

**THE ROLE OF HEDGE FUNDS IN OUR CAPITAL  
MARKETS**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
SECURITIES AND INVESTMENT  
OF THE  
COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

EDUCATING AND INFORMING THE CONGRESS AND THE AMERICAN  
PEOPLE ON THE ROLE OF HEDGE FUNDS IN OUR CAPITAL MARKETS

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MAY 16, 2006  
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## **THE ROLE OF HEDGE FUNDS IN OUR CAPITAL MARKETS**

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**TUESDAY, MAY 16, 2006**

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

The Committee met, pursuant to notice, at 2:21 p.m., in room SD-538, Dirksen Senate Office Building, Senator Chuck Hagel (Chairman of the Subcommittee) presiding.

### **OPENING STATEMENT OF SENATOR CHUCK HAGEL**

Senator HAGEL. Good afternoon. Today's hearing will focus on the role of hedge funds in our capital markets. The intent of this hearing is to educate and inform the Congress and the American people on this growing sector of our financial markets. According to the Economist Magazine, a hedge fund is defined as a managed pool of capital for institutional or wealthy individual investors that employs one of various strategies in equities, bonds, or derivatives, attempting to gain from market inefficiencies and, to some extent, hedge underlying risks.

Charles Mingus, an American jazz bassist and composer once said, quote, making the simple complicated is commonplace. Making the complicated simple, awesomely simple, now, that is creativity, end of quote. Suffice it to say we are looking for creativity from our witnesses today.

Alfred Jones is credited as the father of hedge funds. He established the Jones Hedge Fund in 1949. Roy Neuberger and Benjamin Graham are also credited for laying the foundations for the industry; however, hedge funds did not begin to gain popularity until the 1960s. In 1969, almost 200 hedge funds managed \$1.5 billion in assets. Since then, the growth of the hedge fund industry has exploded, with most of the growth occurring in the past decade. Currently, over 8,000 hedge fund managers are controlling over \$1 trillion in assets.

Today's hearing will look at the benefits and risks of hedge funds to investors and to our economy. We will explore the current oversight of hedge funds, the level of transparency, the different types of investors, and the cause for the explosive growth of this industry over the last decade. The hearing will also examine the current dynamic of the over-the-counter derivatives market and assess the growing risks and benefits of this industry. We will look at the types of derivatives offered, the main users of derivatives, potential concerns for investors, and the industry's impact on our capital

markets. And finally, we will consider whether the Federal Government should play a greater oversight and regulatory role in these areas and also assess the risks of overregulation.

In today's global economy, large amounts of money can be transferred in a moment's notice, and it is important that our investors have confidence in the systems and funds that transfer and administer their investment and assets as well as a good understanding of both their investment benefits and risks. Just as important is keeping our capital markets here in the United States strong and dynamic and the envy of the world.

I welcome our witnesses today, who will help us explore these important issues. Our first two panels feature representatives from the President's Working Group on Financial Markets. We will look at the work of the President's Working Group on this issue. Our first panel includes the Hon. Randal K. Quarles, Under Secretary for Domestic Finance at the U.S. Department of the Treasury.

Our second panel includes Ms. Susan Wyderko, current Director of the Office of Investor Education and Assistance and former Acting Director of the Division of Investment Management at the Securities and Exchange Commission; Dr. Pat Parkinson, the Deputy Director of the Division of Research and Statistics at the Board of Governors of the Federal Reserve System; and Dr. James Overdahl, Chief Economist at the U.S. Commodity Futures Trading Commission.

Our third panel today features five experts who will offer their thoughts on hedge funds. First, the Hon. Richard McCormack. Dr. McCormack is currently a senior advisor for the Center for Strategic and International Studies. He is a former Under Secretary of State for Economic Affairs, Assistant Secretary of State for Economic and Business, and deputy to the Assistant Secretary of Treasury for International Economic Affairs. He is an expert on the role of international financial institutions. Dr. Adam Lerrick is a visiting scholar at the American Enterprise Institute and a Professor of Economics at Carnegie Mellon University. Dr. Lerrick's expertise is in international capital markets and hedge funds. Mr. Kurt Schacht, Executive Director of the Center for Financial Market Integrity of the Chartered Financial Analysts Institute; he is former chief legal officer for the State of Wisconsin Investment Board and has an extensive background in hedge funds and corporate governance matters. Mr. Jim Chanos, President of Kynikos Associates and Chairman of the Coalition of Private Investment Companies. Mr. Chanos has extensive experience in managing hedge funds and represents a coalition of hedge fund investment companies.

Our fifth panelist has sent word that he will be unable to be here with us today, although he is providing testimony. It is Mr. Jack Gaine, President of the Managed Funds Association. And to all of our panelists, we are most grateful and appreciate your testimony.

Senator HAGEL. Before we get to our witnesses, let me next call upon the Ranking Member of the Subcommittee, my colleague, Senator Dodd.

**STATEMENT OF SENATOR CHRISTOPHER DODD**

Senator DODD. Thank you very much, Mr. Chairman, and you have underscored the points here, I think, and I want to commend you for holding the hearing. This is very worthwhile for us to spend some time and examine this remarkable success story of hedge funds. You pointed out the success of this vehicle over the years. I note that in just the last 14 or 15 years, we have gone from a \$50 billion industry, which is not small, obviously, to in excess of \$1 trillion. Some 9,000 hedge funds are now operating in the United States, and in my State of Connecticut, and Fairfield County has become sort of the de facto capital in some ways of hedge funds.

I have a lot of constituents who are directly involved in this and have been tremendously, tremendously successful with it, obviously, improving efficiencies in markets, great liquidity as well, so this has been a wealth creator. It has been a source of tremendous success. And obviously, there have been some impacts as well on the corporate decisionmaking which people are raising some issues about; increasingly become mainstream investment vehicles for pension plans, institutional investors, and in some cases, real estate or retail investors as well.

In my view, we know far too little about the role that hedge funds play in our capital markets, and thus, this hearing, I think, is extremely important for us to learn more about the role that these funds can play. It is our responsibility; it is my hope that we will continue to help us better understand the benefits and potential concerns associated with hedge funds.

If it is this Committee's responsibility, as I believe it is, to ensure proper statutory and regulatory oversight of hedge funds, then, regulation that we look at should be effective and efficient. If it is going to be implemented, it should protect, obviously, investors and prevent against systemic risks, while at the same time striking this balance of not being anywhere near overburdensome or irrelevant to industry participants. And while I recognize the SEC's recent registration requirements have just recently gone into effect, I hope that our witnesses, and we have some very good ones here today, that they can discuss the increased regulatory oversight of hedge funds and touch on some of the implementation issues that are associated with the just finalized regulations.

At first blush, the registration requirements and the basic examination regime seem to provide some rudimentary transparency for investors and regulators alike. Greater transparency becomes particularly important, in my view, as the number of hedge funds increase, and they play a greater and greater role in our capital markets. One of the fundamental issues for this Member and I believe for others as well is whether unsophisticated investors are impacted either directly or indirectly by hedge funds and whether the standards for accredited investors should be raised by the SEC.

Mr. Chairman, I am very eager to hear if these registration requirements are helping or hindering the hedge fund industry and if investors are getting better information about the practices and management of their investments. I think that it is appropriate, again, as I said earlier, to take a close, hard look at this. I commend the Chairman for doing so. We have got some wonderful wit-

nesses. I would just caution again, I know there are some strong feelings about this issue, but having sat on this Committee now for 25 years, I have watched situations in the past where there were great concentrations of wealth, and we did not watch as carefully as we should, and we paid a price for it, the country paid a price for it.

So I think it is extremely worthwhile that are undertaking this kind of examination today, and I would note that our last witness here is Jack Gaine. Truth in advertising: Jack and I went to high school together, so I am very interested in hearing what Jack Gaine has to say about hedge funds.

Senator HAGEL. Senator Dodd, thank you.  
Senator Crapo.

#### **STATEMENT OF SENATOR MICHAEL CRAPO**

Senator CRAPO. Thank you very much, Senator Hagel, for holding this hearing. I think it is a very timely hearing, and it is important that we in this Subcommittee and as Members of the Banking Committee develop a much stronger expertise on the issue of hedge funds and their role in our capital markets.

In recent years, we have been hearing more and more about the role of hedge funds, particularly as the amount of capital invested in this sector grows. The importance, in my opinion, is to understand what they are, and that is that they are alternative investment vehicles, alternatives available to qualifying investors, either institutional or individual. The securities laws have for decades imposed restrictions and other limitations on the nature of investors, the nature of solicitation activities, advertising, and aggregation of offerings applicable to alternative investment vehicles offering unregistered securities to investors, and this flexibility in our securities laws has been and continues to be beneficial to our capital markets.

As we are learning with the Sarbanes-Oxley Act, a one size fits all statutory or regulatory model gives rise to inequities and unintended consequences. As we explore the role of alternative investment vehicles in our capital markets, we should keep this in mind.

With respect to the SEC's Hedge Fund Advisor Registration Rule, I would note that in my opinion, it is this Subcommittee in the first instance and our Committee overall where these issues should be resolved. First, the SEC rule was challenged in Federal court, and I for one am hopeful that the D.C. Circuit Court of Appeals will invalidate the rule, because as I see it, the SEC lacks the statutory authority to require many of the changes that it has required.

Second, the rule is not a logical outgrowth of SEC staff studies on hedge funds, which finds that there is no inherent hedge fund fraud; no retailization in the industry and that most hedge funds operate responsibly.

Third, there is a legitimate concern expressed by Commissioner Atkins and the Government Accountability Office that the SEC lacks appropriate expertise and resources to enforce the rule properly. That is not to say that we should not conduct oversight. It is not to say that this Committee should not develop the expertise and the information necessary to assure that we properly review



this issue. As Senator Dodd has indicated, we need to pay attention and make sure that we do not allow problems to arise.

While the SEC is an independent agency, it seems to me that it should not be permitted to take the term independent to an extreme, and it is unauthorized to write new law through regulation, as it has tried, and it must not be encouraged to do so in the future. It should focus on the enforcement and implementation of laws that we pass in Congress, and it must apply its resources responsibly.

Again, I thank you, Mr. Chairman, for holding this hearing, and I look forward to the testimony of the witnesses and to working with the Members of this Committee to be sure that we do strike the right balance and achieve the right legislative response to hedge funds.

Senator HAGEL. Senator Crapo, thank you.  
Senator Reed.

#### **STATEMENT OF SENATOR JACK REED**

Senator REED. Well, thank you, Mr. Chairman. I want to commend you and Senator Dodd for holding this hearing. It is a very important topic. Our concern must be the safety and soundness of the financial system, and we have to pay special attention to any type of systemic risk, and it is important that we consider this topic, and I think it is important for the industry to be able to explain the benefits of hedge funds. And there are demonstrable benefits in terms of sources of liquidity, increases in efficiency, and decreases in volatility, and I think it is also incumbent on them to lay out potential risks.

And the more comfortable we are with both the benefits and the risks of these funds, the better able we will be to legislate and to guide the regulatory agencies in their tasks, and I thank you for the opportunity to have this hearing today.

Senator HAGEL. Senator Reed, thank you.  
Senator Sununu.

#### **STATEMENT OF SENATOR JOHN SUNUNU**

Senator SUNUNU. Thank you, Mr. Chairman.

I think it is important that we have open discussion hearings designed to give us better information about the financial services industry in general, and hedge funds are an important part of that for the reasons that have been discussed. Senator Dodd pointed out that the success story behind hedge funds, the wealth creation; the improvement in liquidity in the market, Senator Reed also mentioned. And I think it is important to underscore that behind that success is a tremendous amount of diversity as well.

We will sit here as Members of Congress and speak in vague, general terms about hedge funds, but the fact remains that the strategies and the investment approaches are as diverse as the entire financial services industry: long-term investments versus short-term investments; focus on commodities; focus on bonds; focus on equities; focus on other types of securities; mathematical modeling of weather phenomena to technical trading of commodities and metals and some of the recent materials where we are seeing big changes in pricing, radically different strategies em-

ployed, and I think we can start from the very basic idea that it does us a disservice and this process a disservice if we speak about hedge funds in some vague and general terms.

It is important to note that hedge funds are already subject to fraud statutes, trading requirements, trading regulations that any other financial service firm or trader is subjected to. They have to comply with all those trading rules and regulations. What we are really talking about, though, is a new set of regulations: the one mentioned by Senator Crapo, promulgated by the Securities and Exchange Commission requiring registration, and I think we have to ask very basically whether or not the SEC really is the appropriate agency to be undertaking that kind of regulatory requirement when their charter is to protect the small retail investor.

And by definition, not our definition, the definition that is in statute, hedge funds are designed to be marketed, sold to very sophisticated investors. Senator Dodd is very right: I think there is a legitimate question as to whether we should revisit those accreditation standards. Perhaps they should be strengthened. The threshold should be raised.

I think that is an important point of discussion, because it is essential that we maintain the distinction. And in fact, the anecdotal stories that we have heard about problems in this industry in some cases were created by provisions within the SEC that allowed funds of funds to be marketed to less sophisticated investors, allowing hedge fund vehicles to register under the Investment Company Act that in turn allowed them to be marketed to individuals who did not meet the accreditation standards, that did not meet the \$1 million asset threshold, that did not meet the \$200,000 income threshold.

We need to be mindful that regulations can create as many or more problems than they were originally intended to solve. The point was made that the country paid a very high price at another time for not exercising good oversight. I think that was a reference to the S&L crisis, but I think it is worth pointing out that that was a case where the taxpayers were asked, under statute, to explicitly underwrite insurance for the industry.

Now, we have another situation which is before us where taxpayers have been effectively asked to implicitly guarantee bonds within the GSEs, Fannie and Freddie, and here, we are not talking about billions. We are talking about a trillion, a trillion and a half in securities that are out there, and I would argue that our time would be at least as well spent if were to make a determined effort to deal with that systemic risk that we know exists and we know there is an implied guarantee. We do not have such an implied guarantee in this industry. We should not have an implied guarantee in this industry. I hope, I believe Congress will be smart enough not to create one, but we also ought not to create regulations that have unintended consequences.

If the problem is that we do not want pensions investing in hedge funds, fine. Then, the approach should be to regulate the pensions and not allow pensions to invest in hedge funds. Again, if the problem is that we are worried about the retail investor, fine; we should draw a bright, clear, distinct line and not allow individuals of a certain means to invest in these vehicles.

But we should not start crafting regulations in order to sort of gather information so that we can pass new regulations, and in any way you look at it, that is what the SEC has done. There is no problem that they have identified, no problem that they have discussed, that they have documented that has led to the registration requirement under the Investment Advisors Act, and I do not think we should be promulgating regulations without defining a specific problem that we wish to address.

I hope today's hearing will address at least a few of those issues, and I hope that this Committee and Congress will be very cautious in looking for new areas of the financial service industries to regulate, because our past record has not always been a good one.

Thank you, Mr. Chairman.

Senator HAGEL. Thank you, Senator Sununu.

Senator Bunning.

#### **STATEMENT OF SENATOR JIM BUNNING**

Senator BUNNING. Thank you, Chairman Hagel.

I am glad we are taking some time to get a closer look at hedge funds. There has been a lot of news about hedge funds lately, because more and more people are putting money in them. They have even become popular investment vehicles for our universities and pensions. A lot of money and a lot of people's futures are riding on them, and that raises a lot of questions and concerns.

Some people are even calling for regulation of the industry. I think it is important for us to take some time to know what we are talking about before we do anything. I think the biggest cause for concern about hedge funds is that we do not know a lot about them. Due to the lack of information, we cannot be sure just how much risk this sector is exposing our financial market system to. I think we need to know more, and hopefully, we will get some good answers in this hearing.

We can all agree that it is important to take reasonable steps to protect investors, but even more importantly, we must be sure that we are keeping a close eye on threats to the stability of our financial markets. That is why we need to know more about the hedge funds and what they are doing and what they are not doing. We do not need to stop investors from taking any risk, but we do need to address risk to our financial markets and our overall economic wellbeing of this country.

I hope we can get a better picture on what is going on so that investors can make smarter decisions, and government can determine what action, if any is necessary. The SEC is trying to do that by requiring hedge funds to register as investment advisors, but that rule is being challenged in the courts and could be thrown out at any time. Hopefully, this hearing will help us see where we need to go from here.

Thank you, Mr. Chairman. I look forward to asking questions.

Senator HAGEL. Thank you, Senator Bunning.

Senator Allard.

**STATEMENT OF SENATOR WAYNE ALLARD**

Senator ALLARD. Well, thank you, Mr. Chairman.

I would just like to thank you for convening the hearing of the Securities Subcommittee to examine the role of hedge funds in our capital markets. Historically, hedge funds have provided an investment vehicle for financially sophisticated investors with sizable capital to invest, and I realize that these investors and advisors that deal with hedge funds, these are complicated transactions, so I am glad that you are taking the time to kind of brief the Committee and myself on various aspects of the hedge funds and how you deal with them.

Not all mutual funds are required to register with the SEC and are not required to provide the same level of disclosure. So I am interested to know how this phenomenon is operating in the marketplace. And as investors look for ways to maximize returns, I see more and more are turning to hedge funds, but do these investors, particularly those investing in registered funds of hedge funds absolutely understand the risks involved? And how does the looser regulation of hedge funds translate in the capital markets?

So I think this hearing is going to be a good opportunity, Mr. Chairman, for us to explore these and other matters, and it looks like we have an excellent lineup of witnesses that will be able to provide helpful insight, and I thank you for holding the hearing today, and I look forward to their testimony, Mr. Chairman.

Senator HAGEL. Thank you, Senator Allard.  
Secretary Quarles.

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

Mr. QUARLES. Thank you, Mr. Chairman.

Chairman Hagel, Ranking Member Dodd, Members of the Subcommittee, thank you very much for inviting me to testify and present the Treasury Department's views on the role of hedge funds in the capital markets. As you have all noted, it is an interesting and important issue, and I think the purpose here of this hearing and improving our understanding of a critical component of our capital markets should be viewed by everybody as a welcome one.

Mr. Chairman, I have prepared written testimony that discusses the subject in some detail, and with your permission, I would like to submit that for the record and simply summarize my points briefly here.

Senator HAGEL. All of the written testimony will be submitted for the record. Please proceed.

Mr. QUARLES. Thank you.

To begin, I want to emphasize that both my written testimony and my remarks today are focused on the topic of today's hearing, which is the role of hedge funds in our markets. That is a different question from the one that has gathered quite a bit of attention the last few years, which is the regulation of hedge funds. I also think it is the right question at this time.

If government addresses the question of regulation of any financial institution or activity without a clear understanding of the

place that it plays in our financial system, the risk of unnecessary or excessive or inappropriate legislation is increased, so while I am sure we will touch on certain regulatory aspects, I intend to focus my remarks on what hedge funds do in and for our financial markets.

Second, I want to state that while capital in these vehicles has grown substantially in recent years, they are not a recent invention, as has been noted. Their history typically dates to 1949. Today, the term hedge fund is used to describe much more than those early funds that adopted hedging techniques. They follow a wide variety of investment strategies. They invest in a wide variety of assets. There is no generally accepted definition, but it might be useful to list some features that are generally common, recognizing that no single feature is a defining characteristic. Those features include a passthrough legal structure, flexible investment strategies, incentive compensation structures, a restricted investor base, and relative ease of investor subscription and withdrawal.

Looking at it that way, I think it is clear that whether or not we characterize them as hedge funds, investment vehicles with those characteristics are likely to be around for a considerable period of time because of the obvious advantages and attractiveness of a number of those features.

I think it is also important to note that while there has been rapid growth, particularly over the course of the last several years in the amount of money that is invested in hedge funds that that growth has been accompanied by a certain amount of private sector discipline. Originally, the hedge fund investor base was composed almost entirely of high net worth individuals. Later, university endowments and other endowments and foundations were added as investors. Still later, pension funds, with their sophisticated managers and the consequence of the evolution of the investor base has been an increasing professionalization of the evaluation of hedge funds and their investment strategies, and each of these investor groups has imposed certain forms of discipline on hedge funds, and the hedge fund market has become much more institutionalized as a result. So while the hedge fund market has grown dramatically, there is at least some reasonable to believe that that growth has been subject to private sector discipline.

Let me summarize briefly some of the principal benefits that I see hedge funds bringing to the financial marketplace and then some of the risks. The first, as all of you have already noted, is liquidity. One of the reasons that the financial markets of the United States are so attractive to investors is because of their liquidity. Because of the varying strategies that hedge funds employ, they are often the willing buyers or sellers that provide additional liquidity to financial markets. Hedge funds represent the overwhelming majority of trading volume in the distressed debt markets, in convertible bond markets, in the exchange traded funds markets. They also bring the benefits of price efficiency.

Many hedge funds seek to create returns by targeting price efficiencies where there is a discrepancy between one or more markets or where there are wide bid-ask spreads, and thus, this activity produces the public good of better price discovery and more efficient markets. They help distribute risk. Concentration of market

wide risk is one of the greatest threats to a smoothly functioning marketplace, and hedge funds help distribute that risk.

There are benefits to investors as well. They provide more choices to the investor community. They help produce excess returns or capital protection, but there are risks that we should be focused on. Our written testimony discusses these in some detail. I think the principal ones are the large use of leverage, which we need to be focused on and as well different ways that leverage can be generated, including it being embedded in some of the instruments that hedge funds trade in.

There are evaluation issues with hedge funds' portfolios, particularly given that hedge funds calculate their returns on the basis of periodic valuations, and there is the issue of clearing and settlement systems. While I do not think that that is something that is specific to hedge funds, it is something that because of the instruments, some of the instruments that hedge funds trade in, is something that we should be looking at in connection with today's hearing.

So in conclusion, I would want to stress that we see significant benefits in the financial marketplace from hedge funds. We see some risks. At the Treasury Department going forward, we are going to be focused on engaging with financial market participants generally in order to better understand these over the course of the next several months, and we will be involved with the President's working group in doing that, too.

Thank you very much.

Senator HAGEL. Secretary Quarles, thank you.

Let's begin with 5-minute rounds? We have three panels today, and we have good attendance, and I think we will have other Senators stop by as well, and we will ensure that everyone gets all the questions asked that they would like to ask.

So I will begin my 5 minutes with this question: in your opinion, Mr. Secretary, as you ended in describing in summary fashion risks, benefits, in your opinion, should the Federal Government be looking at a more defined regulatory role for hedge funds?

Mr. QUARLES. Well, I think at this point, I would not see evidence that would suggest that there should be greater regulation of hedge funds or a different concept than so far we in the official sector have generally been approaching with respect to hedge fund regulation, which is following recommendations of the President's Working Group in the report in the late nineties to focus on counterparty risk management as the way to deal with the risk that hedge funds may pose in the financial marketplace.

I think that it is incumbent upon us to understand how hedge fund activities are evolving, and that is the reason for this program that I described to you of the Treasury Department reaching out in the financial marketplace over the course of the next several months to ensure that we do have a good understanding in concert with the President's Working Group of some of these current issues that may pose risks to the financial markets, but on the basis of information we have now, I would not say that there is anything that would cause us to believe there is a particular area or particular type of regulation that is lacking or that would be useful.

Senator HAGEL. How much transparency is there in the hedge fund industry, starting with Treasury's oversight?

Mr. QUARLES. We have, as I described, since we are focused on counterparty risk management, obviously, the official sector in general, the members of the President's Working Group various regulators, the Treasury Department as chair of the President's Working Group has a significant amount of information about the exposure of various regulated counterparties to hedge funds.

In addition, post-LTCM and some of the recommendations of the President's Working Group that were proposed, and many of them have been adopted afterwards, there has been an increasing focus in the private sector and private sector counterparties of hedge funds on ensuring that they have the information they need in order to assess the risk of their exposure to hedge funds.

So both official sector transparency and private sector transparency, there is a great deal of information that is available to the relevant parties about hedge funds, certainly more than there was even five or six years ago.

Senator HAGEL. What is the level of regulation, oversight, transparency of hedge funds in other countries?

Mr. QUARLES. Well, it varies, in part because, as I indicated in my remarks, there is no universally accepted definition of hedge funds. I am not aware really of any jurisdiction that has a formal definition of a hedge fund and then seeks to regulate them. Most jurisdictions have registration and some regulation of investment advisors, and the way that that plays out with respect to the advisors of hedge funds differs from jurisdiction to jurisdiction. But for the most part, you know, while the regulatory schemes of various countries are quite different, as a practical matter, hedge funds operating globally are not subject to a significant amount of official sector regulation in any jurisdiction.

Senator HAGEL. So no country has any particularly strong oversight or regulatory function over hedge funds?

Mr. QUARLES. I am not aware of a country that has, again, that has regulation within their jurisdiction that defined hedge fund activity as such, and more importantly, significantly affects the operation of hedge funds that might be organized outside of that jurisdiction within the country in question.

Senator HAGEL. You noted, I notice, in your written testimony, which we had a chance to look at prior to your coming before the Committee as well as in your just recent reference to LTCM, which I think everyone knows, it is Long Term Capital Management and what happened there in the late 1990s, what systemic risks do you see might be in some parallel way eventually facing the financial services industry not just in hedge funds, but I think of Fannie Mae, Freddie Mac, the leveraged funds that they are involved in, derivatives, and if we do not have adequate transparency, oversight, how fast can these explosions take down markets?

Mr. QUARLES. That is an interesting question. Obviously, with respect to Long Term Capital Management, LTCM, I think two of the significant issues there were leverage, as we have noted, a substantial amount of leverage, and lack of counterparty discipline, lack of market discipline, in part because of the just financial environment at the time, lack of understanding of what they were

doing, and the genius factor of LTCM, so there was a lack of discipline on their strategies.

You can draw some fair analogies on both of those points between the risks that we have long said that we see with the operation of the housing GSEs, Fannie Mae and Freddie Mac: leverage; obviously, with LTCM, you had an entity that was leveraged about 25 to 1, \$4 billion of capital to \$100 billion of assets. The GSEs are leveraged to a greater degree, almost 33 to 1, so you have a greater degree of leverage there, and you have the same lack of market discipline because of the perceived Federal backstop.

It is a different source of the lack of market discipline, but the concept and the effect is the same, and those two reasons are chief among those that we have argued that the risk in these entities needs to be addressed, and I think it is a very fair point to draw the analogy to some of the risks that we saw in the LTCM situation.

Senator HAGEL. Secretary Quarles, thank you.

Senator Dodd.

Senator DODD. Yes, thanks, Mr. Chairman.

Again, thank you, Secretary, for testifying, and I want to sort of just pick up on that last interview of the Chairman. There was a recent interview done with Maria Marteromo I guess is her last name here, and she was interviewing Tim Geithner of the Federal Reserve Bank of New York and asked specifically about the question the Chairman raised with you, and the question she raised, is there another Long Term Capital Management crisis lurking out there?

And his answer was even though the core institutions are strong in terms of capital, and risk is now spread more broadly, rapid growth in derivatives and hedge funds creates risk that future financial stresses may be harder to manage. Do you agree with that?

Mr. QUARLES. I do not know that that is necessarily the case. Rapid growth in any area increases the importance of understanding what the implications of that growth are, and, you know, there can be growing pains. Mr. Geithner has addressed some of them in the credit derivatives market by working to clear up the backlog of confirmations that I think you are all aware of. There were back office operational difficulties as to which there have been made significant strides that he is working on, and you can trace those to sort of rapid growth in that market. I think that is a fair point.

But I do not think it is necessarily the case. Certainly, since LTCM, there is much more focus by hedge fund counterparties on ensuring that they understand the financial position of the hedge funds that they are dealing with, that they are providing credit to or are otherwise counterparties of; that they have greater disclosure about the facts that they think are necessary in order to assess their own exposures to the hedge funds. Balance sheet leverage, certainly, to hedge funds is significantly less than it was in the past.

Now, I think there is an issue about evaluating overall leverage. We have some difficulty in measuring that as you have, you know, increasingly complex financial instruments with embedded leverage in them, and that is an issue that we need to think about, but I



would not draw the same conclusion at least as that quote that you described to me, at least if one interpreted the quote as saying that necessarily, because of this rapid growth, there is more risk.

I think there are some things we need to look at, but I would not necessarily say there is more risk.

Senator DODD. OK, I appreciate that, and I want to underscore your point, the opening comment you made that there are the obvious benefits we have all identified here on the Committee that have occurred as a result of hedge funds and their growth. But you also point out that there are some potential systemic risks. This was one. I wonder if you would identify any further systemic risks that you think this Committee ought to be aware of and what prudent steps that you advise the Committee or the regulators to take regarding hedge funds.

Mr. QUARLES. I think in addition to leverage, which is something you need to look at, two additional risks that we will be focused on understanding better is, one, you could call the risk of crowded trades. I talk about that somewhat in my written testimony, that as you have an increasing number of hedge fund managers, that while one potential benefit of that is diversification, because you have a larger number of people following a variety of strategies, that you could, in fact, have a hurting behavior that smaller managers of capital, in order to be able to attract capital, have to follow strategies that have been proven by others to be effective, and so, you have a hurting effect rather than a diversification effect, and trades can become crowded.

If trades become crowded in illiquid instruments, that can result in destabilization if there is an attempt by a large number of investment managers to liquidate similar positions in illiquid instruments at the same time. So I think that is one thing that we need to understand better. And I think in addition, research are the valuation issues that I also mentioned, which are thrown into greater relief with respect to hedge funds than some other alternative pools of investment capital because of the compensation structure of hedge funds, the practice of hedge funds in valuing their assets generally annually in order to determine their carry, the 20 percent compensation that they get.

As hedge funds increasingly move into instruments that do not have a readily determinable market price and raise valuation issues, that is something that I think we need to understand better. So the question of leverage, the question of crowded trades, the question of valuation, those are some of the things that we will be seeking to understand better over the course of the next several months.

Senator DODD. What about the current accredited investor requirement? Senator Sununu raised this issue. Others have raised it as well, going after these greater risks of some of these vehicles that are being used where the smaller investor is losing; the sophisticated investor seems to be shrinking in size. I think Senator Sununu raised a very good point about that. What are your thoughts on that issue very quickly?

