly.

Someone in a sophisticated regulatory position needs to understand that leverage position so we do not have an LTCM like event, and I do not mean that somebody loses money.

I mean when people showed up in the work out room, everybody was surprised by who was at the table, that there is some sense of systemic scope of what that hedge fund is engaged in, and that gets you to the counterparty risk.

Although there is a counterparty risk management policy group that Chairman Bernanke referenced in recent testimony, and generally speaking, if we are going to constrain the hedge fund activities by limiting their access to capital, which is not true equity, then we really begin to sit heavily around the neck of these operations and potentially minimize the systemic risk potential that everyone seems to express concern about.

Is there anything inconsistent with your view of market function about those areas of focus? Who gets in a regulatory responsibility to understand leverage, embedded or otherwise, and counterparty risk management tools to watch?

In my judgment, registration does not work. All that does is just say you have a label on your door and you can still be a bad actor.

Mr. HALL. I appreciate your comments and I thank you for addressing the question to me. I am happy to discuss this.

I think you have isolated two very important points. Effectively, what is it that lawmakers have to worry about? You pointed out investor protection, who loses the money, and is it okay if it is wealthy people or retail investors.

You make a very good point. An example that I use many times is that finance professors probably would not be able to pass the net worth test, even though they are qualified to invest in these instruments.

Mr. BAKER. For some folks, you could move their Bentley and they would not be able to find it.

Mr. HALL. That is true. There are other wealthy people who should not be investing.

I think ultimately the link between sophistication and wealth is really not the basis for this, even though many times people say that.

The real link is who can afford to lose it. If you have a Bentley, you probably also have a Rolls Royce. If you lose the Bentley, you are still going to be okay.

It is not the best system for determining who is sophisticated enough, but it is really the best we have to prevent things from coming across your desk that you need to worry about.

The second issue, aside from investor protection, is the systemic risk. I firmly believe the President's Working Group believes is best handled at the counterparty level, through the banking system, the brokerage system.

Mr. BAKER. Excuse me for interrupting. Does that not necessitate a more standardized methodology of disclosure and a disclosure of values to that counterparty for them to be able to make appropriate judgments about risk?

Mr. HALL. I think that already happens. I think the relationship between hedge funds or private investment pools and their prime brokers, if they are borrowing money, the prime brokers and the counterparties demand an enormous amount of information and transparency.

Mr. BAKER. What I am getting to is that methodology for oversight will vary from practitioner to practitioner. There is not some kind of standard boilerplate. If I am at Bank "X" which is generally viewed as a good management team, but their practices are a little weak in this arena, is there any advisability, not in Congress but in a regulatory overview of the consistency of those practices?

That is what bothers me, not just from hedge fund to hedge fund, but from bank to bank. How capable are those folks in asking the right questions?

Mr. HALL. My own experience is it is relatively consistent across the sophisticated brokerage firms and banks. The most important shock absorber, I think, for the system is capital. The capital charge against these types of loans that banks and brokers would make is in the regulations, and ultimately they will evaluate whether making a loan gets them the appropriate return on capital.

I think there is a reasonably consistent methodology that has been put in place by the capital charges.

Long term capital comes up a lot. Prior to Amaranth, that was the last big blow up in a hedge fund. We have had more blow up's in the stock market since then.

The President's Working Group of 1999 pointed out that long term capital had enormous amounts of leverage relative to their peer group. They were on a plateau of their own in terms of their ability to get leverage, and frankly, I think the message is that even the banking and brokerage community overextended themselves to long term capital.

Mr. BAKER. My point exactly. Thank you.

Mr. HALL. If I have answered your question, I am finished. Thank you.

Mr. BAKER. Thank you.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Let me focus, if I can, on two areas. One of the witnesses raised the question of whether the Working Group's proposal about who

qualifies as an accredited investor is or is not the appropriate definition. I cannot remember which witness it was. Maybe Mr. Brown, Dr. Brown.

I wanted to follow up on Mr. Baker's question and be a little bit more pointed on that issue. Is that the appropriate level or should it be a different level?

Dr. Brown, was it you who made that point?

Mr. BROWN. I made it, as well as another gentleman.

Mr. WATT. Let's start with you and get the perspective of the other gentlemen on the panel.

Mr. BROWN. When I teach, I often have aggressive students who say, you know, if you are so smart, why are you not rich. The temptation is always to say well, how do you know I am not rich.

Another possible response is you know, if you are so rich, why are you so stupid. Wealth and intelligence, particularly in investment matters, is not at all related.

I can point to many anecdotes and many cases.

Mr. WATT. I think I did accept the proposition that the monetary figure is appropriate as opposed to—how are you ever going to evaluate somebody's sophistication and evaluate their financial well being or worth or ability to lose.

Mr. BROWN. That is right. You have exactly the point.

Mr. WATT. It is the monetary figure that I am zeroing in on more than the sophistication issue that Mr. Baker was zeroing in on.

Is the net worth figure an appropriate figure?

Mr. BROWN. I have various thoughts about this. For a high net worth individual, they know what they are doing and there is no real business for us to be too concerned about what they do.

I must confess to some concern about the level of involvement of pension funds and the ability of the pension benefit guarantee corporation and absorbing any potential losses that come through investing in these vehicles.

The issue is really to look at risk, I think, and to understand what the financial resources are of the sponsoring organization of the pension, any defined benefit pension plans.

I am concerned about that.

Mr. WATT. Let's start with Mr. Golden and go all the way down. What do you say in response to the question I asked, and to Dr. Brown's comments?

Mr. GOLDEN. I commented earlier that I think the capital test should be raised. I do not know how high they should go. That is something that I think could be derived through a lot of conversations with the participants.

I do wonder about this issue of assuring that people can afford to lose money in this. I am not convinced that any particular hedge fund investment is any more risky than a single stock investment in a single company. We do not have the same kind of concerns about people losing money in those particular investments.

Mr. WATT. You are not advocating to lower the threshold?

Mr. GOLDEN. Absolutely not. I think it should be raised. The fact of the matter is people—we need to make the bite size with which they invest to be small enough that they can weather the storm. The diversified portfolio is a really important measure of protection.

Mr. WATT. You all may need to speed up your responses if I am going to get all the way down the panel.

Mr. Matthews, Mr. Hall, Mr. Chanos.

Mr. MATTHEWS. Personally, my feeling is that the question is, can you afford to lose it? That is the question that should be asked. I do not know what that means in terms of the level you set.

Mr. HALL. That is correct. It is an issue of net worth. It is an issue of income. It is an issue of investing experience. I think actually some of my colleagues at the MFA have done some work and we would be happy to present you with some more definitive information on our recommendations.

Mr. WATT. That is consistent with the Working Group or different from the Working Group?

Mr. HALL. Consistent with the Working Group.

Mr. CHANOS. I would echo most of these comments with the one exception that we do have members in our Coalition who make the very good point that, for example, the people who were made very wealthy by a man named Warren Buffett, who ran his partnership as a hedge fund for 20 years, would not have been accredited investors under the standard.

It is a good point. We have to understand that these numbers are arbitrarily policy driven numbers, not economic numbers. The industry and the proper authorities have to coalesce around figures that broadly represent the ability of investors to shoulder the risk, as my colleague said.

Mr. WATT. Mr. Brody?

Mr. BRODY. It is probably not a bad number. It is hard to determine what it should be. I think nobody has great wisdom on this score. The number serves as an imperfect proxy for understanding, and the reality, as has been mentioned earlier, is hedge funds in general are not riskier than most other investments.

Mr. WATT. Mr. Corrigan?

Mr. CORRIGAN. I would raise the limit to at least what is being contemplated by the SEC's current proposals. These standards are not perfect, but they are easy to understand. We have standards like that in a lot of places. That is probably the best we can do.

Mr. WATT. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. I do have to interject for 30 seconds, as we talk about the level at which we protect people.

I am going to propose with regard to the bill that we passed last year that prevents anybody from betting on blackjack, that maybe if you can invest in a hedge fund, we will at least let you gamble. This committee decided that we would protect people from gambling at all; maybe we can link the two.

The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman. I certainly appreciate you calling this hearing. It is an important hearing. Clearly, I think the committee has identified several areas of legitimate concern.

First, are investors possibly being misled? Do we have the proper level of transparency? Second, is there a legitimate issue of systemic risk? Third, as the gentleman from Louisiana has pointed out, we certainly have a concern about the institutional investor represented by pensions, and what could happen to individual pen-

sioners, much less the American taxpayer who might have to bail out the PBCG.

Having said all of that, although I am not a physician, I am reminded of the Hippocratic Oath; first, do no harm. It should also apply to Members of Congress.

I recently came across a couple of statements of our present and former Fed Chairman, and apparently Chairman Greenspan said it would be counterproductive to directly regulate hedge funds.

I know that Chairman Bernanke has been quoted as saying that direct regulation of hedge funds would impose costs in the form of moral hazard and the likely loss of private market discipline, and possible limits on funds' ability to provide market liquidity.

My first question, which is kind of tossing the ball up in the air for anybody who wants to take a strike at it, is if we do not get the regulation right, what harm might we do, and particularly if you could comment on Chairman Bernanke's statement about possible moral hazard.

Dr. Brown, it looked like you were reaching for the button first.

Mr. BROWN. There is an issue with the tendency of the industry to be more expanded overseas than it is here. I have different views on this.

I do not hold with the view that industry is going to disappear any time soon. The plain fact is that other jurisdictions have a much more significant regulatory environment than we do here. I do not think there is any danger of this industry going anywhere very soon.

Mr. HENSARLING. Anybody else care to comment?

Mr. HALL. The one thing to be cognizant of is if there is regulation that keeps hedge funds from doing their business, which is out of the ordinary.

One of the great things about what I think private pools of capital do is they do things that are out of the mainstream, like investing in insurance risk after the hurricanes.

If there is regulation and it is inappropriate regulation or if it overly restricts the ability to make these types of one off investments or out of the mainstream investments, then the economy will overall suffer from that.

Mr. HENSARLING. The investment capital represented by the hedge fund industry, just how fluid is it? Some of us have been concerned about certain provisions of Sarbanes-Oxley that might be helping drive capital to overseas markets, the number of IPOs that have taken place on domestic markets versus international markets.

Just how easy is it to locate these investment vehicles overseas and if it is easy, is that something that Congress should be concerned about?

Mr. Chanos?

Mr. CHANOS. I can speak personally to that, because I set up an operation in London a few years ago to complement our New York office.

There is a lot of concern about capital moving overseas. We hear about this. Capital can move overseas at the flick of a button and does so all day long all around the world. Capital moves around.

The bigger issue, I believe, and have told my New York political friends this, is the human capital that moves.

When I set up an office in London, I am now paying people overseas. All of those effects of economy are benefitting the U.K. directly and not the United States.

I am more worried about that and losing our competitiveness of keeping good people and keeping our financial primacy in the United States from the human side and the organizational side than the capital side. Capital flows very freely across borders all day long, 365 days a year.

Mr. HENSARLING. If I could hit the risk issue again. I certainly hold myself up to be no expert, but for a couple of years in the early 1990's, I was actually an officer in a hedge fund.

It basically ran a very classic AW Jones kind of operation, classic stock pickers, long, short, they levered it up 2:1.

I was able to invest in the fund as an officer, and during the time I was there, I discovered that our investment fund, number one, gave a greater rate of return to my family than my alternative investments at a low correlation to the market and had less volatility.

I am kind of asking the question, what is wrong with this picture? Is there anything inherently risky, since I think it was Mr. Golden who said that hedge funds are not a distinctive asset class, it is more of a structure, is there anything about the structure of having a private investment vehicle that has a performance fee that leads these investments to be more risky than alternative investments that might be found in the mutual fund industry?

Mr. Matthews?

Mr. MATTHEWS. Absolutely. It is the 20 percent performance fee. If you can make 20 percent on $50 million that you earned for your investors, that is pretty good. If you can make 20 percent on $50 billion, that is even way better.

The inclination is to take on more investors, more leverage, and greater risk to try to hit the jackpot. That is why hedge funds occasionally do fail, and mutual funds never fail. Mutual funds do not take the leverage but a hedge fund does.

Mr. CORRIGAN. We get a little bit bogged down here because we use this term "hedge fund." There is an enormous dispersion in terms of the behavioral characteristics of hedge funds, and in particular, the extent to which individual hedge funds take more risk, have higher risk profiles than other hedge funds.

I think it is fair to say that if you look at the universe as a whole, the characterizations that have been made by several of the other witnesses are correct. It is not so true that to the extent one or more individual hedge funds are reaching for extraordinary returns, by definition, they have to be taking extraordinary risk.

That is where the dilemma lies. How do you square the circle in terms of performance in general with outliers?

I want to add, if I could, very quickly, Mr. Chairman, a point about Amaranth. Several people have noted that Amaranth worked itself out in a very, very successful fashion, and it did. I, like others, take a lot of comfort from that.

In my statement, I have identified several factors associated with the Amaranth event which I think warrant a fairly high degree of

caution as to how one should judge the Amaranth episode in a vacuum compared to a similar type of episode under different circumstances in the future.

The CHAIRMAN. We will go to the gentleman from Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman. First of all, I want to thank you and the ranking member for having this hearing, and also thank the panelists for helping us with our work.

To begin with, I think that we all take the position that the best regulation is self-regulation. As the chairman indicated before, it actually allows us to focus on some other things.

Given the size of these hedge funds and the possibility that at least in the currency exchanges, there is a possibility of hedge funds working in concert, not necessarily deliberately, but their impact could be multiplied, and the sort of mercenary strategy, it could be good mercenaries, but it is definitely geared strictly to the investor, and the OPIC nature of these hedge funds, the secretive way in which they operate, it does raise some concerns in a number of areas.

The chairman mentioned in his opening remarks the situation with our pension funds, and while the Amaranth work out might have been suitable for some, I am not sure that the pensioners who were affected would come to the same conclusion.

I know that Mr. Matthews raised the possibility that it might be good to look at some limits, not necessarily on hedge funds, but on pension funds that would invest in a hedge fund, and maybe put some limits on either a percentage or based on their unfunded liabilities, their exposure. We might do that.

The other area I am concerned about, and this goes to the mortgage issue and somewhat the subprime market, but in the area of mortgage backed securities held by hedge funds and what could happen if a hedge fund dumps those securities back into the market, putting downward pressure on those securities, what could happen to the distribution of capital available for housing.

That is an essential good in terms of affordable housing, that I am concerned about.

The last dimension of this that concerns me is I also wear another hat sort of ancillary to my work on this committee, and that is as the chairman of the Taskforce on Anti-Terrorist Financing. I work a lot with Treasury. I work a lot with FinCen and a number of our counterterrorist organizations.

They say that it is very difficult to track and to scrutinize these hedge funds to make sure that the proper anti-money laundering and anti-terrorist financing protocols are in place.

That concerns me greatly, given the amount of money that is flowing here. I will just let the panelists take a crack at what might we do, with your cooperation, rather than acting upon the hedge fund industry, what can you give us? We would rather have the suggestions come from you as to ways to address these concerns rather than us trying to do it from whole cloth from this side of the table.

Mr. Brown?

Mr. BROWN. I think first of all, you have to understand the international nature of this business. This body cannot even in principle examine the very important issues you raise about terrorist financ-

ing through vehicles of this kind because the international business is far greater than the national business, the U.S. domiciled business—

Mr. LYNCH. I am not talking about just us. We are working with the Egmont Group, which is made up of FIUs from all over the globe, 94 countries. I would not suggest us doing it alone; we would work with our international counterparts.

Mr. BROWN. Okay, great. I am also a little concerned about the anecdotal evidence on systemic risk that you referred to.

My own research, for example, for the most obvious example is the Asia currency crisis in 1997, and the allegation that Mahathir Mohamad, the Prime Minister from Malaysia, made that George Soros had engineered the whole affair for his benefit.

I looked at the numbers, and it turned out that the hedge funds actually were very risk adverse during that period and had pulled out of the markets, and in fact, George Soros had lost 10 percent, hemorrhaging 10 percent right through that period.

The anecdotal evidence of massive systemic risk, I would argue, is just not there. Yet, a lot of central banks, in particular, the Australian Central Bank, were trying to get actively involved.

Mr. LYNCH. I appreciate that remark. If you could focus on the question, the pension funds. Two, mortgage backed securities. Three, anti-money laundering protocols that are not in place right now with hedge funds. If you could just address that question.

Mr. BROWN. I am sorry. The pension funds, I do agree there is an issue there and we have to examine the amount or the at-risk status of pension funds with regard to any kind of high-risk investment, in particular, hedge funds, and we may have to look at ERISA to do that.

On mortgage backed securities, I am less concerned because that is not a huge amount of this business. The hedge funds are only involved in about 4 percent of that business. It is not a big thing.

That is about all I have to say.

Mr. HALL. If I may.

Mr. LYNCH. Sure, Mr. Hall.

Mr. HALL. In this hearing, we have talked about Amaranth in 2007, and long term capital in 1998, two high profile blow up's that were terrible for a lot of investors.

We really have not talked at all about the fundamental risk of the stock market. If you look at the 2001 crash of the stock market, and you look at the fact that it was only recently that the S&P actually recovered all the losses over the last 6 years, ultimately, it has not made much money in the last 5 or 6 years, whereas hedge funds have actually generated positive returns, with much less volatility than the stock market.

In terms of investments in hedge funds, if we look at the pension market, which you asked about, no one disagrees, or very few disagree, that pension funds should not be investing in common equities.

Unfortunately, I think the reality is—I should not say unfortunately—I think the reality is that common equities in most cases may be more risky than the overall hedge fund market.

The CHAIRMAN. We are going to have to wrap this up.

Mr. HALL. In terms of the housing issue, I will address it quickly. I think it will probably be if a hedge fund blows out, as you point out, of securities, it will be another hedge fund. It has the flexibility to enhance their leverage and buy these assets and provide that shock absorber for any liquidations that will occur.

The CHAIRMAN. Thank you. Mr. Shays of Connecticut.

Mr. SHAYS. Thank you very much, Mr. Chairman. Again, thank you for holding this hearing, and I thank the ranking member, as well.

Long term capital and Amaranth were both from the Fourth Congressional District, one from Greenwich and one from Westport.

I wrestle with memories of savings and loans, and I wrestle with memories of when we changed the tax laws, what happened to real estate, and it kind of stared us in the face, and we all kind of knew it was going to happen. I think all of us are just trying to look for assurances that you will not just see another day like that.

What I wrestle with is long term capital basically was dealt with with a proactive—as you point out, Mr. Matthews—effort on the part of the Fed.

How did Amaranth resolve itself, Mr. Matthews? What took place and why would I feel comfortable that would happen again? In other words, that people would buy a lesser position? What happened?

Mr. MATTHEWS. The prime broker for Amaranth, J.P. Morgan, the prime creditor, that had the most at stake, took over the natural gas portfolio and re-sold it. They made a low ball bid that Amaranth was forced to take because Amaranth needed to liquidate and pay back other creditors.

J.P. Morgan turned around and re-sold the same positions to other hedge funds. Those other hedge funds provided the liquidity that caused it to not spread.

Mr. SHAYS. The question I have, and I would ask all of you, is when that happens again, and it will happen again because there will be foolish mistakes done by foolish people or very smart people who do foolish mistakes, which model is most likely to occur, the long capital or Amaranth? Tell me what model is likely to occur in the future.

Mr. CORRIGAN. I will take a stab at that. The answer is we do not know. I think one can argue about probabilities, but we do not know.

As I said before, if you look at Amaranth and you contrast it with long term capital, the world of long term capital does not exist any more, in terms of the way that fund was run and the mesmerizing effect—

Mr. SHAYS. Then let me ask you this. What is the likelihood then, instead of one company going under, and evidently, I guess they both were from Greenwich, not Westport, but what is the likelihood that instead of one, you would have three, four, or five?

What would be the kind of circumstance that would create it happening for more than one company?

Mr. CORRIGAN. Let's look at the characteristics of Amaranth for a minute in terms of why that worked out as well as it did.

There are a couple of things that I think are very important. One, the instruments that were used to construct those natural gas

trades, by today's standards, were relatively simple and straightforward.

Mr. SHAYS. I need you to give me as short an answer as you can, because I have another question.

Mr. CORRIGAN. The short answer is I cannot tell you the probability—low, but not zero.

Mr. SHAYS. Let me ask you this. Are any of you concerned that you could have three or four companies go down at the same time and then would we still see the Amaranth model working out or would the Fed or someone else have to step in, if you had two or three companies go down at once?

Mr. BROWN. I think the important thing you have to note is the incredible diversity of the fund business. I think the industry is not doing itself a service in really explaining this to the world, and the fact that we have so focused on Amaranth and long term capital management and assume this is the whole industry—

Mr. SHAYS. One answer is just diversity?

Mr. BROWN. Diversity. Incredible diversity of this business is a great protection, I think.

Mr. SHAYS. Can anyone else give another reason or diversity would be the biggest?

Mr. MATTHEWS. Diversity and size of capital. As I point out in my testimony, there are three hedge funds in the United States alone with $30 billion or more in assets. That did not exist in Amaranth and long term capital's day. It just did not exist.

Mr. SHAYS. One of my friends owns a hedge fund and they had three partners. They bought out one because one partner wanted to keep expanding and they were happy making millions and millions of dollars, but they did not want to keep adding because they did not think they could service their clients as well.

I frankly thought it was remarkable. Obviously, he makes about $10 million a year, each of them do. It is not like they are suffering.

They had a chance of making more, but they honestly could not service their customers as well the larger they became.

Why is it the larger you become sometimes you cannot get as good a return? I do not understand that.

Mr. HALL. If I may, the answer to that is an important part of the distinction between the classic mutual fund long only business and hedge funds. Hedge funds, because they have an incentive fee, they look at the opportunity set and they have no interest in increasing assets under management unless it is in fact going to yield an appropriate marginal return. When that marginal return decreases, they have no incentive.

Hedge funds for years and years have been giving back money, closing, not taking any new money. If you contrast that to the long only business, frankly, they are asset gatherers, in my view, and they pretty much take as much money as they can because as they take new money, it is greater fees, but not necessarily greater marginal opportunities to invest in.

Mr. BROWN. I can address that issue as well. The evidence does show that there is some economies of scale that hedge funds face. Interestingly enough, if you look at funds of funds, there is actually economies of scale, because of the important due diligence function

that they serve in vetting out the funds under their management, and the funds that have the greatest amount of assets under management are the ones that can afford to do the greatest amount of due diligence on behalf of the institutional clients they serve.

Mr. SHAYS. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman. This is a fascinating hearing on the evolving topic of hedge funds.

My understanding of hedge funds, I want to make sure I am right on this, and if I am not, you all correct me, is that they are massive unregulated investment pools that are typically invested in only by institutional investors or wealthy individuals, that try to hedge the value of assets it holds and provides returns to investors that are not correlated to those of traditional stock or bond markets.

Is that a fairly good assessment there?

Mr. MATTHEWS. My only correction would be they are not necessarily all massive. It is like the retail business. You have Wal-Mart, Target, and Home Depot, but you also have a lot of local mom and pop's, like myself.

Mr. SCOTT. I am very glad that you said that, because that leads into my question in terms of the retail. As many of the particularly retail industry giants move closer to departure from this traditional form of long-standing traditional industry practices, it has somewhat created an interest and an apprehension for what is on the horizon for some of these companies.

Let me give an example of what I am talking about. If we take Sears, for example, Sears is now being classified as more of a hedge fund over its traditional role. Granted, Mr. Lambert, who was the chairman of Sears, has done a great job for the company as far as investments and the like.

Are you worried that more and more of our Nation's stores, especially retailers, will turn more to hedge funds and unrelated investment strategies to survive, and do you believe that more and more corporations whose sales are hurting will move in this same direction?

Do you believe we have a worrisome trend here? This is kind of a lead in to that. Is there a concern that the more unpredictable ventures like hedge funds may lead to yet other problematic issues in corporations? Should they stick to what they were formed to do and work on inventive and further creative ways of bringing in the customers instead of focusing more on unrelated investments like hedge funds?

Are they counting more primarily on these hedge fund investments over store performance, as sales decline, stores lose customers, and those customers are finding other places that address their needs or the prices.

This way of doing business is good for shareholders, but what about retailers? Do you believe this will further become the ongoing trend, retailers taking their focus off the classic focus of same store growth, market share, and store spending, and substantial losses in the long run?

What I am asking is the impact of this trend on some of our retail giants, like Sears.

Mr. Brody or Mr. Chanos or Mr. Hall?

Mr. BRODY. I will give it a quick try. The rationalization of businesses really has little to do with hedge funds. What we see over time is that some businesses are successful and some businesses are not successful. Some retailers are successful and some retailers are not successful.

When a retailer has "X" number of stores and a bunch of them are not successful, if the retailer is to survive, it needs to rationalize itself, get out of some stores, and change its merchandising. We have seen that in the retailing business and we have seen that in many, many industries in the United States.

I guess what I would say is that sound management is needed for all businesses and it has little to do with hedge funds.

Mr. SCOTT. Do you believe that down the road, some sort of reform will need to take place to address hedge funds with respect to their size and scope?

Mr. BRODY. Let me just make a comment on size. Many of the top 10 hedge funds by assets are terrific performers, and I think it just depends upon hedge fund by hedge fund, their management, the activities that they invest in, and each, in my view, in our capital system, should be free to make the economic choices that they do.

Mr. SCOTT. Am I being over cautious or overreacting in my concern that a lack of transparency in the current hedge fund market could lead to volatility down the road?

Am I seeing something that is not there? Is there anything to worry about with this move towards hedge funds?

Mr. BRODY. I think there are always plenty of things to worry about, not just with hedge funds, but probably everything else in life.

Mr. SCOTT. Is there volatility?

Mr. BRODY. The hedge fund world actually has less volatility in the aggregate than the stock market world does, and Mr. Corrigan went through a very useful notion of transparency and transparency to whom, to the regulators, to the prime brokers, to those who are lending you money, to the institutions that are investing in you, and to the general public.

I think the major point is that where the transparency is needed, it exists.

Mr. SCOTT. Was it hedge funds that—my final question, my mind is foggy. Did hedge funds play a role in the situation regarding Fannie Mae?

Mr. BRODY. No.

The CHAIRMAN. If the gentleman will yield to me, I think Fannie Mae got in trouble over their own accounting for derivatives. It was their own derivative investments and the dispute over the accounting standard that was the last straw.

The gentleman from Illinois.

Mr. CORRIGAN. Mr. Chairman, can I just see if I can help a little bit.

The CHAIRMAN. Yes.

Mr. CORRIGAN. I am one of the world's great worriers. I worry about those things, too. If you look at the size of hedge funds, the threat of retailers going amuck via financial activities, those risks

really are very, very small. I appreciate your concern. There are more important things I think in this area to worry about than those.

The CHAIRMAN. The gentleman from Illinois.

Mr. ROSKAM. Thank you, Mr. Chairman.

I just wanted to follow up briefly on what Mr. Shays was bringing up and to put it in a context. I apologize. I went out for three constituent meetings in the hallway that started with your testimony, Mr. Corrigan, and I came in, Mr. Brown, as you were clearing your throat at the end basically. I missed all your good stuff.

That being said, could you comment—I will just open it up for anybody who has anything interesting and insightful to say—could you comment on the characterization of long term capital management, the environment where the Fed obviously came in and intervened, the Amaranth situation—which I think the best phrase today, by the way, was that it worked itself out. I just thought that was a brilliant nice use of language, that it sort of worked itself out.

What is different today in terms of the sophistication in the marketplace so that we do not have to have that sort of intervention that we saw in the late 1990's?

I think, Mr. Matthews, you mentioned diversification, and then you also referenced the size of several funds.

Could you go further on that? I did not follow what you meant by that.

Mr. MATTHEWS. It is those two issues, diversification and size. Back when long term capital blew up, I think they lost $4.5 billion. I think that was the number.

There were no other $4.5 billion funds around that either could or had the ability to or wanted to step in and help. They could not do it. You needed the Fed to step in.

Today, we have three funds alone that have $30 billion each in the United States. There is one in London that has $60 billion, I believe.

There is tons of capital around. They do a lot of different things. They have branched into all kinds and all different classes of financial instruments and commodities and markets around the world.

It is simply not at all the kind of environment that long term capital was. They were the biggest and there was nobody out there who could rescue them.

Mr. ROSKAM. The old notion of being too big to fail is really the marketplace has matured since then, and now there are others who would be big enough to assume that market share?

Mr. MATTHEWS. It has. There is an issue that gets back to Mr. Scott's question about are they not too big or can they get too big.

There is a very Darwinian factor to our business model. The person who runs the management firm gets 20 percent of the profits. The investors know this. They are paying that money. If they are not getting a return on that investment, they are out of there very quickly.

A fund cannot keep growing forever just for the heck of it. The investors have to be satisfied or the money will go elsewhere. It is a very efficient marketplace.

Mr. ROSKAM. Could someone comment on the failure of hedge funds? I assume it is the natural thing, right? Some flourish. Some diminish. They do well and they stumble, like normal, and we ought not overreact to hedge fund failures?

Mr. HALL. One of the things that I think the President's Working Group points out is that there is responsibility on the part of investors themselves.

I think there was clearly a failure in the long term capital situation on the part of the counterparties, but it was not a system wide failure. There is clearly long term capital, I think, arrangements that were extended credit that other people did not get, so it was not a systemwide problem.

The Amaranth problem is strictly investors losing money. I do not think there was any threat to the system. Ultimately, due diligence is important and investors have to focus on due diligence, and keep in mind that Amaranth advertised and achieved extraordinarily high returns in the years subsequent to that.

You get higher returns from taking high risk. Investors knew that going in, I would assume. If they did not know, then we really need to focus on the due diligence aspect.

It is really going to be difficult to regulate the due diligence process, and the MFA is doing the best it can with creating standardized due diligence forms and processes.

Mr. ROSKAM. Mr. Chanos?

Mr. CHANOS. I would like to point out that hedge funds actually are very fragile vehicles. I would like to amplify what Mr. Matthews said; 10 to 20 percent of all hedge funds go out of business every year. It is a very large number. They do not because of stupendous losses, but for the very Darwinian thing that he mentioned, investors are constantly looking for the best return in this area, even though the evidence is exactly the opposite, that returns have been relatively high with less risk in aggregate.

However, investors are shopping for the best returns in a very high fee world and tend to move very quickly out of something that is not performing, and therefore, keeping the market disciplined in that way.

Mr. ROSKAM. Thank you.

Mr. BRODY. I think an important thing is to make sure that the investors get a fair shake. I think that is what registration does, it surely does not guarantee investors that they cannot lose their money.

Mr. CORRIGAN. Just very quickly on long term capital. We should not forget the circumstances in which long term capital happened. Long term capital was horribly mismanaged, the fact of the matter is that coming off the Asian crisis and the Russian crisis, that combination of circumstances in 1998 made long term capital a hell of a lot harder to deal with than it would have been had it happened in a more tranquil environment.

The CHAIRMAN. We should make sure that there are no hedge funds around when we have a crisis?

[Laughter]

Mr. CORRIGAN. We are not going to be that lucky.

The CHAIRMAN. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for your testimony. Our friends, it seems to me that every failsafe system is failsafe until it fails to be safe. And before long-term capital, there was no long-term capital. And my suspicion is that there is something else out there that we cannot prognosticate currently that may manifest itself, and then that will be the pariah paradigm that we'll have hearings about and talk about.

So, it seems to me that we do have to concern ourselves with the taxpayers in this paradigm, because the taxpayers are at the very foundation of the payout, because we now have the commingling of sophisticated and unsophisticated capital, and that occurs through the pension funds.

The sophisticated investor, as Mr. Golden said, is one that you may have little sympathy for. But I have a great deal of sympathy for the pension fund that happens to have pensioners who are unsophisticated investors who happen to be a part of this system that necessitates sophistication.

And I might add also that sophisticated investors make some very unsophisticated decisions, and I think we have to be mindful of this. So, if the—just to take us through it, if the sophisticated investor puts his money in the hedge fund, that's great. The pension is in the hedge fund. At some point, the pension fails. And at this point, the person who receives his benefits from the pension then relies on the taxpayer, perhaps through some sort of social program.

So in the final analysis, the taxpayers have a vested interest in what happens with funds that are supposed to be entirely supported by sophisticated investors. So the question for me becomes this, that I'd like to have each of you address. Do you agree, each of you, that something must be done about the commingling of sophisticated and unsophisticated funds? And I'll start with Mr. Brown.

Mr. BROWN. Thank you.

Mr. GREEN. If you could start with a yes or a no. And I say this only because sometimes when folks finish, I don't know whether they've said yes or no.

Mr. BROWN. I think there is an issue, and I think that there are a lot of hedge fund salespeople out there who will tell you about S&P returns and Treasury bill risk and that you need to be sophisticated in terms of your ability to understand the markets, although—

Mr. GREEN. Mr. Brown, if I may, would you then say yes is the answer, that there should be something done about this commingling of sophisticated and unsophisticated funds?

Mr. BROWN. I'm concerned about it, but I'm not sure what to do.

Mr. GREEN. Okay. In a world where something can be done, would you do something?

Mr. BROWN. I think I probably would.

Mr. GREEN. Okay. Mr. Golden?

Mr. GOLDEN. I'm not entirely sure I understand the question.

Mr. GREEN. Well, it gets to the pensions. The pensions. The guy who happens to be a pipefitter who happens to have his pension fund invested in the hedge fund, he, by definition, may not be a sophisticated investor. You could have a Ph.D. and not be a sophis-

ticated investor. So, he's not a sophisticated investor. What about him? What about the fact that the taxpayer eventually picks up the tab if that pension fund loses money and he then has to have some sort of social benefit that taxpayers cover?

Mr. GOLDEN. I think the answer is no. I think it's definitely no at the level of the hedge fund. I think we have concerns about the safety of pension funds, and we should be focusing attention on those who manage the pension funds, and seeing whether or not they are operating in a prudent fashion, using proper elements of diversification.

Mr. GREEN. But your answer is that we should not do anything with reference to the commingling of the sophisticated and unsophisticated money?

Mr. GOLDEN. I guess I'm not sure that the pension fund money is unsophisticated, because there is a fiduciary involved at that point.

Mr. GREEN. Well, the guy who manages the pension fund, we're going to assume that he's sophisticated. But the guy who benefits, the person who receives the pension, I think we all agree that the overwhelming majority of them would not be classified as sophisticated investors, correct?

Mr. GOLDEN. Yes.

Mr. GREEN. All right. So they're the people who lose. And then the taxpayers pick up the tab. Should we do something to avoid that type of occurrence? And your position is you'd do it with the manager as opposed to with the fund itself?

Mr. GOLDEN. Right. Right. I agree with that. The manager of the San Diego pension fund that invested in Amaranth made a bad decision. They put too much money in Amaranth. Something people should be asking—the pipefitter should be asking the pension fund manager for San Diego why did you do that? And I—

Mr. GREEN. I agree with you, sir, that the pipefitter should pose this question, but the problem becomes the pipefitter still needs the social services. He has a family; he has children, and they need the social services that we, the taxpayers, seem to provide. So we still get back to the taxpayer having a vested interest in what happens to the pipefitter who had a manager who made an unsophisticated decision who is a sophisticated investor.

Mr. GOLDEN. So—and I understand completely, and I think the regulation should—the concern you should have is who is running these funds? If they're making bad decisions regularly, that's a real problem. The hedge fund is just doing its job, and I don't know if you can regulate that.

Mr. GREEN. Well, tell me this. How would you manage the managers such that we can do exactly what you're talking about?

Mr. GOLDEN. It's a great question. Off the top of my head, I don't know.

Mr. GREEN. Does anybody have an answer? Yes, sir?

Mr. CHANOS. Aren't we really talking about an ERISA issue here?

Mr. GREEN. Say again?

Mr. CHANOS. Aren't we really talking about an ERISA issue here, which is the way in which pension funds are managed and how those pension funds are advised? For example, self-directed pension

plans and 401(k)s, which we be more direct to what you're saying, aren't investing in hedge funds.

So really, that pipefitter is getting advice, or should be under ERISA, getting fiduciary responsible advice from an advisor, and that's always the case, for example, in our fund. We never talk to the underlying investor directly. There's always an advisor. That is where the nexus of this concern should be, and I think it is a really good question. But I think we're looking at it from the wrong side of the telescope.

Mr. GREEN. Do you really think that the majority of people who are pension investors, they have money in pension plans, do you really think that the majority of these persons are receiving the level of advice that they need in terms of what a sophisticated investor is and how that impacts their investments?

Mr. CHANOS. Well, if they're in a defined benefit plan, generally, yes, they are. I don't know of any pension, large pension funds that have failed due to one hedge fund investment.

Mr. GREEN. But we're not talking about the ones that have. We're looking to the future. Eventually we'll have that discussion. Thank you, Mr. Chairman.

The CHAIRMAN. And I would also note, one of our concerns is the public pension funds, so that you don't have the ERISA rules, and that is something we'll be looking at. Mr. Campbell?

Mr. CAMPBELL. Thank you, Mr. Chairman. Mr. Matthews and Dr. Brown, both of you in your presentations talked about leverage in hedge funds, and I don't mean the leverage in the investments, Mr. Corrigan, but the actual leverage in the fund investment itself. Is the degree and amount of that leverage transparent to the investors?

Mr. BROWN. To the informed investor, there's a whole industry out there for people to investigate and do due diligence. And if I were investing—I'm not a qualified investor—if I were investing a substantial portion of my wealth, I would certainly investigate. And the investor has every right to demand any kind of information they need to make an informed decision.

Mr. CAMPBELL. So I guess my question is that's not information that is readily available to an investor so an investor could be, I think Mr. Matthews had talked about a three to one leverage fund.

Mr. BROWN. Right.

Mr. CAMPBELL. So someone investing in that might not know—a sophisticated investor, I realize, or pension fund?

Mr. BROWN. My evidence is that sophisticated investors, as indicated by people who grant the leverage, the counterparties, they know and they have access to that information already, and it's evidenced by the fact that if you look at the ADV filings, and I've looked at 2,270 of them, that the sophisticated investors lending money already knew of the operational risk characteristics that were revealed in those forms. So they've done their homework, and the people who are lending money, and that's really the systemic risk concern that we have is what effect this is going to have on the financial system as a whole.

Mr. CAMPBELL. Does anyone else want to comment? I mean, just from my perspective, obviously, we're talking about multiplying the risk—

Mr. BROWN. Right.

Mr. CAMPBELL.—dramatically when you take what hedge funds invest in and add to that degrees of leverage. Yes, Mr. Brody?

Mr. BRODY. There's a wide range of sophistication among investors, and some will have a very good idea of what they're getting into and what the leverage is, and some will not. My view on the proper kind of registration is that a principles-based registration would require the disclosure of the important items to all investors, and that kind of disclosure then would benefit the unsophisticated—

Mr. CAMPBELL. Do any of you disagree with that?

Mr. HALL. Well, I'd put that in perspective. I think "leverage" is too simple a term to really have a whole lot of meaning. If you leverage Treasury bills or if you leverage Internet stocks, you have—or Internet stocks without leverage can be significantly more risky. So I'd be concerned about providing rules-based disclosure as opposed to principle-based regulation that makes people feel comfortable but they're really not.

Mr. CAMPBELL. Do any of you believe there's a proprietary issue there? I mean, part of the reasons that hedge funds don't disclose, as you said, is because they're using oftentimes proprietary methods. Yes, Mr. Chanos.

Mr. CHANOS. I think there's a big proprietary issue at work here, and we need to make the distinction between disclosure of leverage and positions to our investors and our counterparties and our custodians, and disclosure of positions to the general public.

Mr. CAMPBELL. Right.

Mr. CHANOS. And I think that's an important distinction, and I think that the committee understands, but I want to emphasize it. But quite frankly, and I know a number of people in the written testimony have touched upon this, I run a fund in addition to being an industry person, and our investors all have on-site inspection ability, and they take advantage of it.

They routinely come in, look at our books, look at our positions, query us over and over and over again. Talk to our counterparties, talk to our prime brokers. This type of due diligence is done all the time and increasingly so both from high net worth individuals, public and private pension funds. These people are doing their work. When we have these blow-ups, they are very much the exception to the rule.

Mr. CAMPBELL. Okay. The second question is about accredited investor. Do any of you, and anybody, you can answer this. Should that be changed? Is it right? Do you support the SEC's proposal to change the threshold? Anybody want to take that?

Mr. HALL. Well, I would support it. On behalf of the MFA, we would support it.

Mr. CAMPBELL. You support the SEC's proposal?

Mr. HALL. Yes.

Mr. CAMPBELL. Anybody else? I mean, do we have the right definition of accredited investor, or should it be changed?

Mr. CORRIGAN. I think the definition is as good as it's going to get. There's no way to perfectly define these things.

Mr. CAMPBELL. And the threshold is okay?

Mr. CORRIGAN. The threshold proposed by the SEC is a big improvement. I actually might go a little bit further, but that's another story.

Mr. BROWN. As one of the members said, it's not an issue of intelligence about such matters, it's about the degree to which you can afford any losses that you may incur. And that's the reason for that standard.

Mr. CAMPBELL. Okay. And then one last question.

Mr. GOLDEN. Can I just add?

Mr. CAMPBELL. Sorry.

Mr. GOLDEN. I'd like to see the threshold raised as high as is politically feasible, at least as high as the SEC's.

Mr. CAMPBELL. And one last little question for Mr. Chanos. We talked about this fortress company that went public and you said it was the management of the hedge fund. I'm just curious. People access the public markets for capital. Why would a manager of a hedge fund require capital?

Mr. CHANOS. Well, I think that it's not only for requiring capital but to possibly use their stock as currency for possible acquisitions, or to incentivize their senior and mid-level people perhaps through stock options. There are all kinds of reasons why companies go public that don't necessarily need the capital, so I think that's sort of a broader issue, perhaps beyond the purview of this panel.

Mr. CAMPBELL. All right. Thank you. I yield back, Mr. Chairman.

The CHAIRMAN. Thank you. I did just want to add one thing to Dr. Brown and the very useful and interesting questions Mr. Campbell is asking about what people know. Did I read you correctly as basically saying that even if you tell them, they don't pay any attention, they just chase returns? I mean, is that an accurate statement?

Mr. BROWN. That's an accurate statement.

The CHAIRMAN. So that you tell them that, but they don't—even the sophisticated ones, don't factor into account and just, as you say, chase returns?

Mr. BROWN. That's what the evidence seems to suggest. Either they don't know the information and they can't have access to it, which I find rather unusual, or they do have access to it and it's immaterial.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. I just have one question for the entire panel. Mr. Chanos, you earlier brought up Warren Buffett and his hedge fund history. He's fond of using the adage in describing hedge funds if a man with money proposes a deal to a man with experience, the man with money ends up with the experience and the man with the experience ends up with his money.

That's kind of the theme of what's been going on, and Mr. Buffett has become very critical of the hedge fund fee arrangements, as you may or may not know, and he calls the managers the 2 and 20 crowd. And I frankly think that he raises some very pertinent issues. How would you characterize the fairness and the accuracy of Mr. Buffett's comments?

Mr. CHANOS. Well, I don't want to put words in Mr. Buffett's mouth, but I—

Mr. CLEAVER. No, I'd like to give an exact quote. Hold on just a second. "It is a lopsided system whereby 2 percent of your principal is paid each year to the manager even if he accomplishes nothing, or for that matter, loses you a bundle and additionally, 20 percent of your profit is paid to him if he succeeds, even if his success is due simply to a rising tide."

Mr. CHANOS. All right. Well, I think those, while factually accurate, and he's entitled to his opinion, I would point out Mr. Buffett ran a hedge fund for 20 years, just about.

The CHAIRMAN. Well, it takes one to know one.

[Laughter]

Mr. CHANOS. So, again, perhaps he's speaking from personal experience, I don't know. But every hedge fund is different. Every business is different. Everything should be judged on the merits of its management team, its performance, and its fee structure, and to make blanket statements about every single hedge fund, something like that seems to me to be a bit strong. It's like saying, well, all of corporate America is not performing well for its shareholders, or every corporate executive is making too much money.

I mean, these are individual cases, and I think that while there's plenty of examples of hedge funds that aren't probably doing a good job and are charging fees that are too high, as one of my panelists said here that this market is pretty Darwinian, and it weeds out those people pretty quickly. If you're not performing, you don't tend to keep those assets very long.

Mr. CLEAVER. So the 2 and 20 crowd is actually a small crowd?

Mr. CHANOS. It's not a small crowd. In fact, it's a growing crowd.

Mr. CLEAVER. Or is it the in crowd?

Mr. CHANOS. But there's a reason it's growing, Mr. Cleaver, in that there is a reason. No one here has asked the question, why are we having this—because of the growth of the industry, obviously something must be happening here where relatively sophisticated investors want to put more money with these managers. It's not because simply they're hanging out a shingle in front of their house. There is good performance being done with less risk. That's why it's attractive in the aggregate. But individually and specifically, there will always be, as one of our members said, the fools and the frauds are going to make things difficult for most of the good actors.