Mr. QUARLES. Well, I think it is an interesting question. I am not sure at this point, you know, maybe with more information as we look more into it, I would feel differently. I am not sure at this

point that with respect to hedge funds, that would necessarily drive a change in the rules, since in addition, most hedge funds still have very substantial minimum investment requirements that even if one would view the accredited investor definition as shrinking in significance, the minimum investment requirements for most hedge funds are still quite substantial and thus ensure that were moved out of the retail area.

But again, if our engagement with various market participants and others' engagement, other regulators' information that they continue to gather would suggest that those minimum investment requirements are not sufficient to prevent retailization of the sector, looking at the accredited investor definition is certainly a sensible approach.

Senator DODD. Thanks, Mr. Chairman.

Senator HAGEL. Senator Sununu.

Senator SUNUNU. Thank you.

I think I want to follow up on that a little bit. My question would be not if you think the accreditation level that is currently in Regulation D is problematic but if you think it would be unwise to raise that threshold. I mean, you set that threshold for a variety of reasons. One is the substantive protection that it affords a retail investor for whom these are not intended to be investment vehicles, but also, you send a message about the expectations, the relative level of sophistication and knowledge that you expect investors to have.

It is my understanding that Regulation D does allow or does give the accredited label to people that have income in excess of \$200,000 per year or net worth of \$1 million, and the fact remains that both of those, I think, are thresholds that are much more readily attainable by people that at least elected officials rightly or wrongly might term middle class.

So my question is, well, is there any harm? Is there any negative outfall that you see to raising those thresholds, because it easy to multiply by two, to \$2 million and \$400,000 in individual income? What unintended consequences might that have, if any?

Mr. QUARLES. Before I would say, before I would be comfortable saying that there was no harm in raising the threshold, I would want to have done, you know, more of a comprehensive analysis than certainly we in the Treasury Department have, and I would certainly want to hear the views and expertise of the SEC and others on all of the uses of that definition, because it is, you know, very commonly used not just as a reference in various statutes but as a reference in various market practices.

I would, in part for the reasons that I said that these very, very high minimum investment requirements, unless I were to learn that there was a trend away from that in the hedge fund space, in part, because I do not think that hedge fund activity in itself should drive that. I would be reluctant to take a concern that there might be some future retailization of the hedge fund industry and move from that to a change in the accredited investor definition without a much more comprehensive review of all the potential implications of that than I would be able to give you today.

Still, that said, it is a sensible question to ask, and it is a sensible inquiry to undertake.

Senator SUNUNU. I appreciate your support for my question.

[Laughter.]

Senator SUNUNU. Have there been any documented problems, to the best of your knowledge, in applying or enforcing the applicable fraud statutes, trading regulations to hedge funds? Is there anything about them that prevents enforcement officials from doing their job where applicable securities law, trading law, and anti-fraud statutes are concerned?

Mr. QUARLES. I am not aware of any at all, and I think it is an important point to stress that where there are concerns about, and there have been documented instances and certainly allegations of market manipulation by hedge funds as there are for other market participants, hedge funds are subject to all of the same rules against market manipulation, against investor fraud as any other market participant, and the SEC and other regulators have the same panoply of enforcement tools available to apply to hedge funds that they do to anyone else who participates in the financial markets, and we have seen them apply them.

Senator SUNUNU. I appreciate that response and appreciate your point, although I think it is worth saying that the fact that something is already against the law and effectively enforced has never really prevented Congress from attempting to make it against the law again in a number of circumstances. So I think it is a good cautionary tale, and I hope that and I sense that that is not where we are headed in this case.

Thank you, Mr. Chairman.

Senator HAGEL. A very high note to end on, Senator Sununu. Thank you.

[Laughter.]

Senator HAGEL. Senator Reed.

Senator REED. Thank you, Mr. Chairman. Thank you, Secretary Quarles.

I think the Chairman has touched on this issue of the international ramifications of hedge fund regulations, but I would note that Britain and Ireland and other countries are moving toward more retail access to hedge funds. Separating from the specifics of their proposals this notion of—do other regulatory schemes put pressure on our hedge funds, even though we are the biggest source of hedge funds in the world, our hedge funds to either move offshore, to change their practices, or to modify our practices here locally?

Mr. QUARLES. Let me answer that with two parts: one, I am not aware that there is at least at this point kind of a significant pull effect from other regulatory regimes being viewed as relatively attractive versus our current regulatory regime and pulling hedge fund domiciles offshore and hedge fund activity offshore in a way that could have an adverse effect on our financial markets.

I do think that there is some concern and some reason for concern that in an increasingly global financial marketplace where hedge fund activity among other activities in the capital markets is able to move with relative ease to other jurisdictions, there is some concern that potential developments in hedge fund regulation or legislation in this country could serve to push hedge fund activity offshore. So I think as we look at the issue, I think that is one

of the things that we need to evaluate. We do need to be careful as we look at what the proper official sector policy response ought to be that we do not push beneficial activity offshore, but with respect to what I think was the principal thrust of your question, is there already some pulling offshore because of more attractive or laxer regulatory regimes abroad, I have not seen that yet.

Senator REED. One of the risks you pointed out was leverage, and it raises an issue that Senator Sununu suggested. That is, you know, what is the proper venue for regulation? Is it the hedge fund, or is it in some cases, the financial institutions that are lending to these hedge funds? Could you comment on that?

Mr. QUARLES. I think that the framework that the official sector, the President's Working Group and all the regulators that are part of that identified some years ago as the right approach, I think we have seen as the recommendations for that counterparty risk management framework be implemented, both in the official sector and the private sector over time.

I think that we have seen that it has been quite effective. There are still some issues, that, again, as I have indicated, we want to understand, but the regulation of counterparties and the aggregation of information from regulated counterparties of hedge funds and the improvement of private sector counterparty risk management both conceptually and I think we have seen in practice can have and has had beneficial effects for the financial marketplace and with respect to some of the concerns like excessive leverage in the hedge fund industry that we have seen earlier.

If there is a way to improve that, I mean, it is then incumbent upon the official sector with respect to our own responsibilities, at least, that that is going to be the framework to ensure that we are appropriately aggregating and looking at the information that we can have from the various regulated entities that are counterparties to the hedge funds. There may be ways to improve that going forward, but as far as the general concept and the good effects of implementing that concept over the last several years, I would say that they have both been positive.

Senator REED. Is there a practical issue of sort of fragmented, where there is a hedge fund that has a relationship with one financial institution, maybe three or four financial institutions, that one regulator is looking at one small piece; another regulator is looking at another piece; those pieces seem good, but when you put them all together, it is a different story requiring more coordination among financial regulators? Is that—

Mr. QUARLES. Exactly. That was kind of the—that was the better articulated thrust of my response about organizing and possibly increasing the sharing of information among regulators. I would stress that we have not seen any kind of actual practical problems as a consequence of that, but if we are going to describe that, and I think it is a good approach as the right framework to think about official sector management of hedge fund risk and activity, then, it is incumbent on us to ensure that we are appropriately aggregating that information.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

Senator HAGEL. Senator Reed, thank you.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Have you seen any evidence that hedge funds are manipulating the market in any way, such as driving stock prices down, forcing companies to take actions they otherwise would not, or anything else?

Mr. QUARLES. When you say hedge funds, so the industry as a whole, I have not seen that evidence. Now, in any—if you are talking about any industry in which there are between 8,000 and 9,000 different participants, it would be surprising if there were not at least a handful among them who were not turning corners.

There have certainly been allegations that there have been some hedge funds, not hedge funds as an industry but some hedge fund managers that have engaged in activities that may be illegal or may have an adverse effect on the marketplace. In each of those cases of which I am aware, appropriate enforcement action is being considered or undertaken against them as it would be for any other market participant.

So I would not, on the basis, again, of the isolated incidents of which I am aware conclude that there was an industry-specific problem or propensity.

Senator BUNNING. And you know for a fact that each and every one of those violations are being investigated by proper authorities?

Mr. QUARLES. All of those of which I am aware.

Senator BUNNING. As the hedge fund industry has evolved, even more people are investing in it through different investment vehicles such as a fund of funds without regulation. Is there an unfair advantage in the market by being able to choose an investment that is unregulated? Does the large investor have an unfair advantage over the individual investor, small investor?

Mr. QUARLES. That is an interesting question. I would not say that it is an unfair advantage. The evaluation of the risk that is involved in a variety of hedge fund strategies is complex. I think that it is appropriate to require a certain amount of investor sophistication to view that investment opportunity as appropriate. It certainly is an important part of our evaluation of the overall adequacy and appropriateness of our current regulatory stance toward hedge funds that they are limited to sophisticated investors and are not marketed or available in any significant degree to retail investors. So is that a disadvantage to the retail investor that they are not able to take advantage of a manager that is following a particular hedge fund strategy?

I think when you balance benefit and risk and the need for a significant amount of sophistication to be able to evaluate a number of these hedge fund strategies, I think it is probably the right stance.

Senator BUNNING. In your written testimony, you said the President's Working Group on Financial Markets has made several recommendations to support a market discipline approach to controlling leverage. Would you go into more detail about these recommendations, and which do you support?

Mr. QUARLES. Yes, among the recommendations were recommendations for increased transparency from hedge funds to their private sector providers of leverage to ensure that those lever-

age providers were aware of the overall financial position of the hedge fund as they provided leverage. And conceptually, that is of a variety of more detailed recommendations. That is at the heart of the counterparty risk management strategy recommended by the President's Working Group.

There have been a number of public and private sector groups that have moved to implement that. The Counterparty Risk Management Group II under Jerry Corrigan has also taken up the cause of enhancing counterparty credit risk management, and I think that the end result of all of these efforts has been a significant reduction in balance sheet leverage in the hedge fund industry as a whole and a much better sense of hedge fund counterparties of what the financial position of their hedge fund credits are, and as a consequence, significant benefits to the financial sector generally.

Senator BUNNING. My time has expired, Mr. Chairman.

Senator HAGEL. Thank you, Senator Bunning.

Senator Carper.

Senator CARPER. Thanks, Mr. Chairman, and Secretary Quarles, welcome. Thank you for joining us today.

I missed your testimony. I understand you did not talk for long. I am going to ask you to just give us a couple of nuggets, the most important elements of your testimony that you would want me to take out of here and never forget.

[Laughter.]

Mr. QUARLES. I would be happy to do that. I did not talk for long, but I did talk for 45 seconds more than my 5 minutes, contrary to the strict injunction of my legislative affairs colleague.

If I were to say to take three things away from what the Treasury Department has presented here today, it would be, one, that it is important that we understand the topic of this hearing, which is the role of hedge funds, before we move in any degree to seeking to further regulate or legislate with respect to hedge funds. So the order is important, and I think there is more that we need to understand about the role of hedge funds. There is a lot that we do understand about benefits and risks. The second point is that we need to understand that role.

That role is, on balance, positive because of the benefits of increased liquidity, increased efficiency of markets, price discovery, increased investor choice, you know, increased competition in markets. All of these are positive benefits of hedge funds, and there are, however, some risks that I think it is incumbent on us in the official sector to understand better than we do. We can identify some of them. I mentioned leverage; I mentioned valuation issues; I mentioned the crowded trades issue.

And as a consequence, the third point is that is why, you know, at the Treasury Department, we have identified that we will, over the course of the next several months, be actively engaged in reaching out to private sector market participants, both hedge fund counterparties, hedge fund managers themselves. We will be working to bring together members of the official sector through the President's Working Group to look at some of these current issues with respect to risk as well as the overall facts about the current role of hedge funds in the markets to make sure that we have a

very sound understanding of that before we come to some conclusions about what, if any, policy response there ought to be.

Senator CARPER. OK, thanks. Do I understand that hedge fund registration has been required since February of this year?

Mr. QUARLES. I think that is right. It has been relatively recently.

Senator CARPER. Do you have any idea how compliance has been? And to what effect do you think the registration helps or hinders investors?

Mr. QUARLES. Well, I mean, it might be appropriate for me to—the SEC representative on the next panel, Ms. Wyderko, will have more detail about what the SEC has learned from its registration effort and how compliance has been. I think from our point of view, it would probably be premature for us at the Treasury Department to have any strong views as to what we can learn from that, because it is such early days in the implementation of the regulation.

Senator CARPER. OK, one last question I would have: a couple of weeks ago we marked up in this Committee legislation that we called Reg Relief, and during the discussion on Reg Relief, among the provisions we discussed were those that were designed to impede money laundering in our financial institutions. Let me just ask a related question: to the best of your knowledge, what are the hedge funds doing to impede money laundering, or what more should they be doing?

Mr. QUARLES. That is a good question. The hedge funds, obviously, are complying with any laws that are applicable to them about, you know, transfers of funds in or out over a certain size, and regulated financial institutions that are counterparties of hedge funds as they move client monies in and out of hedge funds themselves have to know who those clients are, and, you know, they have the Know Your Customer rules, and they also keep track of those financial flows. So I think in the current scheme of things, the principal tool, if you will, that we have for addressing those issues, the money laundering issues, is, again, through the regulation of counterparties.

Senator CARPER. My time has expired. Can I ask just one real short one, just one quick one? What further advice would you have for us other than holding hearings like this for this Committee with respect to hedge funds?

Mr. QUARLES. I am not sure that—I think I would just simply reemphasize that in this rapidly developing sector, I think it is important for the Members of this Committee, those in the administration, the independent regulators, to ensure that do we have a good finger on the pulse of this industry so that we know what developments are that we are not in some future period of stress moved to respond on the basis of an insufficient knowledge base but at the same time not to squeeze so hard that we cutoff circulation.

Senator CARPER. All right, thanks so much.

Thanks, Mr. Chairman.

Senator HAGEL. Senator Carper, thank you.

Senator Allard.

Senator ALLARD. In the hedge funds, we have a lot of private contract agreements or not, or are those more into other derivatives?

Mr. QUARLES. I am sorry, do we have a lot of—

Senator ALLARD. Sort of private contract type.

Mr. QUARLES. Yes.

Senator ALLARD. And where do you draw the line between a private contract and maybe a more public transaction? Let us just say a stock transaction, for example, if we would just put it in those general terms, one extreme over the other; where do you draw the line?

Mr. QUARLES. Well, I think that if you are talking about—if an instrument has been created that trades easily with retail investors or that moves easily through the financial marketplace in ways that could have knock-on consequences significantly beyond those of the counterparties, that is something that one might appropriately view as having public aspects, that the public might have an interest in. To the extent that you are dealing with a private contract affecting the financial relationship between two counterparties, even when that contract might key off in some way of a publicly traded instrument, then, I think it is not inappropriate for those parties to believe that the risks of that contract are for them to judge.

Senator ALLARD. Usually, those are Ph.D.s and pretty well educated individuals, I would assume.

Mr. QUARLES. As a general rule.

Senator ALLARD. If we just took an average, well, let us say an informed investor that meets the threshold, who makes \$200,000 a year, and they have over \$1 million in net assets, net value, is there enough information out there for that type of consumer to make an informed decision on hedge funds?

Mr. QUARLES. Well, that is a good question. I think one of the issues is that certainly, in this day and age, those criteria that you have described describe a broad range of people. Obviously, some people who fit in that category will be very able to evaluate the risks of a particular hedge fund investment. Others would not. It is, however, the case that most hedge funds in addition to those restrictions on who can invest have substantial additional minimum investment requirements that effectively restrict the investor pool well beyond those minimum limitations.

Senator ALLARD. Do they have balance sheets and what not that an investor can go on, net value, net assets and—

Mr. QUARLES. They do. Each fund has, you know, each fund has a differing private practice with respect to the amount of information that it is willing to make public to its potential investors or to disclose to its potential investors, and for the most part, you know, the investor can then decide whether he feels that, on the basis of the information that a particular fund is willing to disclose to him, that he can make an informed judgment about whether he can invest in the fund.

Senator ALLARD. What would you say were the main characteristics of a well managed hedge fund?

Mr. QUARLES. Certainly, sort of a very lively and close attention to the risks of their investment strategy; having a clear investment



strategy; having a clear focus on risk; having a clear focus on how potential stresses in the overall financial environment could affect the investment strategy that they are following.

Senator ALLARD. And a consumer visiting with a hedge fund manager could ascertain this information, or is it in written form, or do you have to basically pull it out of them?

Mr. QUARLES. Again, there is not a Website or a standard form of disclosure that the consumer would have, but each fund would have both differing methods in which they make disclosures and differing degrees of disclosure that they make to potential investors. Increasingly, again, as part of the increasing amount of competition that there is in the industry and the increasing number of participants, there is much more disclosure to potential investors than there had been even a few years ago.

Senator ALLARD. Thank you, Mr. Chairman. I see my time is about ready to expire.

Senator HAGEL. Senator Allard, thank you.

Senator Bunning had one additional question he wanted to ask, Mr. Secretary, as did Mr. Dodd, so I will ask Senator Dodd to proceed.

Senator DODD. Thank you, Mr. Chairman.

Just very briefly, I just want to know about the corporate decisionmaking process. And to the extent that hedge funds are making that more difficult, there is certainly—there has been anecdotal evidence that this is creating difficulty for boards wanting to make longer term decisions, and given the rapidity with which hedge funds move, that is posing some problems. Anecdotally, we are hearing that. To what extent is that a problem, in your view?

Mr. QUARLES. We have certainly heard the same anecdotes. You know, we are familiar with the maxim that the plural of anecdote is not data, and we have not seen yet substantial data that would suggest that this is a problem. Conceptually, the fact that hedge funds, like any other investor in the marketplace, can purchase shares and then use those shares to influence company management in ways that they think will improve the value of the shares is not something that you would say, you would think is necessarily of itself something that is to be resisted in the marketplace.

Senator DODD. What about playing a positive role? Let me put it in that—

Mr. QUARLES. Yes, exactly. Conceptually and apart from, again, some of these isolated anecdotes that we have heard, you would say that that has to be a benefit, that the increased attention on the part of shareholders to the activities of management in an attempt to influence those activities to increase shareholder value, which is, of course, the interest of a hedge fund that owns the shares, is a positive for the marketplace.

Senator DODD. Thanks.

Senator HAGEL. Senator Dodd, thank you.

Senator Bunning.

Senator BUNNING. Last question for me, anyway.

In a regulated mutual fund industry, many questionable practices that were not in the best interests of the individual investor in the markets had to be corrected by government intervention. Why would we not assume in a lightly regulated hedge fund indus-

try that we would not encounter similar practices by managers of hedge funds?

Mr. QUARLES. The generation of those rules governing registered funds many decades ago was principally a result of the losses sustained by unsophisticated retail investors who were drawn into funds that were following investment strategies that they were not as a practical matter in a position to assess.

I think it is a very different situation where you have—and in fact, that is how it is that funds that wish to follow more flexible investment strategies came to structure themselves the way they do. It was to ensure that they did not cross the thresholds that were deemed by our investment laws to entail a significant degree of retailization. So, you know, I think that it is an important element of our assessing the adequacy of our current approach to hedge funds.

It is an important element that they are not—that retail investors do not form a significant part of the investor base, and as I say, we have not seen a lot of evidence that that trend is developing, and that is the principal reason I would say we can feel comfortable with the more flexible investment strategies that these funds follow.

Senator BUNNING. It seems to me that there are two sets of rules: one for the wealthy that make over \$200,000 and have over \$1 million in assets and another set of rules for the unsophisticated investor. And I think that is incorrect. I think that is wrong. And I will hope that the Treasury and all other regulating bodies of hedge funds would take a very thorough look and make recommendations to this Subcommittee so we can do our job better.

Senator HAGEL. Senator Bunning, thank you.

Senator Allard, do you have any additional questions?

Senator ALLARD. No more. Thank you, Chairman.

Senator HAGEL. Secretary Quarles, thank you. We may keep the record open to send additional questions in writing, and we would appreciate very much if you would address those, but for now, thank you for coming, and we appreciate your good work.

Mr. QUARLES. Thank you very much. Thank you.

Senator HAGEL. As Secretary Quarles leaves, if the second panel would come forward. Thank you.

The second panel is comfortably ensconced, I presume. You look comfortable. You have water, all the necessary requirements for penetrating testimony. Thank you again. Since I have introduced this panel, I will ask Ms. Wyderko, who is representing the Securities and Exchange Commission, to begin the second panel's testimony. Thank you. Ms. Wyderko.

**STATEMENT OF SUSAN WYDERKO  
DIRECTOR,  
OFFICE OF INVESTOR EDUCATION AND ASSISTANCE  
FORMER ACTING DIRECTOR,  
DIVISION OF INVESTMENT MANAGEMENT,  
U.S. SECURITIES AND EXCHANGE COMMISSION**

Ms. WYDERKO. Chairman Hagel, Ranking Member Dodd, and Members of the Subcommittee, thank you for inviting me to testify

today about hedge funds, the role they play in our securities markets, and the Commission's role in their oversight.

The Commission has a substantial interest in the activities of hedge funds and their advisors which are today major participants in our securities markets. We estimate that hedge funds today have more than \$1.2 trillion in assets, a remarkable growth of almost 3,000 percent in the last 16 years. Much of the growth of hedge funds is attributable to increased investments by institutions such as private and public pension plans, endowments, and foundations. Many of these investors sought out hedge funds during the recent bear markets in order to address losses from traditional investments.

Hedge funds are operated so that they are not subject to the Investment Company Act of 1940, which contains many safeguards for retail investors. In addition, hedge funds issue securities in private offerings that are not registered with the Commission under the Securities Act of 1933, and hedge funds are not required to make periodic reports under the Securities Exchange Act of 1934. However, hedge funds are subject to the same prohibitions against fraud as are other market participants, and their managers have the same fiduciary obligations as other investment advisors.

Because hedge fund managers are investment advisors under the Investment Advisors Act of 1940, they owe the fund and its investors a fiduciary duty that requires the manager to place the interests of the hedge fund and its investors first or at least fully disclose any material conflicts of interest the manager may have with the fund and its investors. Hedge fund advisors have this fiduciary obligation as a matter of law, regardless of whether they are registered with the Commission.

The Advisors Act provides the Commission with authority to enforce these obligations, which the Commission has exercised vigorously in order to protect investors. Examples of cases we have brought are included in my written testimony.

Until recently, registration with the Commission was optional for many hedge fund advisors. In February of this year, new rules became effective that require that most hedge fund advisors register with the Commission under the Advisors Act. The new rules do not regulate hedge fund strategies, risks, or investments. The new rules have given the Commission basic census data about hedge fund advisors. The staff is in the process of evaluating these data and considering methods to refine its ability to target our examination resources by more precisely identifying those advisors, including hedge fund advisors, who pose greater compliance risks. In addition, registration has required hedge fund advisors to implement compliance programs, to detect, prevent, and correct compliance violations and to designate a chief compliance officer to administer each advisor's compliance program.

Hedge funds provide many benefits to investors and our national securities markets that contribute substantially to market efficiency, price discovery, and liquidity. By actively participating, for example, in markets for derivative instruments, hedge funds can help counterparties reduce or manage their own risks, thus reducing risks assumed by other market participants.

When market activity by hedge fund advisors, like any other participant in the securities markets, crosses the line and violates the law, the Commission has taken appropriate remedial action. My written testimony has illustrative examples.

In conclusion, I would like to thank the Subcommittee for holding this hearing on a subject of growing importance to us and all American investors. Hedge funds play an important role in our financial markets, and the Commission will continue to vigorously enforce the Federal securities laws with respect to hedge funds, their advisors, and all market participants.

Senator HAGEL. Ms. Wyderko, thank you.

Mr. Parkinson, who is here on behalf of the Federal Reserve System, welcome.

**STATEMENT OF PATRICK PARKINSON  
DEPUTY DIRECTOR, DIVISION OF RESEARCH AND STATISTICS,  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. PARKINSON. Chairman Hagel, Senator Dodd, I thank you for the opportunity to testify on the role of hedge funds in the capital markets.

Hedge funds clearly are playing an increasingly important role, especially as providers of liquidity and absorbers of risk. For example, a study of the markets in U.S. dollar interest rate options indicated that participants viewed hedge funds as a significant stabilizing force. Hedge funds reportedly are significant buyers of the riskier equity and subordinated tranches of collateralized debt obligations and of asset-backed securities, including securities backed by nonconforming residential mortgages.

At the same time, however, the growing role of hedge funds has given rise to public policy concerns. These include concerns about whether hedge fund leverage is being constrained effectively and what potential risks the funds pose to the financial system if their leverage becomes excessive. The near failure of the hedge fund Long Term Capital Management in September 1998 illustrated the potential for a large hedge fund to become excessively leveraged and raised concerns that a forced liquidation of large positions held by a highly leveraged institution would create systematic risk by exacerbating market volatility and illiquidity.

In the wake of the LTCM episode, the President's Working Group on Financial Markets considered how to best constrain excessive leverage by hedge funds and concluded that this could be achieved most effectively by promoting measures that enhance market discipline by improving credit risk management by hedge funds, counterparties, and creditors. Because those counterparties nearly all are regulated banks and securities firms, the Working Group termed this approach indirect regulation of hedge funds. The Working Group considered the alternative of direct government regulation of hedge funds, but it concluded that developing a regulatory regime for hedge funds would present formidable challenges in terms of cost and effectiveness.

The Working Group made a series of recommendations for improving market discipline on hedge funds. According to supervisors and most market participants, counterparty risk management has improved significantly since the LTCM episode in 1998. However,

since that time, hedge funds have greatly expanded their activities and strategies in an environment of intense competition for hedge fund business among banks and securities firms. Furthermore, some hedge funds are among the most active investors in new, more complex structured financial products, for which valuation and risk management are challenging both to the funds themselves and to their counterparties.

Counterparties and supervisors need to ensure that competitive pressures do not result in any significant weakening of counterparty risk management and that risk maintenance practices are evolving as necessary to address the increasing complexity of the financial instruments used by hedge funds.

The Federal Reserve has also sought to limit hedge funds' potential to be a source of systemic risk by ensuring the robustness of the clearing and settlement infrastructure that supports the markets in which the funds trade. Very active trading by hedge funds has contributed significantly to the extraordinary growth in the past several years of the markets for credit derivatives. By last year, it had become apparent to many that the clearing and settlement infrastructure for credit derivatives had not kept pace with the volume of trading.

In September of 2005, the Federal Reserve Bank of New York brought together 14 major U.S. and foreign derivatives dealers and their supervisors. The supervisors collectively made clear their concerns about the risks created by the infrastructure weaknesses and asked the dealers to develop plans to address those concerns. Since then, the dealers and their hedge fund clients have made remarkable progress toward addressing supervisors' concerns and have committed to making further progress within the next 6 months.

Thank you.

Senator HAGEL. Mr. Parkinson, thank you.

Mr. Overdahl, who is here with the Commodity Futures Trading Commission, welcome, thank you.

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

Mr. OVERDAHL. Mr. Chairman, Senator Dodd, and Members of the Subcommittee, I appear before you today in my capacity as Chief Economist of the Commodity Futures Trading Commission or CFTC, the Federal Government regulator of futures markets in the United States. To the extent that any subsidiary fund within a hedge fund complex uses exchange-traded derivatives, the operator of that subsidiary fund and its advisory may be subject under certain circumstances to registration reporting requirements under the Commodity Exchange Act, the statute administered by the CFTC.

Futures markets serve an important role in our economy by providing a means of transferring risk from those who do not want it to those who are willing to accept it for a price. In order for businesses to hedge the risk they face in their day-to-day commercial activities, they need to trade with someone willing to accept the risk the hedger is trying to shed. Data from the CFTC's large trader reporting system are consistent with the notion that hedge funds

and other professionally managed funds are often the ones who facilitate the needs of hedgers.

CFTC large trader data also show that hedge funds and other professionally managed funds hold significant spread positions; that is, positions across related contracts. These spread positions play a vital role in keeping the prices of related contracts in proper alignment with one another. Hedge funds also add to overall trading volume, which contributes to the formation of liquid and well functioning markets.

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

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

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

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

Senator HAGEL. Mr. Overdahl, thank you.

Mr. Parkinson, let me begin the questioning with you. As you noted toward the end of your testimony that the Federal Reserve Bank of New York has been looking at some of these issues, and I am particularly interested in some of your thoughts on what the Federal Reserve-New York was looking at ways to improve industry practices and credit derivatives, and it is my understanding that Chairman Bernanke is addressing the Atlanta Federal Reserve tonight on these issues, hedge funds and credit derivatives. Let me begin with this question: what are the Federal Reserve's specific concerns about credit derivatives?

Mr. PARKINSON. Thank you, Chairman.

I think broadly speaking, the Federal Reserve is concerned about whether banks and other participants in the credit derivatives markets are managing the risks associated with those instruments effectively, and then, second, alluding to the other thing you men-

tioned earlier, whether the market infrastructure is sufficiently robust.

As I think has been mentioned in the previous panel, some credit derivatives are extremely complex and are traded on illiquid markets. And consequently the measurement or management of the risks poses challenges to even the most sophisticated market participants. And really, the Fed in that area has been conducting a variety of reviews of bank risk management practices with respect to these instruments, and it has communicated to the banks through our supervisory process and to the marketplace through speeches like the one that President Geithner gave this morning and the one that Chairman Bernanke will be giving this evening, areas in which risk management practices should be strengthened.

With regard to clearance and settlement, the infrastructure, I think I discussed that in my testimony, that by last year, it had become apparent to many that the infrastructure simply was not keeping up with the growth of the markets, so last September, the New York Fed got together these large dealers and their supervisors and really said here are the problems. We want you to come up with a solution, and they have made remarkable progress since then. They have promised to address the remaining issues, so I think that has been a real success.

Let me finally say that to put this in perspective, I think a point that President Geithner has emphasized and that I would like to emphasize, too is that while we have these concerns, the Federal Reserve officials feel that notwithstanding those concerns, the development of credit derivatives has made both banks and the financial system safer and more resilient, and the key thing is to make sure it continues to be by addressing those specific concerns.

Senator HAGEL. What is the timeframe on the solutions?

Mr. PARKINSON. In terms of the clearance and settlement infrastructure, the firms have committed to a variety of steps to complete them by October 31 of this year, so, really, quite an ambitious timetable.

Senator HAGEL. And what do you anticipate will be included in that solution agenda?