Mr. HALL. If I may, it's important in my view, a semantic issue about the 2 percent of the 2 and 20 is on capital. And that doesn't, if you look at—if someone manages $100 million and takes a smaller fee, but 90 percent of their fund is coincident with the index, then they're really—their marginal benefit is only on a small portion of that $100 million, $100 billion.

So a hedge fund may manage a smaller amount of capital and charge a higher fee on a smaller amount of capital, then they also manage leverage, they manage short positions, they manage hedges. So, you really have to look at the services that one is providing for that fee, and percentage of fee on capital is not necessarily what the manager is ultimately getting compensated for.

Mr. BROWN. I need to make one clarification point on the 2 and 20 issue. You only earn the 20 once you've won back any losses

that you've incurred in the past. It's called a high water mark provision.

It's that high water mark provision that really enforces the Darwinian aspect of it, and, in fact, hedge funds are like radioactive substances. They have a half-life of 2½ years, typically, because, you know, you lose, you lose, you die in this world very quickly because you just aren't earning any returns.

Mr. CLEAVER. I yield back my time.

The CHAIRMAN. Thank you. Let me just ask two quick questions. One, we will be talking next time about—we were talking about how these things should run and do run in general. There are always aberrations with anything. The insider trading issue is one of the issues that we will be looking at next time, the SEC has been involved in.

One of the questions is, record retention for entities that are otherwise unregulated. Is that an issue? Should we look at that? That is, over and above everything else, there is an argument for record retention to be able to help law enforcement for the aberrant cases. I'd be interested in any comments.

Would there be objections to some kind of record retention requirement that for those—and I realize a lot of them already have them, because they're otherwise regulated. But would there be any objection to a generalized sort of record retention requirement for entities that otherwise didn't have them? Mr. Chanos?

Mr. CHANOS. I don't think our members would have—we have not canvassed them, but I don't think our members would have a problem with that.

The CHAIRMAN. Mr. Hall?

Mr. HALL. I think we would have no objection.

The CHAIRMAN. All right. I'm quitting while I'm ahead. The next question is one of the ones that some of the staff have suggested, and that is on the counterparty issue, the—who's in charge of the aggregates? I mean, obviously, you have each individual counterparty, but is anybody looking at the aggregate counterparty responsibility, and is that something that somebody should be looking at? Mr. Corrigan?

Mr. CORRIGAN. That—the short answer to that is no, because—

The CHAIRMAN. Nobody's looking at it or nobody should look at it?

Mr. CORRIGAN. Well, we should look at it, and we are making efforts through the regulatory process to better look at it through the regulated institutions, yes. But it's not easy.

The CHAIRMAN. Again, would there be objection if there was a way to do that that did not impinge on proprietary concerns?

Mr. BROWN. I would agree with that.

The CHAIRMAN. Mr. Chanos? Yes?

Mr. CHANOS. Let me just point out. We could look across the pond to our financial cousins in the United Kingdom who have a very interesting process through their FSA. Their FSA, it's my understanding, occasionally canvasses all of its major prime brokers and then canvasses them separately in relation to their specific hedge fund exposure and looks for cross—

The CHAIRMAN. So that would be a good thing to do?

Mr. CHANOS. I think it would be—

The CHAIRMAN. Well, good. If the FSA is— Mr. Corrigan?

Mr. CORRIGAN.—here, too, right now.

The CHAIRMAN. What's that, Mr. Corrigan?

Mr. CORRIGAN. We do that right now here.

The CHAIRMAN. Well, we might want to improve on that. These days if the FSA is doing it, one of the great passionate love affairs in the world today is between the American financial community and the FSA, except where it comes to executive compensation.

I understand no love affair is perfect, and the lover may have a blemish. And in fact, McCarthy was here the other day and said, yes, he is enjoying being the flavor of the month through the FSA. So both of those are areas I think we would pursue.

If you'll indulge us, the gentleman from Louisiana had one last question.

Mr. BAKER. I thank you, Mr. Chairman. Mr. Corrigan, I went back and looked at the written statement relative to Amaranth, and what I drew from your comments was had Amaranth occurred in an illiquid market, or where there was a crowded trade going on, the unwinding of it all may have been less pretty.

Mr. CORRIGAN. That's correct.

Mr. BAKER. And so the cautionary tale was, although we escaped it, let's not assume our system is functioning exactly as we would like to that end. I just wanted to do a quick wrap-up of sort of the elements I've drawn from this. Limitation on who gets in needs to be reviewed whether it's the individual's net worth standard, or whether it's pension fund management capability. And I'm adding one to the list which I don't think I've heard, and that is limitations more restrained on the fund of funds, the $25,000 entry fee into that, I think, is highly inappropriate in today's world.

Then establishing a benchmark of best practices, not only for the private investment company side, but—and I'm asking here—but shouldn't we do that as well on the counterparty side with the broker-dealer community, financials, insurance, whoever is playing with these guys needs to be required. And then last would be some sort of formal and/or informal exchange. For example, I'm not clear today, if I'm the counterparty and I see something that I think is ill-advised, when am I obligated to notify my regulator as to the hedge fund conduct, not my conduct, which I think is a lower standard of responsibility?

If we were to address those issues, do you feel that is an appropriate litany of steps to take in light of the relatively low systemic risk potential we think is likely to be in the near term?

Mr. CORRIGAN. I think the list is approximately right, and so long as we do it in a way that honors this more principles based as opposed to checking boxes approach, I think that's right.

Mr. BAKER. Thank you. Anybody want to comment? Mr. Hall?

Mr. HALL. I would agree with that.

Mr. BAKER. Great. Thank you very much, Mr. Chairman.

The CHAIRMAN. I thank you all. This is very useful in advancing our understanding, and the hearing is adjourned.

[Whereupon, at 12:43 p.m., the hearing was adjourned.]

APPENDIX

March 13, 2007

OPENING STATEMENT
GSE REFORM
CAPITAL MARKETS SUBCOMMITTEE
RANKING MEMBER SPENCER BACHUS
Monday, March 12, 2007

Thank you, Chairman Kanjorski, for holding this important hearing today on a frequently overlooked component of GSE reform: the Federal Home Loan Bank System.

This system of cooperatively owned institutions was established during the Great Depression to help facilitate liquidity for the extension of credit for the purchase of homes by individuals. Today, the bank system is composed of 12 separate districts with nearly 8,000 members and is enjoying a growth in its programmatic and financial activities as a result of several legislative changes through the years, most recently in the Gramm-Leach-Bliley Act of 1999.

Federal Home Loan Banks help create a liquid residential mortgage market, but they also promote small business financing and supply funds for affordable housing and community investment.

In light of these important responsibilities, Congress has the duty to ensure the safety and soundness of the Home Loan Bank System and to monitor whether the Banks appropriately satisfy their missions. As these institutions' financing and risk management strategies have become more complex in recent years, the need for vigilant congressional oversight has only increased.

Sound corporate governance is critical to the functioning of any enterprise. The arguments to include the Home Loan Banks in a better, stronger regulatory framework are consistent with the arguments to include Fannie Mae and Freddie

Mac. In my view, the benefits of better regulation will accrue not only to the taxpayer and financial system at-large but also to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Also, I understand that the Subcommittee Chairman has a long-standing interest in the issue of public interest board membership for these public-private institutions. I have been concerned that the Banks have not been operating with full boards of directors. However, I want to commend the Federal Housing Finance Board and its Chairman, Mr. Rosenfeld, for responding to this problem and issuing a sensible interim rule to fill these seats. The Finance Board is authorized to appoint public interest directors to the Banks' boards and it is my view that its proposed procedures will enhance its ability to appoint well-qualified individuals.

Homeownership is available today to more Americans than ever before, and further promoting homeownership – increasing access to the American Dream -- is a priority of the Republican members of this Committee. It is time to strengthen the GSEs' safety and soundness regulator, to ensure the regulator has the resources to do its job effectively and to ensure that America's system of housing finance is secure. By passing meaningful legislation, we can achieve these goals.

Statement of Congressman Michael N. Castle

Financial Services Committee hearing on
Hedge Funds and Systemic Risk in the Financial Markets

March 13, 2007

Thank you Chairman Frank and Ranking Member Bachus for holding this important hearing before the Financial Services Committee today.

Last month the Under Secretary for Domestic Finance at the Department of Treasury, Secretary Steele, reported on the tremendous influence hedge funds are having on our markets. The President's Working Group discussed how the number of hedge funds has more than doubled in the last five years, growing to over 9,000 funds today. Since their last study in 1999, the industry has grown by more than 400% totaling nearly $1.4 trillion. Last year, the combined assets of the 100 largest hedge fund firms represented about 65% of the total industry. Secretary Steele further explained the vast amount of trading volume hedge funds are generating, and speculated that they may represent up to 50% of trading in particular instances. The Treasury also discussed how institutional investors, like pension funds, constitute more than half of investments in hedge funds.

With pension funds placing more of their money in hedge funds workers, retirees, and other average investors may unknowingly be exposed to hedge fund losses. The President's Working Group recommended that investors in hedge funds gather necessary information regarding the fund's "strategies, terms, conditions and risk management" to make informed investment decisions and perform due diligence. Yet, hedge funds are not legally required to disclose this information. I am concerned with this lack of transparency, because the manager of a pension fund cannot fulfill their fiduciary duty and may not understand the risk of their investments to perform due diligence before committing funds.

This lack of transparency in the industry also poses systemic risk to the financial markets. The Long-Term Capital Management incident showed how overexposure of counterparties has the potential to cause system wide damage to financial markets.

After Long-Term Capital Management incident, the Federal Reserve expressed concerns about the systemic risk hedge funds pose to the financial markets. At that time, the President's Working Group recommended that the very largest hedge funds be required to disclose information about their financial activities, including meaningful and comprehensive measures of market risk. The Working Group now concludes that no government agency needs any information about hedge fund activities, and that we can rely on hedge fund investors themselves to protect the markets from systemic risk. It is unclear to me why the Treasury now appears a lot less cautious than they were in 1999, since the industry has grown considerably.

During the last Congress, I introduced legislation requesting the President's Working Group on Financial Markets to conduct a study on this evolving industry and make certain recommendations regarding hedge fund disclosure based on this information. The bill passed the House however it was not introduced in the Senate. I will continue to follow the developments in the House Financial Services Committee pertaining to hedge funds and determine if it is necessary to legislate in this area.

Mr. Chairman, I thank you for holding this important hearing today and I look forward to hearing from our witnesses and learning more about this industry.

Opening Remarks Honorable Maxine Waters D-35th CA

Committee on Financial Services

Hearing on

"Hedge Funds and Systemic Risk in the Financial Markets"

Tuesday, March 13, 2007

2128 Rayburn House Office building
10:00AM

Good morning ladies and gentlemen. I want to thank Chairman Frank and Ranking Member Bachus for holding the first of a series of hearings on the issue of hedge funds. These hearings are designed to examine the emerging role of hedge funds and private equity pools in the U.S. and global markets.

Indeed, this is a timely hearing because I have become fascinated by hedge funds and their dramatic growth over the last several years. The estimates suggest that hedge funds have grown in number to more than 9,000, double what they were just five years ago. The assets have also grown by some 400 percent to $1.4 trillion. The primary purpose of hedge funds is to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions. Have the funds grown because they are the most flexible investment tool in today's volatile financial system?

I ask this question because, just last week it was revealed that a number of hedge funds are heavily invested in mortgage backed securities related to subprime loans. Unfortunately, it is precisely this type of investment

activity that raises concern in the market place. I am sure that we have just seen the tip of the iceberg as it relates to subprime lending – 2.2 million defaults according to some estimates by next year.

Interestingly, some hedge fund strategies are designed to capitalize on these negative conditions in the market. So, what are the costs/benefits associated with hedge fund activity in the U.S and global economy? Thank you.

WRITTEN TESTIMONY OF
KENNETH D. BRODY,
TACONIC CAPITAL ADVISORS, LP
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
March 13, 2007

Taconic Capital Advisors, LP ("Taconic Capital") appreciates the opportunity to testify before the House Committee on Financial Services on "Hedge Funds and Systemic Risk." The number of private pools of capital has grown in recent years, as have the aggregate amount of assets managed via private pools and the share of trading in U.S. public capital markets accounted for by private pools. The Treasury Department recently estimated hedge fund assets under management at $1.4 trillion, an increase of more than 400% since 1999.[1] The Securities and Exchange Commission ("SEC") has cited estimates that hedge funds account for approximately 10 to 20 percent of U.S. equity trading volume.[2]

These developments have led policymakers, in the United States and in other jurisdictions, to study their implications both for financial markets in general and for investors in private pools in particular. Issues of systemic risk and investor protection are perhaps receiving the greatest attention. Chairman Frank and the Committee on Financial Services are to be commended for taking part in this debate and for advancing the ongoing dialogue on the appropriate regulation of private pools of capital, including what are commonly referred to as "hedge funds."

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[1] "Remarks of Treasury Under Secretary for Domestic Finance Robert K. Steel on Private Pools of Capital," Treasury Department Cash Room, Washington, DC (February 27. 2007).
[2] Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Rel. No. IA-2333, (December 2, 2004), at 4.

Background Information on Taconic Capital

Founded in 1999, Taconic Capital is registered with the SEC as an investment adviser. Taconic Capital manages seven hedge funds, totaling approximately $5 billion under management. Our staff of 60 includes 20 investment professionals. Taconic Capital's funds are primarily event-driven and its management philosophy is characterized by teamwork and collegiality. Taconic is a strategically conservative firm. It strongly supports a prudent risk taking mentality throughout the organization and adheres to stringent risk controls at all times in its investment portfolios.

Kenneth D. Brody is a co-founder of Taconic Capital. In addition, his relevant experience on hedge fund and capital market issues includes his service as Chairman of the Investment Committee of the University of Maryland and his position as a general partner and member of the management committee of Goldman, Sachs & Co. At the University of Maryland, he supervises the allocation of endowment funds among asset classes and investment strategies, including hedge funds.

Executive Summary

At least since the collapse of Long Term Capital Management in 1999, legislators and regulators in the United States and other jurisdictions have been grappling with the systemic risk and investor protection issues raised by the growth of private pools of capital, including hedge funds. Since that time, hedge funds have become even more important in the capital markets, as measured by their asset size and their share of trading in public securities. At the same time, the profile of investors in hedge funds has

expanded from wealthy individuals to institutional investors such as endowments and finally to public and private pension funds.[3]

With regard to systemic risk, Taconic Capital believes that hedge funds in the aggregate reduce systemic risk in the global capital markets. Regulation of hedge funds with the intention of reducing systemic risk would do little to improve stability in capital markets and would run the risk of actually increasing instability by reducing the benefits that hedge funds contribute to markets. These benefits are well recognized. The President's Working Group on Financial Markets stated in 1999, "In general, active market participants such as hedge funds can provide benefits to financial markets by enhancing liquidity and efficiency. Additionally, they can play a role in financial innovation and the reallocation of financial risk."[4]

With regard to investor protection, Taconic Capital believes that mandatory registration of hedge fund managers as investment advisers with the SEC would promote self-policing and internal discipline. Taconic Capital is mindful that an effort by the SEC to require the registration of certain managers as investment advisers was overturned in court on the technical basis of whether the SEC could change the definition of "client" to embrace not just a fund but the investors in that fund.[5] Nonetheless, the enhancements to investor protection resulting from mandatory registration suggest that it is an appropriate policy option for Congress to consider. To best secure these benefits and produce the most effective form of regulatory oversight, Taconic Capital suggests that SEC regulation

[3] "The investor base has changed from a largely high net worth, both on shore and off shore, to a more institutional investor base." Comments of Michael Neus of Andor Capital Management, SEC Hedge Fund Roundtable, Day 1, at 38.
[4] President's Working Group Report on Long Term Capital Management, at 2.
[5] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006). "The Commission cannot explain why 'client' should mean one thing when determining to whom fiduciary duties are owed…and something else entirely when determining whether an investment adviser must register under the Act."

and inspections of hedge fund managers focus on adherence to certain key elements described under "Discussion of investor protection" below.

Definition of hedge fund

For discussion of the systemic risk and investor protection issues raised by hedge funds to be meaningful, one must first set out a definition of "hedge fund" as distinguished from public or other private pools of capital. Taconic Capital suggests the following definition of "hedge fund" and will adopt it for purposes of this testimony. Taconic Capital considers a hedge fund to be:

- A private pool of capital – one raised without a public offering of securities;
- That invests primarily in publicly-traded securities and publicly-traded instruments other than securities, such as futures and currencies;
- That is managed by a professional manager – one engaged principally in the management of financial assets;
- Where the managers are entitled to compensation in the form of a share of the profits they generate on behalf of the pool; and
- Where the size of the pools advised by the manager aggregates to more than $25 million.

The hedge funds that would be encompassed by this definition are diverse in nature and it is difficult to make generalizations about them. Some use mathematical models to determine investment strategies while others rely on human judgments on which securities to buy or sell. Some sell securities short while others do not. Some use

significant leverage while many do not use leverage. The differences that exist among hedge funds are too numerous to list.

Discussion of systemic risk

From the collapse of Long Term Capital Management in 1999 to the collapse of Amaranth in 2006, public dialogue regarding hedge funds has included discussion of systemic risk. Some suggest that the growth of hedge funds in itself has raised the level of risk in the global financial system. Others express concern that the collapse of a hedge fund could initiate shock waves that would travel throughout the financial system, causing the failure of intermediaries or other financial institutions via ripple effect. The use of leverage by hedge funds is often cited as a principal factor increasing the risks of a systemic disturbance.[6]

On the other hand, regulators identify many other and more significant areas of potential systemic risk. For example, the most recent Financial Stability Report issued by the Bank of England identified six main sources of vulnerability in the financial system. The growth of hedge funds was not among them. The Bank's Deputy Governor, Sir John Gieve, has stated that he believes that hedge funds would not have been listed even had the report covered the next six sources as well.[7] He has further stated that central bankers and financial regulators believe that the greatest risk to stability is posed by the key intermediaries at the center of the financial system. The substantial role played by hedge

[6] "Hedge funds vary greatly in their use of leverage. Nevertheless, compared with other trading institutions, hedge funds' use of leverage, combined with any structured or illiquid positions whose full value cannot be realized in a quick sale, can potentially make them somewhat fragile institutions that are vulnerable to liquidity shocks." President's Working Group Report on Long Term Capital Management, at 5.

[7] Speech by Sir John Give, Deputy Governor, Bank of England, HEDGE 2006 Conference (October 17, 2006).

funds in today's sophisticated markets, allowing for the transfer of risk from parties who do not want it to parties that do, reduces systemic risk.

The benefits of hedge funds have been further elaborated by SEC Chairman Cox, who testified last year that hedge funds "provide investors and our national securities markets with tangible benefits. They contribute substantially to capital formation, market efficiency, price discovery, and liquidity."[8] Taconic Capital believes that these contributions would be undermined by the imposition of direct regulatory requirements, such as capital levels or leverage ratios, on hedge funds. In addition, hedge funds may choose to organize outside the United States to avoid such requirements.[9]

Taconic Capital agrees with the recent conclusion of the President's Working Group that "market discipline most effectively addresses systemic risks posed by private pools of capital."[10] Hedge funds' creditors and counterparties tend to be sophisticated financial institutions. These institutions have the ability and the incentive to limit their exposures in case of default, which in turn reduces the likelihood that a hedge fund's default could endanger the stability of the financial system as a whole. In addition, the risk management systems and operational capabilities of these intermediaries are subject to oversight by Federal banking and securities regulators. Federal regulators show every sign of vigorously monitoring these aspects of the firms they supervise. The President's Working Group issued the following specific injunction:

> Supervisors should clearly communicate their expectations regarding prudent management of counterparty credit exposures, including those to private pools of

[8] Testimony of SEC Chairman Cox before the Senate Committee on Banking, Housing and Urban Affairs, July 25, 2006, at 2.
[9] "...if the expense of regulation becomes too great relative to reducing opportunities, then I think you'll see people seek other locations or jurisdictions... Remarks of Robert Steel of Goldman Sachs & Co., SEC Hedge Fund Roundtable, Day 2, at 69-70.
[10] Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, at Paragraph 2.

> capital and other leveraged counterparties, who are increasingly utilizing complex instruments, including certain over-the-counter derivatives and structured securities, such as collateralized debt obligations. Because key creditors and counterparties to pools are organized in various jurisdictions, international policy collaboration and coordination are essential.[11]

The Working Group went on to say that regulators should review their guidance and revise their policies to take into account developments in financial markets and advances in best practices.[12]

<u>Discussion of investor protection</u>

Under current law, hedge fund managers may be able to rely on the "private adviser exemption." The Investment Advisers Act of 1940 exempts from registration any adviser who "has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser" to a registered investment company.[13] Taconic Capital believes that nearly all large hedge fund managers run fewer than fifteen separate hedge funds and therefore are not currently compelled to register. However, many remain registered with the SEC voluntarily.

While the application of the private adviser exemption to hedge fund managers may have promoted public policy objectives in past years, changes in the financial markets make it appropriate for policymakers to review this application. In particular, the changing profile of hedge fund investors has raised legitimate investor protection concerns. Direct investments in hedge funds remain off-limits for retail investors. The

[11] Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, at Paragraph 10.
[12] Id. at Paragraph 10.1.
[13] 15 U.S.C. Sec. 80b-3(b)(3).

SEC has recently proposed changes to the definition of "accredited investor" with the stated intent of ensuring that retail investors not access hedge funds directly.[14]

Investor protection concerns arise, however, because the indirect participation of individuals in hedge funds has increased through pension fund investments. This in turn raises concerns about the protection of the ultimate beneficiaries of such institutional investors. The President's Working Group recently placed emphasis on the sound practices and due diligence responsibilities of the fiduciaries that manage vehicles such as pension funds.[15]

While it is appropriate to insist that fiduciaries meet their responsibilities, mandatory registration of hedge fund advisers with the SEC as investment advisers would further enhance investor protection at an acceptable cost, primarily by promoting self-policing and internal discipline. Taconic Capital believes that the following key elements of the current investment adviser registration regime promote investor protection:

- Requirement that adviser designate a chief compliance officer. Every registered investment adviser is required to designate a chief compliance officer.[16] The chief compliance officer must administer the firm's compliance policies and procedures. The SEC specified that the chief compliance officer "should be competent and knowledgeable regarding the Advisers Act and should be

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[14] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Rel. No. 33-8766 (December 27, 2006). "...many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments." Id. at 17.
[15] Id. at Paragraph 5.
[16] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IA-2204 (December 17, 2003).

empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm."[17]

- Requirement of written compliance polices and procedures. The rule also requires every registered investment adviser to adopt written compliance policies and procedures.[18] An adviser's policies and procedures must take into account the nature of the firm's operations. At a minimum, the SEC requires that the policies and procedures address portfolio management processes; trading practices; proprietary trading of the adviser and personal trading activities of supervised persons; the accuracy of disclosures made to investors, clients and regulators; safeguarding of client assets; the accurate creation and maintenance of required records; the marketing of advisory services including the use of solicitors; the process of valuing client holdings and assessing fees based on those valuations; safeguards for the privacy protection of client records and information; and the adoption of a business continuity plan
- Code of ethics. SEC rules require registered investment advisers to adopt codes of ethics setting forth standards of conduct that will apply to advisory personnel.[19] Among other things, codes of ethics must be drafted to (i) set forth standards of conduct and compliance with securities laws expected of advisory personnel that reflect the investment adviser's fiduciary obligations, (ii) safeguard material nonpublic information about the adviser's securities recommendations and client holdings and transactions, and (iii) require that "access persons" of an investment adviser report their personal securities transactions.

[17] Id. at 10.
[18] Id. at 5.
[19] 17 C.F.R. 275.204A-1.

- Filing of Form ADV. All registered investment advisers are required to maintain a two-part Form ADV and to deliver Part II of the Form in satisfaction of Rule 204-3 under the Advisers Act (the "brochure rule"), which requires a registered investment adviser to provide certain written disclosures to prospective and existing clients at specified times. These rules benefit investors because they receive more complete information about fees, expenses and conflicts of interest than they might otherwise receive. The Form ADV also enables a prospective client to easily access information about an adviser's ownership structure and about the regulatory history of the investment adviser and its associated persons.
- Independent custodian requirements. The Advisers Act custody rule requires registered advisers that have custody of client funds and securities to maintain controls intended to protect those assets from loss, misuse or misappropriation.[20] The custody rule further states that an investment adviser to a pooled vehicle who also serves as a general partner to that pooled vehicle is deemed to have custody of that vehicle's assets. All client assets of registered investment advisers are required to be held by a qualified custodian -- a bank, trust company, broker-dealer, futures commission merchant or foreign financial regulatory institution. In addition, the custody rule effectively requires that pooled vehicles be audited in accordance with Generally Accepted Accounting Principles on an annual basis, because most advisers to pooled vehicles that are subject to the custody rule choose to have those vehicles audited in order to avoid the more burdensome reporting requirements imposed by the rule.

[20] 17 C.F.R. Sec. 275.206(4)-2(a).

- SEC on-site inspection and examination. Given the performance fee compensation that hedge fund managers stand to earn, they may have an incentive to inflate the value of their assets. Inflating asset values may also allow managers to hide losses. The possibility that the SEC will conduct an on-site examination will tend to discourage unscrupulous managers from mispricing securities, inflating asset values or falsifying performance information provided to investors. Consequences of unlawful conduct include fines, disgorgement, and industry suspensions and bars. While it will not deter all fraud, the prospect of an examination will discourage wrongdoers. The inspection and examination process also incentivizes registered investment advisers to follow their compliance policies and procedures and to keep them updated.
- Retention of books and records. SEC rules require a registered investment adviser to make and maintain a number of books and records, with the objective of promoting fair treatment of the adviser's clients.[21] These include records of all receipts and disbursements of cash; memoranda of each order for the purchase or sale of any security; certain communications sent to clients; and certain books and records used to calculate performance or rate of return.

At this point, it should be clear that Taconic Capital believes that hedge fund managers should be registered with the SEC under a robust investment adviser regulatory regime. However, Taconic Capital also believes that the current regime can be improved. In general, we believe a more "principles-based" approach would increase regulatory efficiency and thereby promote investor protection. As Treasury Secretary Paulson stated in a recent speech before the Economic Club of New York:

[21] 17 C.F.R. Sec. 275.204-2.

> "The advantage of a principles-based system is that it is flexible and sensible in dealing with new or special situations. A rules-based system typically gives more specific guidance than a principles-based system, but it can be too rigid and may lead to a 'tick the box' approach."[22]

The nature of hedge fund investors – wealthy individuals and institutions – suggests a different regulatory framework than that which is appropriate for advisers with retail clients only. A one-size-fits-all regulatory approach that does not take into account such elements as a fund's client base, investment focus or other potential risk factors is neither flexible nor effective. The SEC can and should adopt a more prudential approach, working with regulated entities to improve compliance. This would promote investor protection by increasing attention on areas of greatest importance. It could also increase the deterrent effect of SEC examinations by making inspections more efficient and thus more numerous. Of course, a vigorous enforcement regime for those who violate regulatory principles remains essential.

Taconic Capital wishes to make clear that it does not believe the SEC should, through the investment adviser regulatory process, evaluate the investment strategies of hedge fund managers. As the President's Working Group noted, hedge funds and other private pools often "involve complex, illiquid or opaque investments." So long as hedge funds remain unavailable to retail investors, it is appropriate that hedge fund investors themselves bear responsibility for identifying and assessing the risks of investing in a particular fund and their appetite for bearing these risks. SEC regulation and inspection of hedge fund managers registered as investment advisers should focus on adherence to key principles of investor protection. As may be inferred from the list of investor protection elements described above, these include compliance systems designed to

[22] "Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets," Economic Club of New York, New York, NY (November 20, 2006).

prevent fraud and conflicts of interest; adequacy of adherence to those compliance systems; and accuracy of disclosures to investors.

Conclusion

Pools of capital – from mutual funds to insurance companies – have generally been subject to regulation under Federal or State law. Hedge funds have historically been exempt from direct regulation because of their private nature. Taconic Capital believes that direct regulation of hedge funds is unlikely to reduce systemic risk and would threaten to undermine the benefits of efficiency, liquidity and risk transference that hedge funds bring to capital markets. Taconic Capital further believes that registration of hedge fund managers as investment advisers would promote investor protection, an appropriate goal given the growth of hedge funds and the increasing role of pension funds as hedge fund investors. Taconic Capital stands ready to work with the Committee, the Congress, and the Executive Branch to develop appropriate public policy regarding hedge funds.

KENNETH D. BRODY

Kenneth D. Brody is a co-founder of Taconic Capital Advisors LLC, an investment firm focused on event investing.

Mr. Brody served as President and Chairman of the Export-Import Bank of the United States from 1993 to early 1996. Prior to his government service, Mr. Brody spent twenty years at Goldman, Sachs & Co. where he was founder and head of High Technology Investment Banking, head of Real Estate Investment Banking, and Co-head of Principal Investing. He was a general partner and a member of the firm's management committee.

Mr. Brody has served on the boards of directors of Quest Diagnostics Incorporated, Alex Brown Incorporated, Federal Realty Investment Trust, and Telerate Incorporated. He serves as the Chair of the investment committee of the University of Maryland. Mr. Brody is also a member of the Council on Foreign Relations.

Mr. Brody received a Bachelor of Science in Electrical Engineering degree with high honors from the University of Maryland and a Master of Business Administration degree with high distinction from the Harvard Business School, where he was a Baker Scholar. Mr. Brody was in the United States Army from 1966-69, attaining the rank of Captain.

Stephen J. Brown
David S. Loeb Professor of Finance, NYU Stern School of Business

Testimony before the
U.S. House of Representatives
Committee on Financial Services
"Hedge Funds and Systemic Risk in the Financial Markets"
Hearing held on March 13, 2007

The President's Working Group on Financial Markets tells us that "private pools of capital bring significant benefits to the financial markets." What are these benefits? Some would tell us that their only objective is to enrich themselves and their rich clients. The industry needs to show that these benefits outweigh the problems they cause. A premise of the PWG is that hedge funds do ***not*** pose a systemic risk for the financial markets.

What is a hedge fund? The term actually comes from Carol Loomis, a *Fortune* journalist writing in 1966 about the strategy of AW Jones who invested in undervalued companies financed in part by short positions in companies he felt were overvalued. In this sense the investment was "hedged" against general market movements. The term "hedge fund" was a stretch even for AW Jones as his short positions never equalled the size or economic significance of his long positions.

Subsequent funds adopted the regulatory form of AW Jones, but not his investment philosophy. Indeed, the term "hedge fund" belies their considerable risk. Sophisticated investors should be allowed to do as they please, provided they not hurt innocent bystanders. Unfortunately, the industry interprets the general solicitation ban as limiting all kinds of public disclosure. Indeed, some view lack of transparency as part of their business model. I argue that it is this lack of information, this lack of transparency at an industry level, that is of greatest concern.

Absent industry wide disclosure, the only reliable information we have is the purely voluntary disclosure to data vendors such as Lipper TASS. According to their numbers U.S. domiciled funds have grown from close to $20 Billion assets under management in December1995 to $131 Billion today.

The data show a remarkable diversity of styles of management under the "hedge fund" banner. The AW Jones long-short strategy captures about 30 to 40 percent of the business. The style mix has been fairly stable (in terms of percentage of funds) although there has been a dramatic rise in assets managed by funds of funds. These diversified portfolios of hedge funds are attractive to an institutional clientele. Event-driven funds focussing on private equity have risen in market share from 19% to 25% over the past decade, while the global macro style popularized by Soros has actually fallen from 19% to 3%.

There is concern about the role of hedge funds in the credit derivatives and CDO markets. How big is this issue? We don't know since the industry is not required to tell us. But based on TASS fixed income arbitrage is just 4 percent of the hedge fund business. The industry should make the case that entering this market, their 'rich clients' are taking on significant risk which would otherwise fall on the banking system. They are thus reducing systemic risk, not increasing it.

What about leverage? According to TASS the fraction of funds that use leverage has fallen from 69 percent in 2002 to 57 percent today. In addition, there are vast differences in the

degree of leverage across funds. Strategies that report the highest degree of leverage have quite small market share.

More information would certainly help. But does the general lack of transparency detract from the due diligence of sophisticated investors? With colleagues I studied the recent controversial and ultimately unsuccessful SEC attempt to increase hedge fund disclosure. We examine disclosures filed by many hedge funds in February 2006. Leverage and ownership structures as of December 2005 suggest that lenders and hedge fund equity investors were already aware of hedge fund operational risk revealed in these forms. However, operational risk does not mediate the naive tendency of investors to chase past returns. Investors either lack this information, or regard it as immaterial

What is the role of government? Perhaps Congress needs to revisit the '40 Act. The "sophisticated investor" exemption seems quaint. The industry argues that the ban on direct solicitation inhibits disclosure. However, Congress can mandate any level of selective disclosure necessary for 3C1 or 3C7 exemption. There is no need to know proprietary trading information. However, by being more forthcoming, the industry could allay public concern about systemic risk and operational risk.

Appendix to the Testimony of Stephen Brown 3/13/2007

Assets under management ($Million) U.S. Domicile Hedge Funds

	12/31/1995		12/31/2000		12/31/2005		12/31/2006	
Convertible Arbitrage	$720	4%	$2,282	4%	$1,529	1%	$809	1%
Dedicated Short Bias	$191	1%	$881	1%	$897	1%	$592	0%
Emerging Markets	$528	3%	$495	1%	$1,518	1%	$1,093	1%
Equity Market Neutral	$340	2%	$3,293	5%	$5,677	4%	$4,585	3%
Event Driven	$3,624	19%	$9,630	16%	$35,894	26%	$32,279	25%
Fixed Income Arbitrage	$517	3%	$1,490	2%	$5,931	4%	$4,980	4%
Fund of Funds	$1,699	9%	$7,399	12%	$25,169	18%	$17,190	13%
Global Macro	$2,532	13%	$488	1%	$2,103	2%	$3,303	3%
Long/Short Equity Hedge	$7,537	39%	$30,838	50%	$42,901	31%	$45,921	35%
Managed Futures	$1,476	8%	$2,026	3%	$9,625	7%	$10,644	8%
Multi-Strategy	$367	2%	$2,619	4%	$8,143	6%	$9,629	7%
Total	$19,531	100%	$61,440	100%	$139,386	100%	$131,024	100%

Number of U.S. Domicile Hedge Funds

	12/31/1995		12/31/2000		12/31/2005		12/31/2006	
Convertible Arbitrage	24	4%	37	4%	40	3%	36	3%
Dedicated Short Bias	10	2%	15	1%	12	1%	11	1%
Emerging Markets	15	3%	23	2%	25	2%	25	2%
Equity Market Neutral	17	3%	52	5%	75	6%	68	6%
Event Driven	63	11%	118	11%	142	11%	118	11%
Fixed Income Arbitrage	13	2%	29	3%	62	5%	48	4%
Fund of Funds	87	16%	146	14%	221	17%	184	17%
Global Macro	18	3%	22	2%	43	3%	35	3%
Long/Short Equity Hedge	191	35%	473	46%	524	40%	429	39%
Managed Futures	97	18%	82	8%	94	7%	87	8%
Multi-Strategy	13	2%	39	4%	64	5%	50	5%
Total	548	100%	1036	100%	1302	100%	1091	100%

Source: Lipper TASS Database 3/5/2007

TESTIMONY OF JAMES CHANOS
CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON HEDGE FUNDS
AND SYSTEMIC RISK IN THE FINANCIAL MARKETS

March 13, 2007

Chairman Frank, Ranking Member Bachus, and members of the Committee on Financial Services. My name is James Chanos, and I am President of Kynikos Associates, 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" or "the Coalition"), whose members and associates manage or advise more than $60 billion in assets.[2] I would like to thank the Chairman and Ranking Member for inviting us to participate in today's important hearing.

The Coalition welcomes the attention of this Committee on our industry. Rapid growth in all alternative investment funds – whether they call themselves hedge funds, private equity or venture capital – has brought significant rewards to investors and the financial markets. But, to paraphrase the great Stan Lee, with great growth comes great

1 Prior to founding Kynikos Associates, 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.

2 Our members are diverse in size and in the investment strategies they pursue. While most of our members are multi-strategy funds that trade a range of financial instruments, some are long-short equity funds, some pursue strategies that are event-driven, and several are fundamental short funds.

responsibility. This responsibility derives from the industry's more prominent role in various parts of the financial markets, its visibility in leading more activist shareholders who are willing to challenge management plans at public companies, and, perhaps most importantly, the trust placed in our managers to properly invest the assets of our investors, including pension funds and endowments – institutions whose ultimate beneficiaries are not themselves wealthy individuals.

Consequently, hearings such as this present a unique opportunity for our industry to explain the way it works, dispel some of the myths and misconceptions that surround it, and make clear our commitment to work with policymakers in the Congress and in the financial regulatory agencies, in order to improve those areas where the system of oversight may not be keeping pace with the growth of this sector.

Overview / Summary

CPIC would like to suggest a few ideas that may be useful in thinking about the issues associated with private pooled investment vehicles.

First, almost all private investment pools – whether a hedge fund, venture capital fund or private equity fund – share many common characteristics in terms of their disclosures to their investors and counterparties without detailed government mandates. Consequently, we would suggest that policymakers, instead of creating distinctions between these types of entities, treat all private pooled investment vehicles similarly, regardless of their underlying investment strategies. Even though we may all use the term "hedge fund" in the context of today's hearing, the most accurate phrase is not "hedge fund" as much as "private investment company."

Second, in terms of investment activity – the buying or selling of securities or commodities or derivatives or foreign currency – hedge funds are but one type of many market participants engaged in the same activity. For example, in order to gain the most complete understanding of the collateralized debt obligation ("CDO") market – to use one of the examples from the letter of invitation – one should not focus solely on a single segment of the market but should look at all of the participants engaged in that activity. Looking at CDOs solely through the prism of hedge funds, without looking at banks, investment banks, insurance companies, and other types of dealers and investors will create a distorted picture of how and why that market operates as it does. A focus on the *activity* rather than the *actor* is more likely to yield the information desired by policymakers in assessing the appropriate level of oversight and regulation.

Third, the phrase "lightly regulated," which typically is applied to hedge funds and other alternative investment vehicles, is somewhat misleading, as it really only applies to governmental regulation of the relationship between the fund (and its manger/advisor) and its investors. In this area, sophisticated or institutional investors are deemed by the government to have the capacity and equal footing to obtain the requisite information from fund managers on their own, instead of relying on standardized government-mandated disclosures, such as those required for registration of securities under the Securities Act of 1933,[3] or relying upon the mandates of the Investment Company Act of 1940[4] and its governance of the relationship between advisers and the pools of capital they manage. In almost all other aspects of the U.S. financial system,

[3] 15 U.S.C. § 77a *et seq.*

[4] 15 U.S.C. § 80a-1 *et seq.*

hedge funds are subject to the same web of statutory and regulatory requirements as all other institutional market participants engaged in the same activities.

Fourth, the so-called secrecy surrounding hedge funds is actually a consequence of both the proprietary nature of the investment strategies employed, and of the mandates of the Securities and Exchange Commission ("SEC" or "Commission") itself. The SEC's restrictions on general solicitations and public offerings, under which all hedge funds operate, prohibit fund managers from discussing their strategies and performance in any venue or in any way that could be construed as a solicitation of investment from the general public. Certainly, it means that fund managers must limit the content of or access to their websites and limit public interviews about their funds and investment strategies that could be viewed as designed to attract the interest of the general public to invest in the funds. Accordingly, most fund managers prefer to err on the side of less public discussion, rather than risk running afoul of the SEC.

Fifth, if there are gaps in the system of regulatory oversight, there should be ways to address them, consistent with the Principles and Guidelines recently issued by the President's Working Group on Financial Markets.[5] Such deficiencies can be addressed without trying to shoehorn this institutional business into statutes that were designed primarily for the interaction of investment professionals and the general public. In this regard, we have some suggestions for consideration that we will describe later in the testimony.

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[5] Press Release, Dep't. of Treasury, Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, (Feb. 22, 2007) *available at* http://www.treasury.gov/press/releases/reports/hp272_principles.pdf).

Importance of the Hedge Fund Industry to the Financial Markets

The financial and capital markets in the U.S. and in the developed world have been stunningly successful in providing capital and financing for economic growth and development, both in the U.S. and abroad. Our markets benefit from a wide diversity of players -- 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. While hedge funds are but one category of market participant, they serve a vitally important role in the U.S. and global markets -- a role repeatedly acknowledged by the President's Working Group on Financial Markets, as well as all of its members individually: the Commodity Futures Trading Commission ("CFTC"), the SEC, the Department of the Treasury, and the Federal Reserve Board.

As the SEC has said, there is no statutory or regulatory definition of the term "hedge fund." The term generally is used to refer to privately-offered investment funds that invest primarily in liquid securities and derivatives, that are managed by professional investment managers, that in many cases use leverage, short-selling, active trading and arbitrage as investment techniques, and that are exempt from registration under the Investment Company Act. Interests in these funds are sold in private offerings, primarily to high net worth individuals and institutions.

Hedge funds are as diverse as the individual managers who run them. They may invest in or trade a variety of financial instruments, including stocks, bonds, currencies, futures, options, other derivatives and physical commodities. Although funds that invest

primarily in illiquid assets such as real estate, venture capital and private equity generally are not considered "hedge funds," some hedge funds invest to some degree in private, illiquid investments. Some invest in securities and hold long term; some are fundamental short funds; and some are long-short funds. Some are strictly traders. Many serve as important counterparties to other players 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. Indeed, some of the most talented individuals in the financial markets are hedge fund managers, who 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.

Regulation of Hedge Funds

One of the greatest misconceptions about the hedge fund industry is that fostered by the media, which calls hedge funds "lightly regulated." This description really only applies to one aspect of any hedge fund's business. In terms of the interaction and flow of information between the hedge fund and its investors, it is true that the regulatory requirements are less than those mandated elsewhere by the federal securities laws. However, as a substantive matter, we believe that the "average" hedge fund investor or prospective investor has as good an understanding of the risks and rewards associated with his or her investment, including the costs and fees involved, as does the average investor in any other private placement or in any mutual fund, or even the average shareholder gleaning information from the reports required of public companies.

This is, in fact, the way the system is supposed to work. By limiting hedge fund investors to those who can be presumed to have the requisite investing skills themselves or the capacity to hire expert advice, hedge funds are, by-and-large, held to very high standards by those investors.

The conditional exemptions under which hedge funds operate in offering their securities to this limited class of investors were enacted by Congress and implemented by the SEC and CFTC, through carefully crafted rules, developed in notice and comment rulemakings and in recognition of the importance and functions of private investment funds to investors and to the markets.[6] With respect to their actual trading or other investment activities, hedge funds are subject to the same restrictions as most other securities investors, including such requirements as the margin rules[7] (which limit their use of leverage to purchase and carry publicly traded securities and options), SEC Regulation SHO[8] (which regulates short-selling), the Williams Act amendments to the Securities Exchange Act of 1934[9] and related SEC rules (which regulate and require public reporting on the acquisition of blocks of securities and other activities in

6 Hedge funds are regulated by the terms of certain exemptions from registration under the Securities Act of 1933, the Investment Company Act, and in some cases the Commodity Exchange Act ("CEA"), under which they operate. To meet these exemptions, they must limit their offerings to private placements with sophisticated investors, who are able to understand and bear the risks of the investment. The hedge 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 purchaser" individuals with over $5 million in investments and institutions with over $25 million in investments. Many hedge funds file exemptive notices with the SEC and state securities commissioners under Regulation D. Many also file notices with the National Futures Association under the CEA as to any exemptions under which they operate (which exemptions impose their own, additional restrictions on the qualifications of investors).

7 12 C.F.R. §§ 220.1 *et seq.*, 221.1 *et seq.*

8 17 C.F.R. §§ 242.200-.203.

9 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).

connection with takeovers and proxy contests), and the NASD's "new issues" rule 2790 (which governs allocations of Initial Public Offerings). Hedge funds must also abide by the rules and regulations of the markets in which they seek to buy or sell financial products. Those hedge fund managers that are registered under the Investment Advisers Act[10] also are subject to a range of additional disclosure and other requirements. Perhaps most important, hedge funds are subject to anti-fraud and anti-manipulation requirements, such as Section 10(b) of the Securities Exchange Act of 1934[11] and Rule 10b-5,[12] 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. In addition to SEC regulation, many hedge funds are also subject to regulation by the Commodity Futures Trading Commission ("CFTC"). Funds that invest in exchange-traded futures and options on futures are subject to the requirements of the Commodity Exchange Act ("CEA"), which may include registration and reporting obligations administered by the CFTC.[13]

10 15 U.S.C. § 80b-1 *et seq.*

11 15 U.S.C. § 78j.

12 17 C.F.R § 240.10b-5.