Mr. PARKINSON. There are many parts to it. I think that a key part is that they are already, one of the problems has been that there has been manual processing of transactions to a large degree, and in recent years, electronic platforms for processing trades had been developed, but the takeup was not very good, and they really have committed essentially that if a transaction can be confirmed electronically, it will be confirmed electronically.

And then, with respect to the ones that cannot be confirmed electronically, they have set deadlines for processing those transactions, completing the conforms, and I think importantly, have agreed that very soon after the trade date, they will make sure that they have a common understanding of the material economic terms of the trade, so that notwithstanding delays and completing the legal confirmations that their books and records will be accurate, and therefore, their measures of counterparty risk and market risk will be accurate.

Senator HAGEL. Thank you.

You noted in your testimony, I will quote just a line, quote, that hedge funds are increasingly consequential as providers of liquidity, end of your quote. Would you explain that in a little more detail, what you meant by that?

Mr. PARKINSON. Sure. I think that first, it is important to recognize that in recent years, our entire financial system has become less bank-centric and more market-centric. More credit demands are being met by the financial markets rather than being met directly by banks.

And in that kind of environment, the liquidity of financial markets really is critical. In other words, the ability to buy and sell quickly and in size. Now, in normal times, liquidity tends to be ample. I think hedge funds contribute to that. But I think what is really important is that when economic conditions become uncertain and prices move rapidly, then, liquidity has a tendency to evaporate. As we say, markets have a tendency to seize up. Examples would be the equity markets in 1987 and I think the interest rate options markets back in the summer of 2003.

And what is needed in those circumstances is really someone that recognizes that those kinds of disorderly markets in fact create profit opportunities for those who are willing to engage in arbitrage transactions and that have the willingness to take the risk that that involves to exploit those opportunities and to bring stability back to those markets. And I think this is an instance where back in 2003, I think we observed that as the option markets became unstable and prices soared that the hedge funds stepped in and profited from that disorder by selling options and bringing liquidity back to that market.

It is purely speculative, but I think it is an interesting question if we were again in a situation we were in October 1987 when equity prices were falling rapidly, I think there is a real potential for hedge funds to play a stabilizing role in that kind of market circumstance, where I think back in 1987, ultimately, what turned things around was corporations going back into the market and buying their own shares at these very depressed prices. I think you have this large pool of capital now that is willing to take risks in the hedge fund sector that could perhaps perform that service more quickly and limit the damage.

Senator HAGEL. Thank you.

Ms. Wyderko, let me ask a question of you regarding—I have in front of me an April 26, 2006, Washington Post story, Two Firms Claim Conspiracy in Analysts' Reports. I am sure you are familiar with this. These are issues that have surfaced recently, and the particular case I want to ask about is a case involving overstock where hedge funds are alleged to have paid securities analysts to issue misleading research to the marketplace. What is the SEC doing to monitor such situations?

Ms. WYDERKO. The Commission's staff carefully considers all allegations of fraud and manipulation. I cannot comment on that case, because, as you have read, it is a pending case. We have regulations in place to deter fraud, and we go after it vigorously when we find it.

Senator HAGEL. And I am aware of that limitation that you have in answering the question further. Let me just see if I can come



at this in a little more general way. Does the SEC have the authority to guarantee that securities research and analysis that is held out is independent is actually so? Do you need additional tools?

Ms. WYDERKO. Well, we have got Reg AC, and if false research is deliberately issued by any broker-dealer, it implicates Reg AC, which seeks to promote the integrity of research. We do have the tools to go after market manipulation. We do.

Senator HAGEL. What are those tools? What are you doing about these such things? I know you will have to stay away from the specific case that I have mentioned, but how is the SEC ensuring that this research, in fact, is independent. You say that you have the tools. Explain that.

Ms. WYDERKO. We have the tools in Rule 10(b)(5), the anti-fraud rule. Making or facilitating misrepresentations for the purpose of affecting a price of a stock is an illegal manipulative device, and that violates securities laws such as Rule 10(b)(5). We also have the tools to go after anyone who engages in transactions that are done in order to create actual or apparent trading in a security or to depress the price of a security for the purpose of inducing someone else to purchase or sell a security. So we have anti-fraud tools enforcement staff.

Senator HAGEL. Which covers the analysis aspect of this.

Ms. WYDERKO. Yes, sir.

Senator HAGEL. Ms. Wyderko, thank you.

Let me ask a question of the three of you that I asked of Secretary Quarles, and it is the very basic question, realizing that your three agencies represent the President's Working Group on this general issue. Do we need additional oversight? Do we need greater regulation, if any additional regulation on hedge funds? Ms. Wyderko, begin with you.

Ms. WYDERKO. Well, as you know, we have just adopted a new regulation that went into effect in February to require registration of investment advisors. It might interest you to know that we have about 2,400 registered hedge fund investment advisors, and of that number, over half were registered prior to February 1. That means they were registered voluntarily. The data is now coming in. We are acquiring basic census information about the activities of the investment advisors, and we are monitoring that data, looking at it. We are also using our risk based analysis parameters to select hedge fund advisors like other advisors for examinations by our examinations staff.

Senator HAGEL. So your answer is you do not think anything additional is required?

Ms. WYDERKO. At this point, I think we need to see the effects of our registration requirement, and we are actively monitoring the information that we are receiving.

Senator HAGEL. Thank you.

Mr. Parkinson.

Mr. PARKINSON. No, we do not see the need for any additional regulation. Again, we focus primarily on this financial stability or systemic risk issue. I think we still think that the indirect regulation approach is much more attractive than direct regulation and likely to be much more effective. We do see some specific issues around counterparty risk management that concern us, but we are

addressing those issues through our bank exams and through encouraging market participants to tighten up where appropriate and necessary.

Senator HAGEL. Thank you.

Mr. Overdahl.

Mr. OVERDAHL. Based on the information I see today, I see no additional tools that we need. I think what we are focused on is understanding the role of funds in the markets under CFTC jurisdiction, and we have a sizable program underway right now looking at the role of funds, and pending the outcome of that, I cannot recommend anything.

Senator HAGEL. Let me ask each of you: in light of what you heard Secretary Quarles say, the line of questioning that he addressed here over the last hour, hour and a half a general question. First, are you each providing more oversight in the way of transparency of your own agency's involvement on hedge funds? That would be one of the questions, and you would take that, each of you, in any direction you would like depending on your agency and each of your responsibilities in your agencies.

Also, I would like to get your reaction to some of the questioning of Secretary Quarles in the area of systematic risk. We talked here over the last hour and a half specifically about what happened in the late nineties. We talked about the GSEs, more leverage, more debt, use of derivatives. I would like your general comments in those areas that you heard us talk to Secretary Quarles about and his responses back.

We will begin with you, Ms. Wyderko.

Ms. WYDERKO. The Commission focuses on broker-dealers' exposure to hedge fund risks and the broader implications that that might have to our financial system. Our Commission staff works regularly with other members of the President's Working Group on Financial Markets, and we work with the industry members that comprise the Counterparty Risk Management Policy Group in terms of transparency. And our consolidated supervision program for banks now allows us to examine not only the broker-dealer entities within a group but also the unregistered affiliates and holding companies where the certain financing transactions with hedge funds are generally booked.

Senator HAGEL. Would you like to address any other aspects of what we talked about here in the last hour and a half from the SEC perspective?

Ms. WYDERKO. Well, we work closely with the President's Working Group on systemic risk, so I think I will let my colleagues take over from that. We really focus on broker-dealers' exposure at the SEC.

Senator HAGEL. OK, thank you.

Mr. Parkinson.

Mr. PARKINSON. First, on transparency, I guess the first question I always ask is transparency to whom, and I think there are three possible categories of people; one, to investors, that is primarily an issue of investor protection. That is an SEC issue that we do not focus on.

Importantly is the issue of transparency of hedge funds to their counterparties and their creditors, and that is where that was an

important theme of the PWG recommendations, the need for greater transparency. We have also emphasized, I think, recently where there is not the kind of transparency that would be ideal that banks and other creditors adjust their credit terms so they are more conservative; so, for example, if there is not enough transparency about what the hedge fund is doing, they need to charge higher margins of that hedge fund and do that in a systematic way.

And finally, transparency to regulators, again, because we believe in the indirect regulation approach, not a direct regulation approach. That is not an area where we are really seeking greater transparency.

With regard to systemic risk, I keep coming back to our sort of two key points: how do we deal with concerns about systemic risk? We try to promote sound risk management practices, particularly counterparty credit risk management practices, which we do both through our exams of banks and cooperation with other regulators; increasingly, I think a lot of these inquiries about practices are done on a coordinated basis, particularly with the FSA and with the SEC, because between the U.S. banking regulators and those other two sets of regulators, that covers most of the major counterparties and creditors; and then, second, on strengthening the infrastructure of the financial markets, where again, particularly when it comes to securities markets, we work closely with the SEC, and when it comes to the exchange-traded derivatives markets, with the CFTC.

Senator HAGEL. Thank you.

Mr. Overdahl.

Mr. OVERDAHL. With respect to transparency, I have two comments to make. One, there is a lot of information about funds themselves that is transparent to us through our Large Trader Reporting System. These are reports that we receive on positions of all traders or most of the large traders in the market, between 70 percent and 90 percent of the open interest. We receive that information daily, and many of these participants are hedge funds, so we do see that as the regulator.

From those reports, we compile a weekly report that we put out publicly, called the Commitments to Traders Report that goes out every Friday afternoon at 3:30, and many people look at that; many people have suggested to the CFTC that we disaggregate that report to break out, perhaps, hedge funds and other large traders.

I think what we are going to do as the staff of the Commission is put options together for the Commission and have a process with public comment and full public participation to understand the costs and benefits of perhaps a finer breakout of those reports. With respect to systematic risk, we treat all large traders the same way no matter the source or who they are and how they affect risk in our market. With respect to GSEs specifically, I would defer to my colleagues here. We certainly participate with them in the PWG, but we have very little intersection with that area within the jurisdiction of the CFTC.

Senator HAGEL. Thank you.

I want to refer back to a point that Senator Sununu made early in the hearing, and others picked up on it, regarding overregula-

tion. And my question is this: do you believe that overregulation of any segment of our financial services market, in this case, particularly the hedge funds, would drive hedge fund investments off our shores, overseas? Basic question: does overregulation have an impact on investing in this country and our system or any country?

We will start with you, Ms. Wyderko.

Ms. WYDERKO. I think we all agree that overregulation is bad.

Senator HAGEL. I am not sure that everybody does.

[Laughter.]

Ms. WYDERKO. Our rules for registration of investment advisors are not based on the advisor's domicile. That is important to understand. Hedge fund managers, wherever based, if they accept money from 15 or more U.S. investors, they must register with the Commission as investment advisors. So I do not think that it is a question of driving advisors offshore. If investment advisors wish to access U.S. capital sources, U.S. investors, then, they will need to register with the SEC if they have 15 or more U.S. investors.

Senator HAGEL. But what I am asking is, aside, in addition to, aside from, in addition to, for example, what the SEC, in your area of responsibility, of regulation, protecting the consumer, the individual investor, if there was more regulation. That is what I am trying to get at, because if, for example, something were to happen in the hedge fund market, and we find some kind of a significant adjustment which, just as Senator Sununu noted, that tends to elicit an immediate reaction from the Congress. Sometimes it is the right thing; sometimes, it is not the right thing.

And that is where the universe of overregulation lies. We talked earlier about are we not wiser to understand this industry now in anticipation not necessarily of that kind of adjustment but just knowledge, information, a basis to appreciate what this business is about so that we do not overregulate, so that we do not do something not in the interests of our economy and of our markets.

So if we were to advance any regulatory regime within the SEC, any of the agencies represented here, my question is does that automatically or does it have very little consequence to how investors see, in this case, hedge funds, especially, as you recall, when I asked Secretary Quarles about how other countries regulate, where the regimes differ, and you heard what he said. You know, of course, what the answer is.

So that is what I was trying to get at, because what we are trying to do in this hearing and maybe a series of hearings is establish some basis for us to better understand not just the role of hedge funds but what role those funds play in our overall economy, in our investment opportunities, therefore equipping us better to understand these things, not allowing us to overreact if something happens. So in anticipation of that—that is my question—does overregulation or any degree of that in your data, your own analysis, tend to, in fact, undermine our markets or incentives or investment opportunities?

Ms. WYDERKO. Well, I think it is important to realize a couple of things. First of all, as Mr. Quarles said, at this point, we are working with foreign regulators, and we are imposing a regulatory regime that is remarkably consistent with other developed countries, so that is an important baseline comment.

If we were to more heavily regulate hedge funds, for example, we do not currently regulate their strategies or their risks or their investments, if we were to impose more onerous regulations on hedge funds, it may be that we would diminish the utility of those investment vehicles for those investors who are investing in them. I mean, you have heard discussion today about the various uses that investors use hedge funds for: hedging other investments, trying to achieve returns that differ from recognized market indices. You may well diminish the utility of the hedge funds to provide that service for investors.

Senator HAGEL. Thank you.

Mr. Parkinson.

Mr. PARKINSON. I guess I do not think we are concerned that overregulation is going to drive activity abroad for precisely the reasons that Ms. Wyderko mentioned. I do think that we worry about overregulation, and from our perspective, it is not that it would limit the investment opportunities of investors so much as it would impair the ability of hedge funds to provide the benefits they do to markets: the provision of liquidity, the bearing of risk. And if you got into in particular regulating the fund as opposed to the advisor, and the SEC currently regulates the advisors but not the funds; in particular, if that involved constraining their strategies, investments, et cetera, I think that is precisely the sort of thing that could have a very adverse effect on the markets. And that is the reason we would be concerned about overregulation, not driving the activity offshore.

Senator HAGEL. Thank you.

Mr. Overdahl.

Mr. OVERDAHL. I can think of some instances where, you know, a proposed regulation, for example, to achieve greater transparency might have the opposite effect and drive it outside of the jurisdiction of regulators where you see less of it than perhaps you would otherwise. And it is certainly something that we always consider in promulgating any regulations, the costs and benefits of that regulation.

I would say one thing we have been particularly interested in is focusing regulation, trying to make sure that we are achieving the purposes of the statute Congress has given us without any more requirements than necessary. We have certainly sought to work with the SEC in coordinating our work with them so that participants are not facing duplicative standards. And so, we are trying to work that way to make sure that we do not have this situation.

Senator HAGEL. Thank you.

Since a vote has been called, it is quite timely. This might be an appropriate time to break for a moment as we excuse our second panel and ask for the third panel, but before I do, not only do I want to thank you, but let me ask each of you if there are any additional comments or points that you would like to make to put on the record.

Ms. WYDERKO. No, sir.

Mr. PARKINSON. No, sir.

Senator HAGEL. Well, again, thank you. We will, again, as we did for Secretary Quarles, keep the record open in case colleagues have questions they would like to submit in writing.

Thank you very much. This Committee is in recess until the Chairman votes and returns.

[Recess.]

Senator HAGEL. All right, so, you are recording. You feel good about America and our future. All right. Is this an NSA hearing?

[Laughter.]

Senator HAGEL. Welcome again.

This is the third panel of our hearing today on the role of hedge funds in our capital markets, and I once again welcome our distinguished panelists. Each of you have had a long career in financial services, government, industry, and continue to contribute and be productive members of that segment of our economy, and we appreciate it.

I have introduced each of you, as you know, and so, I will get right to your testimony. And then, if you have time, we will entertain some questions, and I appreciate, again, your testimony and your willingness to come before this Committee.

With that, let me begin with Secretary McCormack. Secretary McCormack, welcome. Nice to have you here. Thank you.

**STATEMENT OF HON. RICHARD MCCORMACK  
SENIOR ADVISOR, CENTER FOR STRATEGIC AND  
INTERNATIONAL STUDIES**

Mr. MCCORMACK. Thank you very much, Senator. I am obviously very pleased to be here today.

I thought I would say a few words about derivatives, about the macroeconomic environment in which hedge funds and derivatives are operating and what that macroeconomic environment might be in the years ahead and a few words about the potential for systemic risk.

I have a full statement, which I will put on the record, and I will summarize my remarks briefly here now.

Senator HAGEL. Thank you. I would remind all of our witnesses that the full text of your testimony will be included in the record, so if you feel so inclined to abbreviate that or summarize it, that is certainly acceptable.

Secretary McCormack, would you pull that mike down a little bit just so we can hear you better?

Mr. MCCORMACK. Is that better?

Senator HAGEL. I think that is better. Thank you.

Mr. MCCORMACK. Virtually everyone who understands the derivative industry recognizes its value in the economy and its ability to manage and defuse financial risks by individuals and companies. History shows, too, that some derivatives do contain the potential for abuse and mistakes. We all know spectacular examples of this, including the Long Term Capital Management debacle, which was an honest miscalculation by some very intelligent people.

It is, of course, important to remember that for each Enron type problem that surfaces in connection with derivatives, there are thousands of transactions that occur every day that benefit all parties involved. The challenge we now have is to examine this industry and those involved in it, with the help of those deeply engaged to correct any structural or technical problems that could increase

the likelihood of systemic risk following a future shock to financial markets, such as the Russian default in 1998.

There is obviously no such a thing as a permanent fix to the problems in the derivative industry. This industry is so dynamic, and its strengths and weaknesses change every few years. Ten years ago, credit derivatives were a tiny blip on the screen. Today, these credit derivatives, which provide a default insurance to creditors, are the fastest growing segment of this industry, as much as \$17 trillion of notional value.

Last year, when serious and potentially dangerous operational problems in credit derivative markets alarmed regulators, Jerry Corrigan, the former Federal Reserve official now with Goldman Sachs led an effort to analyze and repair these problems. This effort was a good example of how the industry and regulators can work together to solve problems on the operational side of the derivative business.

Beyond operational risk, however, credit risk and market risks pose other issues. Long periods of growth and prosperity tend to induce a certain amount of complacency in financial markets. It is important to remind recent entries to the derivative business that the business cycle still exists. There are potential vulnerabilities in the global economy that could impact financial markets at some point. Every decade, the two or three crises threaten the instability of financial markets.

I would just like to conclude by making several general remarks:

One, estimates of the total size of the notional value of over-the-counter derivative contracts vary widely. The President of the New York Federal Reserve estimates that number at \$300 trillion. The Bank for International Settlement estimates that number at \$270 trillion. The International Association of Swaps and Derivatives estimates the total outstanding value at \$219 trillion.

Even value at risk, which is a much smaller number, is subject to varying interpretations and estimates. When rounding errors for estimates of notional value of outstanding derivative contracts are in the tens of trillions of dollars, it is hard to have total confidence that we understand all the potential vulnerabilities that may exist in this industry.

Two, in his February 28 presentation on financial risk, Mr. Geithner raises the possibility of a potential rush to the exit by highly leveraged derivative holders during any future period of financial turmoil. Obviously, the Federal Reserve can play a role in addressing certain kinds of liquidity shortages and crises, but individual investors should be mindful of the need for an adequate capital cushion to address potentially unfavorable market developments.

Three, should early signs of possible vulnerabilities begin to emerge in financial markets, the most sophisticated investors will, of course, quickly shed risky investments. These hearings should serve as a reminder to investors of the oldest lesson in business dealings: *caveat emptor*—let the buyer beware. Complex derivatives are not a place for amateur investors. There is an enduring connection between high yields and high risks.

Four, regulation of the derivative and hedge fund industries is faced with a fundamental dilemma: if government regulates these

industries so tightly as to avoid all risk of market failure, it will kill a valuable part of the financial system. Finding the right middle path in this constantly changing environment is a challenging task.

Five, the U.S. regulatory system monitoring the financial industry is highly fragmented, as you have seen today with the previous panel. If our government were to start today from scratch and design a regulatory system for today's financial system, it would not look like the system we now have in place, even though the existing system has generally served us well. But with the increasing globalization of the financial industry as a whole, it is clear that more of the regulatory emphasis and monitoring will have to be international in character. This will not be an easy task.

The entire international global financial system is interconnected by hundreds of trillions of dollars of derivatives. Any future banking crisis in China which slows that economy will immediately impact commodity prices dramatically and the bonds of commodity producers. Any further sustained spike in oil prices could impact huge segments of the derivative industry. Those holding some credit derivatives against default could find them very costly indeed in this environment.

In conclusion, in well-functioning capital markets governments should not be concerned about the possible gains and losses of individual investors. That is what capitalism is all about and one of the reasons why this country is so prosperous. We take risks. We invest capital. The market apportions the winners and losers. This needs to continue. Government's focus should be on potential systemic risk, any inappropriate market manipulation, fraud, and any structural problems that increase the likelihood of these broader concerns.

Thank you very much.

Senator HAGEL. Dr. McCormack, thank you.

Dr. Lerrick.

**STATEMENT OF DR. ADAM LERRICK  
VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE**

Mr. LERRICK. Good afternoon, Mr. Chairman, and thank you for this opportunity.

Every day, somewhere in the global marketplace, hedge funds are shaking up the comfortable status quo, and from China's central bank to Germany's chancellery, voices in high places are raised in protest. But are hedge funds really to blame for all the ills that befall the international financial system? Are they disruptive speculators or dispassionate agents that expose fundamental flaws and speed up inevitable change?

Hedge funds are simply pools of money seeking the highest absolute return across the capital markets, where managers are compensated with a high share of profits. Like any financial innovation, they are following a normal life cycle. First, a small number of pioneers garner excess profits. Next, competition and capital are broadly attracted. Finally, the industry moves into the mainstream, matures, and is winnowed out.

Managers search for momentary anomalies in the pricing of securities, currencies, and commodities around the world. They match



holdings with short sales to isolate generalized market risk, they borrow heavily to leverage positions and magnify returns. Rewards have been overwhelming and consistent at 40 percent per annum.

Hedge funds are now a major force in the global financial markets. There are now over 8,000 funds holding \$1.5 trillion in assets, double the level in 2000. Leverage in the use of derivatives multiply their real impact manyfold. They dominate the trading arena—they are the predominant source of Wall Street earnings.

Hedge funds are constantly moving money around the globe to where it is most productive. They challenge private equity firms, venture capitalists, and real estate developers. They lend to companies in distress, they take large positions as shareholder activists to force corporate restructurings. The client base has moved from a closed society of the very rich to embrace the entire investor spectrum. Large institutions now account for more than half of hedge fund capital. A whole new layer of intermediaries known as funds of funds provide a conduit for the retail investor with as little as \$25,000 to risk.

Hedge funds depend on secrecy to prosper. They have a large investment in human capital, in technology, and in information, and none of these can be patented or protected. In a world that demands transparency, secrecy is a red flag for fear, suspicion, and calls for regulation. But the public interest can be satisfied without driving hedge funds to pack up and resettle offshore. The framework to monitor and to safeguard the global financial system and the unaware investor is already in place.

Hedge funds do not operate in a vacuum. They interact through a marketplace where their lenders, their trading counterparties, and the markets themselves are already under the scrutiny of an array of regulators: the SEC, the Federal Reserve, the Comptroller of the Currency, the CFTC, and their counterparts in the capital markets around the world.

Hedge fund objectives should not be confused with their tools. The hedge fund formula relies on leverage to magnify returns, but excessive leverage can disrupt markets. The danger to those who finance hedge funds and to the global system as a whole lies in ignorance of risks. Total exposure and total leverage across all lenders and across all national boundaries should now be aggregated and published to inform and improve the risk evaluations of market participants and regulators alike.

Under U.S. securities laws, all hedge fund clients, the very rich, the institutional investors, and the managers of funds of hedge funds who are the stewards of funds of small investors, have the skills to inform their decisions without official help. The market will be ultimate regulator as ever more money competes for a diminishing set of opportunities. Average profitability is already approaching rates on more commonplace efforts, and during the shakeout, players with weak risk management will be winnowed away.

Soon, there will be fewer but better hedge funds. Thank you, Mr. Chairman.

Senator HAGEL. Dr. Lerrick, thank you.

Mr. Schacht.

**STATEMENT OF KURT SCHACHT  
EXECUTIVE DIRECTOR,  
CENTER FOR FINANCIAL MARKET INTEGRITY,  
CHARTERED FINANCIAL ANALYST INSTITUTE**

Mr. SCHACHT. Thank you, Senator Hagel. We appreciate the opportunity to add our views today.

Our organization comes at this maybe a little bit differently than some of the perspectives that you heard yesterday, and that is that we approach this really as an investor advocate with an interest in promoting appropriate professional standards in the industry. And we have spent a good deal of focus in the past 18 months as an organization looking at trying to promote a comprehensive set of standards for hedge fund operators.

We have been looking very closely at the issues of hedge fund performance reporting, investor education, and we have been meeting with regulators around the world to discuss this whole notion of hedge funds and how and who and why the industry should be regulated.

Just to stay on topic, very quickly, to be true to our topic today, the role of hedge funds from the investor's perspective, I think it is evolving significantly. It has traditionally been high, uncorrelated historical returns, and I think everybody is hoping that it is not going to be just historical.

But one of the newest opportunities, newest developments with respect to the role of hedge funds, we think, and sort of the elephant in the room is the entry of the pension fund industry into the hedge fund space in a big way, trying to get higher returns to meet some of those increasing liabilities, and we think that is an important issue to keep track of.

This is a very interesting industry. It has all sorts of contradictions. I am not sure that we have ever seen an industry before where we have had huge and growing demand, huge and growing supply. We have had an absolute media frenzy with respect to this industry. One report says there are over 100 stories on average a day about the industry in 2005, and consequently, increasingly, the suspicions of regulators around the world have grown dramatically in our travels in the last 18 months, so it has been a sort of a jumble of dynamics.

I think it continues to be viewed as an asset class with exposure sort of leaning all in one direction and subject to maybe a systemic meltdown. In essence, we agree with the Under Secretary that this is really the universal exposure. It is all assets, all markets, in all directions, and we sort of agree with this notion that it has become sort of the complete market concept.

I think there are some specific concerns about leverage. There are some specific concerns about the level and interplay of counterparty exposure. Those are an issue. But I think in our view, this is not a house of cards but rather a broad-based industry with some pockets of concern.

We mention in our written testimony several other regulatory concerns that we have been hearing from regulators around the world, and I would be happy to talk about those if you have any questions. I would note very quickly that we supported the recent move to register hedge fund managers under the 1940 act as an ap-

propriate step, leaving some exemptions in that activity, but we think it does very little to get at this concern of leverage and of pockets of systemic imbalance, so just so nobody is confused by that, the hedge fund registration really does not get at that.

Very quickly, I just wanted to talk about better investor education and proper hedge fund manager conduct, because those are two very important things to our organization, and I would mention that a key component of that, of investor understanding and industry transparency is understanding what a hedge fund manager should offer in terms of ethics and professional conduct to the investors that they serve. It is certainly the case, as we have heard today, that investors have some significant responsibility to know what the heck they are getting into, to know what to look for, but the fact of the matter is that on a global basis, this is a much less regulated industry and historically because it has been promoted to sophisticated, trained investors who understand the appropriate due diligence process.

We are not sure that is still the case, and we have come out with something called the Asset Manager Code of Professional Conduct, which we think is a decent template for every investor, for the sort of things that every investor should expect and demand from their hedge fund managers, and it has done so with a self-regulatory approach to this.

A number of things that it covers include portfolio evaluation and performance reporting, and I will wrap up quickly on performance reporting issues, because we have done a lot of work on that issue. It is one of the areas that we think is most prone to mischief in the investment management industry and certainly in the hedge fund industry. There has been a recent spate of articles and calls for regulation of hedge fund performance reporting, because the feeling is that it misleads investors, that it might be as much as 600 basis points off in certain cases.

I would encourage you and the Committee when you are looking at this to look at it with some caution for several reasons. First of all, the performance that people are criticizing is really voluntary private data bases, and I think it has been acknowledged of all of the statistical shortcomings in those reports. Second of all, we would doubt highly whether any serious hedge fund investors are making investment decisions based on that information. I think they know the importance of looking at performance at the individual fund level and the importance of having a very quality due diligence program to confirm and verify that.

Finally, just on performance and how you calculate it, we believe the industry benchmark for this is the global investment performance standards or GIPS. It is a standard that we have developed. It has been in use and development over the last 10 years. It is the industry standard in nearly 30 countries around the world, and it provides a consistent and a verifiable process that is comparable across managers.

So thank you very much. We commend you for continuing to oversee this industry, your vigilance with this as it evolves. We would encourage you to monitor the new investment advisor registration approach, allow that to settle in over the course of the

next several months and determine if further regulation of either the manager or the fund itself would be warranted.

Thank you.

Senator HAGEL. Mr. Schacht, thank you.

Mr. Chanos.

**STATEMENT OF JAMES CHANOS  
CHAIRMAN,  
COALITION OF PRIVATE INVESTMENT COMPANIES,  
PRESIDENT, KYNIKOS ASSOCIATES**

Mr. CHANOS. Thank you, Chairman Hagel, and thank you to Ranking Member Dodd and other Members of your Subcommittee. My name is Jim Chanos. I am President of Kynikos Associates, a hedge fund management firm based in New York City. Thank you for the opportunity to appear today, and I am here today on behalf of the Coalition of Private Investment Companies.

To paraphrase the great American Stan Lee, with great growth comes great responsibility. By any measurement or definition, the hedge fund industry has enjoyed great growth over the past decade. Now, we must meet the responsibility that comes with managing more than \$1.2 trillion invested by pension funds, endowments, individuals, and other institutions. There is no shortage of activities by which hedge funds play an extremely vital role at making the U.S. capital markets the envy of the world. Other witnesses today have amply discussed that, and to avoid repetition, I would simply say that we share those views.

I would like to draw the Subcommittee's attention to three particular areas that our coalition believes are issues that will be of significance to policymakers in the months to come. First, we believe that hedge funds are very important participants in our capital markets, and it makes sense to include them in any review of issues that arise within these markets. That said, we do not believe that the industry warrants greater scrutiny than other market participants engaged in the same or similar activities. In fact, we encourage policymakers to think horizontally, across market participants, rather than vertically, in which artificial distinctions are drawn between participants who are doing the same things.

Taking this point one step further, CPIC also believes that regulatory treatment of private pools of capital should be consistent regardless of what those entities call themselves. We believe that too often, policymakers spend unneeded time and effort trying to draw distinctions between one kind of fund or another, while in the marketplace itself, the lines that formerly distinguished institutions from one another are either rapidly blurring or have ceased to exist altogether.