13 Also, through its Large Trader Reporting System, the CFTC oversees futures markets in order to ascertain that they are operating openly, competitively and free of manipulation. In addition, under the CEA, all futures exchanges must affirmatively and effectively supervise trading, prices, and trading positions for abusive practices. *Role of Hedge Funds in U.S. Capital Markets: Hearing Before the S. Banking Subcomm. on Securities & Investments* (May 16, 2006) (Statement of James A. Overdahl, Chief Economist, U. S. Commodity Futures Trading Commission), *available at* http://banking.senate.gov/_files/overdahl.pdf.

Areas for Continued Oversight

Systemic Risk

The recent Principles and Guidelines issued by the President's Working Group on Financial Markets effectively stated the basis of current oversight of all private investment companies with respect to systemic risk:

> The vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors. Market discipline most effectively addresses systemic risks posed by private pools of capital. Supervisors should use their existing authorities with respect to creditors, counterparties, investors, and fiduciaries to foster market discipline on private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.[14]

The total amount of assets managed by the entire hedge fund industry, even at its highest estimate of $1.6 trillion dollars under management, is dwarfed by almost any other class of asset manager, from mutual funds to investment banks to life insurance companies to commercial banks.[15] Indeed, the largest hedge fund is a fraction of the size of the leading financial institutions. Even so, there remains concern among regulators and policy makers about the potential impact of the failure of one or more large funds as a triggering event in which counterparties -- those entities that provide hedge funds with funding or which are on the other side of various transactions -- would be at risk.

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14 Press Release, *supra* n. 5.

15 For example, the mutual fund industry manages $10.5 trillion dollars. *See* Investment Company Institute: Trends In Mutual Fund Investing (Jan.2007) *at* http://www.ici.org/stats/mf/trends_01_07.html. The Securities Industry Association estimated, as of 2005, total assets to be in excess of $5 trillion. *See* http://www.sia.com/research/html/quarterly_securities_results.html). Assets managed by the life insurance industry are estimated by the American Council of Life Insurers at over $4.5 trillion. *See* Life Insurers Fact Book (http://www.acli.org/ACLI/Tools/Industry+Facts/Life+Insurers+Fact+Book/Default.htm). The FDIC estimates total assets of the banking industry at $11.86 trillion. *See* FDIC Quarterly Banking Profile *available at* http://www2.fdic.gov/qbp/2006dec/all2a.html.

Ever since the Long Term Capital Management crisis, it has been U.S. policy to focus on maintaining proper risk management techniques at the institutions that are counterparties to hedge funds and other private investment pools and that provide them with funding, clearing, and other services. If these regulated entities, including banks and prime brokers, manage their exposure properly, then the possibility of any hedge fund or private equity fund threatening the whole financial system is greatly diminished.

To that end, a number of important developments have occurred since 1998. The President's Working Group on Financial Markets in 1999 issued a lengthy report[16] that set the benchmark for prudent risk management. Those recommendations were put into practice by the Counterparty Risk Management Policy Group I and II,[17] which provided very specific sets of practices for prime brokers to follow.

In May 2006, Federal Reserve Board Chairman Ben Bernanke gave an address entitled "Hedge Funds and Systemic Risk" in which he summarized the view of the Federal Reserve – the financial regulator charged with managing systemic risk in the financial sector – with respect to the sufficiency of the resulting counterparty risk management system. Chairman Bernanke asked whether the current system was still working. His answer was, in a word, yes.

> Has the approach proposed by the President's Working Group worked? Any answer must be provisional, but, to date, it apparently has been effective. Since the LTCM crisis, ongoing improvements in counterparty risk management and the resultant strengthening of market discipline appear to have limited hedge fund leverage and improved the ability of

16 President's Working Group on Financial Markets, Report on Hedge Funds, Leverage and the Lessons of Long Term Capital Management, *at* https://www.treasury.gov/press/releases/reports/hedgfund.pdf.

17 See the original July 1999 report at http://www.mfainfo.org/washington/derivatives/Improving%20Counterparty%20risk.pdf and the second round report from July 2005 at http://www.crmpolicygroup.org/docs/CRMPG-II.pdf.

> banks and broker-dealers to monitor risk, despite the rapidly increasing size, diversity, and complexity of the hedge fund industry. Many hedge funds have been liquidated, and investors have suffered losses, but creditors and counterparties have, for the most part, not taken losses. The general perception among market participants is that hedge funds are less highly leveraged today than in 1998 though, to be sure, meaningful and consistent measurements of leverage are not easy to come by and many newer financial products embed significant leverage in relatively nontransparent ways.
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> According to bank supervisors and most market participants, counterparty risk management has improved significantly since 1998. Some of this progress is due to industry-led efforts, such as two reports by the Counterparty Risk Management Policy Group (CRMPG) that lay out principles that institutions should use in measuring, monitoring, and managing risk. Reviews conducted by bank supervisors in 2004 and 2005 indicated that banks have become more diligent in their dealings with hedge funds.[18]

What members of Congress can draw comfort from in this speech is not that Chairman Bernanke expressed confidence in the status quo, but that he did so based upon "reviews conducted by bank supervisors" over a two-year period prior to his speech last May. The SEC has the authority to conduct similar reviews for the entities under its supervision, although it is not clear from Chairman Donaldson's comments in 2004 and 2005 whether the SEC did so in conjunction with the review conducted by the bank regulators.

It is regulators' systematic and rigorous monitoring and examination of the adherence of counterparties to prudent risk management standards that is the backbone of this system of risk mitigation. It cannot be said that regulators have asked for voluntary compliance and then have done nothing to ensure that those best practices are in place.

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18 Hon. Benjamin Bernanke, Chairman of the Board of Governors of the Federal Reserve System, Hedge Funds and Systemic Risk, Speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006).

They have worked diligently to monitor the activities of regulated entities under their supervision.

To date, CPIC believes that this remains the most effective means of reducing the systemic risk that could be deemed to flow uniquely from hedge funds and other private pools of capital. Of course, the purpose of this system is not to prevent losses from occurring – even large losses such as those at Amaranth, LLC last year – but to ensure that such losses by individual market participants do not cause the financial system as a whole to cease functioning.

Retailization

While we believe the issue of systemic risk is one best addressed through coordinated review and consultation among the members of the President's Working Group, the issue of investor protection is properly addressed primarily by the SEC. The SEC has been vigorous in bringing enforcement actions against hedge fund managers who violate the law, but its regulatory agenda has had setbacks, such as the Distinct of Columbia Circuit's decision last year overturning the SEC's hedge fund adviser registration rule.[19] However, we continue to believe the SEC has adequate authority to protect investors in pooled investment vehicles. For example, last December, the SEC issued for comment a rule that would effectively raise the qualifications for individuals who want to make investments in private investment companies such as hedge funds, private equity funds and some venture capital funds.[20] The SEC's proposal would add to the current income and net worth tests for individual accredited investors a new standard

19 Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

20 *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Pooled Investment Vehicles. 72 Fed. Reg. 400 (Jan. 4, 2007) Release Nos. 33-8766, IA-2576.

that requires the individual to possess at least \$2.5 million in investible assets -- creating a new category of "accredited natural person" for purposes of investments in private placements of pooled investment vehicles.[21] The SEC also proposed a new anti-fraud rule under the Investment Advisers Act, which, if adopted, would prohibit investment advisers, whether registered or not, from making false or misleading statements to, or otherwise defrauding, investors in pooled investment vehicles.[22]

The Commission and its staff in recent years have voiced a range of investor protection concerns regarding hedge funds, such as in the 2003 Staff Report on the *Implications of the Growth of Hedge Funds* (the "Staff Report")[23] and the SEC's release accompanying its proposed hedge fund adviser registration rule.[24] The SEC's proposal to modernize the accredited investor standard appears to be aimed at the "retailization" concern, described in the Staff Report as the phenomenon of "significant numbers of less sophisticated investors … investing in hedge funds."[25]

The Coalition recognizes that the accredited investor standard functions to achieve a public policy objective – where the government can presume an investor's

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[21] Proposed Rules 509 and 216; 72 Fed. Reg. 403-408.

[22] Proposed Rule 206(4)-8; 72 Fed. Reg. at 404.

[23] *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (Sept. 29, 2003), (*available at* http://www.sec.gov/spotlight/ hedgefunds.htm) ("*Staff Report*"). The Staff Report noted concerns not only with the test for "accredited investor" status, but also with the retail offering of registered funds-of-hedge-funds and the exposure that individual investors may have to hedge funds through investments in pension plans. Other concerns described by the Report included the protection of hedge fund investors from fraud or deficient disclosure, the methods employed by hedge funds to solicit investors, conflicts of interest arising from side-by-side management of hedge funds and other client accounts, the potential existence of *quid pro quo* arrangements between hedge funds and prime brokers, questionable valuations by advisers of hedge fund portfolios, and a lack of transparency with respect to advisers' valuation policies. *Id. at* 79-87.

[24] Registration Under the Investment Advisers Act of Certain Hedge Fund Advisers, 69 F.R. 45172 (July 28, 2004) Investment Act Release No. IA-2266.

[25] Staff Report, *supra* n. 23.

knowledge or capacity to hire expert advice in making investment decisions – rather than a pure economic standard. As such, we support the SEC's proposal to modernize the standard, although the comment letter we filed with the SEC observes that there are a number of ways in which the SEC could do this, The Commission's 2003 Staff Report stated that the SEC had "not uncovered evidence of significant numbers of retail investors investing directly in hedge funds,"[26] and there is no information in the SEC's recent rulemaking release to indicate that this situation has changed. Thus, the SEC's concern that the accredited investor standard may no longer suffice to protect investors is *prospective* in nature. The proposed rule change therefore presents challenges in that it represents only the SEC's best guess as to what an appropriate standard might be, rather than one based upon empirical data.

The Availability of Data on Hedge Funds

One of the most common refrains heard by policy makers today about hedge funds is that "we don't know who's out there." It is difficult to get an accurate assessment of the total number of funds that are currently in existence, even though many hedge fund managers are registered under the Investment Advisers Act. Before the SEC implemented its mandatory registration rule, it estimated that between one-third and one-half of hedge fund managers were registered, and that those managers represented a majority of the assets managed by the industry. Several months after the now vitiated rule went into effect, SEC Chairman Christopher Cox estimated that nearly 2400 fund managers were registered with the SEC.[27] Even now, eight months after the rule was

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26 *Id.* at 80.

27 *See* A Review of Current Securities Issues Before the S. Comm. on Banking, Housing & Urban Affairs (Apr. 25, 2006) (statement of Christopher Cox, Chairman, SEC) (unpublished transcript).

overturned, it is safe to estimate that most of those hedge fund managers who previously registered remain registered as investment advisers.

If the SEC believes it needs to gather "census" information about hedge funds and their advisers, it has the authority to obtain significant information, without resort to a requirement for registration under the Investment Advisers Act. In the comment letter we filed with the SEC in connection with its recent rulemaking, we observed that the SEC could amend the forms filed by pooled investment vehicles[28] when they engage in private offerings of their securities under Regulation D. The Commission could require the submission and periodic updating of the information currently required, such as the name and address of the issuer, the names of its senior management and control persons, the types of securities being issued, and the number of investors and amounts of their investments in each state, as well as information identifying the issuer as a pooled investment vehicle. Other information about pooled investments that would be particularly useful to investors and the Commission would be:

- The identities of the Fund's manager, custodians, and independent auditors;
- The Fund's fee structure and expense information;
- The Fund's assets under management;
- The Fund's general categories of investment strategies and assets;
- Information as to any exemptions that the Fund relies upon under the Company Act and/or Commodity Exchange Act; and
- The Fund's policies as to the use of "soft dollars" and brokerage allocations.

Other information that would be helpful for investor and law enforcement purposes also could be required, such as the issuer's prior names (if any) and the issuer's disciplinary

[28] As a coalition of private investment companies, we do not take a position on whether the Commission needs additional Form D information on issuers other than pooled investment vehicles.

history. All this basic census data could be supplied through a modified, web-based version of Form D that could be shared with, or be accessible to, other appropriate regulatory authorities, such as the members of the President's Working Group on Financial Markets, state securities regulators, the National Association of Securities Dealers and the National Futures Association.

Best Practices to Protect Investors Against Fraud; SEC Authority

As mentioned earlier, the level of due diligence performed by most investors contemplating placing money with a hedge fund manager is considerable. In the case of my funds, for example, investors or their financial managers generally require us to provide answers to detailed questions regarding our background, strategies and research, personnel, returns, compliance programs, risk profile, and accounting and valuation practices. Prospective investors also review terms such as liquidity restrictions, management and performance fees, and any applicable lockup periods. Depending upon the nature of the investor, our personnel may meet an institution's portfolio managers or compliance officers. Some investors also ask to speak to our lawyers, auditors and prime brokers for references. The process usually also includes any number of on-site visits by the potential investor or their representatives. The right to on-site visits continues after the investment is made, as well as continued oral and written communications on a regular basis so that the investor can assure him/herself that the representations that we made at the outset are being honored.

The Coalition believes that these practices are the rule rather than the exception for the industry. Moreover, we fundamentally believe that a government policy which places responsibility for due diligence in the hands of the motivated, institutional or

sophisticated investor acting in their own financial interest yields more transparency and information than a system of mandated government disclosures. Nevertheless, no system is so good that it cannot be improved upon, nor is there any single system that can protect all investors (or fund managers for that matter) from "fools and frauds" – to borrow a phrase coined by one of the Coalition's members.

For example, CPIC notes that the increasing amount of interest in investing in hedge funds by pension funds and others with fiduciary responsibilities to plan beneficiaries or endowments may well produce new industry initiatives to create some type of accreditation clearinghouse for use by investors to assure themselves that certain disclosures and best practices are followed.[29] In addition, there are other ways for the SEC to improve practices important for fraud prevention by all investment advisers to pooled investment vehicles who are not registered under the Advisers Act.

In 1960, Congress amended the Advisers Act to make the antifraud provisions applicable to all investment advisers, whether registered or not, and to give the Commission express rulemaking authority over unregistered advisers in subsection 206(4).[30] The Commission recently utilized this rulemaking authority in proposing new Rule 206(4)-8 to prohibit investment advisers, whether or not they are required to be registered, from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in pooled investment vehicles.[31] Using this authority -- to "prescribe means reasonably designed to prevent" fraudulent and deceptive acts,

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29 See, for example, the recent comments by former SEC Chairman Harvey Pitt at http://www.corpct.com/articles/2007/0227/pitt.php.

30 Pub. L. No. 86-750 § 9, 74 Stat. 885 (1960).

31 72 Fed. Reg. 400.

practices or courses of business[32] -- the Commission may write other rules for the prevention of fraud without resort to creation of a registration regime. For example, the Commission has the power to promulgate minimum protections against fraud for hedge fund investors -- protections that are "best practices" for any reputable hedge fund manager and which reduce the opportunities for unscrupulous managers to abscond with investor funds or defraud investors with misvaluations.[33]

The SEC has used this authority in the past to write prophylactic rules applicable to unregistered, as well as registered, investment advisers. However, it limited a number of its anti-fraud rules to SEC-registered advisers after Congress enacted Title III of the 1996 National Securities Market Improvement Act ("NSMIA") (the "Investment Advisers Supervision Coordination Act"), which, in brief, delegated the responsibility for regulating smaller advisers to state securities authorities.[34] Nonetheless, because the Advisers Act exempts investment advisers with fewer than fifteen clients from registration, an investment adviser with a small number of clients (including pooled investment vehicles) that manages large amounts of investor assets could, depending on the requirements of applicable state law, operate without being subject to the minimal

32 The statutory provision states, in full: "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly--

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 80b-6.

33 *See e.g.* SEC v. Samuel Israel III, SEC Litigation Release No. 19,406, 2005 WL 2397234 (Sept. 29, 2005) (managers of a group of hedge funds known as the Bayou Funds grossly exaggerated claims regarding funds' performance, when in fact, the funds had never posted a year-end profit, and misappropriated funds); SEC v. Haligiannis, SEC Litigation Release No. 18,853, 2004 WL 1908196 (Aug. 25, 2004) (fund and its general partners systematically defrauded investors by misrepresenting performance to investors and potential investors and distributing phony account statements that showed fictitious gains and account balances).

34 72 Fed. Reg. at 402. *See also* Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. 1633, 62 Fed. Reg. 28,112 (May 22, 1997).

types of investor protections that laws such as the Advisers Act might otherwise afford.[35] Thus, it may be appropriate for the SEC to examine the extent to which investors in private investment pools are not protected by federal or state requirements and whether the industry cannot, on its own, adopt best practices in critical areas. The SEC could then consider whether it should exercise its rulemaking authority and apply certain base-level requirements to advisers of funds who may "fall between the cracks."

For example, any investment adviser to a pooled investment vehicle should hold the assets that they control at, and make transfers of such assets only through, a bank or trust company, broker-dealer, futures commission merchant, or certain well-regulated foreign banks and broker-dealers. This is a sound practice that is currently required of investment advisers that are registered or required to be registered under the Advisers Act.[36] Before the SEC amended its custody rules in 1997, the SEC's then-existing custody rule was applicable to unregistered advisers as well. Such a custody requirement should not impose any undue regulatory burdens. It is simply reflects good practice by any reputable adviser to a pooled investment vehicle.

Similarly, using its antifraud rulemaking authority, the SEC could consider extending to unregistered advisers certain of the key investor protections that presently apply only to investment advisers that are registered or required to be registered with the SEC. As with the custody rule, some of these requirements were previously applied, in some fashion, to advisers that are not registered with the SEC. More importantly, they

35 Specifically, Section 203 exempts from registration any investment adviser who during any twelve-month period has fewer than fifteen clients and that does not holds itself out to the public as an investment adviser or act as an adviser to any mutual fund. 15 U.S.C. § 80b-3.

36 Advisers Act Rule 206(4)-2; 17 C.F.R. § 275.206(4)-2.

are fundamentally sound ways of doing business that would not impose substantial burdens on legitimate private investment funds or their advisers. These include:

- Requiring private investment pools -- whether or not their advisers are required to register with the SEC -- to undergo an annual audit by an independent accounting firm and to provide their investors with audited financial statements on a yearly basis, and un-audited financial reports on a quarterly basis.[37] Such requirements would serve to detect and deter fraud and would give investors assurance that the financial information that they receive from a Fund is fair and accurate.
- Requiring that prospective fund investors receive information relating to the adviser's disciplinary history and financial condition, similar to the disclosures required by Rule 206(4)-4.[38]
- Requiring advisers, whether or not registered, to adopt and disclose written supervisory and compliance policies and procedures and codes of ethics.[39] Such policies and procedures, at a minimum, would address the disclosure of financial arrangements between advisers and other interested parties such as prime brokers, the disclosure of an adviser's allocation policies so investors know how an adviser with multiple clients allocates investment opportunities, and disclosure of objective standards for the calculation of unit values for investor reports, fees, admissions and withdrawals.[40]

The requirements generally discussed above would be non-intrusive, consistent with best practices and impose little or no burden on advisers. We raise them here, because we believe they are important practices to prevent fraud by investment advisers, and we believe the SEC has authority to implement them without resort to a requirement

37 *See* Rule 206(4)-2; 17 C.F.R. § 275.206(4)-2.

38 17 C.F.R. § 275.206(4)-4.

39 *See* Rules 204A-1, 206(4)-7; 17 C.F.R. §§ 275.204A-1, 275.206(4)-7.

40 *See generally* Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204, 68 Fed. Reg. 74,714, 74,716 (Dec. 24, 2003). We do not suggest that all the rules that apply to investment advisers that are registered or required to be registered with the Commission should be extended to hedge fund managers. Rather, the SEC should consider select protections that would help prevent flagrant or criminal misconduct, such as theft. To illustrate, we believe that hedge fund advisers should not have to adopt and disclose proxy voting policies, as do investment advisers that are registered or required to be registered. Rule 206(4)-6; 17 C.F.R § 275.206(4)-6. This requirement does not serve the purpose of preventing flagrant misconduct, and if investors in private placements care for such information, they may always ask for it.

that all hedge fund managers register under the Investment Advisers Act. However, they should be considered and proposed only after significant input from investors, the hedge fund industry, and others, and considered in connection with a concept release or a separate SEC rulemaking.

Other Issues

There are other issues that we believe warrant the attention of policy makers and regulators. When we testified last May before the Senate Subcommittee on Securities,[41] we raised as a concern the issue of valuation of illiquid and over-the-counter securities. We continue to believe that valuation is an area of activity by pooled investment vehicles open to abuse -- both as to the potential for outright fraud, and as to the lack of or failure of adequate models or policies and procedures to conduct valuation of derivatives, other illiquid assets, or securities for which market prices are not readily available.

Proper valuation of fund assets is an extremely important component of investor protection. Valuations serve many crucial functions, and it therefore is important that they be accurate and performed in an unbiased, consistent and transparent manner. Valuations of assets and liabilities are used to determine the value of the units of the fund owned by investors. As reported numbers, they tell the investor what his or her investment is worth at a given point in time. These numbers also determine the price at which new units are issued and existing units are redeemed. To avoid dilution and unfairness, these numbers must be accurate and unbiased. Valuations are used to determine the compensation of the hedge fund's managers -- which typically is a

41 *Hedge Fund Industry: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking, Housing, and Urban Affairs* (May 16, 2006) (statement of James Chanos, Chairman, Coalition of Private Investment Companies), *available at* http://banking.senate.gove/_files/ACF82BA.pdf.

percentage of the asset value of the fund during a month, quarter or year, and a percentage of the increase in value of the fund of the past year. Valuations are also used to calculate performance reporting numbers, to inform investors how the fund is performing over time, both in absolute return terms, relative to the relevant market index benchmarks, and under various statistical measures of volatility and tracking that are designed to measure risk and the degree to which the fund manager sticks to its investment strategy.

The consistency and uniformity of performance reporting also is an area of concern. It goes to the heart of an investor's ability to choose wisely among a myriad of financial and investment products -- giving the investor an "apples vs. apples" choice -- a true comparison.

Despite the existing requirements on valuations and performance reporting, there is substantial room for improvement in this area by hedge funds, mutual funds and other investment management vehicles.[42] We believe that valuation and performance reporting issues are appropriate governmental concerns -- but first and foremost, they should be the concern of any fund manager or other market participant, as well as hedge fund investors.[43] Valuation issues cannot be solved by the SEC acting alone. Valuation of over-the-counter derivatives or other types of illiquid investments is a topic that rightly

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42 The situation is most acute for positions in complex and illiquid assets, for which there is not a reporting market providing a transparent daily consensus valuation. By necessity, estimates and pricing models must be used to value these types of fund portfolio positions, and there is much opportunity for mischief. In the derivatives area in particular, hedge funds should delineate their unrealized derivative gains and losses by breaking them out on the income statement and balance sheet. This will aid transparency and is simply good public policy.