Second, CPIC believes there is significant room for improvement in asset valuation and performance reporting by hedge funds. There is both opportunity for outright fraud, and there is also a lack of broadly accepted policies and procedures to conduct valuation of the investments for which market prices are not readily available. Our coalition believes that there is an important role for the Federal Government to play in fostering a dialog with market practitioners, academics, economists, and others to improve practices in this area. We also believe it is important for hedge fund

managers to adopt practices that improve balance sheet transparency by breaking out unrealized gains and losses and assets that are not mark to market.

Last on this point, we strongly encourage the participation of all members of the President's Working Group on Financial Markets in discussing this issue. Again, the activity should be more important than the entity.

Third, we would like to bring to the Committee's attention the apparent rising incidence of corporate intimidation of analysts, shareholders, and reporters who report or offer opinions critical of company's management. The ability of business journalists to communicate with sources is of paramount interest to the functioning of our markets, as is the ability of analysts to disseminate their views free from the threat of retaliation and shareholders to question the managers they hire.

Unfortunately, the recent subpoenas issued by the SEC staff and then hastily withdrawn had the potential to hinder the ability of the press to do its job and thus limit the information readily available to all investors. We commend Chairman Cox for clarifying SEC policy, which will be to the benefit all investors. We also hope that the Commission will be as zealous in investigating issuer intimidation as it appears to have been in pursuing the complaints of generally underperforming corporate managements.

A free market only functions to the extent that competing views and opinions are allowed to mix without artificial constraints. This is at the heart of how a market discovers the true value of a company. If we do not allow investors, analysts, or reporters on both the long and short side, whether hedge funds, private capital, mutual funds, or other investors to openly question and test management's programs, plans, and projections, our markets and those who invest in them will suffer as a result. Honest skepticism does not equal market manipulation.

As I said, there are a number of other issues that are more thoroughly addressed in my written statement, and I am happy to try to answer any questions the Subcommittee might have. Thank you again for the opportunity to present before you.

Senator HAGEL. Mr. Chanos, thank you, and again, to each of you, thank you. My questions will be broad enough that I would appreciate each of your response to them, and I want to begin with just a couple of very basic questions, because I think they are part of building a foundation in this hearing on what hedge funds are and further developing an appreciation of that knowledge that comes from these hearings. So here is the first question: what is the typical hedge fund? How large is the typical hedge fund? Is there a hedge fund? Secretary McCormack, I will start with you.

Mr. MCCORMACK. I do not think there is a typical hedge fund. They vary enormously in size, investment strategies, and earnings. They vary in the proprietary information that they use upon which they make these investments. So I do not think there is a typical hedge fund. They are involved in every kind of investment activity, from investment banking to real estate to currency speculation.

Senator HAGEL. Dr. Lerrick.

Mr. LERRICK. Senator Hagel, I think that is one of the difficulties for the Committee. Twenty years ago, hedge funds were relatively

easy to define in terms of the kind of activities they pursued. They mostly invested in liquid markets and used trading to try to find momentary misalignments of prices that would disappear very quickly, and they used leverage.

Today, hedge fund can describe any private investment fund basically, because you read hedge funds are financing movies in Hollywood now. They are financing nuclear waste treatment plants in Europe. They are developing pipelines in Latin America. So how different are they than a private equity fund? How different are they than a real estate developer?

And that is why I would reiterate Mr. Chanos' comment that to try to define a hedge fund I think is a waste of time. It is more of a question of defining the type of activity that funds do perform, and whether you call them hedge funds or private equity funds or real estate funds or arbitrage funds really is irrelevant once you look at the function they play, not what their name is.

Senator HAGEL. Let me ask you this before I get to the other two members of the panel. And you said it correctly: it is part of the difficulty of getting our arms around this for people to understand what it is when I cannot elicit an answer on what a typical hedge fund number is. But the difference to start with that most funds have some dynamic of accountability, whether it is a year end report, a quarterly report, a balance sheet, something that they send out to their investors—is that correct?

Mr. LERRICK. True.

Senator HAGEL. So are we saying here that these are so nebulous that there are no numbers, we just cannot figure them out?

Mr. LERRICK. No, not at all, Senator. What I am saying is that I assume that any responsible hedge fund or any hedge fund that can actually attract funds today, capital, has to report periodically, monthly or quarterly and certainly more frequently than annually on what its portfolio looks like, what types of activities it is pursuing, what its performance has been.

But I think stepping back and trying to put myself in the position of a Senator and saying what should be my concerns, well, there are really only two concerns that should come before the Congress. One is, when it comes to investments, which is protection of unsophisticated investors, and that is clearly a concern. I think in the case of the hedge fund industry, that need not be a concern, because unsophisticated investors really do not have access to hedge funds. The only way they can get to hedge funds is through funds of funds, where there are professionals who are choosing their investments for them, so they actually have a professional intermediary who is making their choices.

The second is the question of systemic risk, risk to the entire financial system. And there, it is not hedge funds that should be the concern. It should be what are the dangers to the financial system? Is the danger to the financial system excessive leverage, whether it is from a hedge fund, whether it is from a private individual; I mean, if you remember, there was a total market failure when Nelson Bunker Hunt tried to corner the silver market. Now, he was not a hedge fund. He was not regulated. He did not have to report to anyone. He was just large enough that he could do it by himself.

And so, I think—and again, the concentration of positions, which is something that Secretary Quarles raised.

So I think those are the issues the Congress should focus on, not whether it is a hedge fund, whether it is a mutual fund with a performance base and the ability to short securities, whether it is a private individual, they should try to get to the source of the problem, not try to narrowly define who they want to look at.

Senator HAGEL. Which is going to lead to another round of questions on transparency as to what is appropriate and what is not, but let me ask the other two panelists to comment on any piece of the question and what the other two panelists have said.

Mr. SCHACHT. Yes, thank you. Understanding that it is not a very simplistic definition for hedge funds, someone once said it is really a fee structure masquerading as an asset class, but there are approximately 8,600 funds, between 8,600 and 9,000, depending on whether you count them at 8 in the morning or 5 at night, and the numbers we have been hearing are that 80 percent of those funds are under \$200 million in assets under management. So the bulk of the industry tends to be on the smaller end of a managed fund.

Senator HAGEL. Thank you.

Mr. Chanos.

Mr. CHANOS. I would echo what Dr. Lerrick and Mr. Schacht said, in particular, the comment on the fee structure as opposed to an asset class. There is something to that. It is interesting, though, however, I will make a couple of additional observations in that first of all, the life span of a typical hedge fund is very, very short. They have a very high failure rate. The market works. Investors move quickly out of poorly performing hedge funds when they do not perform, often because of the structure of the hedge fund itself in which management teams get a piece of the profits but if they lose money must work strictly for the management fee before the performance bonus kicks back in.

This leads investors to quickly flee any poorly performing fund, thus creating a vicious cycle as opposed to a virtuous circle. So the structure of most hedge fund management companies is very brittle, interestingly enough, and I think that that has led the industry to actually embrace less risky business practices if not investment practices, which hopefully will lead to more stability in the industry going forward. We shall see.

But again, I would stress my earlier comments about singling out hedge funds which employ a wide variety of investment techniques today and using the prism of hedge funds to look at all those techniques as opposed to perhaps a better policy view, which is to look at the techniques themselves as practiced by all market participants, whether they be private equity, venture capital, hedge funds, large individual investors, or pension funds. I think we are going to get bogged down in trying to define this term hedge fund, and we are going to miss the forest for the trees.

Senator HAGEL. Thank you.

Back to the issue of transparency, disclosure, how much should there be, how much need there be, starting with you now, Mr. McCormack.

Mr. MCCORMACK. Well, my sense is that the amount of disclosure that we have now, on the macro side, it is not sufficient. I

mentioned the question we had earlier about one slice of the process, which is the involvement in the derivative side. We do not have a clear idea about the overall quantity of activity in the derivative area. We have very subjective decisions about what "value at risk" really means. Those very subjective judgments are sometimes even divergent within different parts of the same creditor institutions.

So there is some need for a further attempt to get a more accurate sense of valuation in this process. I personally do not have any problem with requiring people to register who are in this business. We had a situation years ago where some of the smartest people in the world were running the Long Term Capital Management Hedge Fund. They were brilliant people. They had judgment. They were Nobel Prize winners. One served on the Federal Reserve Board.

These were people of unquestioned judgment and integrity. They still made disastrous mistakes. It is safe to say that not everybody in this 8,000 member hedge fund industry is of the same standard brains and integrity. To have some additional information about who really is involved is probably not such a bad idea. The British, many other Europeans, and Japanese are certainly of this view.

Senator HAGEL. Thank you.

Dr. Lerrick.

Mr. LERRICK. Senator Hagel, I think you have to distinguish three levels of transparency. The first is the transparency or the information provided to investors in hedge funds, and there, the investors, given that we are dealing with a restricted universe of, quote, either sophisticated or large investors, they should be able to make their own determination of whether they have sufficient information or not from a hedge fund they are considering investing in.

The second level is the lenders and the counterparties to these funds, and there again, when you are talking about major investment banks, major commercial banks, major universal banks that are the counterparties or the lenders, they should be able to take care of themselves and demand the kind of information that is required for them to do appropriate risk evaluations.

The last group is basically those that must be concerned about systemic risk, the policymakers, the official sector. And there, I think there is a hole in the information process. And I think the danger there is that there is an ignorance of some of the risks that are in the international financial system. In that, there is a role for the official sector to require aggregation of the types of information about leverage, about borrowing, about concentrations, so that policymakers can themselves identify potential sources of risk. But I believe that information should also be disseminated to the public so other market participants can also make the correct adjustments.

Remember, market crises come from surprises. If there are no surprises, markets adjust very smoothly. And so, the whole point is to make sure the market has as much information as it possibly can to make informed judgments on a continuous basis, and then, that is the easiest way of reducing the frequency and the severity of crises.



Senator HAGEL. Thank you.

Mr. Schacht.

Mr. SCHACHT. I will just talk very quickly on the transparency at level one that Dr. Lerrick mentioned, and that is at the investor level, and if Susan Wyderko's numbers are correct that 2,400 roughly hedge funds are registered, that says that somewhere in the range of 5,600 plus are not registered, so they are not required as a registered investment advisor to provide that level of disclosure.

So it really becomes a matter of investor education, and that is the sort of thing that we have been trying to focus on: what an investor should demand and what they should know about from the hedge fund service providers that they select.

Senator HAGEL. Thank you.

Mr. Chanos.

Mr. CHANOS. Speaking as an industry participant, I can tell you from a practitioner's point of view that in addition to weekly, monthly, and annual reporting that our fund does and most of our member firms do, as the industry has grown in the past 10 years and has become more institutionalized that the requirements of these institutional investors have basically from a business practices standpoint mandated better controls and better disclosure.

We are often visited quarterly by our largest investors, and if they cannot visit onsite, they have conference calls with us to query us on positions, leverage, market outlook, so on and so forth. All of our investors, in our case, have ability for onsite complete visit. So not only now do we entertain the possibility of the SEC paying us visits, but our clients do often to exercise their due diligence, and we welcome it.

So the industry has grown up quite a bit in terms of what it tells its investors by and large. There are always exceptions, as some of the preceding speakers have indicated. But as the industry has geared up for mandatory SEC registration, we have pointed out to a number of market observers that most reasonably large hedge fund management organizations already were employing the compliance, back office, and financial controls necessary to satisfy their clients, which go a long way to satisfying the SEC without a lot of added burden and cost.

Senator HAGEL. Thank you.

Dr. McCormack, I am going to read from your testimony, and in fact, it is your summary, a line here. It says, quote, our concern should be potential systemic risk, fraud, and structural problems that increase the likelihood of these two broader potential problems, end of quote. Would you share with us, and I would ask the same question of the other three panelists, what you then think we should be doing, regulatory regimes, some of the things we have just talked about, compliance, more transparency? What should we be doing that we are now doing, or should we be doing anything? Define that a little more, not just the concern, but how do we address the concern?

Mr. MCCORMACK. Well, let me focus on the key problem as I see it or one of the key problems as I see it. If you look at some of the reports that have been done by the Federal Reserve and others about financial crisis management and what happens during a fi-

nancial crisis, the key problem, of course, is that suddenly, liquidity dries up. Suddenly, there is not enough people wanting to buy when there are too many people wanting to sell. You wind up with a market meltdown.

Your earlier witness from the Federal Reserve said that hedge funds were, in fact, an additional source of liquidity in this situation. That might be the case. But it is very important to remember that hedge fund investors are just as subject to panic reclaiming capital in the middle of a threatening market environment as any other part of the investment community. Hedge funds are now so important as a driver of markets that if sudden, large scale, capital repatriations occur in a crisis, you can wind up with that being an additional source of liquidity problems rather than that being an asset for easing a future crisis.

That is another one of the reasons why I think we need to understand what is happening in this investment structure.

Senator HAGEL. So you would not advocate anything beyond what we have in place now with the Federal regulatory regimes.

Mr. MCCORMACK. One of the most important things that the Federal Government could do and should do is public warning of potential problems. One of the failures we had, for example, in the bubble that developed in the late 1990s was, Chairman Greenspan said only once, in 1996, that there was irrational exuberance in financial markets, and he did not say anything again for a very, very long time as the bubble built and built, even though there were concerns inside the U.S. regulatory system. Nobody said anything until the very end.

I think the time is now where government's responsibility is to say yes, the environment now is good; yes, the U.S. economy is growing. Yes, the global economy is growing at a 5 percent rate, but this will not last forever. There is such a thing as a business cycle. People need to watch very carefully their investments so that they do not get caught blindsided in the event that the situation deteriorates somewhat.

Potential liquidity shortages also suggest the need for adequate capital cushions by investor groups are needed, so that they do not require the Federal Reserve to provide all of the liquidity in the event of a problem. Individual investor groups themselves, including hedge funds, should have larger capital cushions than they currently do.

Now, that is a technical subject and one that is potentially expensive, and it is one I am not prepared today to make a definitive quantitative recommendation on. But that is the kind of issue that we need to explore: whether a larger capital cushion is necessary for hedge funds engaged in these markets to buffer against the inevitable day, the inevitable day, when there is a serious and sudden surprise to markets that causes liquidity to dry up.

Senator HAGEL. Thank you.

Dr. Lerrick.

Mr. LERRICK. Senator Hagel, very quickly, Secretary McCormack is absolutely right. There are going to be financial crises. They are going to come. There is no question about it. My colleague, Alan Meltzer, likes to say capitalism without losses is like religion without sin. It does not work. And that is true.

And therefore, there are going to be crises. Trying to eliminate crises, in order to eliminate crises, you are going to have eliminate massive benefits from markets and capitalism, and it is certainly not worth that. I think in terms of—you asked a very specific question: what would be a recommendation for future government intervention, let us not call it necessarily regulation.

I think the only advantage at this stage would be for the government to mandate the collection of information on leverage and exposures in the system. And that would serve both as a tool for the policymakers themselves to potentially identify sources of strain on the system and then to disseminate that information so that the other participants in the market can take appropriate action, and that will eliminate—that will reduce, it will not eliminate, the surprises that Secretary McCormack talked about, and that will increase dramatically the stability of the financial system.

Senator HAGEL. Thank you.

Mr. Schacht.

Mr. SCHACHT. Just two brief thoughts: make sure that the SEC has adequate resources to conduct those reviews of hedge fund managers on a consistent and a competent basis, No. 1; No. 2, I am agreeing with Dr. Lerrick. If there is a concern about leverage and imbalances related to counterparties and so forth, addressing that through greater disclosure. And I think as you know, the Financial Services Authority in the United Kingdom is in the process right now of doing an exposure draft on this, and they are feeling that you can reveal and correct these potential imbalances through more required disclosures from the counterparties that you already regulate.

Senator HAGEL. Thank you.

Mr. Chanos.

Mr. CHANOS. Very quickly, in addition to agreeing with what most of my compatriots here have just said, I would add that one thing this Committee could do would be to continue to foster the President's Working Group to make outreaches to all industry participants on an ongoing basis, whether through symposia, formal or informal get-togethers, to make sure that ideas that are out there or that are perhaps not so visible from Washington's perspective can get out so policymakers can evaluate any possible questions or responses. And the industry stands ready to be asked to participate.

Senator HAGEL. Thank you. Gentlemen, last kind of summary question: of all of the comments that you have heard this afternoon, especially from the previous two panels representing our government, anything that you would like to get on the record in response to anything you heard or anything that you did not hear or anything you want to say specifically that was not asked today that you want to comment on?

Secretary McCormack.

Mr. MCCORMACK. I support Secretary Quarles' comment about the importance of first looking at potential problems carefully before one rushes with remedies. We are dealing with an extremely complicated industry, about which there is insufficient knowledge, even within the very community of regulators.

Senator I think what you are doing with these hearings and the more broad effort to look at potential vulnerabilities in financial markets is important. At the end of this process we will all have a much clearer idea where the holes are that governments and investor, working together, need to fix.

Senator HAGEL. Thank you.

Dr. Lerrick.

Mr. LERRICK. Senator Hagel, I always enjoy testifying on the same day as Secretary Quarles, because I always am amazed at how he answers the same question that I would answer, but he does it in such a diplomatic way.

[Laughter.]

Mr. LERRICK. You asked him sort of would regulation, and I do not want to use the word excessive, but large-scale regulation, drive hedge funds offshore? And Secretary Quarles said, well, the incentives, and people would move if it caused problems in their operations.

Let me say very clearly: I do not know of a single large hedge fund that cannot move offshore in a matter of hours its entire operations. Any attempt to put large-scale regulation on hedge funds, private equity funds, these pools of money, will meet with total defeat. And I think that is something the Committee should keep in mind when it thinks of what it thinks might be appropriate action to take.

The second point I would like to touch upon is that official policy always lags behind the market. That is just a given. And that is why, again, any attempts to try to catch up with overly heavy-handed regulation will just either limit the industry if it is effective or drive it outside of the U.S. regulatory environment.

The other point I would like to raise is something that Senator Bunning raised when he talked about the concept of manipulation, when he asked the witnesses do they know of any manipulation? And he put in the category of manipulation something that I think is quite extraordinary. He said do you know any cases where hedge funds have forced companies to take actions they really would not have liked to do? And he viewed that as manipulation.

I do not view that as manipulation. Hedge funds and investors and markets in general are every day forcing companies, forcing governments, forcing any participant to take actions they do not want to take, but that is their chief benefit for the global economy. And therefore, I think any attempt to reduce their ability to force those changes will only be detrimental both to this economy and to the financial markets in general.

Senator HAGEL. Thank you.

Mr. Schacht.

Mr. SCHACHT. Senator, I think we just all appreciate the fact that you are looking at this at a stage where it is beginning to be consequential. It was about 1.5 percent of the investment management business last year. It is probably somewhere in the range of 2, 2.5 percent of the overall industry, but that could change very quickly with the advent of the pension funds getting into this sector.

So I think you continue to look at it and keep your eye on it.

Senator HAGEL. Thank you.

Mr. Chanos.

Mr. CHANOS. And finally, in the interest of brevity, I would just add that for too long, the term hedge fund has been used as a pejorative, with images of managers hiding behind trees or sunbathing on yachts off the Cayman Islands. And the reality is that most hedge fund managers are hard working people based here in the United States who are trying very hard to compete in a viciously competitive side of the financial marketplace.

I think the industry welcomes these hearings. It welcomes the opportunity to get into the glare of the spotlight as opposed to to remain in the shadows, which was never the case anyway, and we look forward to continuing working with the Committee, your Committee and others, as well as the members of the President's Working Group as you try to grapple with these issues.

Thank you.

Senator HAGEL. Mr. Chanos, thank you.

I would just add that politicians hate the glare of the spotlight. [Laughter.]

Senator HAGEL. You notice we had very limited participation here today, six United States Senators for a Subcommittee hearing, and that is rather significant, having nothing to do with the Chairman, I can assure you. It was the subject, and the subject is very important and really having nothing to do with the spotlight. But it gives you some reflection and understanding of how seriously policymakers are viewing responsibilities in these areas. And so, I think it is a good sign that we had this kind of turnout today.

Secretary McCormack.

Mr. MCCORMACK. Just one final comment.

You have seen the Corrigan Report of July 27, 2005, where he discussed the problems in the credit derivative industry. Just think how bad that situation got before it was finally identified and appraised. You had a situation where there was sometimes as much as 3 months between the day the trade was orally made and when it was actually confirmed, creating all kinds of problems and ambiguities in the event that the credit insurance actually was called on. You had situations where counterparties were not really vetted in terms of their creditworthiness.

If this potentially dangerous situation could develop so fast and create such potential problems, it suggests that there is no room for complacency.

Senator HAGEL. Dr. Lerrick.

Mr. LERRICK. Senator Hagel, Secretary McCormack is absolutely right. I mean, one of the key roles of the official sector is to try to identify problems before they occur, but that does not mean it has to regulate the solutions.

The Federal Reserve took a very important step when it said we identified this problem; we are inviting all of the market participants in. We say this is a problem; we want you to solve it. Go to it. That is a very valid role for the official sector. The Federal Reserve did not come in and say we are just going to regulate you all and tell you how to do it. They said solve the problem, and the private sector did or is in the midst of doing it.

Senator HAGEL. Well, gentlemen, this Committee is grateful for your participation and your insights and your experience. It has been very helpful.

I would like, as I did with the other two panels, to keep the record open in case any of my colleagues have additional questions, if you would be good enough to see if you could respond to, and we certainly will be calling upon you in the future, as all four of you have been involved with Committee activities before, and again, we thank you. It is good timing. I have another vote. So this Committee is adjourned.

[Whereupon, at 5:26 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

**PREPARED STATEMENT OF HON. RANDAL K. QUARLES**

UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

MAY 16, 2006

Chairman Hagel, Ranking Member Dodd, Members of the Subcommittee, good afternoon, it is a pleasure to be here today. Let me first thank you for holding this hearing and allowing the Treasury Department to present its views. I am particularly pleased to be here because our discussion today is an effort to gain a better understanding of a critical component of our financial markets.

Our charge today is to examine the role of hedge funds in our financial markets. I note at the outset that this topic is different from an issue about which there has been considerable discussion in the past few years: the regulation of hedge funds. I think your choice of topic for today's hearing is the right one—if government addresses the question of regulation of any financial institution or activity without a clear understanding of the place it plays in our financial system, the risk of unnecessary, excessive, or inappropriate legislation is increased. While I am sure we will touch on certain regulatory aspects, I intend to focus my remarks on what hedge funds do for and in our financial markets.

As we consider this issue, we should also keep in mind that the role of hedge funds in our financial markets is continuously evolving; and in recent years it has been evolving rapidly. While change like this often brings about improvements and efficiencies, it can also create insecurity or concern. The lens through which we examine the evolution of hedge funds' role in the financial markets often shapes our view of what, if anything, the government needs to do to react to the changes so we should ensure that this lens is as clear and polished as possible.

Hedge funds are not a recent invention. Their history is typically tied to the fund created by Alfred Winslow Jones in 1949. During this time period, these new investment vehicles were created mainly as a reaction to significant regulatory restrictions on investment funds embodied in the Investment Company Act of 1940 (the '40 Act). Unlike mutual funds registered under the '40 Act, an unregistered fund could sell securities short, buy securities using leverage, and use diverse financial instruments and strategies. The name "hedge fund" was used to identify these new funds that were able to hedge or protect against loss of capital in down markets.

Today, the term hedge fund is used to describe much more than a fund that employs hedging techniques. There is, however, no universally accepted definition of a hedge fund. In the late '90s, for example, the President's Working Group on Financial Markets (PWG) defined a hedge fund as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." This is a useful working definition for some purposes, but it does not distinguish hedge funds from other forms of unregistered capital pools that generally are recognized to have distinctive features, such as private equity funds and venture capital funds.

Perhaps the most useful approach is to identify a list of features that distinguish hedge funds from other capital pools, recognizing that the list is evolving, that various combinations of such features are possible, that some are shared with other investment vehicles, and that no single feature is a defining characteristic. Such features would include legal structure (a private entity with unlimited life and with pass-through tax benefits); investment objective (positive absolute return in all market conditions, rather than measurement against an industry benchmark); investment strategy (flexible, including the ability to use short selling, leverage and derivatives in a wide variety of markets); compensation structure (usually 1–2 percent management fee and 15–25 percent performance fee, calculated annually on the basis of accrued gain); investor base (high net worth individuals and institutional investors; high minimum investment; not widely available to the public); investor capital commitment (full commitment paid at time of subscription rather than drawn down over time; withdrawals regularly available, usually monthly or quarterly); and disclosure (generally restricted to that contractually agreed upon between the manager and the investors, with limited public information).

Hedge funds have experienced phenomenal growth during their history especially in recent years. They have grown from an estimated \$50 billion in assets in 1988 to about \$300 billion in 1998 to over \$1 trillion in assets today.<sup>1</sup> Current estimates suggest that there are about 9,000 hedge funds.

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

Today, hedge funds employ a variety of investment strategies that vary considerably depending on the goals and needs of the investors and the types of instruments in which the fund invests. Much, if not all, of this growth has been market driven, and, as a consequence, it has been subject to a significant amount of market discipline. For example, as hedge funds have grown, their investor base has evolved. The original hedge fund investors were wealthy individuals. Then, university endowments began investing in hedge funds—most likely because the individuals that typically sit on these boards were already exposed to these types of investments. Later, institutional investors such as pension funds seeking greater diversification wanted to participate. Through this growth process, each of these investor groups imposed certain forms of discipline on hedge funds. Thus, the hedge fund market has become much more “institutionalized” as it has grown and evolved.

Hedge fund growth and practices also have been tempered by significant market events, most notably, the failure of Long Term Capital Management (LTCM) in 1998. As a result, hedge fund investors now demand more transparency of their fund managers (you might recall that LTCM principals notoriously provided little transparency). Post LTCM, investors also recognize the need for more discipline regarding the use of leverage and collateral.

Therefore, while the hedge fund market has grown drastically in the past twenty years, there is at least some reason to believe this growth has been subject to private sector discipline.

What role this very large, trillion-dollar group of alternative investments plays in our financial markets is a very important question. While hedge funds provide certain benefits to the financial markets, they can also put stresses on it that need attention.

### **Benefits to the Financial Marketplace**

#### *Liquidity Provision*

One of the reasons that the U.S. financial markets are so attractive to investors is because of their liquidity. In general, the U.S. financial markets are the deepest and most liquid markets in the world. Hedge funds are significant liquidity providers in many marketplaces.

Because of the varying strategies employed by hedge funds, they are often the willing buyers or sellers that provide additional liquidity to financial markets. For example, hedge funds’ desire to seek arbitrage opportunities adds significantly to a markets’ liquidity. In fact, some reports suggest that hedge funds account for between one-third or one-half of the daily volume on the New York and London stock exchanges. Hedge funds contribute even more significantly to marketplace liquidity in less traditional markets. For example, hedge funds represent the overwhelming majority of trading volume in the distressed debt markets, the convertible bond markets, and the exchange-traded fund markets.

#### *Price Efficiency*

Many hedge funds seek to create returns by targeting price inefficiencies. Such price inefficiencies might occur when there is discrepancy between two or more markets. A sophisticated investment manager can enter both of these markets and profit by taking advantage of this pricing anomaly. Former Federal Reserve Chairman Alan Greenspan characterized the ability of hedge fund managers to obtain profit from these inefficiencies as picking the “low-hanging fruit” in the marketplace. While this activity certainly benefits the hedge funds that are profiting from the trades, it has the salutary effect of creating more efficient markets.

Similarly, hedge funds also target wide bid/ask spreads as ways to generate positive return, which generally has the effect of narrowing them. This private, profit-making activity on the part of hedge funds produces the public good of better price discovery and more efficient markets.

#### *Risk Distribution*

Concentration of market-wide risk is one of the greatest threats to a smoothly functioning marketplace. Hedge funds can help mitigate this risk by helping to transfer and distribute market risk. For example, when financial institutions seek to lay off some of the very large risks inherent in their normal business activities by buying or selling derivatives, hedge funds are often the counterparties to these trades. Without market participants that are willing to trade these derivatives in significant quantities, financial institutions would have to retain more risk, which could have a ripple effect throughout the financial markets.

There is no question that hedge funds are one of the dominant participants in the re-distribution of market risk. Among the most common risk distribution instruments used by hedge funds are credit default swaps. Most simply, these are insur-



ance-like products that provide protection against default or bankruptcy, in that they pay bondholders some form of compensation after a defined credit event. Use of these instruments has grown substantially from about \$631.5 billion in 2001 to about \$17.3 trillion in 2005. The significant growth in these securities does raise some important public policy issues, which I will address below.

#### *Further Globalization*

Because of the dynamic and evolving nature of hedge funds, I have tried to avoid over-generalizing them. However, I am comfortable making the observation that, in general, one attribute that is common across the entire hedge fund community is that the managers are involved in a relentless search for the next profit opportunity. In such a competitive marketplace, hedge funds often lead the way to identify new and emerging markets. These markets often provide opportunities that no longer exist in more mature marketplaces. This, in turn, leads to further globalization of our marketplace which provides more choice for investors and greater efficiency of markets globally.

#### **Potential Investor Benefits**

Hedge funds can have a direct positive impact on the investing community. Speaking broadly, hedge funds can provide investors with opportunities for diversification, “alpha” or excess returns, and capital protection in down markets.

Hedge funds provide more choices to the investing community. More choices allow investors the ability to diversify their investment portfolios, which is a common goal of many investors. A recent survey suggested that almost half of institutional investors had more than 10 percent of their assets in hedge funds. Most of these allocations were made by reducing allocations to active and passive equity strategies. All of the surveyed investors said that their diversification needs were being met and over three-quarters of surveyed investors saw reductions in overall portfolio volatility.

Historically, most non-professional investors were limited to investment vehicles that employed traditional “go-long” strategies. These funds attempt to outperform a particular index, such as the S&P 500. Notably, these funds typically profit only in positive markets and try to mitigate losses in down markets. Some hedge funds try to fill the obvious gap here with strategies that attempt to produce positive returns in both bull and bear markets. The flexibility in the hedge fund structure can provide many opportunities to outperform indexes, even in thriving years. This is often referred to as generating “alpha” or excess returns. A common technique employed by many hedge funds attempting to generate excess returns is employing leverage, which, of course, presents its own specific set of concerns.