43 The Managed Fund Association, for example, in its publication "MFA's 2005 Sound Practices for Hedge Fund Managers," addresses the importance of hedge fund managers establishing valuation policies and procedures that are fair, consistent and verifiable, and it discusses a number of steps hedge fund managers should take in pricing assets and performing valuations. *Available at* www.mfainfo.org/images/PDF/MFA2005SoundPracticesPublished.pdf.

must involve all of the members of the President's Working Group, and in particular, the Board of Governors of the Federal Reserve System, to ensure consistency and harmony. In our view, the appropriate role for government in this area is to facilitate and encourage a dialogue among experts from across the financial services industry, academia, the accounting profession, economists and others, on valuation issues and best practices.

Conclusion

The Coalition again thanks Chairman Frank, Ranking Member Bachus and the members of the Financial Services Committee for the opportunity to testify this morning. We strongly believe that this type of open discussion of the issues confronting our financial markets is an excellent antidote to the misconceptions and misinformation that exists about this vital industry. We further believe that it provides a salutary benefit of keeping the industry itself mindful of the need to continue improving upon its practices, so that hedge funds will remain an appropriate investment choice for institutions such as pension funds and endowments. I would be happy to answer any questions that the Committee may have.

Coalition of Private Investment Companies

James S. Chanos
Chairman

Jim Chanos is the Chairman of the Coalition of Private Investment Companies ("CPIC"), a coalition of hedge funds with an aggregate of over $60 billion in assets under management. Mr. Chanos is the founder and Managing Partner of Kynikos Associates. As the largest exclusive short selling investment firm, Kynikos provides investment management services for both domestic and offshore clients. Through investment funds, partnerships, corporations and managed accounts, both domestic and offshore, Kynikos Associates maintains private portfolios of securities for clients. The funds, Ursus Partners, as well as Ursus International for non-U.S. clients, attempt to profit from the unusually high alphas found on the short side of the U.S. equity market.

Mr. Chanos opened Kynikos Associates in 1985 to implement investment strategies he had uncovered while beginning his Wall Street carreer as a financial analyst with Paine Webber, Gilford Securities and Deutsche Bank. Throughout his investment career, Mr. Chanos has identified and sold short the shares of numerous well-known corporate financial disasters; among them, Baldwin-United, Commodore International, Coleco, Integrated Resources, Boston Chicken, Sunbeam, Conseco and Tyco International. His celebrated short-sale of Enron shares was recently dubbed by *Barron's* as "the market call of the decade, if not the past fifty years."

Born and raised in Milwaukee, Wisconsin, Mr. Chanos currently lives in New York with his four children and is active in many charitable foundations and educational institutions. Mr. Chanos received his BA in economics and political science in 1980 from Yale University.

Statement by E. Gerald Corrigan
Managing Director
Goldman, Sachs & Co.
before the

Committee on Financial Services
U.S. House of Representatives

Hedge Funds and Systemic Risk in the Financial Markets

March 13, 2007
Washington, DC

Introduction

Mr. Chairman and members of the Committee; I welcome the opportunity to appear before you this morning to discuss the issues surrounding the role of hedge funds in our contemporary financial system and the larger question of what steps might be taken to further enhance the stability of the national and global financial system. In my remarks I will wear two hats; first as a Managing Director of Goldman Sachs where my duties include serving as Co-Chair of the firm's Risk Management Committee; and second, as Chairman of the Counterparty Risk Management Policy Group which, as you know, published a far reaching and comprehensive Report entitled: "Toward Greater Financial Stability" about 18 months ago.

My written testimony covers four closely related subjects as follows; First; a broad overview of the evolution of the hedge fund industry over the past decade or so; Second; the relationships between hedge funds and large integrated financial intermediaries; Third; a discussion of systemic financial risk; and Fourth; my very positive views regarding the President's Working Group "Principles and Guidelines regarding Private Pools of Capital."

In the interest of time, I would ask that my statement be entered into the record so that I can briefly summarize its major points.

I. The Evolution of the Hedge Fund Industry

— A useful point of departure in tracking the evolution of the hedge fund industry is to trace major developments in the period since the collapse of LTCM in the fall of 1998.

- The staggering growth of the hedge fund industry since then is well know to this Committee;

- Since the particulars of that growth will be covered by other witnesses, I will not repeat the details except to say that the presence of hedge funds across all segments of financial markets nationally and internationally is truly pervasive.

— It is also widely recognized that hedge funds contribute importantly to the liquidity, efficiency and effectiveness of financial markets as those markets play their vital role in mobilizing savings and putting those savings to their best use.

- This process of financial intermediation is central to economic growth and rising standards of living.

— While the risk profiles of individual hedge funds vary considerably from one to the next, many funds are significant risk takers.

- Many such funds also employ complex trading strategies that involve the use of highly complex financial instruments and very large value trades that facilitate rapid turnover in positions;

- The volume and value of aggregate hedge fund activities now represent a significant fraction of total activity in many classes of financial markets.

— While the growing importance of hedge funds since 1998 is widely recognized, what is not always fully appreciated is the extent to which business practices in the hedge fund sector have matured in recent years.

- As examples; corporate governance, risk management, disclosures to investors and operational infrastructure capabilities of many hedge funds have improved substantially.

  - For some funds these capabilities now have much in common with best practices across the financial system.

- More generally, we have seen in the hedge fund sector what I will call a "cultural institutionalization" whereby many individual hedge funds are now much more sensitive to the broad institutional framework within which they operate including a heightened recognition that hedge funds, too, have a large vested interest in the stability of the financial system.

— Looking to the future we can reasonably anticipate that the pace of evolution in the hedge fund community will remain brisk if not accelerate. Some of the likely future trends may include the following:

- Hedge funds will continue to attract highly talented and experienced personnel from other segments of the financial sector;
- Sustaining high returns across thousands of hedge funds will be increasingly difficult;
- The reach for returns may drive some funds to still more complex and illiquid instruments as well as more risky patterns of asset allocation;
- Pressures on fees are likely to grow, especially for under-performing funds thereby contributing to further consolidation in the industry;
- The distinction between hedge funds and private equity funds will narrow further;
- Spin-offs and/or IPO's of some hedge funds will occur with increasing regularity;
- As the premium on performance intensifies, the orderly attrition of under performing funds may accelerate and, inevitably, a few funds will encounter serious financial problems.

- Such developments are a natural and healthy market-driven phenomenon which need not have material adverse consequences for the stability of the financial system.

II. <u>The Relationship between Hedge Funds and Large Integrated financial Intermediaries</u>

— There are a small number of large integrated financial intermediaries that are major service providers, credit suppliers and trading counterparties for hedge funds.

- Typically these large financial intermediaries are major banks and securities firms that are all subject to some form of consolidated prudential supervision.

— At the risk of considerable oversimplification the business relationship between hedge funds and such large financial intermediaries consists of two closely related elements as follows:

A. <u>Prime Brokerage</u>

- Large financial intermediaries provide a wide range of financial, administrative and operational services to hedge funds through their prime brokerage franchises;
    - About a dozen or so of such intermediaries account for a very substantial market share of the prime brokerage business;
    - Most hedge funds have more than one prime broker and some have several

– Multiple prime brokers are seen by hedge funds as a way to protect proprietary trading positions and strategies and to diversify their credit and operational risk.

— The primary source of credit exposure arising between prime brokers and their hedge fund clients arises in the context of loans provided to hedge funds which are secured by either cash margin or by collateral in the form of securities pledged to the prime brokers.

– A prudently managed prime broker should always have a generous amount of excess margin or collateral relative to the amount of credit extended.

— The process of (1) evaluating the credit worthiness of hedge funds; (2) determining the value of margin and/or collateral that can be securely obtained by the prime broker and (3) determining the amount of credit extended against the value of the margin or collateral is extremely complex requiring a multi-disciplinary approach anchored in sound credit fundamentals.

– Contrary to popular opinion in some circles, a well managed secured lending program by prime brokers – with appropriate covenants and trip wires – is a relatively low credit risk activity by such prime brokers.

B. Other Counterparty Relationships

— Aside from the prime brokerage relationship, large financial intermediaries often have multiple counterparty relationships with large numbers of individual hedge funds, some of which are not prime broker clients. Hedge funds are (1) major trading counterparties of large banks and securities firms across the full range of financial instruments including OTC and exchange traded derivatives; (2) active participants in the primary and

secondary markets for all classes of securities, listed options, futures, private placements, syndicated loans and most classes of structured financial products.

— These relationships – especially the bi-lateral trading relationships – give rise to significant elements of market, credit, liquidity and reputational risk to both the large intermediaries and to their hedge funds counterparties.

— At Goldman Sachs – and at other major financial institutions as well – counterparty risk management is a core competence involving all levels of management including the Chief Executive Officer.

— While the menu of risk management tools and techniques involves thousand of metrics and hundreds of mathematical or statistical models, the foundation for effective risk management rests on a culture of sound corporate governance, collective analysis and decision-making and, above all, sound judgments by experienced business leaders

— Looked at in this light, risk management is more an art than a science.

- As an example, there will always be gaps in the information that can be compiled as a part of the counterparty due diligence process;

    - Typically, for example, using stress tests and other tools to monitor a given counterparties' risk profile can only be performed on positions that are visible to its trading partner and those visible positions may only be a small fraction of that counterparties overall risk profile.

        - The implications of crowded trades are especially difficult to anticipate much less quantify with any precision.

- Similarly, even monthly financial statements may be stale almost before the printers' ink is dry.

— These and other limitations in the risk management process are well understood by experienced practitioners and by prudential supervisors. More importantly, these limitations also forcefully underscore the point that risk management cannot be left to the models and the mathematics but must be guided by the judgment of experienced executives.

III. Systemic Risk

— The starting point for the Report of the Counterparty Risk Management Policy Group was an effort to better understand the phenomenon of systemic financial risk and to help frame approaches to better mitigate the ever present risk of future systemic financial shocks.

- Systemic financial risk is typically defined as a financial shock that brings with it the reality – or the clear and present danger – of inflicting significant damage on the financial system and the real economy.

  - Financial shocks are distinguished from financial disturbances the latter of which occur with some frequency but are sorted out by the marketplace with little or no damage to the financial system or the economy.
  - Since 1998 we have experienced a not inconsequential number of financial disturbances all of which have been absorbed by the financial system with a remarkable degree of resiliency.

- Examples of such shocks include the bursting of the dot.com bubble, a recession, September 11, two wars, multiple corporate scandals, oil shocks, serious trade imbalances, and periodic bouts of instability in segments of financial markets.

- The forty seven Recommendations of the CRMPG Report were shaped by three threshold conclusions about systemic financial risk as follows:

  - **First**; overtime, the already low statistical probabilities of the occurrence of systemic financial shocks had declined further but were still well short of zero.

  - **Second**; while the probabilities of such shocks were lower, the potential damage that could result from such shocks is greater due to the increased spread, complexity and tighter linkages that characterize the global financial system.

  - **Third**; our collective capacity to anticipate the specific timing and triggers of future financial shocks is extremely low, if not nil.
    - Indeed, if we could anticipate the timing and triggers such shocks would not occur.

— Thus, since we certainly cannot rule out future financial shocks we have no choice but to strengthen what I like to call the "shock absorbers" of the global financial system in order to limit and contain the damage caused by future financial shocks when – not if – they occur.

- I believe it is fair to say that the CRMPG Report has played an important role in helping to stimulate efforts to strengthen those shock absorbers.

- More generally, both the official community and the private sector are actively engaged in multiple initiatives all working constructively in that same direction.

— Before turning to the President's Working Group Principles and Guidelines, allow me to digress briefly to offer a few observations about the Amaranth episode.

- In looking at the Amaranth incident, many observers take comfort from the fact that the marketplace was able to mange this incident with a remarkable degree of success especially considering the staggering losses incurred in that funds' natural gas trading activities.

  - In many respects that sense of comfort is justified.

- However, there were features of the Amaranth episode that point to the need for caution in drawing generalized conclusions from this event. For example.

  - The trades in question, while hugely concentrated, were in large part executed using relatively simple and straight-forward transactions;
  - There was little or no evidence of the so-called "crowded trade" phenomenon;
  - Once the scale of the losses became evident, the management of Amaranth moved quickly to sell or liquidate both the natural gas and other positions such that all margin and related obligations were met in a timely fashion thus avoiding default or bankruptcy.

  - Since a default did not occur, counterparties of Amaranth did not face the need to close out their positions with Amaranth – a process that under the best of conditions is extremely complex and potentially destabilizing.

— In pointing to these features of the Amaranth episode, I want to be clear that I, too, take comfort from how well the system worked in managing this situation but I would urge caution in drawing conclusions from this event as to how other situations in the future may play out especially if they were to occur in a more hostile market environment.

IV. The PWG and U.S. Agency Principles and Guidelines

— In my judgment the Principles and Guidelines regarding Private Pools of Capital as spelled out by the President's Working Group and the Leaders of the major regulatory agencies constitute a timely and constructive approach aimed at further strengthening the broad range of institutional, behavioral and risk management arrangements as they apply to the relationships between private pools of capital and virtually all other classes of market participants. The principles and guidelines warrant particular praise because:

- They rely heavily on market forces and market discipline;
- They are principles based in a context in which the speed and complexity of the activities to which they are directed cannot be managed or supervised by reliance on detailed rule books;
- They pay particular attention to sensible approaches to enhanced transparency that should not aggravate the already counter-productive information overload problem associated with public disclosure;
- They stress the responsibilities of all classes of market participants to strengthen due diligence and risk management capabilities with particular emphasis on valuation practices especially as applied to complex and illiquid instruments; and
- Finally, they stress the clear need for international policy collaboration and coordination. In this connection, I would note that the FSA in the UK is already

moving in the direction of a principles based approach to these issues, the philosophy and practices of which have much in common with the approach contained in the PWG Principles and Guidelines.

While I consider the Principles and Guidelines to be a constructive step forward, I would respectfully suggest a couple of areas in which some fine-tuning to the approach might be considered.

First; the statement of Principles and Guidelines acknowledges that the PWG Principles "have increasingly been reflected in best practices." While not disputing that conclusion, the question that arises in my mind is whether some effort should be made to develop a common benchmark of best practices especially as such best practices would apply to the "Systemic Risk Principles" in the PWG statement.

Having in place such a common benchmark of best practices would provide some real assurance across classes of institutions that "best" means "best." In turn this should help encourage an environment that stresses competitive excellence rather than a gradual drift toward the least common denominator of such practices.

The obvious major drawback to the creation of a common benchmark of best practices is the difficulty of drafting such a statement in a manner that guards against slippage into unwanted detail that compromises the principle's based approach called for by PWG. While that risk is very real, the potential benefits arising from the presence of common benchmarks of best practices are considerable. Moreover, many of the building blocks for such a statement of best practices are already available in the CRMPG Report and elsewhere.

Second; the Principles and Guidelines call for enhanced transparency and rightly so. In discussions about transparency it is important to keep in mind that transparency in this context has four mutually interdependent legs as highlighted in the CRMPG Report. The *first* is the bilateral and confidential exchanges of information that take place between counterparties. The *second* is the information such as offering memoranda which are made available to prospective investors in hedge funds or other private pools of capital. The *third* is the formal and informal exchanges of information – much of it also confidential – that take place between regulated institutions and their supervisors. The *fourth* leg is, of course, information that is disclosed to the public at large.

While there are opportunities to strengthen all four legs of the infrastructure surrounding transparency I would argue that the greatest payback in financial stability terms is to be found in the first three legs rather than the fourth. This is especially true if much of the emphasis surrounding exchanges of information have elements of informality associated with the process. The recent exercise whereby the Fed, the SEC and the FSA conducted a joint inquiry into the business relationships between a small group of major banks and investment banks and their hedge fund counterparties is an excellent example of the benefits of a less formal dialogue on these critical issues. In this regard, even as hedge funds remain largely unregulated, I would hope that systemically important hedge funds would welcome the opportunity to participate in periodic voluntary and informal discussions with the official community about market developments and changing business practices, including risk management practices.

However, if we are to maximize the benefits of increased reliance on the first three legs of enhanced transparency, we must be prepared to allow the philosophy of PWG Principles and Guidelines to shape the process and we must avoid the temptation to back slide into a detailed

“rules of the road” approach aimed at micro-managing the process. Such a temptation will surely arise when, inevitably, something goes badly wrong.

In conclusion, Mr. Chairman, allow me to congratulate you and the Committee for holding this hearing. The issues you have focused on are of vital importance and they are also extraordinarily complex. For almost 40 years, these issues have been a large part of my professional life but even after all that time, hardly a week goes by when I don’t find something new to worry about. By the same token, hardly a week goes by when I don’t learn of some initiative or development that is working in the direction of strengthening those shock absorbers I spoke of earlier. One of the most difficult challenges in human endeavor is how we manage low probability events – such as financial shocks – that can cause so much damage. In the financial arena I believe we are making progress in meeting that challenge and we must continue the effort for we know that the future will bring new tests of the stability and resiliency of the financial system.

Thank you.

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Testimony of Andrew K. Golden, CFA
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presented to the
Financial Services Committee
United States House of Representatives
March 13, 2007

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to share my perspective on "Hedge Funds and Systemic Risk in the Financial Markets." I speak as someone who has been active as an institutional investor in hedge funds for almost two decades.

For the past twelve years I have been the President of the Princeton University Investment Company (known as "PRINCO"), a University office with responsibility for investing Princeton's $14.2 billion Endowment. Previously, I worked in the investment arms of Duke University, and Yale University. At all three schools, I was involved in the development and maintenance of hedge fund investment programs. At all three schools these programs comprised a substantial share of assets and were integral to the strong investment performance of the respective endowments.

As PRINCO's president I oversee a staff consisting of 13 investment professionals who develop asset allocation plans, select and monitor a roster of 140+ external managers, and co-ordinate asset deployment across that roster. (I should underscore that all of Princeton's investing in every asset class is done via outside specialist managers. PRINCO acts essentially as a large fund-of-funds manager.) In addition to the investment team, PRINCO has 11 more staff who provide administrative, technical, and operations support. (Additional back-office support is provided by several members of the University Treasurer's Office.) Staff operates under the oversight of a 12 member Board of Directors, composed primarily of alumni investment experts, many of whom also serve as University Trustees.

The bulk of my comments today will relate to describing the role of hedge funds in Princeton's investment strategy and our approach to making hedge fund investments. While I like to believe that we are particularly good at executing our approach, my sense is that it is broadly similar to that employed by a number of other sophisticated institutions. Thus, I think Princeton's hedge fund program can be illustrative of a substantial cohort of hedge fund investors. I hope it will be apparent that for sensible, sophisticated investors, hedge fund investments need not entail great risk. Indeed, hedge funds can be important tools for reducing risk.

After discussing Princeton's hedge fund investment approach, I will respond to some other questions that Chairman Frank asked me to cover.

Princeton has enjoyed success as an investor. For example, the annualized investment return of Princeton's Endowment during the past ten fiscal years (ending June 30, 2006) was 15.7%. During the same period, the median annualized investment return among the 477 schools surveyed by NACUBO (The National Association of College and University Business Officers) was 8.7%, similar to the 8.3% gain of the S&P500. During my tenure we have never had a year of negative investment performance, even during the post-bubble bear market, suggesting that our substantial investment gains reflect something more than merely the taking on of high levels of risk.

Princeton has enjoyed particular success as an investor in hedge funds. But before going any further, let me say that all my comments today are complicated by the fact that "hedge funds" do not represent a distinctive investment category. They are not an asset class, as are investments such as U.S. stocks, real estate and venture capital, where the members of the set share inherent qualities that cause them to perform in broadly similar fashion. Rather, hedge funds are a relationship format, defined by the nature of the contractual arrangement between an investment manager and his or her clients. The key features of hedge fund contracts are: 1) a partnership structure with limited liability for at least some of the partners (the clients); 2) a commitment by the investment manager to put at least some amount of personal assets in the partnership to be invested alongside the clients' assets; and 3) a fee schedule that includes an incentive fee, meaning that the manager receives a share of the profits generated by the clients' money. (It is common practice to also distinguish hedge funds from other private investment partnerships by using the term only to refer to partnerships that invest mainly, although not necessarily exclusively, in relatively liquid holdings. Thus, hedge funds are distinguished from venture capital, buyout, real estate and other similar partnerships.) The hedge fund structure can be used in the pursuit of a very broad variety of strategies across a spectrum of market sectors.

At Princeton, the hedge fund structure is prevalent throughout our portfolio. Roughly 45% of the Endowment is invested via the hedge fund format. However, included in this number is the roughly 15% of the Endowment that is invested in 14 funds that pursue traditional, long-only investment strategies, with typically just $1, or slightly less, of market exposure for every $1 we have invested. In terms of opportunity and risk exposures, these funds tend to walk and quack like mutual funds or traditional institutional investment accounts, albeit ones that are managed very, very well, with superior track records.

The hedge fund format entails a higher fee schedule than that of traditional institutional investment accounts. So why do we take an approach that is seemingly more expensive to gain exposure to plain-vanilla investment strategies? We do it because the hedge fund format better aligns the managers' interests with our own. The reduction of agency

(small "a," as in principal vs. agent, not Government Agency) costs creates a fertile environment for superior *net* returns.

In the hedge fund format, the manager has strong incentive to strive for excellence, and to take contrarian positions if they offer attractive prospects. Importantly, the manager can gain extraordinary personal wealth if our portfolio performs well. This phenomenon is in contrast with traditional fee schedules where in order to increase income, the manager has to continuously increase assets, probably beyond the point where assets become greater than the most attractive opportunity set. The hedge fund manager can become fabulously rich while limiting assets to an appropriate size.

The hedge fund relationship format, at least as practiced by Princeton and other savvy clients, dis-incentivizes managers from taking inappropriate risks. All of our managers have a significant share, typically the vast majority, of their personal net worth invested side-by-side with us. Thus, if they make a bet that has an unfortunate outcome, the manager will certainly "feel our pain."

Of course, aligned interests do not guarantee superior performance. Our decision to invest in any hedge fund presumes that the manager can add value greater than the fees we are paying. If we misjudge in this regard, our decision will have been "sub-optimal." But this is true for any decision to engage in active management, whether the relationship format is a hedge fund, a mutual fund, a classic institutional management account, or a retail brokerage account.

Approximately 30% of the Endowment is invested in 16 hedge funds that do pursue less-traditional strategies. We categorize these hedge funds as "Independent Return" managers. These managers focus on areas where market inefficiencies are of such magnitude that the managers have hopes of creating equity-level returns with risk levels no worse than traditional equity investments. For insight into the risk levels assumed by our managers, I turn to one imperfect, but nonetheless illustrative *ex post* measure of risk—annualized standard deviation of monthly returns. Our Independent Return managers in aggregate have displayed risk levels (standard deviation = 7%) that are more similar to fixed income (4%) than to equities (13%). Importantly, our managers' returns are driven largely by idiosyncratic factors, and therefore their performance has low correlation with broad market moves in most environments. This low correlation means that our Independent Return program has been particularly effective at reducing the Endowment's total risk. Indeed, the Independent Return portfolio has had a stabilizing impact on the Endowment's performance during every market downdraft during my tenure at Princeton. (This phenomenon does reflect luck. Low correlation is different from negative correlations. It should be expected that there will be times when the Independent Return program will move similarly to the broad market, and thus the program could exacerbate, rather than mitigate, losses in other parts of the Endowment.)

Our Independent Return managers can be loosely divided into two similar sized groups The first comprise stock-picking managers who have the license and expertise to sell short as well as invest long. The second group pursues arbitrage and event-driven strategies, such as investing in the securities of bankrupt companies, where the outcome of the investment depends upon the outcomes of unique events.

We do not invest with managers pursuing inherently opaque strategies or ones where we cannot understand how the manager can gain an "edge." Thus, we do not invest with global-macro punters or black-box traders. Our managers do not employ significant leverage. Our independent return managers in aggregate have net market exposure of 40% equity and 45% fixed income. Gross exposure (summing the absolute values of all long and short positions) is 166%. The exposures to which I am referring reflect market values, and are not adjusted for differences in the inherent risk (or *beta*) of positions. Nonetheless, the figures should give a good general sense that our Independent Return program is "low-octane." The leverage figures are representative of typical exposure, although they are perhaps somewhat below historical averages.

We hope for slow and relatively steady success in our Independent Return program. We have never been attracted to hedge funds that have track records of extraordinarily high returns. We are suspicious that such returns can be achieved without the assumption of excessive risk. Several years ago, we in fact withdrew the bulk of our investment in a hedge fund that had just produced an 80% gain in one year. We did this in part because of concerns that the manager's risk profile had become too aggressive. The manager's results subsequently supported our hypothesis.

Our low-octane approach has nonetheless generated strong performance. The ten-year annualized return to our Independent Return program is 16.4%.

Our success in Hedge Fund investing has been the result of several factors. We have some natural advantages as an investor. Princeton's and PRINCO's reputations make us a desirable client, so we at times get access to managers that turn other clients away in order to limit assets to optimal size. Our intelligence networks are strengthened by the inclusion of devoted alumni. We have a naturally long investment horizon and low liquidity needs, making the range of investment strategies that are appropriate for us very broad. Our assets are of "goldilocks" size—small enough so that choice, small-scale opportunities can have meaningful impact on our bottom-line, yet big enough to cost-effectively support necessary due diligence and monitoring activity.

Indeed, the exhaustive level of due diligence we perform before hiring a manager, and the extensive efforts we make in monitoring and working with the manager after the hire, are probably the second most important factors behind our Hedge Fund investing success. (I will reveal the most important factor in a moment.) We spend at least 400 person-hours in our due diligence process before investing in a hedge fund. Several managers have noted similarities between our due diligence process and a medical exam. The process

involves several meetings with the manager including at least one in the manager's office. We spend considerable time going through portfolios and individual positions. We look through randomly selected investment files of the manager in order to get a better sense of analytic approaches, and importantly to see if there is evidence that the manager has considered down-side possibilities. We check dozens of references, using our networks to go beyond the references provided by the manager. (Included in our reference checks are the management of portfolio companies. Through these references, we get a sense of the depth of the hedge fund manager's understanding of his or her investments, and also insight into the appropriateness of the manager's methods.) Not all of our due diligence is exciting—we do spend time looking at the manager's operations to assure that there are no weaknesses.

A lot of our due diligence focuses on getting clarity on the character and motivations of the manager. This is vital, because it is impossible to contract good behavior.

The intensity of our examination of the manager does not let up after the hire. We average approximately 70 person-hours per year monitoring each of our hedge funds. After investing in a hedge fund, we continue to meet with the manager in his or her office, and even continue to occasionally check references.

The extensiveness of our due diligence and monitoring has been critical to our success. However, the single most important success factor has been that we are always guided by a simple, over-arching rule—we will not invest in something we don't understand.

I believe the quality of our due diligence is distinctive, but not unique. I believe that a substantial number of other hedge fund investors perform prudent levels of due diligence, but many do not. However, I do not think this phenomenon is limited to investors in hedge funds. In all areas of investment, there are investors who fail to perform adequate due diligence.

The markets for client money, particularly institutional client money, do provide a small amount of discipline with regard to whether a particular hedge fund manager will flourish. That is to say that managers lacking sensible approaches and well-developed operations are less likely to be able to raise large funds. But the market discipline is relatively small, as evidenced by Amaranth. That said, I am not sure that there is any danger, certainly any systemic risk, from the fact that client market discipline is somewhat weak. It should be noted that financial, commodity and derivative markets absorbed the blow-up and aftermath of Amaranth in a very orderly fashion.

It is also worth noting that with the growth of the hedge fund industry, it is becoming ever more common for hedge funds to be on the opposite side of each other's trades. In this way hedge funds are providing their own market discipline to limit systemic risk. In other words, hedge funds do not act monolithically as a group. They provide liquidity for each other and therefore are likely helping create more orderly markets.

The description of our intensive due diligence process should make clear that the hedge funds we invest in provide us with adequate transparency. We require such transparency, but not all managers are willing to give it. In these cases we are perfectly comfortable walking away. There have been instances where hedge funds that we chose not to invest with because of insufficient transparency have gone on to produce fantastic results. I have no regrets regarding these decisions.

As to whether other investors are able to get adequate transparency, the answer would seem tautologically "yes," because no investor has ever been forced to invest in any particular hedge fund. If someone is investing in a hedge fund, they must feel that they have adequate information to make that decision. I say this because hedge funds, as opposed to mutual funds, are meant for sophisticated investors. The investors' sophistication should include an ability to decide whether or not the investor has sufficient information to prudently make decisions regarding initial and continuing investment in a particular fund. I do not believe that sophisticated investors who willingly invest in any thing, hedge fund or otherwise, without satisfying themselves that they have adequate information deserve any sympathy, let alone additional regulatory safeguards.

Transparency refers to the availability of information. A separate issue, of course is whether the investor has the capability and time to process that information. If the answer is "no," then the investor would be investing in violation of the basic common sense rule I previously articulated: "Don't invest in something you don't understand." Again, I don't believe that violators of this rule deserve sympathy or additional regulatory support. Indeed, I believe that fiduciaries who violate this rule in a significant manner deserve to be sued or prosecuted.

Understanding an investment does not guarantee happy results. But sophisticated investors should understand that equity-level risk entails the possibility of underperformance, substantial loss, and even complete loss of the investment. I note that not every investment Princeton has made turned out well. However, we accept responsibility for having made the investment choice.

I feel compelled to digress for a moment and note that there seems to be growing concern that a consequence of the growth of the hedge fund industry will be increased risk that some investors in hedge funds will lose money. I do not believe this is a risk; it is a *certainty* that some investors will suffer significant losses in their hedge fund investments. It is likely that all investors will suffer some amount of loss. But all of this is part and parcel of exposure to "equity-like" risk.

For perspective, it should be noted that when the tech bubble burst, U.S. stock investors collectively lost almost $7 trillion. Among the losers were sophisticated and unsophisticated investors; endowments, pension funds, and "average Joes." The losses

were suffered through the entire spectrum of relationship formats, including institutional accounts, retail brokerage accounts, mutual funds and hedge funds. The $7 trillion losses give interesting context to worries about the hedge fund industry, to which total investor exposure is between $1 and $2 trillion.

I have described the relatively low levels of leverage incorporated in Princeton's hedge fund program. I know there are other hedge funds that use substantially more leverage. I think it very likely that there are hedge funds that are using imprudent amounts of leverage, and I suspect that investors in such funds will likely have unpleasant experiences at some point in the future. When this happens it will simply confirm that the hedge fund investor was exposed to equity-like risk.

When I think about the important systemic risks facing markets today, aggregate hedge fund leverage is not a major concern. I should offer the disclaimer, though, that I am not much of an expert on macro factors, and I am certainly less of an expert than others testifying today. With that caveat, I should say that I am much more worried about mortgage and federal debt levels than I am about leverage at hedge funds.

The Chair has asked that I comment on the current levels of risk in the markets. It is hard to talk about risk without referring to price. (Any given investment becomes much riskier the more you pay for it.) My sense, supported by conversations with our managers, is that, in broadest brush terms, markets are fully priced. This suggests that investors *ex ante* are receiving below-normal compensation for the risks they are taking. There is a good chance that returns experienced by investors in the aggregate will probably disappoint. However, I have no ability to know whether the likely path to that disappointment will be via sharp downdrafts or through more prolonged periods of mediocre results.

The Chair also asked for comment on the extent to which market practices have improved since the issuance of the CRMPG II report. Here I know that others testifying today are definitely better qualified to answer. I can say that conversations with our managers indicate that over the past two years market practices with respect to OTC derivatives have matured. As one indication, there is much greater discipline in trade documentation than there was in the past.

Finally, I will address the Chair's request that I give my views on the appropriate role of government with regard to hedge funds, their activities in markets, and those who invest in them. The headline is that I believe that the President's Working Group essentially has it right.

I believe that hedge funds make markets more efficient. Markets benefit from having participants that operate with minimal agency constraints.

For hedge funds to avoid becoming institutionalized, *i.e.,* for them to not develop their own agency constraints, their capital sources must be limited to sophisticated investors who are capable of evaluating the quality of the hedge fund manager for themselves.

For quite some time I have felt that the income and net worth tests that are meant to determine the likelihood of sophistication need to be raised. Indeed, I would consider setting even higher thresholds than have been proposed.

Requiring SEC registration would be a feel-good measure that would offer little incremental protection and would risk diverting limited oversight resources. I note that Princeton feels compelled to perform the same exacting due diligence on registered advisors as we do on unregistered ones.

I fear that SEC registration can be misinterpreted as a stamp of approval, akin to a UL seal. It is easy to imagine that mandated registration will actually lead to more confusion as to the inherent risk of a hedge fund.

I have heard concerns that unsophisticated individuals may be getting exposure to hedge funds through their pension funds. Clearly the "average Joe or Jane" is not qualified to assess a hedge fund investment, but presumably there is some professional management of the pension fund who should be sophisticated enough to ask and answer the key question: "Do I understand what I am investing in?" If Congress is concerned that this is not adequate protection, than perhaps ERISA should be amended to restrict pension plans to investing only with registered advisors. Or, the PBGC could base premiums in part on the extent to which a pension fund has investments with unregistered advisors. These would be less invasive measures than requiring all hedge funds to register. I think both of these approaches are flawed and would likely have unintended consequences. I offer them only as potentially "less bad" alternatives.

I think better than any of these approaches for safeguarding would be efforts to assure that there are adequate mechanisms to hold accountable those who have fiduciary responsibility for pension funds, and that sufficient regulatory manpower is devoted to using these mechanisms. Fiduciaries who fail to assure their own adequate understanding of an investment or who put imprudent portions of their portfolios in any individual investment that has the risk of substantial loss should suffer consequences.

With respect to the regulation of hedge fund activity in the markets, I think the PWG again has it right. To assure fair markets and control systemic risk, it makes the most sense and is most efficient to focus regulatory and private oversight bandwidth on the large financial institutions that act as counterparties and lenders. Perhaps we should accept guidance from the bank robber Willy Sutton and direct our activities to "where they keep the money."

Thank you again for this opportunity.

MANAGED FUNDS ASSOCIATION

TESTIMONY BEFORE THE

HOUSE FINANCIAL SERVICES COMMITTEE:

"HEDGE FUNDS AND SYSTEMIC RISK IN THE FINANCIAL MARKETS"

MARCH 13, 2007

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TESTIMONY OF GEORGE E. HALL

ON BEHALF OF

MANAGED FUNDS ASSOCIATION

BEFORE THE

HOUSE FINANCIAL SERVICES COMMITTEE

March 13, 2007

I. INTRODUCTION

Mr. Chairman, thank you for the opportunity to testify here today on behalf of Managed Funds Association ("MFA"), which I serve as one of its Directors. I founded and serve as the Chief Investment Officer of Clinton Group, an investment adviser for a diverse group of institutional and high net income individual investors with over $1 billion under management. MFA is the only U.S.-based global membership organization dedicated to serving the needs of those professionals throughout the world who specialize in the alternative investment sector of the capital markets, including hedge funds, funds of funds and managed futures funds. MFA represents the hedge fund industry before the Congress, the Executive Branch and independent agencies, and works closely with the Committee. MFA submitted testimony for the record to this Committee in 2003 and testified before its predecessor committee in 1999.[1]

As this Committee is well aware, the hedge fund industry has experienced significant growth in recent years, with assets under management estimated at over $1.4 trillion.[2] This growth reflects in large part, the needs of institutional investors for investment vehicles that offer a diversity of investment styles and help them meet their future funding obligations and other investment objectives.

As recently recognized by the President's Working Group on Financial Markets ("PWG"), *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital,* private pools of capital "bring significant benefits to the financial markets." Such pools are "an essential part of what keeps the U.S. capital markets the most competitive in the world."[3]

With the growth of hedge funds have come important benefits to the markets as a whole – including increased liquidity, improved price discovery due to arbitrage, and overall enhanced functioning of markets and lower risks for market participants. Treasury Secretary Henry Paulson has observed that hedge funds have "made our capital markets more efficient, facilitating the dispersion of risk."

Recognizing the critical market benefits generated by hedge funds and other private pools of capital, the PWG has recently defined the principles under which the public and private sectors should discharge their "shared responsibility" for the vitality,

stability and integrity of our capital markets by addressing the public policy issues associated with such funds. MFA fully supports the PWG's assessment and its charge to market participants to maintain market discipline — which represents the primary means of addressing risk in a market-based economy. The hedge fund industry and policy makers currently face an important challenge, namely, to preserve the benefits offered by hedge funds while addressing legitimate systemic risk, investor protection and market integrity issues presented by the growth in hedge fund investments. MFA and its members are committed to meeting these challenges.

MFA's Mission. As background, MFA, founded in 1991, is the U.S.-based global membership organization dedicated to serving the needs of the professionals who specialize in the alternative investment industry. The mission of MFA is to enhance the understanding of the hedge fund industry, to further constructive dialogue with regulators, and to foster communications and training of the Association's members. As an example, MFA has an ongoing and regular program to promote implementation of sound industry practices. MFA activities include educational outreach to and representation before the U.S. Congress, Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC"), Federal Reserve Board, U.S. Department of the Treasury, state legislatures and international regulatory agencies.

MFA's over 1,300 members include professionals in hedge funds, funds of hedge funds, and managed futures funds. MFA members manage a substantial portion of the over $1.4 trillion invested in these investment vehicles. Members include representatives of a majority of the 100 largest hedge funds groups in the world. These larger hedge fund managers represented within MFA's membership collectively manage in excess of $530 billion in assets, pursue a wide range of investment strategies and most are investment advisers registered with the Securities and Exchange Commission.

Highlights of MFA's Testimony. In our testimony, we highlight the beneficial role of hedge funds in the economy and make the following points:

- MFA supports the *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital* and the path it sets forth. We accept the PWG role of being ever-vigilant.
- In the spirit of the *Principles and Guidelines,* MFA continues its vigilance in promoting the development of industry sound practices for hedge fund managers.
- MFA representatives have devoted significant resources to working with the Fed 18 in the development and implementation of targets for improving market practices for derivative products in order to reduce systemic risk concerns, particularly with respect to credit derivatives.
- MFA supports the SEC's efforts to increase financial sophistication standards for investors in hedge funds.
- We have suggested in the past that the SEC implement a proposal to collect census data on hedge fund managers.

- MFA endorses efforts to increase understanding of hedge funds among pension plan fiduciaries and trustees, and is committed to helping promote investor financial literacy through the development of due diligence materials.
- Finally, MFA is committed to promoting fair and competitive markets in which the inappropriate use of material non-public information is not tolerated.

These points are developed more fully in this testimony. We are pleased to provide Congress with our views on the hedge fund industry.

II. BENEFICIAL ROLE OF HEDGE FUNDS IN CAPITAL MARKETS

Diversification and Non-Correlated Returns for Institutional Investors. Much of the growth in hedge funds since the 1980s can be attributed to the increasing recognition by sophisticated investors that hedge funds can help diversify returns and thereby reduce the overall risk of an investment portfolio. The majority of direct investment in hedge funds by institutional investors, until recently, has come from university endowments and foundations. The endowment community stands at the forefront of innovation and thought towards portfolio management. From 2005 to 2006, endowments increased their hedge fund allocations from 7.3% to 8.7% on average.[4] Moreover, top endowments, which include America's most prestigious universities, allocated an average of 22.4% of their portfolios to hedge fund strategies.[5]

Corporate and public pension plan investments in hedge funds will also continue to grow, both through direct investments and through fund-of-hedge-funds vehicles. Former Federal Reserve Chairman Alan Greenspan has noted that these inflows may be attributed to institutional investors seeking alternatives to long-only investment strategies in the wake of the bursting of the equity bubble in 2001.

These institutional investors understand that hedge funds provide attractive mechanisms for portfolio diversification because hedge funds' absolute returns tend to have little or no correlation to those of more traditional stock and bond investments. Many hedge fund categories may therefore outperform stock and bond investments when the latter perform poorly. Investment in hedge funds can thus help diversify risk in many institutional investment portfolios. Drawdowns in individual hedge funds — largest drop from peak value to trough value — are often smaller than in publicly-traded indices. Academic research recognizes that hedge fund investments can reduce the overall risk of investment portfolios for investors such as endowments and public and private pension plans.[6]

Source of Liquidity. As active trading participants in international capital markets, hedge funds add depth and liquidity to markets. This characteristic of hedge funds has been recognized by commentators including former Federal Reserve Chairman Alan Greenspan. He testified before the Senate Banking Committee in 2004, "it's so important that [hedge funds] are left free to supply the extent of liquidity that they are supplying to our financial markets. ... [T]he degree of flexibility in our economy has

been instrumental in enabling us to absorb the shocks which have been so extraordinary in recent years. One of the most successful parts of our system is our ability to absorb financial shocks."[7]

Increase in Efficiency. By trading on the basis of sophisticated and extensive market research, hedge funds provide markets with price information that translates into pricing efficiency. In targeting temporary price inefficiencies and market dislocations, hedge funds effectively help to minimize market distortions and eliminate these dislocations. The President's Working Group described this function as follows:

> Hedge funds and other investors with high tolerance for risk play an important supporting role in the financial system in which various risks have been distributed across a broad spectrum of tradable financial instruments. With financial intermediation increasingly taking place in the capital markets instead of banking markets, prices play a larger role in the allocation of capital and risk. In this world, investors such as hedge funds that undertake a combination of long and short positions across markets help maintain the relative prices of related financial instruments.[8]

Decrease in Volatility. The increase in hedge fund growth has coincided with a decrease in overall market volatility. This may be due to the added liquidity that hedge funds provide to the market. This may also result from the fact that hedge funds generally eschew the "momentum trading" that many individual investors engage in. Because hedge fund investors generally have accepted longer redemption horizons, hedge funds have fewer incentives to engage in momentum trading. By contrast, more traditional investors, such as mutual funds, are more likely to buy into rising markets and sell into falling markets as a result of purchases and redemptions by individual retail investors, accentuating market volatility.

III. OVERVIEW OF HEDGE FUNDS AND THEIR STRATEGIES

Definition of Hedge Fund. The term "hedge fund" is not a defined term under the federal securities laws, but it is used generally to connote a private investment fund that is not required to register as an investment company under the Investment Company Act of 1940 (the "Investment Company Act").[9] In general, and for purposes of this testimony, MFA considers a "hedge fund" to be a privately offered investment company that is administered by a professional investment manager that seeks attractive absolute returns, typically through investments and trading in publicly traded securities and other interests. Hedge funds are one category of the universe of "alternative investments". Other categories include: venture capital, private equity, leveraged buyout, oil and gas, and real estate funds.

Size. Because of the non-public nature of hedge funds, there is no universally accepted estimate on the size of the hedge fund universe. MFA believes the industry consists of over 13,000 single hedge funds with approximately 4,900 distinct single hedge fund managers, with total assets under management of over $1.4 trillion. Approximately 240 of these single hedge fund managers are large organizations, each of

which manage at least $1 billion in assets under management. It is estimated that these 240 managers collectively manage over 80% of all hedge fund assets. At the other end of the hedge fund spectrum, there are thousands of small firms managing hedge fund assets under $50 million each, many of them relative newcomers to the industry.

Broad Array of Investment Profiles and Strategies. As noted above, hedge funds are more easily defined in relation to what they are *not*. They are investment companies that are not publicly offered. The hedge fund universe is characterized by a wide variety of strategies, with different risk characteristics and different return expectations. Many hedge funds managers engage in "absolute return" strategies, meaning that, unlike most mutual funds, their returns do not depend on, nor are they benchmarked against, the long-term return of the markets, such as the Dow Jones Industrial Average or S&P 500. Rather, hedge funds seek to achieve positive returns based on the skill or strategy of the manager rather than to meet or exceed the performance of the underlying market or asset class. Many hedge fund strategies employ "enhanced active management," in which managers combine traditional active management with techniques such as short selling and leverage. Some hedge fund strategies may not be based on traditional techniques at all, such as risk arbitrage, convertible hedging, and distressed debt.

The universe of hedge funds divides naturally into four main strategy groups: (1) equity hedge funds,[10] (2) global asset allocators,[11] (3) relative-value managers,[12] and (4) event-driven managers.[13] Within each of these four main categories lie a variety of more specialized sub-strategies. A hedge fund's proprietary trading strategy is what makes it unique. In pursuit of their strategy, hedge funds utilize a broad range of investment tools such as stocks, bonds, options, futures and derivatives. Hedge funds stand at the forefront of financial innovation in pursuit of their strategies and are important sources of new investment products, particularly in the area of derivatives, as explained later in this testimony.

The significance of the broad array of strategies should not be underestimated, as it reflects the increasing segmentation of the hedge fund industry, and with that the growing segmentation of risk. Today's hedge fund industry is actually comprised of many sub-strategies, each with separate and distinct pockets of risk. Each strategy can prudently withstand different levels of leverage, and each strategy has a different time horizon for investment and varying levels of volatility. Policymakers should be mindful of the value of these different strategies to the global marketplace in considering any policy decisions impacting the hedge fund industry.