Producing positive returns in a down market is also assisted by the nimble structures of hedge funds. Indeed, many expected the high-flying hedge funds to be crippled after the bursting of the internet bubble in the late nineties. Some funds were punished, of course. However, many funds exploited their natural flexibility to short stocks and, importantly, to move to cash during market dislocations limiting exposure and mitigating loss.

Therefore, hedge funds have the potential to provide investors with opportunities for excess returns or capital protection, but, of course, this is not always the case.

It is worth noting that as the hedge fund industry grows and becomes more institutionalized, excess returns have become harder to find. Indeed, as more market-based demands are placed on hedge funds for added transparency, investors will demand significant higher returns to justify the hedge fund manager’s fee. Armed with this added transparency, some observers suggest that there might be a shake-out of sorts with underperforming hedge funds suffering the consequences.

#### **Marketplace Risks**

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

#### *Large Use of Leverage*

Leverage refers to the use of repurchase agreements, short positions, derivative contracts, loans, margin, and other forms of credit extension to amplify returns. With increased leverage, of course, comes increased risk. We learned much about this topic after the LTCM failure.

As discussed by the PWG in its report after the LTCM failure, excessive leverage can greatly magnify negative effects of market conditions. For example, the LTCM failure demonstrated the risks of extraordinary leverage when adverse financial market conditions occur. At the time of LTCM's downfall, it had an implied balance-sheet leverage ratio of more than 25 to 1 (assets of \$125+ billion over equity capital of \$4.8 billion). As market conditions worsened, LTCM's size and leverage, combined with the sheer number of trades it had on its books, contributed to a serious deterioration in the liquidity of many markets as LTCM and countless other market participants sought simultaneously to unwind losing positions.

The magnitude of LTCM's leverage, and its dependence on numerous creditors and counterparties, heightened the threat that its problems could spill over to these other institutions and possibly lead to a general breakdown in the functioning of the markets. LTCM's excessive leverage posed very real systemic risks for our financial markets. It is important to note, however, that even though LTCM was a hedge fund, this issue is not confined to hedge funds. Many other types of market participants use leverage in their trading strategies, and some may be more highly leveraged than hedge funds. Moreover, it should be noted that innovations in the market are expanding the ways in which market participants can apply leverage. Many of the complex derivatives and other structured products in which there have been strong growth over the past few years have embedded leverage, which in certain circumstances can amplify changes in portfolio valuations to a greater degree than other forms of leverage.

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

#### *Concentration of Positions*

Linked closely with the issue of leverage and the potential for impaired liquidity in a period of market stress is the issue of concentration of market positions or "crowded trades." Sometimes referred to as "herding," crowded trades can arise to the extent that hedge fund managers are inclined to pursue the same or similar investment strategies. Talented hedge fund managers are constantly searching for new opportunities and devising new strategies to exploit those opportunities, while simultaneously trying to anticipate crowded trades. But as more hedge fund managers open funds and more money flows in from new investors, crowded trades may become more likely. If numerous market participants establish large positions on the same side of a trade, especially in combination with a high degree of leverage, this concentration can contribute to a liquidity crisis if market conditions compel traders simultaneously to seek to unwind their positions. The risk, of course, is market disruption and illiquidity, possibly exacerbating the risk of a systemic financial market crisis.

#### *Valuation Techniques and Models*

As hedge funds become larger, their valuation policies and procedures become more important to the marketplace as a whole. Valuation of many financial instruments, particularly complex or illiquid instruments, can be difficult. Indeed, valuation is often dependent on complex proprietary models. Because of their proprietary nature, these models have not been subject to broad-based scrutiny and there is a concern that there could be unanticipated changes that might only present themselves in certain market conditions. Moreover, valuation concerns are exacerbated in the hedge fund industry because hedge fund adviser compensation is tied to period returns which, of course, requires periodic asset valuations.

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

Treasury and the PWG can contribute significantly to this debate in the first instance by facilitating communication in the official sector and with industry participants and academics regarding valuation techniques and models.

*Settlement and Clearance Systems*

Hedge funds as a group do not pose a greater operational risk to the OTC settlement and clearance systems than any other group of market participants. However, operational risks can be posed by certain market conditions and certain technological conditions in certain products, particularly new products, where technological and legal infrastructures tend to lag product development and volume growth. These acute “growing pains” have developed most recently in the credit derivatives market across a wide spectrum of participants.

Thus, hedge funds, or any other group of participants, potentially could have a disruptive impact if there were concentrations of positions or attempted mass liquidation in illiquid markets. As I noted earlier, hedge funds are major participants in many of these markets such as distressed debt, collateralized debt obligations, and credit derivatives.

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

**Conclusion**

Thank you again for allowing the Treasury Department to participate this afternoon. As I have mentioned, hedge funds play an important role in our financial marketplace. We are also aware that they can present certain risks as well.

As a consequence, as I have noted elsewhere, we at Treasury will be examining in detail the issues I have discussed this morning, with a view to evaluating whether the growth of hedge funds—as well as other phenomena such as derivatives and additional alternative investments and investment pools—hold the potential to change the overall level or nature of risk in our markets and financial institutions. We will be engaging in a broad outreach to the financial community in the coming months to help us examine these questions. In addition, we plan, in concert with the PWG, to bring key government officials together to discuss these financial market issues. As I discussed, the PWG has already undertaken a detailed analysis regarding the causes and consequences of LTCM’s failure. The PWG can and should build on this work to help develop a measured and market-based approach to the impact hedge funds have on our financial markets.

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

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**PREPARED STATEMENT OF SUSAN WYDERKO**

DIRECTOR, OFFICE OF INVESTOR EDUCATION AND ASSISTANCE  
FORMER ACTING DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT,  
U.S. SECURITIES AND EXCHANGE COMMISSION

MAY 16, 2006

Chairman Hagel, Ranking Member Dodd, and Members of the Subcommittee:  
Thank you for inviting me to testify today about hedge funds, the role they play in our securities markets, and the Commission’s role in their oversight. The Com-

mission has a substantial interest in the activities of hedge funds and their advisers, which only recently have become major participants in our securities markets.

The Commission recognized the growing importance of hedge funds almost 4 years ago when it directed the staff of the Division of Investment Management to undertake a fact-finding mission aimed at reviewing the operation and practices of hedge funds and their advisers. That review led to the publication by the Commission of a staff report entitled “Implications of the Growth of Hedge Funds,” in which the staff described in detail the organization of the hedge fund industry, its growth, and regulation.<sup>1</sup>

While identifying a number of concerns and making several policy recommendations, the report also described the many benefits hedge funds provide investors and our national securities markets. They contribute substantially to market efficiency, price discovery and liquidity. By actively participating, for example, in markets for derivative instruments, hedge funds can help counterparties reduce or manage their own risks, thus reducing risk assumed by other market participants. Moreover, many hedge funds provide an important risk management tool for institutional investors wishing to allocate a portion of their portfolio to an investment with low correlation to overall market activity.<sup>2</sup>

### **Background**

Hedge funds are pools of investment capital that are managed by professional investment advisers and that are not offered generally to the public. They are operated so that they are not subject to the same regulatory requirements of mutual funds, which are governed by the Investment Company Act of 1940 which contains many safeguards for retail investors. Hedge funds are not characterized by a single dominant investment strategy, although many seek to obtain returns that are not correlated to market returns and instead seek to obtain an “absolute return” in a variety of market environments. Some adopt a “multi-strategy” approach that permits the adviser to determine, at any given time, what investment strategy to follow to pursue returns for the investors. Hedge funds also do not have a single risk profile. Some utilize leveraging techniques that expose investors to substantial risks, while others adopt investment strategies more similar to mutual funds.

Hedge funds do, however, share some organizational characteristics that distinguish them from most mutual funds. Most are organized by advisers that retain a substantial equity participation in the fund, and who receive compensation based, in large part, upon gains achieved by the fund (a “performance fee”). A typical fee arrangement will pay the adviser 2 percent of the total amount of assets under management and 20 percent of both realized and unrealized gains. Hedge fund managers view these fee structures as better aligning their interests with the interests of their investors and providing substantial incentives for good performance.

Hedge fund managers usually have a great deal of flexibility in managing the fund, which permits them to take advantage of market opportunities that may not be available to other types of institutional investors. They can change investment strategies, trade rapidly, and utilize leveraging techniques not permitted to mutual funds. And, in contrast to mutual funds, which must disclose publicly their portfolio holdings quarterly, many hedge funds do not even disclose portfolio holdings to all of their investors. Hedge fund advisers do, however, often offer disclosure to their investors about the extent and flexibility of their investment strategies.

### *Growth and Significance of Hedge Funds*

The ability of some hedge fund managers to generate significant returns has attracted a great deal of investor interest. It is estimated that hedge funds today have more than \$1.2 trillion dollars of assets, a remarkable growth of almost 3,000 percent in the last 16 years.<sup>3</sup> In 2005, an estimated 2,073 new hedge funds opened for business.<sup>4</sup> One report recently projected that assets of hedge funds may grow to \$6 trillion by 2015.<sup>5</sup>

<sup>1</sup> Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (Sept. 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>

<sup>2</sup> A recent study reported that 78 percent of institutional investors surveyed said that hedge funds reduced the volatility of their portfolio. State Street Corporation, Hedge Fund Research Study (Mar. 2006) at 4.

<sup>3</sup> See Hedge Fund Research, HFR Q1 2006 Industry Report.

<sup>4</sup> See Hedge Fund Research, HFR Q1 2006 Industry Report. During 2005, 848 funds were liquidated. *Id.*

<sup>5</sup> Van Hedge Fund Advisers, International, LLC, Hedge Fund Demand and Capacity 2005–2015 (Aug. 2005).

Much of the growth of hedge funds is attributable to increased investment by institutions, such as private and public pension plans, endowments and foundations.<sup>6</sup> Many of these investors sought out hedge funds during the recent bear markets in order to address losses from traditional investments.

The ability of hedge fund managers to sustain above-market returns is a matter of some debate, as is the likelihood that hedge funds as an asset class will continue to grow.<sup>7</sup> Nonetheless, hedge funds play and will likely continue to play an important role in the securities markets, the significance of which exceeds the amount of their assets. Although hedge funds represent just 5 percent of all U.S. assets under management, they account for about 30 percent of all U.S. equity trading volume.<sup>8</sup> They are highly active in the convertible bond and credit derivatives markets. Moreover, hedge funds are becoming more active in the markets for corporate control,<sup>9</sup> private lending, and crude petroleum. Their activities affect all Americans directly or indirectly.

#### *Application of the Federal Securities Laws*

Press articles typically refer to hedge funds as “lightly regulated” investment pools. In a sense, they are correct. As noted above, hedge funds are organized and operated so that they are not subject to the Investment Company Act of 1940. In addition, hedge funds issue securities in “private offerings” that are not registered with the Commission under the Securities Act of 1933, and hedge funds are not required to make periodic reports under the Securities Exchange Act of 1934. However, hedge funds are subject to the same prohibitions against fraud as are other market participants, and their managers have the same fiduciary obligations as other investment advisers.

#### **The Commission’s Oversight of Hedge Fund Activities**

The Commission’s oversight responsibilities with respect to hedge fund activities generally fall into three principal areas: fiduciary obligations; market abuse; and risks to broker-dealers. Each is described below.

##### *Fiduciary Obligations*

Hedge fund managers are “investment advisers” under the Investment Advisers Act of 1940. As a result, a hedge fund manager owes the fund and its investors a fiduciary duty that requires the manager to place the interests of the hedge fund and its investors first, or at least fully disclose any material conflict of interest the manager may have with the fund and its investors. Hedge fund advisers have this fiduciary obligation as a matter of law regardless of whether they are registered with the Commission.

The Advisers Act provides the Commission with authority to enforce these obligations, which the Commission has exercised vigorously in order to protect investors. Over the past several years the Commission has brought a number of enforcement cases against hedge fund advisers who have violated their fiduciary obligations to their hedge funds and investors. These cases involve advisers who have engaged in misappropriation of fund assets; portfolio pumping; misrepresenting portfolio performance; falsification of experience, credentials and past returns; misleading disclosure regarding claimed trading strategies; and improper valuation of assets. In some cases we have worked with criminal authorities.

Recent examples of significant cases brought by the Commission include:

- *SEC v. Samuel Israel III; Daniel E. Marino; Bayou Management, LLC et al.* The Commission alleged that the advisers of a Connecticut-based group of hedge funds defrauded investors in the funds and misappropriated millions of dollars in investor assets for their personal use. Over \$450 million was raised from investors. The advisers issued fictitious account statements to investors and used a sham accounting firm to forge audited financial statements in order to hide

<sup>6</sup>See Hennessee Group, 2004 Hennessee Hedge Fund Survey of Foundations and Endowments (reporting that the investors surveyed had an average commitment of 17 percent of assets, and a projected commitment of 19 percent by 2005).

<sup>7</sup>See Nicholas Chan, Mila Getmansky, Shane M. Haas, and Andrew W. Lo, “Systemic Risk and Hedge Funds,” (Aug. 1, 2005) (unpublished manuscript, to appear in M. Carey and R. Stulz, eds., *The Risks of Financial Institutions and the Financial Sector*, Chicago, IL: University of Chicago Press).

<sup>8</sup>See Pam Abramowitz, “Trade Secrets,” *Institutional Investor’s Alpha*, January/February 2006.

<sup>9</sup>Mara Der Hovanesian, “Attack of the Hungry Hedge Funds,” *Business Week* (Feb. 2006); Henry Sender, “Hedge Funds: The New Corporate Activists—Investment Vehicles Amass Clout In Public Firms, Then Demand Management Boost Share Price,” *The Wall Street Journal* (May 13, 2005).

substantial losses. These losses resulted from, among other things, the theft of funds by the advisers who withdrew “incentive fees” to which they were not entitled. On September 29, 2005, the Commission filed an action in U.S. District Court seeking injunctions, disgorgement of ill-gotten gains, prejudgment interest, and civil money penalties.<sup>10</sup> Also on that date, Israel and Marino pleaded guilty in a companion criminal case. They have not yet been sentenced. On April 19, 2006, the defendants in the civil case consented to an order permanently enjoining them from future violations of the antifraud statutes of the Federal securities laws.<sup>11</sup>

- *SEC v. Sharon E. Vaughn and Directors Financial Group, Ltd.* The Commission alleged that an Illinois hedge fund adviser registered with the Commission defrauded fund investors by improperly investing fund assets in a fraudulent “prime bank” trading scheme contrary to the fund’s disclosed trading strategy. According to the Commission’s complaint, the adviser and its principal had an undisclosed profit sharing agreement with one of the trading program promoters. The adviser and principal consented to injunctions and agreed to disgorgement of over \$800,000.<sup>12</sup> As a result of the SEC’s action and a subsequent criminal action brought by the U.S. Attorney’s office involving individuals associated with the trading program, hedge fund investors were returned most of their principal investment and profits prior to investment in the trading program.

*New registration requirement.* Until recently, registration with the Commission was optional for many hedge fund advisers. In February of this year, new rules became effective that require that most hedge fund advisers register with the Commission under the Advisers Act.<sup>13</sup> The new rules do not regulate hedge fund strategies, risks or investments. The new rules have given the Commission basic census data about hedge fund advisers. In addition, registration has required hedge fund advisers to implement compliance programs to prevent, detect and correct compliance violations and to designate a chief compliance officer to administer each adviser’s compliance program. Registration also has provided the Commission authority to conduct compliance examinations of registered hedge fund advisers. Based upon registration data we now know that 24 percent of the 10,000 investment advisers currently registered with the Commission advise at least one hedge fund. Of the 2,456 hedge fund advisers registered with us as of the end of April, 1,179 (45 percent) registered in response to the new rule.<sup>14</sup> The vast majority of the hedge fund advisers (88 percent) registered with the Commission are domiciled in the United States.

*Examinations.* As mentioned above, registered hedge fund advisers may be subject to onsite compliance examinations by SEC examiners in the Office of Compliance Inspections and Examinations (OCIE). The SEC maintains a risk-based examination program, and determines which firms to examine based on their risk characteristics. Hedge fund advisers have been included in the same pool as other registered advisers, and thus, like other advisers, the staff determines which firms to examine based on the compliance risks the firm presents to investors. Examination staff are working with the Division of Investment Management and Office of Risk Assessment to develop improved metrics to assess the compliance risks of registered advisers in order to continue to focus our exam resources. In addition, OCIE has developed a specialized training program to better familiarize examiners with the operation of hedge funds and thus improve the effectiveness of our examination of hedge fund advisers.

<sup>10</sup> Litigation Release No. 19406 (Sept. 29, 2005).

<sup>11</sup> Litigation Release No. 19692 (May 9, 2006).

<sup>12</sup> Litigation Release No. 19589 (Mar. 3, 2006).

<sup>13</sup> The Commission’s recent rulemaking required certain hedge fund advisers to register as investment advisers with the Commission under the Investment Advisers Act of 1940, under which registration previously had been optional for many hedge fund advisers. Commissioners Glassman and Atkins dissented from the rulemaking. Registration Rule at 72089. With respect to the management of hedge funds whose advisers are registered with the Commission, the Commission in adopting the adviser registration requirement observed that, “The [Advisers] Act does not require an adviser to follow or avoid any particular investment strategies, nor does it require or prohibit specific investments.” Registration Rule at section II.A. [Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004), 69 FR at 72060, petition for review filed (D.C. Cir. No. 04-1434); argued Dec. 9, 2005. (“Registration Rule”)]

<sup>14</sup> Registration forms indicate that these advisers report just over 13,000 hedge funds with aggregate assets of about \$2 trillion. Because reported assets include assets of “feeder” funds as well as “master” funds in which they invest, total reported assets likely are higher than if assets of “feeder” funds were excluded.

During a routine compliance examination, the staff reviews the effectiveness of the compliance controls that every registered investment adviser must have in place to prevent or detect violations of the Federal securities laws. In those areas where controls appear to be weak, our examiners will obtain additional information to determine if the weak control environment has resulted in a violation of the securities laws. The staff also reviews disclosure documents, including any private placement memoranda provided to hedge fund investors, to determine whether the disclosure appears to accurately reflect the hedge fund adviser's management of the fund. In addition, the staff identifies areas of potential conflicts of interest with respect to the hedge fund adviser and the fund that it advises to determine whether appropriate disclosure has been made.

It is the staff's experience that many of the compliance issues raised by an adviser's management of a hedge fund are similar to those raised by other advisers' asset management activities. For example, these compliance issues include: the use of soft dollar arrangements, the allocation of investment opportunities among clients, the valuation of securities, the calculation of performance, and the safeguards over customers' assets and non-public information. In this regard, let me identify a few areas in which we plan to focus our examinations of hedge fund advisers:

- *Side-by-Side Management.* Some hedge fund managers also advise other types of advisory accounts, including mutual funds.<sup>15</sup> Because the adviser's fee from the hedge fund is based in large measure on the fund's performance—and because the adviser typically invests heavily in the hedge fund itself, this “side-by-side” management presents significant conflicts of interest that could lead the adviser to favor the hedge fund over other clients. The staff will focus on whether the hedge fund manager appears to have sufficient controls in place to prevent such bias and whether, in fact, the adviser has favored its hedge funds over other clients.
- *Side Letter Agreements.* Side letters are agreements that hedge fund advisers enter into with certain investors that give the investors more favorable rights and privileges than other investors receive. Some side letters address matters that raise few concerns, such as the ability to make additional investments, receive treatment as favorable as other investors, or limit management fees and incentives. Others, however, are more troubling because they may involve material conflicts of interest that can harm the interests of other investors. Chief among these types of side letter agreements are those that give certain investors liquidity preferences or provide them with more access to portfolio information. Our examination staff will review side letter agreements and evaluate whether appropriate disclosure of the side letters and relevant conflicts has been made to other investors.
- *Valuation of Fund Assets.* A hedge fund manager typically values the assets of the hedge fund using the market value of those securities. When the fund holds publicly traded securities, that process is fairly simple. Many hedge funds, however, own thinly traded securities and derivative instruments whose valuation can be very complicated and, in some cases, highly subjective. Unlike a mutual fund, hedge fund valuation practices are not overseen by an independent board of directors. A number of the Commission's enforcement cases against hedge fund advisers involve the adviser's valuation of fund assets in order to hide losses or to artificially boost performance. Thus, a review of valuation policies and practices is a key element of hedge fund adviser examinations.
- *Custody of Fund Assets.* A hedge fund manager typically has access to and directs the use of fund assets. Such access presents a significant risk to fund investors—as demonstrated in a number of the Commission's enforcement actions involving theft or misuse of fund assets by a hedge fund manager. Therefore, Commission examiners focus attention on the controls used to protect fund assets.

#### *Market Abuse*

Hedge fund advisers' active trading plays an important role in our capital markets. The Federal securities laws and Commission regulations establish rules designed to prevent market abuses. When market activity by hedge fund advisers—like any other participant in the securities markets—crosses the line and violates the law, the Commission has taken appropriate remedial action. In the past year, the Commission has brought enforcement actions against hedge fund advisers for a variety of market abuses, including insider trading, improper activities in connec-

<sup>15</sup> Almost 15 percent (379) of the hedge fund advisers registered with the Commission report that they also advise at least one mutual fund.

tion with short sales, market manipulation, scalping, and fraudulent market timing and late trading of mutual funds.

Recent significant cases have included:

- *In the Matter of Millennium Partners, L.P., Millennium Management, L.L.C., Millennium International Management, L.L.C., Israel Englander, Terence Feeney, Fred Stone, and Kovan Pillai.* The Commission brought an action against hedge fund managers alleging that the managers generated tens of millions of dollars in profits for their hedge funds through deceptive and fraudulent market timing of mutual funds at the expense of the mutual funds and their shareholders. The adviser and its principals agreed to disgorgement and civil monetary penalties, and have undertaken to implement particular compliance, legal, and ethics oversight measures.<sup>16</sup>
- *SEC v. Hilary Shane.* The Commission alleged a particular type of insider trading involving a PIPE transaction, where the hedge fund adviser agreed to buy shares of a public company in a private offering—a transaction that the Commission alleged was likely to have a significant dilutive effect on the value of the company's shares—and then misused information she had been given (and which she had agreed to keep confidential) about the private offering by short-selling the company's shares. The adviser agreed to disgorge the trading profits, paid a civil penalty, and has consented to be barred from the broker-dealer industry and suspended from the investment advisory industry.<sup>17</sup>
- *SEC v. Scott R. Sacane, et al.* The Commission alleged that hedge fund advisers manipulated the market by creating the appearance of greater demand for two stocks than actually existed. The individual defendants in this case have both pled guilty to related criminal charges and have been barred by the Commission from associating with an investment adviser. In addition, one of the defendants has agreed to pay disgorgement and a civil penalty in the Commission's civil action, which remains pending against the other defendants.<sup>18</sup>

Not only has the Commission brought enforcement actions against the hedge funds and hedge fund advisers that engage in these transactions, it has brought actions against fund service providers who facilitated these unlawful securities trading activities. Recently, for example, we settled an enforcement action against a large broker-dealer that helped hedge funds foil the efforts of mutual funds to detect the hedge funds' market timing, and made it possible for certain favored hedge fund clients to "late trade" mutual fund shares.<sup>19</sup>

#### *Risks to Broker-Dealers*

Hedge funds can (although we understand many do not) make significant use of leverage. Most hedge funds use one or more "prime brokers," which provide clearing and related services to the fund and its adviser. One core service prime brokers offer their hedge fund customers is secured financing, notably margin lending, where the hedge fund borrows from the prime broker in order to buy securities, which then serve as collateral for the loan.<sup>20</sup>

The Commission continues to focus attention on broker-dealers' exposure to hedge fund risks and the broader implications this aspect of the financial system may have. The Commission staff meets regularly with other members of the President's Working Group on Financial Markets, and works with the industry members that comprise the Counterparty Risk Management Policy Group. In addition, the Commission's consolidated supervision program for certain investment banks now allows the staff to examine not only the broker-dealer entities within a group, but also the

<sup>16</sup>Investment Advisers Act Release No. 2453 (Dec. 1, 2005).

<sup>17</sup>Litigation Release No. 19227 (May 18, 2005). Because she entered into the short sales prior to the effective date of the registration statement for the PIPE and then covered her short sales with those she obtained in the PIPE offering, the Commission also alleged that Ms. Shane violated section 5 of the Securities Act.

<sup>18</sup>Litigation Release No. 19424 (Oct. 12, 2005). See also *In the Matter of Scott R. Sacane*, Investment Advisers Act Release No. 2483 (Feb. 8, 2006); *In the Matter of J. Douglas Schmidt*, Investment Advisers Act Release No. 2491 (Feb. 28, 2006); *SEC v. Scott R. Sacane, et al.*, Litigation Release No. 19515 (Dec. 22, 2005); *SEC v. Scott R. Sacane, et al.*, Litigation Release No. 19605 (Mar. 9, 2006).

<sup>19</sup>*In the Matter of Bear, Stearns, and Co., Inc., and Bear, Stearns Securities Corp.*, Securities Act Release No. 8668 (Mar. 16, 2006) (defendants agreed to censure, payment of disgorgement and civil monetary penalties, and have undertaken to implement particular compliance oversight measures).

<sup>20</sup>Prime brokers may also structure these financing transactions as repurchase agreements, where they buy the securities from the hedge fund subject to the fund's obligation to repurchase the securities from the broker in the future at a specified price. Prime brokers may also produce similar economics through the use of over-the-counter derivative contracts with hedge funds.



unregulated affiliates and holding company where certain financing transactions with hedge funds are generally booked. Commission staff meets at least monthly with senior risk managers at these broker-dealer holding companies to review material risk exposures, including those resulting from hedge fund financing and those related to sectors in which hedge funds are highly active.

#### **Looking Forward**

As a result of our recently implemented hedge fund adviser registration rule-making, the Commission now has more data about hedge funds and their advisers. The staff is in the process of evaluating those data and considering methods to refine its ability to target our examination resources by more precisely identifying those advisers, including hedge fund advisers, that pose greater compliance risks.

In addition, the Commission staff is working with the United Kingdom's Financial Services Authority, to coordinate policy and oversight of the 165 hedge fund advisers registered with the Commission that are located in the United Kingdom. The staff also expects to coordinate examinations with the Commodity Futures Trading Commission (CFTC). To that end, we recently provided information to the CFTC indicating the identities of hedge fund advisers registered with the Commission who report on their registration forms that they are also actively engaged in commodities business (approximately 350 firms).

#### **Conclusion**

In conclusion, I would like to thank the Subcommittee for holding this hearing on a subject of growing importance to us and to all American investors. Hedge funds play an important role in our financial markets. With respect to hedge funds, their advisers and all market participants, the Commission will continue to enforce vigorously the Federal securities laws.

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#### **PREPARED STATEMENT OF PATRICK PARKINSON**

DEPUTY DIRECTOR, DIVISION OF RESEARCH AND STATISTICS,  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MAY 16, 2006

Chairman Hagel, Senator Dodd, and members of the Subcommittee, thank you for the opportunity to testify on the role of hedge funds in the capital markets. In my remarks today, I will discuss the increasing importance of that role, the public policy issues associated with it, and what the Federal Reserve has been doing to address concerns about potential systemic risks from hedge funds' activities.

#### **The Role of Hedge Funds in the Capital Markets**

The role that hedge funds are playing in capital markets cannot be quantified with any precision. A fundamental problem is that the definition of a hedge fund is imprecise, and distinctions between hedge funds and other types of funds are increasingly arbitrary. Hedge funds often are characterized as unregulated private funds that can take on significant leverage and employ complex trading strategies using derivatives or other new financial instruments. Private equity funds are usually not considered hedge funds, yet they are typically unregulated and often leverage significantly the companies in which they invest. Likewise, traditional asset managers more and more are using derivatives or are investing in structured securities that allow them to take on leverage or establish short positions.

Although several data bases on hedge funds are compiled by private vendors, they cover only the hedge funds that voluntarily provide data.<sup>1</sup> Consequently, the data are not comprehensive. Furthermore, because the funds that choose to report may not be representative of the total population of hedge funds, generalizations based on these data bases may be misleading. Data collected by the Securities and Exchange Commission (SEC) from registered advisers to hedge funds are not comprehensive either. The primary purpose of registration is to protect investors by discouraging hedge fund fraud. The SEC does not require an adviser to a hedge fund, regardless of how large it is, to register if the fund does not permit investors to redeem their interests within 2 years of purchasing them.<sup>2</sup> While registration of advis-

<sup>1</sup> Examples of hedge fund data bases include Trading Advisors Selection System (TASS), Centre for International Securities and Derivatives Markets (CISDM) Hedge Fund Data base, and Hedge Fund Research Data base.

<sup>2</sup> The commission decided not to require such funds to register because it had not encountered significant problems with fraud at private equity or venture capital funds, which are similar

Continued

ers of such funds may well be unnecessary to discourage fraud, the exclusion from the data base of funds with long lock-up periods makes the data less useful for quantifying the role that hedge funds are playing in the capital markets.

Even if a fund is included in a private data base or its adviser is registered with the SEC, the information available is quite limited. The only quantitative information that the SEC currently collects is total assets under management. Private data bases typically provide assets under management as well as some limited information on how the assets are allocated among investment strategies, but they do not provide detailed balance sheets. Some data bases provide information on funds' use of leverage, but their definition of leverage is often unclear. As hedge funds and other market participants increasingly use financial products such as derivatives and securitized assets that embed leverage, conventional measures of leverage have become much less useful. More meaningful economic measures of leverage are complex and highly sensitive to assumptions about the liquidity of the markets in which financial instruments can be sold or hedged.<sup>3</sup>

Although the role of hedge funds in the capital markets cannot be precisely quantified, the growing importance of that role is clear. Total assets under management are usually reported to exceed \$1 trillion.<sup>4</sup> Furthermore, hedge funds can leverage those assets through borrowing money and through their use of derivatives, short positions, and structured securities. Their market impact is further magnified by the extremely active trading of some hedge funds. The trading volumes of these funds reportedly account for significant shares of total trading volumes in some segments of fixed income, equity, and derivatives markets.<sup>5</sup>

In various capital markets, hedge funds clearly are increasingly consequential as providers of liquidity and absorbers of risk. For example, a study of the markets in U.S. dollar interest rate options indicated that participants viewed hedge funds as a significant stabilizing force. In particular, when the options and other fixed income markets were under stress in the summer of 2003, the willingness of hedge funds to sell options following a spike in options prices helped restore market liquidity and limit losses to derivatives dealers and investors in fixed-rate mortgages and mortgage-backed securities.<sup>6</sup> Hedge funds reportedly are significant buyers of the riskier equity and subordinated tranches of collateralized debt obligations (CDOs) and of asset-backed securities, including securities backed by nonconforming residential mortgages.<sup>7</sup>

At the same time, however, the growing role of hedge funds has given rise to public policy concerns. These include concerns about whether hedge fund investors can protect themselves adequately from the risks associated with such investments, whether hedge fund leverage is being constrained effectively, and what potential risks the funds pose to the financial system if their leverage becomes excessive.

### **Investor Protection**

Hedge funds and their investment advisers historically were exempt from most provisions of the Federal securities laws.<sup>8</sup> Those laws effectively allow only institutions and relatively wealthy individuals to invest in hedge funds. Such investors arguably are in a position to protect themselves from the risks associated with hedge

in some respects to hedge funds but usually require investors to make long-term commitments of capital.

<sup>3</sup>For a discussion of the definition and construction of economically meaningful measures of leverage, see appendix A in Counterparty Risk Management Policy Group (1999), *Improving Counterparty Risk Management Practices* (New York: CRMPG, June).

<sup>4</sup>Some of these estimates may double count investments in funds of funds. At the end of last year, and excluding fund of funds, the TASS data base included funds that had \$979.3 billion in assets. Of course, not all funds are included in this data base.

<sup>5</sup>Greenwich Associates estimates that hedge funds in 2004 accounted for 20 to 30 percent of trading volumes in markets for below-investment-grade debt, credit derivatives, collateralized debt obligations, emerging-market bonds, and leveraged loans, and 80 percent of trading in distressed debt. See Greenwich Associates (2004), *Hedge Funds: The End of the Beginning?* (Greenwich Associates, December). These estimates were based on interviews with hedge funds and other institutional investors that Greenwich Associates conducted from February through April 2004.

<sup>6</sup>Federal Reserve Board (2005), *Concentration and Risk in the OTC Markets for U.S. Dollar Interest Rate Options* (<http://www.Federalreserve.gov/boarddocs/surveys/OpStudySum/OptionsStudySummary.pdf>).

<sup>7</sup>See Fitch Ratings (2005), *Hedge Funds: An Emerging Force in the Global Credit Markets* (New York: Fitch Ratings, 2005), p. 6.

<sup>8</sup>The antifraud provisions of the Securities Act and the Securities Exchange Act apply to the sale of a private fund's securities, whether or not the private fund is registered under the Investment Company Act.

funds.<sup>9</sup> However, in recent years hedge funds reportedly have been marketed increasingly to a less wealthy clientele. Furthermore, pension funds, many of whose beneficiaries are not wealthy, have increased investments in hedge funds.

Concerns about the potential direct and indirect exposures of less wealthy investors from hedge fund investments and hedge fund fraud contributed to the SEC's decision in December 2004 to require many advisers to hedge funds that are offered to U.S. investors to register with the commission.

The SEC believes that the examination of registered hedge fund advisers will deter fraud. But fraud is very difficult to uncover, even through onsite examinations.<sup>10</sup> Therefore, it is critical that investors do not view the SEC registration of advisers as an effective substitute for their own due diligence in selecting funds and their own monitoring of hedge fund performance. Most institutional investors probably understand this well. In a survey several years ago of U.S. endowments and foundations, 70 percent of the respondents said that a hedge fund adviser's registration or lack of registration with the SEC had no effect on their decision about whether or not to invest because the institutions conducted their own due diligence.<sup>11</sup>

In the case of pension funds, sponsors and pension fund regulators should ensure that pension funds conduct appropriate due diligence with respect to all their investments, not just their investments in hedge funds. Pension funds and other institutional investors seem to have a growing appetite for a variety of alternatives to holding stocks and bonds, including real estate, private equity and commodities, and investments in hedge funds are only one means of gaining exposures to those alternative assets. The registration of hedge fund advisers simply cannot protect pension fund beneficiaries from the failures of plan sponsors to carry out their fiduciary responsibilities.

As for individual investors, the income and wealth criteria that define eligible investors in hedge funds unavoidably are a crude test for sophistication.<sup>12</sup> If individuals with relatively little wealth increasingly become the victims of hedge fund fraud, it may become appropriate to tighten the criteria for an individual to be considered an eligible investor.

#### **Excessive Leverage and Systemic Risk**

The near failure of the hedge fund Long-Term Capital Management (LTCM) in September 1998 illustrated the potential for a large hedge fund to become excessively leveraged and raised concerns that a forced liquidation of large positions held by a highly leveraged institution would create systemic risk by exacerbating market volatility and illiquidity. In our market-based economy, the primary mechanism that regulates firms' leverage is the market discipline imposed by creditors and counterparties. Even when the government has oversight of leverage, as in the case of banks and broker-dealers, such oversight is intended to supplement market discipline rather than to replace it. In the case of LTCM, however, market discipline broke down.

In the wake of the LTCM episode, the President's Working Group on Financial Markets considered how best to constrain excessive leverage by hedge funds. The Working Group concluded that hedge funds' leverage could be constrained most effectively by promoting measures that enhance market discipline by improving credit risk management by hedge funds' counterparties and creditors, nearly all of which are regulated banks and securities firms.<sup>13</sup> The Working Group termed this approach "indirect regulation" of hedge funds. The Working Group considered the alternative of direct government regulation of hedge funds, but it concluded that developing a regulatory regime for hedge funds would present formidable challenges in terms of cost and effectiveness. It believed that indirect regulation would address

<sup>9</sup> See President's Working Group on Financial Markets (1999), *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (Washington: President's Working Group, April), p. B-13.

<sup>10</sup> For example, three Federal Reserve examinations of the New York branch of Daiwa Bank between 1992 and 1994 failed to uncover \$1.1 billion of hidden trading losses. See Alan Greenspan (1996), "Statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, November 27, 1995," *Federal Reserve Bulletin*, vol. 82 (January), pp. 31-35.

<sup>11</sup> See Greenwich associates (2004), p. 3.

<sup>12</sup> Each individual investor in a hedge fund that is subject to the Investment Advisers Act and whose adviser charges a performance fee generally must have a net worth of at least \$1.5 million or have at least \$750,000 of assets under management with the adviser. In addition, most hedge funds avoid regulation under the Investment Company Act by meeting a requirement that each investor in the fund must be a "qualified purchaser," which for individual investors means having assets of at least \$5 million.

<sup>13</sup> President's Working Group (1999).

concerns about systemic risks from hedge funds most effectively and would avoid the potential attendant costs of direct regulation.<sup>14</sup>

### **The Federal Reserve and Hedge Funds**

The President's Working Group made a series of recommendations for improving market discipline on hedge funds. These included recommendations for improvements in credit risk management practices by the banks and securities firms that are hedge funds' counterparties and creditors and improvements in supervisory oversight of those banks and securities firms. As a regulator of banks and bank holding companies, the Federal Reserve has worked with other domestic and international regulators to implement the necessary improvements in supervisory oversight. Regulatory cooperation is essential in this area because hedge funds' principal creditors and counterparties include foreign banks as well as U.S. banks and securities firms.

In January 1999, the Basel Committee on Banking Supervision (BCBS) published a set of recommendations for sound practices for managing counterparty credit risks to hedge funds and other highly leveraged institutions. Around the same time, the Federal Reserve, the SEC, and the Treasury Department encouraged a group of twelve major banks and securities firms to form a Counterparty Risk Management Policy Group (CRMPG), which in July 1999 issued its own complementary recommendations for improving counterparty risk management practices.<sup>15</sup>

The BCBS sound practices have been incorporated into Federal Reserve supervisory guidance and examination procedures applicable to banks' capital market activities. In general terms, routine supervisory reviews of counterparty risk management practices with respect to hedge funds and other counterparties seek to ensure that banks (1) perform appropriate due diligence in assessing the business, risk exposures, and credit standing of their counterparties; (2) establish, monitor, and enforce appropriate quantitative risk exposure limits for each of their counterparties; (3) use appropriate systems to measure and manage counterparty credit risk; and (4) deploy appropriate internal controls to ensure the integrity of their processes for managing counterparty credit risk. Besides conducting routine reviews and continually monitoring counterparty credit exposures, the Federal Reserve periodically performs targeted reviews of the credit risk management practices of banks that are major hedge fund counterparties. These targeted reviews examine in depth the banks' practices against the BCBS and Federal Reserve sound practices guidance and the CRMPG recommendations.

According to supervisors and most market participants, counterparty risk management has improved significantly since the LTCM episode in 1998. However, since that time, hedge funds have greatly expanded their activities and strategies in an environment of intense competition for hedge fund business among banks and securities firms. Furthermore, some hedge funds are among the most active investors in new, more-complex structured financial products, for which valuation and risk measurement are challenging both to the funds themselves and to their counterparties. Counterparties and supervisors need to ensure that competitive pressures do not result in any significant weakening of counterparty risk management and that risk management practices are evolving as necessary to address the increasing complexity of the financial instruments used by hedge funds.

The Federal Reserve has also sought to limit hedge funds' potential to be a source of systemic risk by ensuring that the clearing and settlement infrastructure that supports the markets in which the funds trade is robust. Very active trading by hedge funds has contributed significantly to the extraordinary growth in the past several years of the markets for credit derivatives. A July 2005 report by a new Counterparty Risk Management Policy Group (CRMPG II) called attention to the fact that the clearing and settlement infrastructure for credit derivatives (and over-the-counter derivatives generally) had not kept pace with the volume of trading.<sup>16</sup> In particular, a backlog of unsigned trade confirmations was growing, and the acceptance by dealers of assignments of trades by one counterparty without the prior consent of the other, despite trade documentation requirements for such consent, was becoming widespread.

To address these and other concerns about the clearing and settlement of credit derivatives, in September 2005 the Federal Reserve Bank of New York brought together fourteen major U.S. and foreign derivatives dealers and their supervisors. The supervisors collectively made clear their concerns about the risks created by the

<sup>14</sup> See President's Working Group (1999), p. 42.

<sup>15</sup> See CRMPG (1999).

<sup>16</sup> Counterparty Risk Management Policy Group II (2005), *Toward Greater Financial Stability: A Private Sector Perspective* (New York: CRMPG II, July).

infrastructure weaknesses and asked the dealers to develop plans to address those concerns. With supervisors providing common incentives for the collective actions that were necessary, the dealers have made remarkable progress since last September. The practice of unauthorized assignments has almost ceased, and dealers are now expeditiously responding to requests for the authorization of assignments. For the fourteen dealers as a group, total credit derivative confirmations outstanding for more than 30 days fell 70 percent between September 2005 and March 2006. The reduction in outstanding confirmations was made possible in part by more widespread and intensive use of an electronic confirmation-processing system operated by the Depository Trust and Clearing Corporation (DTCC). The dealers have worked with their largest and most active clients, most of which are hedge funds, to ensure that they can electronically confirm trades in credit derivatives. By March 2006, 69 percent of the fourteen dealers' credit derivatives trades were being confirmed electronically, up from 47 percent last September.

Supervisors and market participants agree that further progress is needed, and in March the fourteen dealers committed themselves to achieving by October 31, 2006, a "steady state" position for the industry.<sup>17</sup> The steady state will involve (1) the creation of a largely electronic marketplace in which all trades that can be processed electronically will be; (2) the creation by DTCC of an industry trade information warehouse and support infrastructure to standardize and automate processing of events throughout each contract's life; (3) new processing standards for those trades that cannot be confirmed electronically; and (4) the creation of an automated platform to support notifications and consents with respect to trade assignments. The principal trade association for the hedge fund industry has stated its support for plans embodied in the dealers' commitments.<sup>18</sup>

#### Summary

Hedge funds clearly are becoming more important in the capital markets as sources of liquidity and holders and managers of risk. But as their importance has grown, so too have concerns about investor protection and systemic risk.

The SEC believes that the examination of registered hedge advisers will deter fraud. But investors must not view SEC regulation of advisers as an effective substitute for their own due diligence in selecting funds and their own monitoring of hedge fund performance.

After the LTCM episode, the President's Working Group on Financial Markets considered how best to address concerns about potential systemic risks from excessive hedge fund leverage. The Working Group concluded that hedge funds' leverage could be constrained most effectively by promoting measures that enhance market discipline by improving credit risk management by funds' counterparties and creditors, nearly all of which are regulated banks and securities firms. The Working Group considered the alternative of direct government regulation of hedge funds but concluded that it would be more costly and would be less effective than an approach focused on strengthening market discipline.

The Federal Reserve has been seeking to ensure appropriate market discipline on hedge funds by working with other regulators to promote effective counterparty risk management by hedge funds' counterparties and creditors. It has also sought to limit the potential for hedge funds to be a source of systemic risk by ensuring that the clearing and settlement infrastructure that supports the markets in which they trade is robust.

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### PREPARED STATEMENT OF JAMES OVERDAHL

CHIEF ECONOMIST, U.S. COMMODITY FUTURES TRADING COMMISSION

MAY 16, 2006

Mr. Chairman, Senator Dodd, and Members of the Subcommittee, I appear before you today in my capacity as Chief Economist of the Commodity Futures Trading Commission (CFTC), the Federal Government regulator of futures and futures options markets in the United States. The term "hedge fund" is not a term we use in our regulatory work at the CFTC. To the extent that any subsidiary fund within a hedge fund complex uses exchange-traded derivatives, the operator of that subsidiary fund and its advisor may be subject, under certain circumstances, to reg-

<sup>17</sup> See Federal Reserve Bank of New York press release dated March 13, 2006. (<http://www.newyorkfed.org/newsevents/news/markets/2006/an060313.html>).

<sup>18</sup> See press release by the Managed Funds Association dated March 13, 2006. ([http://www.mfainfo.org/images/PDF/MFA\\_Fed14\\_Stmt\\_3\\_13\\_06.pdf](http://www.mfainfo.org/images/PDF/MFA_Fed14_Stmt_3_13_06.pdf)).

istration and reporting requirements under the Commodity Exchange Act, the statute administered by the CFTC.

In my testimony today I will address several topics. First, I will describe the role that hedge funds play in futures markets in general, and the role they play in commodity futures markets in particular. Second, I will briefly describe the surveillance methods used by the CFTC to monitor large traders, including many hedge funds, in order to ensure market integrity. Third, I will describe the financial safeguard system in place to ensure that the financial distress of a single futures market participant, whether or not that participant is a hedge fund, does not have a disproportionate effect on the overall market. Last, I will describe the CFTC's oversight authority with respect to the operators of pooled investment vehicles trading commodity futures or options.

### **The Role of Hedge Funds in Futures Markets**

Futures markets serve an important role in our economy by providing a means of transferring risk from those who do not want it to those willing to accept it for a price. Traders who are trying to reduce their risks are called "hedgers," a group that typically includes those who have an underlying commercial interest in the commodity upon which the futures contract is written. Futures exchanges know from experience that the markets they host cannot exist with hedgers alone. In order for hedgers to reduce the risk they face in their day-to-day commercial activities, they need to trade with someone willing to accept the risk the hedger is trying to shed. Data from the CFTC's Large Trader Reporting System are consistent with the notion that hedge funds, and other professionally managed funds, are often the ones who facilitate the needs of hedgers.

CFTC large trader data also show that hedge funds and other professionally managed funds hold significant "spread" positions, that is, positions across related contracts. These spread positions are structured to speculate on relative price differences between contracts (*e.g.*, prices for October delivery vs. prices for November delivery), and when structured as such, are unrelated to the overall level of futures prices. These spread trades play a vital role in keeping prices of related markets (and prices of related contracts within the same market complex) in proper alignment with one another. Hedge funds also add to overall trading volume, which contributes to the formation of liquid and well-functioning markets.

One notable development over the past 5 years has been the increased participation by pension funds, university endowments, hedge fund investors, and other financial institutions in futures markets for physical commodities. These institutions view commodities as a distinct "asset class" and have allocated a portion of the portfolios they manage, either directly or indirectly, into futures contracts tied to commodity indexes. The total investment in commodity-linked index products by pension funds, hedge funds and other institutional investors has been estimated by industry observers to exceed \$100 billion. A significant portion of this amount finds its way into futures markets, either through direct participation by those whose commodity investments are benchmarked to a commodity index, or through participation by commodity index swap dealers who use futures markets to hedge the risk associated with their dealing activities.

The greater participation by funds and commodity index investors has raised questions by some market observers about whether their activity is distorting prices in commodity futures markets. These issues strike at the heart of what the futures markets are all about. Futures markets exist because they provide two vital functions for the marketplace: risk management and price discovery. The job of the CFTC is to ensure the integrity of these vital market functions and public confidence in them.

In that regard, some in the industry have urged greater transparency in the CFTC's Commitment of Traders Report (COT) by distinguishing among the market participants that currently comprise the category of "commercials" for each market. They argue that the current reporting system does not appropriately distinguish between traditional commercial activity and non-traditional commercial activity, such as that involving the hedging of commodity index exposure by swap dealers. Questions also have been raised as to whether the COT report should show professionally managed funds, including hedge funds, as a separate category, rather than include them with other non-commercial traders. On the opposing side, however, are those who argue that greater transparency may come at the cost of compromising the confidentiality of traders' proprietary information.

In the coming months, the CFTC will consider these issues in a deliberative fashion through a process that is fully transparent to the public.

### **Surveillance Methods Used To Monitor Large Traders—Including Hedge Funds**

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

Using the large trader reports, CFTC economists monitor futures market trading activity, looking for large positions and large trades that might be used to manipulate prices. Each day, for all active futures and option contract markets, surveillance staff members monitor the daily activities of large traders and key price relationships. In addition, CFTC market analysts maintain close awareness of supply and demand factors and other developments in the underlying cash markets through review of trade publications, government reports, and through industry and exchange contacts. The CFTC's surveillance staff routinely reports to the Commission on surveillance activities at weekly surveillance meetings.

In addition to the efforts of the Commission staff, each futures exchange is required under the Commodity Exchange Act to affirmatively and effectively supervise trading, prices, and positions, and the Commission examines the exchanges to ensure that they have devoted appropriate resources and attention to fulfillment of this important responsibility. All of these efforts are reported upon regularly to the CFTC's commissioners. The Commission's reports on its rule enforcement reviews of the different futures exchanges are posted on our Website at [www.cftc.gov](http://www.cftc.gov).

Finally, the CFTC conducts an aggressive enforcement program that prosecutes and punishes those who break the rules. Nearly one-third of the CFTC's resources are devoted to its enforcement program. The punishment meted out as the result of enforcement proceedings deters would-be violators by sending a certain and clear message that improper conduct will be detected and will not be tolerated. The Commission has brought approximately 72 enforcement actions involving commodity pools and commodity pool operators in the last 7 years. The defendants in these enforcement actions offered investments in what were advertised as hedge funds or commodity pools in which investor funds were misappropriated or misused, or where customers were solicited based upon false track records.

### **Hedge Funds and the Futures Industry's Clearing System**

The collapse of Long Term Capital Management in 1998 highlighted concerns about the risks potentially posed by a large hedge fund on the financial system as a whole. Within the futures industry, the clearinghouse affiliated with each exchange and the clearing member firms of each clearinghouse play a critical role in ensuring that the financial distress of any single futures market participant, whether or not that participant is a hedge fund, does not have a disproportionate effect on the overall market.

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

Futures clearinghouses use a variety of financial safeguards to protect the clearing system from the financial difficulties of any firm that is part of that system. A clearinghouse's financial safeguard system involves multiple tiers. The first tier includes the margin money deposited by clearing member firms on behalf of their customers and their own proprietary accounts. The second tier may include the capital of the clearinghouse in excess of the working capital required for continuing clearinghouse operations. Clearinghouses also maintain guarantee funds that accrue value over time. If all of these funds are exhausted, many clearinghouses have the right to assess clearing members for unsatisfied obligations. Clearinghouses also hold credit lines to ensure that funds are immediately available in the case of an emergency. Finally, clearinghouses perform periodic risk evaluations of clearing member firms in an attempt to detect potential weaknesses in financial condition or risk controls. In addition, each clearing member firm has its own financial safeguards in place to protect itself from the financial distress of a customer—including a hedge fund customer.

### **The CFTC's Oversight Authority With Respect to Hedge Funds**

A hedge fund with positions in contracts under CFTC jurisdiction is a "commodity pool" and its operator or its adviser are required to register with the CFTC as a Commodity Pool Operator (CPO) or Commodity Trading Advisor (CTA), unless an exclusion or exemption from registration is available. Notably, the operators and advisers of commodity pools, but not the pools themselves, are required to register with the CFTC. Once registered, the CPO must comply with certain disclosure, reporting, and recordkeeping requirements and become subject to periodic examinations. Currently, there are approximately 1,800 CPOs and 2,600 CTAs registered with the CFTC.

The disclosure and financial reporting format for registered CPOs and CTAs is designed to ensure that prospective and actual participants in commodity pools receive all information that would be material to their decision to make, or maintain, an investment in a pool. To that end, at the point of sale, CPOs and CTAs are required to provide certain disclosures to prospective investors regarding the pool's investment program, principal risks factors, their conflicts of interests, and performance data and fees. Thereafter, CPOs must provide pool participants with an account statement at least quarterly and an annual report containing a financial statement, which must be audited by an independent public accountant and presented in accordance with Generally Accepted Accounting Principles (GAAP).

CFTC regulations provide a simplified regulatory framework for CPOs and CTAs under certain conditions. Many hedge funds are eligible for this simplified framework. The most significant relief is for pools that are offered only to "qualified eligible persons" who meet certain net worth and sophistication standards under CFTC Regulation 4.7.

CPOs and CTAs registered as such generally must be members of the National Futures Association (NFA), an industry self-regulatory organization. In practice, the CFTC has delegated many of its regulatory responsibilities in this area to the NFA, including the registration processing function, and review of disclosure documents and financial statements.

To this point, I have outlined what CFTC regulation involves. It is equally important to note the limits of that regulation. The CFTC does not prescribe the form of organization of pooled investment vehicles, nor does it impose limits on the fund's market risk appetite, the instruments that may be traded, the fees charged, or who may participate. Although the CFTC reviews financial statements to see that they include all required information and conform to applicable accounting standards, the review does not include an analysis of the transactions themselves.

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

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### **PREPARED STATEMENT OF HON. RICHARD McCORMACK**

SENIOR ADVISOR, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

MAY 16, 2006

Mr. Chairman and Distinguished Members of the Subcommittee:

My name is Richard McCormack. I am a senior advisor for the Center for Strategic and International Studies and a former Under Secretary of State for Economics. I appreciate the opportunity to testify before this Subcommittee on the issue of derivatives and hedge funds. The hearings today are very timely.

During the past several months, there have been a number of important speeches by U.S. officials on derivatives and hedge funds. A February 28 presentation by Timothy Geithner, President of the Federal Reserve Bank of New York, describes some of the potential challenges to financial stability posed by this very large industry. On March 9, Assistant Secretary of the Treasury, Emil Henry, formerly from Wall Street, provided an excellent overview of the industry and noted some of the technical questions that require further attention.

Virtually everyone who understands the derivative industry recognizes its value to the economy in its ability to manage and diffuse financial risks by individuals and companies. It also generates large profits for many of those participating in this industry, as well as the potential for losses, particularly during periods of turmoil in financial markets.

Some derivatives also contain the potential for abuse. For example, Italy secured entrance into the Euro by purchasing exotic derivatives that obscured the true financial condition of the country until after they were admitted. A similar situation occurred when some Japanese banks purchased derivative instruments which disguised the actual catastrophic state of their balance sheets at the time. And we all



remember problems with Enron and other institutions where derivatives played a key role in clouding the actual financial condition of individual institutions.

We also know that in the past there have been spectacular examples of turmoil in financial markets that were caused by honest miscalculations by important players in the derivative industry. The Long-Term Capital Management debacle of 1998 was the most recent example, and it potentially threatened the integrity of the financial system.

It is important to remember, however, that for each Enron type problem that surfaces in connection with derivatives, there are thousands of derivative transactions that occur every day which benefit all parties involved. For that reason, it is important to approach the potential problems with great care and sophistication.

The challenge we have now is to examine this industry, with the help of those deeply involved in it, to correct, if we can, any structural or technical problems that could increase the likelihood of systemic risk in the event of future shock to the financial system, such as the Russian default in 1998. Political risk and market over reaction in a crisis are difficult to prevent or completely factor into economic risk modeling.

History suggests that we may not be totally successful in efforts of prevention, and that any future financial turmoil may well resonate in parts of the derivative market.

Furthermore, there is no such thing as a permanent fix to problems in the derivative industry. This industry is so dynamic that its strengths and weaknesses change every few years. Ten years ago, credit derivatives were a tiny blip on the screen. Today these credit derivatives, which provide a kind of default insurance to creditors, are the fastest growing segment of this industry, as much as \$15 trillion notional value.

Last year when serious operational problems in credit derivative markets alarmed regulators, Gerald Corrigan, a former senior Federal Reserve official, now with Goldman Sachs, led an effort to identify and repair these problems. This effort was a good example of how industry and regulators can work together to address problems on the operational side of the derivative business. The Report of the Counterparty Risk Management Policy Group of July 27, 2005, is a masterpiece of its kind. The larger institutions in the derivative business have subsequently moved to comply with needed reforms by hiring expensive software and putting systems in place to expedite the clearance process.

It has taken some effort, however, by the New York Federal Reserve to get the second tier hedge funds which were involved in this business to make the needed investment in back office staff and systems. Other potential problems have also been addressed, such as credit risk that poorly vetted counterparties might pose if those offering derivative insurance do not have the capital strength to pay up in event of major defaults. These and other reforms make it more likely that institutions will only have to worry about market risk, not potential legal challenges and operational uncertainties.

Beyond operational risk, market risks pose another set of issues.

The global macro economic picture today is highly positive, with global growth at 5 percent and with several years of U.S. growth exceeding 4 percent. Long periods of growth and prosperity tend to induce a certain amount of complacency in financial markets. It is important, however, to remind the growing number of pension funds and other more recent derivative investors that the business cycle still exists. There are potential vulnerabilities in the global economy that could impact financial markets at some point, as I have noted in a recently published analysis, which I would like to attach as an appendix to my testimony.

Mr. Chairman and Distinguished Members, I would like to conclude my remarks by making several recommendations and observations.

First, all involved need to continue efforts to better understand the rapidly evolving derivative and hedge fund industries. For example, estimates of the total size of the notional value of over-the-counter derivative contracts outstanding vary widely. The President of the New York Federal Reserve Bank estimates the number at \$300 trillion. The Bank for International Settlements places the number at \$270 trillion, while the International Swaps and Derivative Association estimates a notional value of \$219 trillion.

Even value at risk, which is a much smaller number, is subject to varying interpretations and estimates.

When rounding errors for estimates for notional value of outstanding derivative contracts are in the tens of trillions of dollars, it is hard to have total confidence that we understand all the potential vulnerabilities that may exist in this industry.

Second, in his February 28, 2006, presentation on financial risk, Mr. Geithner raises the possibility of a potential rush to the exit by highly leveraged derivative

holders during a future period of market turmoil. This development could lead to liquidity shortages and markets failing to clear efficiently. Liquidity shortages are why markets melt down so fast and overshoot in some crises, as was the case in the 1987 stock market debacle. Obviously the Federal Reserve can play a role in addressing certain kinds of liquidity shortages in a crisis, but individual investors should be mindful of the need for an adequate capital cushion to address potentially unfavorable market developments. The issue of potential liquidity shortages during a crisis is one that deserves further study.

As more and more investor groups and pension funds become involved in the derivative business, after a long period of growth and economic stability, some investors may be tempted to take on risks that they do not fully understand. Should early signs of possible vulnerability begin to appear, the most sophisticated investors will, of course, quickly shed risky investments. Remember for example, what happened to Argentine bonds: Before the spectacular default, they ended up in the hands of Belgian dentists and Italian pensioners. These hearings should serve as a reminder to investors of the oldest lesson in business dealings: *caveat emptor*—let the buyer beware. Complex derivatives are not a place for amateur investors. There is an enduring connection between high yields and high risk.

The derivative industry itself has a powerful incentive to avoid the fraud, abuse, and blunders that could lead to massive losses, scandals, and crippling future regulation. The statesmen in the derivative industry are also best positioned to point out to regulators potential structural problems and those few in their ranks who may be engaged in unscrupulous or sloppy business practices.

Third, regulation of the derivative industry is faced with a fundamental dilemma; if government regulates the industry so tightly as to avoid all risk of market failure, it will kill a valuable part of the financial system. Finding the right middle path in this constantly changing environment is a challenging task that can only happen with the closest collaboration between the most sophisticated parts of the industry and their counterparts in the regulatory and political systems.

The U.S. regulatory system monitoring the financial industry is highly fragmented. Because of rapid changes in the industry itself, investment banks, hedge funds, and government-sponsored groups such as Fanny Mae have taken over functions that were once the prerogative of banks. Since banks are more highly regulated, there has been a trend of doing more and more financial business in areas where there is less official regulation. This includes the offshoring of some of the industry to places such as the Cayman Islands.

If the government were to start from scratch and design a regulatory system for today's financial system, it would not look like the system we now have in place, even though the existing system has generally served us well. But with the increasingly globalization of the financial industry as a whole, it is clear that more of the regulatory emphasis will have to be international in character. We need to make sure that derivatives continue to be remarkable instruments of wealth creation, global development, and risk diffusion, and not as Barton Biggs, Morgan Stanley's chief global strategist once feared "the nuclear weapon that ultimately blows us all to smithereens."

Finally, all of us hope that the current global economic boom can be gently managed downward to avoid potential inflationary problems. But with the dollar under pressure from our current account problem and with oil and commodity markets under strain, the potential exists for a somewhat more rapid market correction at some point.