IV. CURRENT ISSUES

Since its creation, MFA has been an advocate for the alternative investment industry on a number of important legislative, regulatory and private sector initiatives. Following is a summary of a few of the major regulatory initiatives on which MFA is focusing.

PWG's Agreement on Principles and Guidelines Regarding Private Pools of Capital. As noted above, on February 22, 2007, the PWG issued its *Principles and*

Guidelines Regarding Private Pools of Capital, intended to guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds. The *Principles and Guidelines* assert the PWG's view that "[t]he vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors" and reaffirm their view that, "market discipline of risk-taking is the rule and government regulation is the exception." The PWG agreed that "[m]arket discipline most effectively addresses systemic risks posed by private pools of capital" and investor protection concerns "can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors."

MFA fully endorses the PWG's conclusion that it is the shared responsibility of the private and public sectors to protect our capital markets and address the potential systemic and investor protection risks that may be presented by private pools of capital. While we believe that the path laid out by the PWG in their agreement is the right path, we pledge to work with Congress and all financial regulators, to ensure that the PWG's principles are carried out by all market participants. MFA is and will do its part in this process.

As the largest U.S.-based association representing hedge funds, MFA has taken a leadership role in ongoing industry initiatives to address potential systemic risks, investor protection issues and other regulatory concerns. As discussed more fully below, our current initiatives include:

- Updating *MFA's Sound Practices for Hedge Fund Managers* — a detailed, comprehensive framework of internal policies, practices and controls for hedge fund managers.
- Participation in private and public sector initiatives to address rapid growth and resulting documentation concerns presented by the use of credit derivatives.
- Participation in the SEC's ongoing review of investor eligibility standards for participation in hedge funds.
- Participation in a joint effort with 11 other trade associations on the "Statement Regarding the Communication and Use of Material Nonpublic Information" and related initiatives to protect against misuse of market information.
- Maintaining ongoing communication and dialogue with regulators, industry participants and investors to address emerging issues relevant to the hedge fund marketplace.

Continued Development of *MFA's Sound Practices*. MFA has a longstanding, ongoing commitment to promoting sound practices in the hedge fund industry. *Sound Practices for Hedge Fund Managers* was first published in 2000 in response to a 1999

recommendation by the PWG that hedge funds establish a set of sound practices for their risk management and internal controls. These sound practices were updated and expanded in 2003 by MFA as a response to industry developments. Recognizing the valuable guidance provided by our 2003 guidance, on August 2, 2005, we published *MFA's 2005 Sound Practices for Hedge Fund Managers*. The 2005 iteration of *MFA's Sound Practices* was widely disseminated to policymakers on Capitol Hill and to U.S. and international regulators. The recommendations set forth in our *2005 Sound Practices* provide a framework of internal policies, practices and controls for and by hedge fund managers, providing specific commentary on recommended internal trading controls, responsibilities to investors, valuation, risk management, regulatory compliance, transactional practices, business continuity and disaster recovery, codes of ethics, best execution, soft dollar practices, and other matters.

Our document has been widely recognized by regulators and industry participants alike, such as the Counterparty Risk Management Policy Group II in their 2005 report, *Toward Greater Financial Stability: A Private Sector Perspective* ("*CRMP Group II Report*"). We continue to encourage hedge fund managers to incorporate MFA's recommendations into their particular internal policies and procedures. MFA has underway a review and expansion of the *2005 Sound Practices* to address new regulatory and marketplace developments and anticipates publishing this additional guidance within the next six months.

Credit Derivatives and Systemic Risk Issues. As mentioned above, hedge funds stand at the cutting edge of financial innovation in pursuit of a wide range of investment strategies. The clearest example of this is in the development of a relatively new investment product known as the credit default swap ("CDS").[14] A credit derivative, such as a CDS, is essentially a privately negotiated agreement that explicitly shifts credit risk from one party to the other. The growth in the use of these types of derivatives products has been widely reported. According to the International Swaps & Derivatives Association ("ISDA"), the outstanding notional value of credit derivative contracts rose from an estimated $700 billion at year-end 2001 to an estimated $26 trillion at mid-year 2006.

The rising use of credit derivatives has attracted the attention of regulators in the U.S. and overseas. In 2005, regulators raised particular concerns about the growing trend of unconfirmed assignments of credit derivative transactions, known as "novations," and the threat that this would pose to systemic risk in the event of a large credit event. Regulators in the United Kingdom and in the U.S. feared that problems could emerge as a result of the high number of unsigned confirmations of novations transactions. These concerns were also expressed in the *CRMP Group II Report*. MFA members who are active participants in the credit derivatives markets took part in discussions with representatives of ISDA, the major derivatives dealer firms, and the Federal Reserve Bank of New York on the finalization of the ISDA 2005 Novation Protocol. These parties worked together to ensure that novations could be transacted successfully under the Protocol.

As an outgrowth of the dialogue between the hedge fund and derivative dealer communities that occurred in late 2005, MFA has been in, and is continuing its, dialogue with representatives of the 18 major dealers (the "Fed 18") and ISDA to provide significant input on the Fed 18's proposed strategy for reducing confirmation backlogs in credit derivatives and other derivative products. Over the past 12 months, MFA representatives have devoted significant time and resources to working with the Fed 18 in the development and implementation of their stated targets for improving credit derivatives market practices. The Fed 18 dealers have shown commitment to working with hedge funds to develop and implement standard processing guidelines for credit derivatives in order to reduce the backlog of unexecuted confirmations and the development of automated solutions for the processing of standardized products. Because of the work in this area, significant reductions in backlogs – over 80%, were achieved last year. Our efforts illustrate that market participants can work together to achieve tangible improvements that benefit all market participants who trade derivative products.

Another tangible result is the release of an industry-wide electronic platform to warehouse credit derivative transactions.[15] MFA continues to educate its members and keep them informed regarding the latest operational developments in derivatives.[16] As major participants in the credit derivatives markets, MFA's members have shown their willingness to work on private sector initiatives with their sell-side counterparties on steps to reduce systemic risk.

The systemic benefits of hedge funds have been widely recognized by regulators, as noted above. The "larger role played by a much-expanded number and more diverse mix of private fund managers," along with improvements in risk management, enhanced risk transfer mechanisms and other developments "seem likely to have improved by the stability and resilience of the financial system."[17] The increased importance of leverage and leveraged funds in the capital markets has focused attention upon the potential impact of adverse market events, particularly "tail events," upon hedge funds and leveraged institutions. Like the PWG, MFA believes that market discipline provides the most effective means of addressing systemic market risks of this nature. Industry leadership in developing specific standards to address these types of risks has already been demonstrated in the *MFA's 2005 Sound Practices* guidance and the *CRMP Group II Report*. As the PWG has recently underscored, managers of private pools of capital, creditors, counterparties, investors and fiduciaries all have responsibilities to foster market discipline. We at MFA are committed to assuring that the hedge fund industry meets these responsibilities and works cooperatively with other stakeholders in addressing all relevant risks.

Investor Protection Issues. As discussed above, one of the reasons for growth in the hedge fund industry in recent years has been an increasing recognition that hedge funds are an attractive asset class that can diversify returns and reduce the overall risk of an investment portfolio. In recent years, regulators have voiced concern that hedge funds are becoming investment vehicles open to the retail public and, consequently, have raised investor protection issues. This concern, coupled with the legally-required, non-public

nature of hedge funds, has led regulators to inquire whether investors without the requisite financial means or sophistication were coming exposed to investments that might not be suitable for them.

From all available information, hedge funds remain chiefly an investment vehicle for institutional investors and high-net worth individuals. However, to address the potential availability to retail investors of hedge fund investments without the intermediation of an institutional investor, the SEC has proposed to create stricter eligibility standards for individual investors in funds that are privately offered in reliance on Regulation D to help ensure that such investors will be capable of evaluating and bearing the risks of these investments.[18] Currently, Regulation D, the safe harbor from registration of securities that privately offered investment vehicles typically rely upon, defines "accredited investors" to include natural persons with individual or joint net worth of $1 million, individual income in each of the last two years in excess of $200,000, or joint income for the same period of $300,000. In the 25 years since the SEC last updated Regulation D, these dollar thresholds have come within the range of many middle class investors. To address this development, the SEC's proposed new category of "accredited natural person" would require that a natural person own, individually or jointly with the person's spouse, not less than $2.5 million in investments in addition to qualifying as an accredited investor under current net worth or income standards.

MFA agrees with the SEC's conclusion that it is no longer appropriate for hedge funds to be sold to natural persons who fall within today's definition of Accredited Investors. MFA has long endorsed raising the financial standards in Regulation D as a means to address the SEC's concerns about the "retailization" of hedge funds and the effect of inflation on income and net worth standards as they relate to the "accredited investor" definition.[19] We have, however, some specific concerns about the proposed new Accredited Natural Person Rule, including its high degree of complexity and the potential for confusion on the part of investors, as well as added costs. MFA has explored these issues fully in our comment letter, dated March 9, 2007, to the SEC on the proposed rule. We ask Congress to consider ways to encourage greater consistency among financial sophistication standards across all regulatory agencies over which it has oversight for the benefit of investors and fund managers alike.

Regulators have also linked investor protection issues to regulations that require investment adviser registration with the SEC. With respect to the registration of hedge fund advisers, we believe the current statutory regime is sound. The vast majority of the top 100 hedge funds in the world are managed by SEC-registered advisers. In the past, mindful of the need of the SEC to gather data on the industry, we have proposed to the SEC that unregistered hedge fund advisers could be required to notify the SEC of its intention to operate as a hedge fund adviser in reliance on the relevant exemptions. Our proposal provided for a notice that could include certain basic census information about the hedge fund adviser determined to be necessary or appropriate. In the future, regulators may wish to re-visit our proposal.

Pension Fund Investments in Hedge Funds. In proposing to reduce the availability of pooled investment vehicles to retail investors, the SEC acknowledged that natural persons may have "indirect exposure" to private pools as a result of their participation in pension plans and certain other pooled vehicles that investment in private pools.[20] However, the SEC distinguished these types of vehicles from the direct investments addressed by its proposed heightened eligibility standards: "[s]uch plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals," protections not present in the case of natural persons who seek to invest in 3(c)(1) pools outside of the structure of such pension plans and pooled investment vehicles.[21] For example, the SEC in recent years has permitted the registration of investment companies that themselves invest in hedge funds. In these circumstances, the Investment Company Act, the Investment Advisers Act of 1940, and all the investor protection mechanisms of the Federal securities laws come into play. These funds are subject to the rule range of protections afforded by SEC registration and oversight, as they are registered with the SEC and sold in registered public offerings. In addition, advisers of registered funds of hedge funds are required to be registered under the Advisers Act. The SEC, therefore, has authority to address any investor protection issues that may be presented.

The PWG also addressed concerns about less sophisticated investors being exposed to hedge funds through their participation as beneficiaries of pension funds. It concluded that such concerns "can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles. These fiduciaries have a duty under applicable law to act in the best interest of the beneficiaries." The PWG recommended that such fiduciaries, in considering whether to invest in a private investment fund, should carefully evaluate the fund's manager and conduct appropriate due diligence regarding the fund's valuation methodology and risk profiles. Such fiduciaries should also consider whether the suitability and the size of an investment are consistent with their investment objectives and the principle of portfolio diversification. MFA agrees with the PWG that the focus of protection for the beneficiaries of pension funds should be on the plan fiduciaries and the skills and sophistication they apply in carrying out their responsibilities. MFA endorses efforts to increase understanding of hedge funds and hedge fund strategies among professional fiduciaries, and is committed to helping such fiduciaries continue to develop their skills in performing due diligence on hedge funds and fund managers. Specifically, MFA is committed to helping promote investor financial literacy through the development of due diligence materials.

While investments in hedge funds by public and private pension funds appear to be growing, such investments are far from a level that would suggest undue risk to individual investors. In 2003, U.S., European, and Canadian pension funds reported that about 1% of their portfolio assets were invested in hedge funds.[22] By comparison, U.S. pension investments in real estate and private equity have been estimated at 3.4% and 3% of pension fund assets respectively.[23] As noted by the SEC, the beneficiaries of such plans have the benefit of professional fiduciaries and investment advisers and these vehicles thus do not present the "retail" investor issues addressed by the SEC in its proposed "accredited natural person" definition.

Joint Statement Regarding the Communication and Use of Material Non-Public Information ("Joint Statement"). In December 2006, MFA, together with 11 other trade associations, issued a Joint Statement reaffirming their commitment and that of their members, "to promote fair and competitive markets in which inappropriate use of material non-public information is not tolerated." As set forth in the Joint Statement, the prohibition against "insider trading" and "insider dealing" – through the misuse of material non-public information in connection with transactions in securities or securities-related derivatives – is firmly established and integral to public confidence in, and the proper functioning of, our capital markets. The signatory associations reaffirmed their previously-issued guidance concerning the communication and use of material non-public information and pledged to "inform, educate and provide additional guidance to our members, non-members and other interested parties alike."

MFA is actively involved in carrying out the commitments set forth in the Joint Statement. *MFA's 2005 Sound Practices* stress that hedge fund managers should establish written compliance procedures that address trading rules and restrictions, confidentiality restrictions, disclosure controls and policies designed to assure compliance with applicable securities and commodities laws, specifically including prohibitions on insider trading and other forms of market manipulation, measures to prevent flow of non-public information from one function to another, and personal trading policies. Specific recommended procedures are also provided. As I have noted, MFA has undertaken to revise and supplement its *2005 Sound Practices* and the new version will include additional specific guidance to reaffirm the principles set forth in the Joint Statement and provide recommended procedures to reinforce these principles.

V. CONCLUSION

The growth of the hedge fund industry has provided enhanced liquidity to our capital markets, increased efficiency, decreased risks, and provided important diversification tools to institutional investors. However, with the growth and evolution of the hedge fund industry have come the new responsibilities and challenges discussed herein. On behalf of its members, MFA is committed to working with Congress, regulatory agencies and the private sector to ensure that these benefits continue while addressing systemic risk and investor protection concerns. MFA appreciates the opportunity to share its views with the Committee.

Source Materials

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- Joint Statement Regarding the Communication and Use of Material Non-Public Information, December 12, 2006.

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[1] *See* Written Statement of Managed Funds Association, "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk," Before the House Financial Services Committee, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (May 22, 2003). *See* Testimony of George E. Crapple, Chairman, Managed Funds Association, before the Committee on Banking and Financial Services, U.S. House of Representatives (May 6, 1999).

[2] Based on reported estimates by PerTrac Financial Solutions, "2006 PerTrac Hedge Fund Database Study." See also, "Hedge Fund AUM Reaches $1.49 Trillion: Lipper TASS," *HedgeWorld News* (February 27, 2007) (*citing* Lipper TASS report asset inflow study).

[3] Remarks of Under Secretary for Domestic Finance Robert K. Steel on Private Pools of Capital, U.S. Department of the Treasury, Treasury Department Cash Room (Feb. 27, 2007).

[4] *See* 2006 NACUBO Endowment Study, at NACUBO website at www.nacubo.org.

[5] *Id.* (includes only endowments of over $1 billion in assets under management).

[6] *See* Written Statement of Managed Funds Association before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, U.S. House of Representatives, May 22, 2003, at Annex A.

[7] "Renomination of Alan Greenspan as Chairman of the Federal Reserve Board of Governors: Hearing before the Senate Committee on Banking, Housing and Urban Affairs Committee" (testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve) (June 15, 2004).

[8] President's Working Group on Financial Markets Report, "Hedge Funds, Leverage and the Lessons of Long-Term Capital Management" ("President's Working Group Report"), April 1999, at A-6.

[9] More technically, a "hedge fund" is an investment company that is not required to register with the SEC by virtue of Section 3(c)(1) or 3(c)(7) of the Investment Company Act and that conducts only private offerings under the SEC's Regulation D or another exemption under the Securities Act of 1933.

[10] This can include long/short strategies for trading in equities; dedicated short sale equity strategies focusing on selling short securities that are deemed to be overvalued; regional strategies, which concentrate on a particular geographic region (such as emerging markets); sectoral strategies, which focus on a particular industry; or long only, or "buy and hold", equity strategies, similar to traditional equity mutual fund strategies, but which may also include active efforts to become involved in the management of holdings.

[11] Also known as "global macro" or global directional investment strategies, which take positions in domestic and international currency, interest rate and equity markets based on global economic conditions and opportunities perceived to be presented by them. This may include specific asset class strategies (such as currencies, commodities, interest rates).

[12] Also called "market-neutral" or arbitrage strategies, which take offsetting long and short positions or otherwise hedged positions to reduce market risk and utilize leverage to achieve desired returns.
[13] Event-driven strategies, which seek to profit from anticipated events or special situations, such as mergers, restructurings, distressed securities.
[14] A credit default swap is a credit derivative contract in which one party (protection buyer) pays a periodic fee to another party (protection seller) in return for compensation upon the default (or similar credit event) by a reference entity. The reference entity is not a party to the credit default swap. It is not necessary for the protection buyer to suffer an actual loss to be eligible for compensation if a credit event occurs. *See* ISDA Web site at www.isda.org ("Product Descriptions & FAQs").
[15] Lauren Teigland-Hunt and Ryan Patino, Teigland-Hunt & Associates LLP, "Taming Credit Derivatives: Assessing the Private Sector Response to Regulatory Concerns," *MFA Reporter* (November 2006), (available at http://www.mfainfo.org/images/PDF/MFA_Nov06.pdf) (describes development of DTCC Trade Information Warehouse to store official electronic records of credit derivatives trades).
[16] For example, on March 1, 2007, MFA, Fed 18 and DTCC representatives led a discussion for MFA members, "Update on Fed Targets, Derivatives Processing and the Role of DTCC & Trade Information Warehouse."
[17] Remarks of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, at the Distinguished Lecture 2006, sponsored by the Hong Kong Monetary Authority and Hong Kong Association of Banks, Hong Kong, September 15, 2006.
[18] Securities Release No. 8766 (Jan. 4, 2007), 72 Fed. Reg. 400 ("SEC Release").
[19] Managed Funds Association, "White Paper on Financial Eligibility Standards for Investors in Hedge Funds" (July 7, 2003), (available at http://www.mfainfo.org/images/pdf/WhitePaperInvestorEligibilityFinal.pdf).
[20] SEC Release, at 404.
[21] *Id.*
[22] Greenwich Associates, "Alternative Investments May Disappoint Dabblers" (January 21, 2004).
[23] Greenwich Associates, "The Alternative Balancing Act" (December 32, 2003).

Congressional Testimony
Jeffrey L. Matthews
General Partner
Ram Partners, LP
March 13, 2007

Mr. Chairman and members of the committee, good morning and thank you for inviting me to speak.

My name is Jeff Matthews and I am General Partner of Ram Partners, LP—a hedge fund I formed in 1994, after working at another hedge fund for four years, and starting my career at Merrill Lynch in 1979.

My fund is small relative to the others here, and rather old-fashioned. We buy stocks for the long term, hedge against short-term fluctuations, and don't do any derivatives.

Nevertheless, 18 years in the hedge fund world does make me something of an old-timer, and I do have views on the issues you have raised.

To understand the growth in hedge funds you might ask yourself "Why do people start them in the first place?"

The answer is simple.

Hedge funds are private partnerships whose investors are wealthy individuals and large institutions. That private structure and more sophisticated investor base gives us flexibility to pursue alternative investments, take greater risks, and reap greater rewards than a more strictly regulated mutual fund.

Furthermore, as a private partnership, hedge fund managers can charge what their investors are willing to pay, including a share of the profits the fund generates. So a successful, multi-billion dollar hedge fund manager can literally earn hundreds of millions of dollars while her mutual fund counterpart cannot.

That's why people start hedge funds, and why this industry has exploded.

In fact, the single biggest change I've witnessed since I started is size. In 1994, the biggest hedge fund had about $6 billion in assets. $6 billion today wouldn't rank in the top 50 U.S. hedge funds today—and the three largest now have over $30 billion each.

Along with that explosive growth has come diversity: hedge funds no longer focus mainly on stocks, bonds and currencies but have branched into sub-prime debt, distressed securities, real estate, uranium ore and even grain silos. In fact, there are hedge funds that do nothing but invest in other hedge funds.

The flood of money has also caused many so-called hedge funds to no longer actively hedge against market declines, because hedging has been a drag on returns during the bull market. It's like paying premiums for an insurance policy you never need.

However, the most significant change I have witnessed in 18 years is the increased use of leverage—meaning borrowed money—to start new hedge funds.

A $400 million hedge fund today, for example, might actually have only $100 million of true equity. The other $300 million might come from a bank that has sold a preferred class of equity which looks, acts, and smells like debt—yet is called equity.

That structure works fine if the value goes up—everyone makes money and the bank gets paid back. But if it goes down, the equity gets wiped out like a house bought with almost no money down.

What type of risks might this pose? Could the greater leverage cause another Long Term Capital-type hedge fund catastrophe that nearly brings down the markets?

Well, we had just such a catastrophe last year, and the outcome was quite instructive.

Amaranth, a $10 billion hedge fund with sophisticated investors run by intelligent managers using computerized trading systems collapsed in just twenty days owing to huge, complex bets on natural gas that went wrong.

What does this tell us?

1. Hedge fund managers can do stupid things, just like any money manager, only in much bigger size.

2. Even sophisticated hedge fund investors don't necessarily mind this kind of risk-taking unless and until it goes wrong, but when it does, they pull the plug quickly.

3. The more exotic the investments, the harder it is for any outsider to know what is going on inside a hedge fund. After all, if Amaranth's General Partner didn't realize his business was at risk, how would the Fed or the SEC have seen what was coming and act to stop it?

There is, however, a fourth, more positive lesson from Amaranth which was not foreseen by many observers at the time. It is this: a $10 billion fund could evaporate in a matter of months, yet aside from a couple of wild weeks in the natural gas pits, the system didn't even blink.

Unlike Long Capital in 1996, which had to be bailed out by the Fed, other hedge funds bought Amaranth's positions and the firm was liquidated without a problem.

It is true that Amaranth's investors, including public sector pension funds, lost a great deal of money. But those investors knew, or should have known, the risks, and they invested anyway.

As I said, I run a smaller, old-fashioned hedge fund. We do not do derivatives, so I am not defending my own business model here—these are simply my real-world observations. Nor am I acting as a cheerleader for all hedge funds: there will be failures again, and they could get ugly.

However, the presence today of so many large funds specializing in all aspects of the world's markets means in my view the systemic risk of broad failure is probably much lower, and certainly not higher, than I have seen it in the past 18 years.

I was there when Long Term Capital blew up, and I was there when Amaranth blew up. And I can tell you this: Amaranth turned out to be no Long Term Capital.

Thank you for inviting me to speak.

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