The entire global financial system is interconnected by the hundreds of trillions of dollars in derivatives, which are the subject of these hearing. For example, any future banking crisis in China, which slows that economy, will immediately impact commodity prices and bonds of commodity producers. Any further sustained spike in oil prices could impact huge segments of the derivative industry. Those holding some credit derivatives against default could find them costly indeed.

During this current period of relative tranquility and prosperity, it is important for government and industry to continue efforts to monitor closely financial markets that could come under future strain and address new structural problems as they are identified. It will require judgment, sophistication, common sense, and contingency planning by all those involved in this valuable industry and their regulators.

In conclusion, we should not be concerned about the gains and losses of individual derivative investors. That is what capitalism is all about, and one of the reasons why this country is so prosperous. We take risks, we invest capital, and the market apportions the winners and the losers. Our concern should be potential systemic risk, fraud, and structural problems that increase the likelihood of these two broader potential problems. Thank you.

**Addendum****LOOKING FORWARD IN WARTIME: SOME VULNERABLE POINTS IN THE GLOBAL ECONOMY**

AMBASSADOR RICHARD T. MCCORMACK

(MARCH 30, 2005)

The purpose of this analysis is to address several key economic issues facing the United States and the world at a time when war and terrorism-related activities may potentially further stress the global economy. In some ways the global economy today resembles a large truck racing down the highway at 70 miles an hour, with four or five bald tires. The odds are that the truck will make it to its destination intact. But a major accident is also possible. This paper explores some of those vulnerabilities and is based on recent conversations with political and financial leaders on five continents. Such confidential conversations are necessary in today's global economy, because what happens in one part of the globe often has major consequences, sometimes quite unexpected, in other parts of the globe. For example, a ruble crisis in Moscow 7 years ago triggered a meltdown of derivative positions on Wall Street that posed a threat to the U.S. financial system itself. That is just one example of the global interconnectedness of everything.

The consequences of the collapse of large segments of global equity markets in 2001 continue to plague the global economy. The vast monetary and fiscal stimulus needed to re float the U.S. economy may have led to new forms of asset inflation, a bubble in real estate and very probably also in bond markets, and not just in the United States. Vast global economic imbalances have also developed, partly as a consequence of this titanic U.S. macro-economic stimulus.

These imbalances and other current global economic conditions remind us of several enduring economic lessons, with powerful future implications. Wise leadership and much good luck may be required to achieve a soft landing and a gradual shift in global trading patterns later in this decade.

**Equity Markets***How the Stock Market Bubble Grew and Burst*

The bursting of the U.S. stock market bubble erased at one point somewhere between 8 and 9 trillion dollars of wealth. When you add to this the immense sums that were lost in overseas equity markets during the same period, the magnitude of liquidity destruction was simply enormous.

Students of history will remember the famous cartoon by Thomas Nast about the corrupt Tweed Ring in New York in the late 19th century. The title of the cartoon was: "Who stole the people's money?" It featured a group of well-fed men standing in a circle, each man pointing his finger at the next person in the circle.

A similar cartoon could be drawn about the great asset bubble and bust of the late 1990s. The former head of the Securities and Exchange Commission points to Congress for failure to heed his warnings. Congress points to some dishonest people on Wall Street for having misled investors. Wall Street analysts point to the Federal Reserve complaisance. The Federal Reserve points to the irrationally exuberant investors and greedy corporate leaders. The greedy corporate leaders point to their auditors. The auditors point to permitted complexities in derivative and accounting rules. And so on around the circle of blame.

The fact of the matter is the blame is widely shared. There was a massive systems failure here and a massive loss of wealth when the bubble burst, particularly for the least sophisticated members of the investment community, including the elderly, many of whom were left holding the bag. The leadership of the Federal Reserve has come in for special criticism because the Federal Reserve is, after all, the ultimate regulator of the health of the nation's financial system, and controls margin requirements and the amount of liquidity made available to the system.

The equity bubble was fuelled in part by accommodative monetary policies in the latter part of the 1990s. Indeed the world was awash in liquidity during most of the bubble years. Attractive investment opportunities grew harder and harder to find. Traditional value analysts of stocks were increasingly discredited, as market momentum confounded one after another of their bearish predictions. Available cash continued to flow into already overpriced stocks, and also into over-investment in capacity for the production of goods and services. Telecoms were a prominent example.

People running U.S. monetary policies were obviously highly competent and experienced individuals. A question now often raised is why monetary authorities did not heed the timely warnings that appeared regularly in the Economist Magazine and

other respected publications, and tighten liquidity, or at the very least, increase margin requirements as a warning signal to dampen the raging speculative fever.

We also know from subsequently released minutes of the 1996 deliberations of the Board of Governors of the Federal Reserve, that some of the Governors, including Larry Lindsey and Chairman Greenspan himself, appeared concerned about the potential for a future catastrophic asset inflation bubble, as happened in Japan during the late 1980s.

These troubled deliberations inside the FED occurred shortly before Chairman Greenspan made his famous "Irrational Exuberance" comment at the American Enterprise Institute.

According to remarks by former Governor Kelly at a conference at CSIS in the summer of 2004, Kelly in retrospect greatly regretted the fact that, after 1996, the subject of a potential asset inflation building in U.S. equity markets never again appeared on the agenda of a single meeting of the open market committee of the Fed. One wonders why this lapse occurred.

Experienced financial leaders, such as former New York Federal Reserve official, Henry Kaufmann, later faulted U.S. monetary authorities for failure to take preemptive action to slow the developing asset inflation. They questioned why Chairman Greenspan did not use his bully pulpit to repeat his warnings about irrational exuberance.

Friends of Chairman Greenspan reply that, as in the Japanese asset bubble of the 1980s, low consumer price inflation might have made it difficult for him to justify to Wall Street and their friends in Congress the sustained increases in interest rates that would have been necessary to deflate the bubble when it was much smaller. Some critics would doubtless have accused him of gratuitously damaging capital markets. Yet this was the very policy advocated by the IMF, the Economist Magazine and others.

Several other developments that took place in the latter part of the 1990s also made it difficult to use a tight money policy to dampen the U.S. economy and financial markets. In the latter part of 1997, the Asian financial crisis unfolded with a vengeance. With the strong encouragement of the U.S. Treasury Department, monetary authorities poured high-powered liquidity into U.S. financial markets to cushion the blow from Asia. Interest rates were cut by 75 basis points the following year.

The Russian ruble and banking crisis subsequently triggered a series of worldwide repercussions that eventually undermined the highly leveraged derivative investments of a number of New York hedge funds, including the respected Long Term Capital Management firm. This particular hedge fund had leveraged few billion dollars worth of capital into over a trillion dollars worth of notional value on derivative markets. Creditors to these derivative speculators from the money center banks were also sucked into the threatening vortex, which briefly imperiled the U.S. financial system itself.

Finally, stating worries about the potential impact of the Year 2000 computer glitch, the U.S. central bank preemptively injected large amounts of liquidity into financial institutions in the fourth quarter of 1999, delaying the impact of a tightening cycle that began in July 1999.

Chairman Greenspan later said that market warnings unaccompanied by large and sustained curbs on available liquidity would have had no more impact on raging bull markets than his original "irrational exuberance" speech.

In 2000 the Federal Reserve System resumed tightening and the enormous bubble eventually burst after the Presidential elections amidst widespread recriminations. There is some talk now about the possible desirability of limits of two terms for future incumbents of the Chairmanship of the Federal Reserve, the nation's second most powerful job. The advantage of a Chairman with four successive terms is that the incumbent accumulates valuable experience from past successes and mistakes as his tenure in office rolls on. The disadvantage is that any deep-seated biases and blind spots on the part of a powerful and influential chairman inevitably become increasingly imbedded in personnel appointments throughout the institution. The temptation potentially also may exist for a Chairman wishing successive reappointments to get too close to political authorities in a position to reappoint him. Some years from now, economists will have a clearer idea of the balance of benefits of a very long serving chairman, when they will be able to assess with the clarity of hindsight the full impact of the Greenspan legacy.

#### *The Bubble's Consequences and Aftershocks*

The vast loss of wealth and purchasing power that accompanied the erasure of stock values, plus the excess capacity that easy money made possible, contributed to a threatened imbalance between supply and demand in some key markets. Profits further weakened and the new concern became deflation and recession.

To help stimulate demand and off-set the massive loss of wealth from the collapse of the stock market, the Federal Reserve reversed itself in 2001 and progressively lowered interest rates, in part to stimulate the housing market and the borrowing power and net wealth of homeowners and consumers. Many believe that a new bubble in housing and real estate has thus been created. The question is if, how much, and how soon will overall property markets weaken?

In considering these questions, it is important to remember that while mortgage interest rates in recent years were at historically low levels, rising insurance rates, local taxes and energy bills in the United States and elsewhere have steadily added to the cost of real estate ownership. It is also important to remember that current low interest rates will not last indefinitely. Indeed, a rising cycle of interest rates is already underway. Rising commodity and producer prices and other indicators suggest possible future inflationary pressures in sectors of the U.S. economy. Should broad inflation return and interest rates rise beyond the levels that many now anticipate, large-scale holders of fixed rate mortgages and their derivatives will be vulnerable. Fanny Mae, Freddy Mac, and those who hold the riskier paper hived off in massive derivative transactions are sometimes cited as weak links in such scenarios. This potential vulnerability has belatedly become apparent to U.S. regulatory authorities, some of whom are now calling for an 80 percent reduction in the trillion and a half dollar mortgage asset holdings of Fanny Mae and Freddy Mac.

In England, where housing costs rose 25 percent in a single recent year, history suggests a possible repeat of the housing bubble that was created and burst during the tenure of former Chancellor Nigel Lawson. This bubble, before collapse, triggered inflation and required draconian monetary retrenchment. This in turn contributed to the sour political climate that ended Margaret Thatcher's historic prime ministership, and helped leave the Conservative Party in shambles from which it has not yet recovered 10 years later. Recently the latest boom in English property markets was noted with concern by the IMF, and is now the subject of close attention by the Bank of England.

The behavior of bond markets is also a troubling phenomenon. Short and long-term yields show remarkable little differentiation, by comparison with historical standards. The same can be said for the collapse in spreads between government and corporate bonds. Markets seem to have forgotten the recent default of Argentina on its 100 billion dollar bond portfolio, and the fact that during the next serious downward move in the global business cycle, other democratically elected leaders in emerging markets will face constituent pressures to use President Kirchner's 70 percent write off as the standard against which to negotiate with their own bond holders. But the problems go well beyond emerging markets. What are the prospects that Japan's titanic quantity of 1 percent bonds will be an attractive proposition 5 years from now? The same can be said for other bonds, including the remarkably low spread on France's recent 50 year bond offering. Those bringing the bonds to market will pocket their commissions. Whether the long-term bond-holders will be as fortunate, is a very large question. Earlier relatively low consumer inflation meant that central banks in many countries, including the United States, Japan, and England, had the opportunity to generate a vast amount of liquidity, big piles of which have wound up in asset markets of all kinds. The question remains about the medium and long term sustainability of these bond and other asset prices, leading to a further question about a possibly painful hang over after the party ends.

In property, bond, and equity markets, as in much else, a great deal obviously depends upon the future trajectory of the U.S. business cycle. Massive fiscal and monetary stimulus has been applied in the past several years, a need anticipated by President Bush's economic advisors as he came into office. This enormous economic stimulus has, however, also contributed to a massive increase in the U.S. current account deficit and a dramatic weakening in the U.S. dollar. No one should be surprised at this latter development. The oldest rule in economics, following the law of supply and demand, is that the surest way to weaken a currency is to print too much of it. Today's dollar buys half the house, a fraction of the college costs and medical attention, and far less gasoline than it could have purchased a decade ago. As the dollar weakens on international markets, its purchasing power in other areas is also likely to erode with time.

Members of the Austrian monetary school take a grimmer view of the long-term consequences of the generous monetary policies of recent years. They believe that the subsidized interest rates, repeated bail-outs, and asset inflations they have financed since 1997 will only postpone a far larger future economic and financial crisis. The Austrian school favors a cautious monetary policy and a prevention of asset inflation, rather than the bailout model now favored by the Fed and supported by Wall Street.

Because of a lack of information, most outside observers are not yet ready to offer a definitive judgment on this dispute between the Austrian school and Greenspan policy preferences. We may all know the answer to this very large question, however, within 5 years, unless the tipping point trigger which sets off any future large scale crisis is in itself so dramatic that it obscures the true role of any past underlying monetary policy mistakes and vulnerabilities.

### **U.S. Vulnerabilities**

#### *Future Prospects—A Global Tour*

Should the Iraq war end soon, not spread to other neighboring countries such as Iran and Turkey, and terrorism problems remain manageable, prospects for continued growth in the American economy in 2005 appear positive at present.

A gradually weakening dollar, although a potential source of sectoral inflation and higher U.S. capital costs, should also eventually encourage more investment in manufacturing and in the production of other tradable goods in the United States. However, any rapid fall in the dollar would create many problems both domestically and abroad. Export dependent economies would face recession and financial dislocations, and the United States would experience both sectoral inflation and increase in the cost of capital, which would also impact housing markets and consumers here.

Should the conflict and follow up with Iraq prove longer and more expensive than anticipated, should terrorists strike key economic targets in the United States, or sabotage impact oil shipping and production facilities beyond those damaged in Iraq itself, U.S. and global economic recovery could be derailed for a period depending on the severity and duration of the disruptions.

In 1990, the first Bush Administration delayed release of oil from the stockpile until the very eve of the Gulf war. This decision, plus the firing of the Kuwaiti oil fields and the embargo against Iraq's oil, led to an increase in oil prices and inflation in the United States and elsewhere. At present oil markets are already tight. Should the conflict with Iraq spread to neighboring oil-producing economies, directly or indirectly through terrorism or civil unrest, the oil shortage scenario of 1990 could easily be repeated on a larger scale. Because oil prices are already very high, the impact of any further tightening of oil markets could be quite dramatic.

#### *Japan's Malaise*

Vast fiscal efforts to prime the pump and delay painful restructuring of the Japanese economy in the aftermath of the collapse of the Japanese asset bubble in 1990 have contributed to a massive public debt. The OECD estimates that this debt equals at present 169 percent of Japan's entire gross national product, the largest by far of any member of the industrialized world. Other well informed observers believe that Japan's actual public debt and contingent liabilities are far higher than even the OECD estimates. Japan is able to service a debt of this magnitude only because interest rates, in a deflating economy, are only about 1 percent in nominal terms. But what happens to all those 1 percent bonds when the inevitable day comes that interest rates rise to support the greater risk that this huge and growing debt entails? Who will want to buy these bonds should perceived risk and inflation mount? And what will happen to the banks and insurance companies now holding many of these 1 percent bonds as collateral and capital? Indeed, the Governor of the Bank of Japan recently worried aloud about the exposure of his own institution's balance sheet, should future inflation and interest rates undermine the value of the Bank's vast and growing bond holdings. According to media accounts, today the Bank of Japan holds a greater percentage of Japanese Government bonds than even during the peak war year of 1944. If true, that is an astounding fact.

Dealing with Japan's multiple structural, financial, and economic problems must inevitably involve some short-term increase in bankruptcies and unemployment, as part of a fundamental transition. More so-called zombie companies, kept alive by constant transfusions of loans from banks, will eventually have to be closed. Alternative policy would involve ever more bad debt piling up in the banks. Much of Japan's political class was resistant to policies involving short-term adjustment pain in the interest of social and political stability, so the debt buildup continued and continued. Japanese officials were, however, remarkably skillful and successful at the management of most perceptions abroad about the actual state of the Japanese economy and finance at any given moment, despite the 15 years of stagnation and false recoveries since the bursting of the great Japanese asset bubble.

A year ago, however, former Finance Vice Minister Ito published in the Financial Times a credible plan for addressing some of Japan's financial and structural problems. It contained the following elements:

1. Since Japan's central bank had failed to grow the money supply sufficiently with lower interest rates alone—the money supply grew by only 2 percent during one recent 12 month period—Ito urged unconventional measures to inject money into the economy. In current circumstances, broad deflation could only be cured by a monetary expansion.
2. Japan must gradually control excesses in deficit financing to avoid a fatal debt buildup, and eventual crisis in debt servicing. Ito also believes that the tax system and public spending patterns must be reconfigured to encourage greater aggregate demand.
3. The non-performing loan problem must be progressively solved, so that Japan's capital could be put to higher and more productive uses than supporting zombie companies. The banking system needed reform, injection of public money, nationalization of some banks, more mergers of others, and the outright closure of some weaker banks.

If a program such as this is not consistently implemented over the next few years, the debt buildup in Japan may eventually trigger a crisis that could shake the Nation to its roots, destroy an immense amount of wealth, require a massive use of the printing press at the Central Bank that will be highly inflationary, and force Japan to face its problems with a vastly reduced capital and savings base. Even with interest rates at slightly over 1 percent, government debt service charges already absorb more than one fifth of Japan's annual budget.

Prolonged oil price increases, a war in Korea, or a deep future U.S. recession would of course put immense new pressure on the Japanese economy and finances. Fortunately, a highly competent man, Mr. Fukui, has recently been named head of the Bank of Japan and has begun a reform effort. No one should envy this man. He has inherited a massive problem now under increasingly stressful geopolitical conditions: The dollar weakens. The competition from China intensifies. Aging Japan's demographic trends accelerate. The public debt mounts.

#### *The Argentina Example*

Argentina is an example of a country which delayed facing its problems until it was too late. The Argentine economy eventually shrank by 25 percent over a 4-year period. The banking system and a large part of the country's domestically held savings were lost. Capital flight added to the disaster. The crisis itself accompanied desperate last minute measures by Finance Minister Cavallo, which further undermined the country's capital-base and economy. The political class was largely discredited. Demagoguery and finger pointing formed an important part of the public discourse. A key problem in Argentina, as in Japan, was that the abler parts of political class were unable for years to implement a sustainable reform program. In the end, foreign holders of a hundred billion dollars worth of Argentine bonds were left holding the bag in one of history's largest defaults. After an excruciating 2 years, soaring global prices for Argentina's agricultural and commodity exports and the default on Argentina's foreign creditors, allowed growth to resume in Argentina, but at the cost of Argentina's long term creditworthiness and foreign investment prospects.

The most expensive bill from the Argentina default may be the new precedent for other future bond defaulters in emerging markets. Which future democratically elected leader with debt service problems will be able to demand less than President Kirchner extracted and received from his defaulted bond holders? This is likely to become a very live issue during the next serious downturn in the global business cycle.

#### *Brazil's Highwire Act*

The high ratio of debt to GDP of Brazil is a major source of concern. International institutions consider that ratios above 50 percent in emerging markets could expose countries to crisis. Such high ratios may not seem threatening in Europe and the United States because of higher capacity of raising government revenue. Theory and data do not provide a reliable measurement of the sustainable debt/GDP ratio for any country. The internal debt of Brazil was 55.5 percent of GDP in 2002, increased to 57.2 percent in 2003 and declined to 51.1 percent in 2004. Vulnerability exists at the point when investors may not be willing to purchase government securities at a "reasonable" cost, forcing default. It may not be feasible empirically to measure such a point. In order to reduce the debt/GDP ratio, Brazil must continue its prudential fiscal management of primary budget surplus, which is now close to 5 percent of GDP. Simultaneously, Brazil converted a current account deficit into a current account surplus of close to 2 percent of GDP by reversing a trade deficit into a trade surplus of more than \$30 billion. Simultaneously, the economy is growing

again. There are still many challenges in Brazil, in particular, tax and labor reform, which would modernize the country, allowing better control of its own destinies.

Similar problems exist in other major Latin American nations. Much of the work done in the 1980s to encourage the adoption of market based economic reforms in Latin America has been undermined by policy failure, some corrupt and discredited privatizations, and similar mistakes. But as the former President of Bolivia stated 2 years ago: "The hangover facing our region is not due to the reforms we have made, but to the reforms which we have not yet made."

As in Argentina, however, soaring world commodity prices have boosted economic growth in many parts of Latin America to levels not seen since the commodity boom of 1980, a boom which ended in tears in 1982, and a lost subsequent decade of economic growth for the whole continent. There is no substitute for getting overall policies right for sustainable balanced economic development. Otherwise heavily indebted commodity dependent economies will continue to be hostage to the full impact of the booms and busts that accompany the global business cycles.

The United States has a very large stake in the outcome of the intensifying struggle between the demagogues and the sound economists in many parts of Latin America. Our stake in economic growth is equally high in other parts of the globe. Unsustainable U.S. trade deficits cannot be corrected without a major global recession unless growth and demand elsewhere contribute to the solution. This plus other measures would then help permit an orderly shifting of global trading patterns.

#### *The Euro Dilemma*

In Europe, Germany's key economy is weakening with core unemployment exceeding 10 percent. Major structural reforms in labor markets, pension systems, and other aspects of the German economy are urgently needed. Prime Minister Schroeder has accomplished a modest increase in labor market flexibility. Politics impedes a broader assault on imbedded problems, which may not be resolved until Germany's two large parties join in a broad coalition to force through needed legislation. Other serious structural problems exist elsewhere within the Euro zone, recently worsened by the European Union's strengthening currency against the dollar zone. Because of the internal trade within the expanding European Union, and because of favorable relative energy prices in Euros, the impact on Europe's economy of the latest currency shift is less dramatic than some predicted. Still, Europe depends upon exports to the dollar zone for millions of jobs, and reduced competitiveness because of its strengthening currency may encourage some European leaders to turn even more heavily to high profile global politics in controversial areas to secure export markets. The Middle East and China are only two of several such theaters where international politics heavily impact local procurement and mineral concession decisions. This then could create more strain on Europe's ties with the United States, and potentially more strain on the economic side of the relationship in future discussions of trade and technology across the Atlantic.

#### *The China Question*

China's intense national ambition rapidly to become the dominant Asian power, its low wages and its undervalued currency have unleashed trends that threaten to turn that country into an engine of deflation in sectors of manufacturing. Over supply of goods continues to cause profit problems for competitors both within China and abroad. Many of China's 150,000 state owned enterprises, burdened with antiquated facilities and heavy benefit programs for their workers, remain in business only because banks are required to provide "loans" to subsidize their operations and prevent unemployment. This is contributing to a bad loan problem that may rival that of Japan in its size and potential implications for the future.

Indeed, mismanagement of banking and finance has been the traditional Achilles heel of the Asian development model, and China is not likely to prove a long-term exception to this rule. But in the meantime, China's exports are expanding at a frantic pace—more than 30 percent per year on a compound basis. According to The Economist magazine, export industries and international commerce now contribute directly and indirectly more than 50 percent of China's entire two tiered national economy. This soaring trend in export growth cannot continue indefinitely without major consequences for the stability of China, China's trading partners, and for the global trading system as a whole.

#### *The U.S. Deficit*

This brings us full circle to the United States, where we have a net debt from accumulated trade deficits now approaching three trillion dollars, a debt that must be serviced with interest and profit remittances. This year the U.S. trade deficit is projected to increase to a yearly total of over 700 billion dollars. (China alone con-



tributes \$135 billion to this figure.) This unsustainable trend has already helped drive the dollar down against the Euro and other floating currencies.

Predicting short-term currency trends in today's volatile conditions is difficult, partly because of massive intervention in Asia, and partly because the dollar's competitors, the yen and the Euro, are based on economies that are themselves deeply troubled. Nevertheless, the massive, growing U.S. current account problems leave the dollar extremely vulnerable in the short and medium term. Should the dollar continue to fall, the U.S. market will be less available to overseas exporters, regardless of our trade and tariff policies.

Past U.S. trade policy concentrated on opening U.S. and global markets. We are now engaged in a new round of trade negotiations aimed at further trade liberalizations. But if we do not succeed in creating opportunities for the United States to reduce its trade deficit—which continued at record levels even during a past recession—the dollar may continue to fall and this will have consequences.

Moreover, persistent global ill-will toward, or misunderstanding of, U.S. foreign policies could trigger a de facto overseas boycott of U.S. goods and services far beyond Macdonald's currently flagging sales in the Arab world, or the disappearance of the Marlborough cowboy from many of its earlier marketing sites throughout Europe, as a now negative symbol. Such attitudes overseas could have long-term implications for Boeing and other big-ticket U.S. exporters, which now contribute importantly to our balance of payments. They could also create long-term strategic commercial opportunities for U.S. competitors in Europe, the Middle East, Latin America, and Asia.

#### **The Promise—and Limits—of Economic Prospects**

As we consider the economic developments of the past century, the trends are overwhelmingly positive. Technology, science, democracy, education, and productivity have improved the quality of life for billions of people on this planet. Ancient illnesses have been fought and defeated. Drudgery in daily life and work has been dramatically reduced. These trends will certainly continue and intensify in our present century.

But there have also been bumps in the road of progress. Debt problems, demagogues, wars, asset and consumer price inflation, and over investment in capacity, have taken their toll in blighted lives, recessions, and a major depression during the past century. We believe we understand now, better than before, how to cope with fundamental economic problems. While we can learn from the past, it is important, however, to recognize that each major economic accident impacting the national, regional, and global economy has been unique. Attempting to build precise models based on past situations has thus far not been very successful in predicting the next economic crisis. In this sense, notwithstanding all the advanced mathematics and powerful computers, economics is still a young science, still learning, still attempting to build paradigms that will allow us all to peer into the future with more confidence to avoid costly debacles. In the meantime we have to look beyond our computers to assess deeper vulnerabilities.

This is not going to be easy. Human nature, with all of its complexity and vulnerabilities, operates on the basis of emotions, values, drives and ambitions the impact of which is difficult to quantify. Statistics will continue to be flawed by false data fed into powerful computers. Confidence will suddenly collapse from time to time, triggering runs on banks and countries. Poorly supervised rogue traders in banks and hedge funds will periodically trigger vast losses to shareholders and investors. Political leaders will not always be totally candid with their followers and their countries' creditors. Politics itself is an unpredictable factor, as is war. People also make honest mistakes.

Painful old lessons about such dangers as asset inflation and over concentration in the financial industry will have to be relearned. As each generation dies off with its deeply imbedded memories of booms and busts, the snake oil salesmen will again appear in force, together with their witting and unwitting accomplices in corporate and public life. There will always be a powerful lobby for a major redistribution of wealth, whether through taxes or monetary policy measures.

Three other issues deserving special attention are problems in the global exchange rate system, some aspects of the derivatives industry, and any underestimation of strain on public finances that could produce renewed inflation.

#### *Global Exchange Rates*

When floating exchange rates were adopted after the collapse of the Bretton Woods system, policymakers expected the new system to trigger automatic adjustments in the balance of payments.

Reality proved more complicated. Some mercantilist countries endeavor to influence currency directions with interventions, dirty floats, fixed arrangements, and large-scale capital transfers of various kinds. Competitive currency devaluations can substitute for tariffs and other non-tariff barriers as an important regulator of the terms of international trade.

Over the long term, floating exchange rates have proven their value to most countries with sound regulatory systems. But in the short term, currency interventions by those with fixed exchange rates of various kinds have greatly complicated international trade, and contributed to the large sustained U.S. trade deficit. Such undervalued currencies disadvantage competing manufacturers in the U.S. and elsewhere. The export-favorable currency of China also encourages more investment in local manufacturing than the global market can absorb without producing future deflationary pressures and broader dislocations.

China's economic development is a good thing, not a bad thing. But some of China's policies to jump-start a once moribund state run economy can be dangerous to China and others if continued too long. Recent international efforts were made to persuade China to allow its currency to appreciate. This is because the undervaluation of China's currency does not involve only China, but the whole East Asian production complex. None of the neighboring countries that form China's hub and spokes trading system can afford to revalue its own currency unless China leads the way.

Appeals for an immediate currency revaluation have been rejected. China cites concerns for its strained banking and political system if growth and export rates taper off for any reason.

Therein lies the great dilemma. China says that it cannot afford to slow down its titanic export drive, and the United States simply cannot afford to accumulate current account debts at the accelerating pace of the past few years.

Thus, if internal problems with China's banking system, energy supplies, politics, and environmental conditions do not ease China's torrid pace of export expansion, China's competitors abroad will surely seek ways to slow down the juggernaut. This would allow time and space for other economies, including those in the Western Hemisphere, to grow and adjust. This is what happened in the mid 1980s to blunt Japan's massive export drive, which also was fueled in part by state capitalism, an undervalued currency, multiple non-tariff barriers, rampant theft of intellectual property and an intense national ambition by the country's leadership to achieve U.S. standards. The fact remains that the U.S. cannot continue to accumulate debt via its collapsing current account position at this pace much longer without undermining the dollar as a reserve currency, radicalizing its domestic politics, and eventually compromising its global strategic position.

Although China has accumulated more than 600 billion dollars worth of foreign exchange reserves to cushion any future problems, China's fears about its own vulnerabilities should not be ignored. China's economy faces serious problems, problems not always fully captured by released official statistics. Although China's economy is stated to be growing at a 9 percent annual pace, China's stock market is at a 6-year low, as of early 2005. Presumably the companies listed on the stock exchange are among China's best. Their sagging value may say a great deal about the financial health of the other building blocks of the Chinese economy, namely the individual companies. Stock markets tend to be leading, not lagging, economic indicators.

#### *The Problem With Derivatives*

In our time, derivatives have added vast new areas of uncertainty. There is somewhere between 100 and 125 trillion dollars worth of those useful instruments outstanding today. While derivatives do reduce risk to individuals and companies, they also spread that risk, often in highly leveraged form, to other individuals, institutions, and in extreme form to the financial system itself—as we saw with the Long-Term Capital Management hedge fund debacle. Some large money-center banks, which are creditors to major derivative issuers, are thought by some to be at risk under some possible scenarios.

It requires a high degree of technical skill, and unusual dedication and effort for outsiders to penetrate constantly evolving derivative markets and understand where the evershifting vulnerabilities lie. This cannot be accomplished by the average investor, who is likely to have no idea what recent gambles a firm's management may have made on derivative markets until the bad news of a massive loss suddenly hits the street. Many have urged greater transparency in derivative reporting. Even Warren Buffett and his skilled associates threw up their hands after attempting to penetrate the explanatory footnotes on the potential derivative related liabilities of some money-center banks.

*Fighting Terrorism: Balancing Short-Term Costs and Long-Term Goals*

Beyond the problem of finding a solution to the global imbalances, the greatest uncertainty facing the American economy undoubtedly has to do with the unpredictable elements of war and terrorism, and the potential for disruption of economic targets, including energy related production and transportation facilities. The Venezuelan and Nigerian oil production disruptions have complicated all this.

Each year since 9/11, economists at the IMF have attempted to calculate the potential economic impact of perceived geo-political uncertainties that could cut projected global economic growth.

One of the reasons for this effort is the vast disproportion between the costs of mounting terrorist attacks and the damage that such attacks can inflict on advanced, open and vulnerable economies like ours. A year after the 9/11 attack, one of Washington's major public policy institutes assembled a group of economists to assess these relative costs. At that time, they concluded that the 9/11 attacks on the Twin Towers and Pentagon had cost Al-Qaeda about \$250,000 to mount. The assembled economists calculated that the net cost to the American economy of this attack, direct and indirect, exceeded \$800 billion dollars. This included the damage to financial markets, transportation industry, insurance industry, hotel industry, the buildings themselves and the titanic costs of striking back at terrorists and protecting the country from future attacks. In the meantime, new costs have arisen as pressure for more domestic defensive measures has developed.

Knowledge that terrorists have targeted civilian aircraft with cheap anti-aircraft missiles, for example, generated proposals to equip civilian planes with anti-missile systems at a cost of \$10 billion dollars. The war with Iraq, partly aimed at avoiding possible future Iraqi cooperation with terrorists, will certainly cost many hundreds of billions of dollars before it is over, plus the large sums our allies asked to secure their cooperation. Since 9/11 the price of oil has doubled. If there is a deeper oil crisis, or terrorist-related economic disruption, this cost will increase. It should be remembered that each thousand point decline in the Dow Jones costs share holders roughly a trillion dollars. It should also be remembered that inflation and other financial instabilities have the potential to jolt bond and derivative markets.

Unless the United States successfully shifts budget priorities, the American economy does not have a limitless ability to absorb the costs from war and terrorism without eventually returning to a sharper cycle of inflation and recession.

The Federal Reserve can indeed cushion massive unexpected blows to the American economy and financial markets, but only at a high risk of future inflation, subsequent monetary restraint, and recession.

The U.S. obviously had no choice but to defend itself from evil. We have moved vigorously to strike at Al-Qaeda and their Taliban hosts and now Iraq. But we also have an obligation to look beyond the immediate issue to seek means to drain the other swamps that help spawn terrorists and recurrent regional wars. That is partly why the President's vision of a Middle East settlement with a secure Israel and a democratic Palestine was so well received by diplomats. It is vital that future scenes of cooperation among the leaders of the three great faiths involved replace the constant mayhem on television throughout the Islamic world from violent events in what was once called "The Holy Land."

History suggests that the U.S. will eventually pass through today's problems and uncertainties. Unlike Japanese economic managers who tend to bury their problems for years and compound their costs, the U.S. tends to address its Enron-like problems brutally and move on. Every 4 years, the Presidential election provides the American people with the opportunity to change, if needed, both policies and personnel. We can also expect that new inventions and technologies will generate whole new areas of economic activity and growth, improving the lives of billions of people.

A key to this happy outcome is wise U.S. leadership and effective diplomacy, plus keeping our economy open, flexible, market oriented, and with a heavy emphasis on quality education. We must also successfully address certain problems in the global trading system that contribute to our current account problem. As long as we continue to master these basic requirements, we will drive over any bumps in the road and continue to lead the world.

**Operative Lessons for Policy Makers**

Based on the key conclusions from this brief review of potential global economic vulnerabilities, a list follows of some key principles that should be noted by policy-makers even during the distractions and turmoil of war-time:

1. It is better to prevent inflation than to have to control it, once unleashed. This is also true of serious asset inflation, which produces bubbles that tend to trap the least sophisticated investors.

2. Excessively loose monetary policy which subsequently generates asset inflation also tends to produce excess investment in capacity, including real estate. In effect, such monetary policies borrow economic growth from the future. This resultant excess capacity ultimately weakens profits, banks, and stock values, and can hang over markets for years before a combination of liquidation of excess capacity and new economic growth allows markets to clear.
3. Wars destroy and waste wealth. Financing by governments of past wars has often generated inflation, unless policymakers were vigilant.
4. Stimulating the housing market in an effort to ease the wealth destructive consequences of a burst stock market asset bubble can either kill or cure the patient, depending on how long the medicine is applied. The same can also be said about bond markets, where serious questions have arisen about the sustainability of current bond market trends.
5. During inflationary times, low fixed rate mortgages on housing can generate serious problems for those institutions holding large portfolios of mortgages or higher risk housing derivatives. Future higher interest rates will tend to make it more difficult for potential buyers to qualify for mortgages when people want to sell their houses. Higher local taxes, which are often indexed, and rising insurance costs are adding to the cost of home ownership, and will tend to reduce the pool of people able to afford such housing at existing prices.
6. The large-scale debt accumulations, via balance of payment deficits, cannot continue indefinitely without triggering a further weakening of the nation's currency, contributing to sectoral inflationary pressures and increasing the cost of capital. U.S. trade deficits are not merely a macroeconomic phenomenon involving the U.S. budget deficit and monetary aggregates, important though that is, but also and powerfully an accumulation of many micro economic problems. These include currency misalignments, failure to enforce successfully past trade opening deals, including China's WTO agreements, subtle but powerful non tariff barriers involving such things as local standards, the European VAT rebate system for exports, poorly negotiated past trade deals such as the 1992 airbus agreement which allowed subsidized and risk free financing of new aircraft, wholesale theft of U.S. intellectual property and trademarks in many parts of the world, complaints about U.S. worker literacy by potential investors, *etc.* Viewed individually, the impact of some of the micro economic obstacles to U.S. exports and competitiveness may seem modest. The collective impact of all the micro economic obstacles on American competitiveness and exports, however, is titanic and strategic. U.S. trade deficits have increased steadily since 1990, regardless of the fluctuating U.S. budget position, suggesting that we must look beyond the fiscal macro issue to help address our current account problems.
7. It is nevertheless essential that projected U.S. Fiscal deficits be brought under control. They contribute to excess U.S. demand, cause confidence problems at home and abroad, and will otherwise lead to higher future U.S. interest rates.
8. Foreign policy rationales for trade policy measures need to be considered from time to time, but only if the collective impact of generous trade policies conducted on this basis does not generate potentially disastrous current account problems.
9. Encouraging more economic growth abroad is the painless textbook solution to a global imbalance problem in trade. Realism compels us to consider the political obstacles likely to delay such growth in Europe and Japan, and understand as well that more export led growth in places like China will only compound our problems. We also need to remember the catastrophic results of efforts in the mid-1980s to encourage Japan to engage in expansionary monetary policies aimed stimulating more domestic demand. In short, we may need to look beyond this textbook solution to help ease our pressing current account problem.
10. As Argentina demonstrates, delay in addressing an underlying national economic imbalance can cause an economy to contract severely when problems have to be addressed in the middle of an urgent crisis. If this happens to the American economy, the consequences will be massive and global.
11. As in Brazil, funding a large public debt with short-term borrowings can be dangerous if, for any reason, markets lose confidence in the borrower's ability to service the debt.
12. Floating exchange rates have proven their value over the long-term for most countries with sound regulatory systems, but such countries can suffer short-term competitiveness problems against trade sold with fixed and undervalued currencies. Major countries like China with such fixed exchange rates and large pools of savings and inexpensive labor can dominate some sections of

- global markets for years, but at a risk of future financial, banking and political instabilities for themselves and for their trading partners.
13. Past models of financial disasters are imperfect guides for predicting future financial debacles. There are several reasons for this. One key problem is a lack of transparency in information. Political and business leaders with financial problems are seldom candid. Political responses to crises are unpredictable. Part of modern finance relies heavily on opaque derivative operations whose individual and collective impact during a crisis cannot be quantified in advance. Human nature itself is volatile, subject on occasion to credulity, panic, and the other manifestations of "the madness of crowds." Relying wholly on computers and the statistics in them can dangerously mislead policymakers who fail to understand the limitations of their economic models.
  14. Allowing the economy to operate on the basis of market signals remains the best available means of running a modern economy. Rapid advances in science and technology will continue to place a tremendous premium on flexibility, quality education, and on the optimum use of capital and labor that a market driven process makes most likely.
  15. Notwithstanding current overall global economic growth, today's world is filled with economic vulnerabilities, large and small. Policymakers and economists need to monitor and address the more obvious individual problems to lessen potential future systemic risks.

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**Demystifying Hedge Funds**

Every day, somewhere in the global marketplace, hedge funds are shaking up the comfortable *status quo* and voices from high places are raised in protest. The Governor of China's central bank Zhou tried to deflect G7 censure of the under-valuation of the yuan by pointing at unruly hedge funds as a greater threat to the world economy. In the American heartland, Warren Staley, CEO of agricultural giant Cargill, accused hedge funds of distorting fundamentals and roiling the commodities markets. In Germany and Japan, politicians denounced hedge fund corporate activists as "locusts" that destroy and disrupt in order to extract quick profits.

Are hedge funds really to blame for all the ills that befall the international financial system? Are they disruptive speculators or dispassionate agents that expose fundamental flaws and speed up inevitable change? Does their search for the highest absolute economic return eliminate inefficiencies and bring balance and liquidity to the market? Or does it lead to excessive risk-taking that may one day entrain widespread crisis?

Hedge funds are simply pools of money seeking the highest absolute rate of return across the capital markets with a management compensation structure that commands a high share of profits. They have been here for more than a generation and, like any financial innovation, are following a normal life cycle. First, a small number of pioneers garner excess profits; next, competition and capital are broadly attracted; finally, the concept moves into the mainstream, matures and is winnowed out until the risk/reward ratio approaches that of other instruments.

When floating exchange rates and volatile interest rate movements transformed the capital markets in the late 1970s, hedge funds entered quietly with an irresistible offer to investors: make money whether the market rises or falls. These were small groups of innovative traders, some inside large investment banks funded by the bank's own capital, others in independent firms financed by less than 100 rich individuals prepared to commit millions to a new technology.

Managers searched for momentary anomalies in the pricing of securities, currencies and commodities around the world. They matched holdings with short sales to isolate generalized market risk. They borrowed heavily to leverage positions and magnify returns. Rewards were overwhelming and consistent at 40 percent per annum. Managers were paid for performance: they received 20 percent of profits. As investors and managers plowed back their gains, small funds quickly grew into multi-billion dollar forces.

Hedge funds are now a major force in the global financial markets. Over 8,000 hedge funds hold \$1.5 trillion in assets, double the level in 2000. Leverage and the use of derivative instruments multiply their real impact many-fold. They dominate the trading arena: one-third of equity volumes; one-fifth of the bond and currency markets; one-half of the commodities sector. They are a mainstay of profits for the

large investment banks through commissions on trading and interest on borrowing; when added to the revenues of in-house proprietary trading, hedge funds overall are the predominant source of Wall Street earnings.

Trading figures are no longer the sole measure of hedge fund power. As more funds and more money chase the same opportunities, hedge funds are constantly moving money around the globe to where it is most productive. They challenge private equity firms, venture capitalists and real estate developers. They lend to companies in distress. They take large positions as shareholder activists to force corporate restructurings. They search the world to manage infrastructure projects and to develop natural resources.

The client base has moved from a closed society of the very rich to embrace the entire investor spectrum. Large institutions that oversee the retirement savings of the nation's workforce and endowments that guard the resources of universities and charitable trusts now account for more than half of hedge fund capital. High rates of return were the initial attraction but even as returns tend toward lower equilibrium levels, hedge funds are valued to reduce over-all portfolio risk because their returns are uncorrelated with general market trends.

A whole new layer of intermediaries has developed to proffer guidance through the maze of proliferating hedge fund choices and to distribute institutional investor assets among specialized funds. These "funds of hedge funds", when marketed by banks and securities firms, provide a conduit for the retail investor with as little as \$25,000 to risk. In the planning stages at Citigroup is a \$30 billion fund of hedge funds to be marketed to its retail client base with the frequent redemption options now offered by mutual funds. Funds of hedge funds now control 50 percent of industry assets and have brought in 60 percent of recent inflows. Each layer adds more fees and reduces investor returns.

The original hedge fund image was a "black box": investors put their money in and asked no questions about what went on inside. Hedge funds continue to depend upon secrecy to prosper. They have a large investment—in human capital from the world's top mathematics, physics and finance institutions; in technology based upon complex quantitative statistical models; in information costly to collect and process—that cannot be patented or protected. A strategy disclosed is a strategy destroyed as immediate imitation by the market wipes out the benefits of expensive proprietary innovation.

In a world that demands transparency, secrecy is a red flag for fear, suspicion and calls for regulation.<sup>1</sup> But the public interest can be satisfied without driving hedge funds to pack up and resettle off-shore. The framework to monitor and safeguard the global financial system and to watch over the unaware investor is already in place.

Hedge funds do not operate in a vacuum. They interact through a marketplace where their lenders, their trading counter-parties and the markets themselves are already under the scrutiny of an array of regulators—the SEC, the Federal Reserve, the Comptroller of the Currency, the CFTC and their counterparts in capital markets around the world.

Hedge fund objectives should not be confused with their tools. The hedge fund formula has always relied on leverage to magnify returns, whether through borrowing or derivative instruments, but as margins narrow there is the pressure to take on more risk to generate the same profit rates. Leverage alone does not add value and excessive leverage can disrupt markets. The danger to those that finance hedge funds and to the global system as a whole lies in ignorance of risks. Total exposure and total leverage across all lenders and across all national boundaries should now be aggregated and published to inform and improve the risk evaluations of market participants and regulators alike.

Under U.S. securities law, all hedge fund clients—the very rich, the institutional investors and the managers of funds of hedge funds who are stewards of the savings of small investors—have the skills to inform their decisions without official help. Many analysts believe that the industry would benefit from standardized disclosure of fund structures and track records. But government agencies need not regulate. If they take the lead to establish uniform benchmarks, the market will enforce their use as funds that refuse to comply will lose clients and capital to those that inform investors.

The marketplace is the ultimate regulator and will control the hedge funds' future. Ever more money is competing for a diminishing set of opportunities. Average profitability is already approaching rates on more commonplace assets when risk is factored in. Industry leaders are raising fees, returning money to their long time

<sup>1</sup>The SEC has recently required registration of most hedge funds with assets above \$30 million and with 15 or more clients.

deep-pocketed backers and focusing on their own capital. Of the 8,000 current hedge funds, 20 percent will close their doors within 1 year. Retail investors, enticed by now-outdated headline returns, will move on as profits fall. During the shake-out, players with weak risk management will be winnowed out. There will be fewer but better hedge funds.

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**PREPARED STATEMENT OF KURT SCHACHT**  
EXECUTIVE DIRECTOR, CENTER FOR FINANCIAL MARKET INTEGRITY,  
CHARTERED FINANCIAL ANALYST INSTITUTE

MAY 16, 2006

Good afternoon. I am Kurt Schacht, the Executive Director of the CFA Centre for Financial Market Integrity, the advocacy arm of CFA Institute. I would like to thank Senator Hagel, Senator Dodd, and other members of this committee for the opportunity to speak to you this afternoon on the role of hedge funds. It has come to dominate much of the financial services industry discussion recently and we are supportive of your committee taking a closer look.

First, some background about CFA Centre and its parent organization, CFA Institute. CFA Institute is a non-profit professional membership organization with over 82,000 members in 126 countries. Its mission is to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation that I share with nearly 68,000 investment professionals worldwide. I direct the advocacy efforts of CFA Institute through the newly created CFA Centre for Financial Market Integrity, which develops research, education projects and promotes ethical standards within the investment industry. The CFA Centre has been actively involved in the hedge fund debate for several years and has developed a number of initiatives related to the industry from the investor's perspective.

For the record, CFA Institute is a staunch proponent of self-regulation. This approach is embodied not just in our Code of Ethics, but also in a number of additional guidelines and standards we have established in areas such as performance reporting and asset manager conduct. As discussed herein, these standards may provide useful models for how to address some of the issues before the Subcommittee today.

In most cases, we believe that self-regulation is a preferred alternative to government-imposed regulation, which adds complexities and increases the costs of capital, which are ultimately shouldered by investors large and small. This, of course, is a view shared by regulators and standard-setters themselves, which is why we frequently have worked closely with these groups, including the Securities and Exchange Commission, to develop such standards.

**Our Perspective on Hedge Funds**

Our organization comes at this topic from a number of perspectives but primarily as an investor advocate with an interest in promoting appropriate professional standards in this industry. We advocate before investor groups, industry associations and the world regulators. Our focus includes industry ethics, asset manager conduct and performance reporting.

As with most membership organizations in the financial services area, we have a growing proportion of our own membership, estimated at approximately 6 percent (about 5,000), directly involved in the industry as hedge fund or fund of funds participants, not to mention the many others in our membership who are involved as buyers or consumers of hedge fund products.

Our work in this area includes a comprehensive set of standards for hedge fund operators. We have been meeting with regulators around the world to discuss hedge fund and manager regulation and recently completed a survey and study of the hedge fund industry in the Asia Pacific region. We continue to review and comment on the issues of hedge fund performance reporting and investor education as well. I will cover each of these aspects below.

**The Role of Hedge Funds**

First, the role of hedge funds in overall portfolio construction and management is evolving. Generally, such investment vehicles are sought for high, uncorrelated historical returns, their attractiveness relative to other investment alternatives and returns in excess of growing liability streams as expected pension portfolio returns have begun to fall short of these growing liabilities. These uncorrelated returns reduce portfolio volatility and actually "hedge" other portfolio exposures. Perhaps most

importantly, hedge funds offer access to some of the premier asset managers in the world.

Conversely, hedge funds are not a panacea and there are most certainly a large number of operators that will fail to deliver sustained performance, net of fees. The level of investor knowledge is also a concern when discussing the role of hedge funds. That role is prone to being oversold to retail investors and certain institutions looking to chase the latest hot strategy and quick returns. The appropriate role of hedge funds is therefore subject to being misunderstood and misapplied in certain cases.

### **The Current State of the Industry and Regulation**

The current industry is a jumble of contradictions we have seldom witnessed. We have huge and growing demand for the products with assets under management approaching \$1.5 trillion and huge and growing supply with nearly 9,000 funds. We have an all out media frenzy concerning the industry with 100 stories per day in 2005, according to one study. Meanwhile, we continue to hear about shaky investor confidence, while every regulator we talk to is increasingly suspicious of what is going on with these funds. They are often described as, mysterious and largely unregulated investment vehicles of the wealthy, sophisticated investor. It is a rather combustible mixture.

To be sure, it is a highly misunderstood industry that is often mistaken for a single asset class, leaning in one direction and prone to a systemic melt down. In reality, the collective industry represents the universal exposure; to all assets, in all directions, in all markets. U.S. Treasury Under Secretary Randal Quarles referred to them recently as part of the evolution to “complete markets.” We would agree. There are legitimate regulatory concerns related to the extent of leverage by certain funds and the level and interplay of counterparty exposures on OTC positions. In our view however, this is not a house of cards poised for systemic disruption, rather a broad based, universal market exposure with pockets of concern.

We are uncertain as to how to address this aspect of the hedge fund concern but would encourage a less prescriptive approach focused on greater disclosure by regulated counterparty entities that will reveal any serious imbalances in a market. The Financial Services Authority in the U.K. is currently reviewing whether regulators can get at the issue of potential systemic risk through more detailed and aggregated disclosures from the counterparty firms they already regulate.

Over the last year, we have been meeting with global regulatory authorities about investment management practices and hedge fund practices in particular. The additional concerns we hear regarding hedge funds are as follows:

- There are concerns with side letters issued by hedge fund managers that give priority for favored clients on things like early exit or allow problem investments to be concealed.
- There are concerns that prime brokers have created hedge fund “incubator” shops that are inducing very high trading volumes and portfolio turnover in exchange for free office space and operations support. There may be arrangements to get hedge fund managers preferred access to issuers and breaking information. These relationships are increasingly being viewed as too cozy as hedge funds begin to dominate trading activities in the stock market.
- Hedge fund promotion has become more attractive for pension consultants due to the better fee structures. This may result in conflicts with client knowledge and suitability.
- There are concerns with investor protection for retail investors as products become more generally available.
- There are growing concerns about market integrity: such as market manipulation, poor internal controls, and fraud by hedge funds.

The recent move in the U.S. to require registration of certain hedge fund managers under the Investment Advisers Act of 1940 may have addressed some of these concerns and we viewed such registration as an appropriate step. Registration does provide some level of deterrence and allows regular examination of managers directly. It also requires a documented compliance framework. However, it does little to address the primary systemic imbalance concern.

### **Investor Education and Hedge Fund Manager Conduct**

Our organization has been discussing the importance of investor education in the context of hedge funds. Investors must understand that they have a serious and significant responsibility to understand all investments, but in particular those that are less liquid and transparent. We have been working with other groups to address educational needs in the hedge fund sector and to provide investors with templates



for reviewing, selecting and monitoring these managers. These include Hedge Funds <http://www.cfainstitute.org/investors/hedgefunds101.html> that outlines five keys for would be hedge fund investors, including rules for investigating credentials, track record, the investment strategy and fee structure and the process for valuation and performance reporting. There are many other excellent resources available including: Best Practices in Hedge Fund Investing: Due Diligence for Global Macro and Managed Futures Strategies, developed by Greenwich Roundtable.

Another key component of investor education is to understand what the manager of a hedge fund product should offer in terms of professional conduct and ethics to their investors. Investors in these funds need some assurance that they are being dealt with fairly and honestly. While we do not see any more prevalent fraud in this sector than in other areas of financial management, it remains the case that this is a less regulated, more independent sector of the funds management business. This is due to the fact that the hedge fund sector has traditionally been limited to more “knowledgeable and sophisticated” investors that understand the risks and engage in appropriate due diligence. We are not sure this is always the case and wanted to assist investors with their responsibility to know what they are getting into and what to look for.

The Asset Manager Code of Professional Conduct ([http://www.cfainstitute.org/cfacentre/positions/pdf/asset\\_manager\\_code.pdf](http://www.cfainstitute.org/cfacentre/positions/pdf/asset_manager_code.pdf)) sets forth a comprehensive template for what we believe every investor should expect and demand from their hedge fund manager. Its purpose is to promote an honest and verifiable approach to hedge fund management and to promote a self-regulatory approach to concerns being expressed by investors and regulators. It covers client loyalty, trading practices and compliance procedures, as well as a comprehensive process for disclosures, portfolio valuation and performance reporting.

#### **Hedge Fund Performance Reporting**

On the issue of performance reporting, we have done much work. One of the more “mischief prone” areas in investment management is performance reporting and that certainly applies to the hedge fund industry as well. Recently, there have been a significant number of studies and articles on the topic of hedge fund performance numbers and calls for its regulation. On the matter of regulating performance reporting, we encourage caution. First, the performance data that people are generally critical of are broad-based, voluntary, private services that have all sorts acknowledged statistical shortcomings. Commentators claim these data significantly overstate hedge fund performance by 100 to 600 basis points and are misleading to investors. Second, we doubt whether many hedge fund investors are making investment decisions based on this information. A more appropriate solution is investor education. Any serious investor will understand that these are merely a general proxy for hedge fund performance. They will understand the critical importance of performance reporting at the individual fund level and the quality of the due diligence the investor must conduct to confirm and verify this performance.

The Asset Manager Code provides a template for investors and managers to understand the various procedures needed to calculate and verify performance and promotes The Global Investment Performance Standards or GIPS® standards [http://www.cfainstitute.org/cfacentre/ips/gips/pdf/GIPS\\_2006.pdf](http://www.cfainstitute.org/cfacentre/ips/gips/pdf/GIPS_2006.pdf). We believe the industry benchmark for historical performance reporting is the GIPS standards, which has been in development and use for nearly 10 years. The GIPS standards have become the industry standard in nearly 30 countries around the world. The broad GIPS standards do provide a framework for calculating and reporting hedge fund performance. For example, section 4.A.5, requires firms to disclose the presence, use and extent of leverage or derivatives (if material), including a sufficient description of the use, frequency and characteristics of the instruments to identify risks. In all, the GIPS standards provide a consistent and verifiable process that is comparable across managers. We believe this self-regulatory approach to industry standards has been very constructive.

#### **Conclusion**

Again we commend the members of the Subcommittee for your continued vigilance and leadership on this important industry topic. We fully expect hedge funds to continue to evolve and become a mature feature of the overall investment industry. Their ongoing regulation and oversight should match the pace of this evolution, with a view to foster flexibility and creativity but not at the expense of market integrity and confidence. We would encourage the Subcommittee and Congress to allow the new advisor registration to settle in and determine if further regulation of managers or funds is warranted.

**PREPARED STATEMENT OF JAMES CHANOS**  
 CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES,  
 PRESIDENT, KYNIKOS ASSOCIATES

MAY 16, 2006

Chairman Hagel, Ranking Member Dodd, and Members of the Subcommittee. My name is James Chanos, and I am President of Kynikos Associates, a New York private investment management company that I founded in 1985.<sup>1</sup> I am appearing today on behalf of the Coalition of Private Investment Companies (“CPIC”), whose members and associates manage or advise an aggregate of over \$30 billion in assets. I want to thank the Chairman and other Senators for their efforts to better understand how this important segment of the financial markets operates. I am honored to have the opportunity to testify before this Subcommittee.

Since I last testified before the Senate Banking Committee in July of 2004 at its hearing on hedge fund regulation, the hedge fund industry has continued to grow and evolve, and the activities of industry members continue to generate attention by the press and by regulators. Indeed, the growth in the industry alone—which is now estimated to include over 10,000 funds with over \$1 trillion under management<sup>2</sup>—is a matter of governmental interest, prompting recent statements by a Treasury Department official that the growth of capital accumulation through entities such as hedge funds and private equity funds is one of a number of “structural” changes in the markets warranting further examination by the Department.<sup>3</sup>

The Coalition of Private Investment Companies hopes to be helpful in furthering governmental understanding of the industry, and in the testimony below, we discuss the importance of the hedge fund industry and certain key issues and concerns that have been raised about it. There are a number of issues confronting policymakers in Washington in which hedge funds are involved. Some of these are broad issues about the evolution, safety and integrity of U.S. capital markets—where hedge funds are one of many key market participants, and some are issues that are unique to the hedge fund industry itself.

**Hedge Funds—In General**

*Importance of the Hedge Fund Industry to the Financial Markets*

The financial and capital markets in the United States and in the developed world have been stunningly successful in providing capital and financing for economic growth and development, both in the United States and abroad. The fundamental integrity of the U.S. markets—and the knowledge that money can be invested in a staggering array of products, free from rampant corruption on the one hand and overly burdensome government control on the other—creates a powerful incentive for all kinds of businesses and individuals to invest in this country.

Our markets benefit from the 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 United States and global markets. The importance of hedge funds to our markets has been acknowledged in the past by the President’s Working Group on Financial Markets, the Commodity Futures Trading Commission, the Securities and Exchange Commis-

<sup>1</sup>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.

<sup>2</sup>See A Review of Current Securities Issues before the S. Comm. On Banking, Housing, and Urban Affairs (statement of Christopher Cox, Chairman, SEC) Apr. 25, 2006 (unpublished transcript). Estimates of the number of hedge funds vary but the number of funds clearly is increasing. See Dane Hamilton, U.S. SEC says to target “high risk” hedge funds, Reuters, May 3, 2006, available at <http://today.reuters.com/misc> (stating that industry estimates vary widely, but funds “conservatively estimated to hold \$1.1 trillion in assets and possibly much more.”) Liz Moyer, Why Hedge Funds?, Forbes.com Jan. 11, 2006 (stating 8,350 funds in existence). Financial journals, citing Hedge Fund Research, stated that 2,073 new hedge funds—a record number—were created in 2005, while 848 were liquidated. These totals include 498 new funds of hedge funds launched and 165 funds of hedge funds liquidated. Amanda Cantrell, Hedge Funds Launch, Close In Record Numbers, CNNMoney.com Mar. 1, 2006; Liz Moyer, Hedge Fund Business Still Attracts Big Players, Forbes.com Mar. 1, 2006.

<sup>3</sup>Randall K. Quarles, Under Secretary of the Treasury for Domestic Finance, Remarks before the Annual Washington Conference of the Institute of International Bankers (Mar. 13, 2006), available at <http://www.treas.gov/press/releases/js4114.htm>

sion, and former Federal Reserve Board Chairman Alan Greenspan, as well as by the current Federal Reserve Board Chairman Bernard Bernanke, who in testimony before this committee last year called hedge funds a “positive force in the American financial system.”<sup>4</sup>

As the SEC has acknowledged, 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 of 1940 (the “1940 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, such as the short fund managed by Kynikos, sell short; 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.

#### *Securities Regulation of Hedge Funds*

Hedge funds are an important alternative to the mutual fund model and provide flexibility to their managers to invest or trade using whatever products and strategies they choose in order to maximize returns. They are not, however, unregulated. Hedge funds are subject to the same restrictions on their investment and portfolio trading activities as most other securities investors, including such requirements as the margin rules<sup>5</sup> (which limit their use of leverage to purchase and carry publicly traded securities and options), SEC Regulation SHO,<sup>6</sup> (which regulates short-selling), the Williams Act amendments to the Securities Exchange Act of 1934<sup>7</sup> and related SEC rules (which regulate and require public reporting on the acquisition of blocks of securities and other activities in connection with takeovers and proxy contests), and the NASD’s “new issues” rule 2790 (which governs allocations of IPOs). Hedge funds must also abide by the rules and regulations of the markets in which they seek to buy or sell financial products. And, perhaps most important, hedge funds are subject to anti-fraud and anti-manipulation requirements, such as Section 10(b) of the Securities Exchange Act of 1934<sup>8</sup> and Rule 10b-5,<sup>9</sup> 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.

Hedge funds are also regulated by the terms of certain exemptions from registration under the Securities Act of 1933, the 1940 Act, and in some cases the Commodity Exchange Act, under which they operate.<sup>10</sup> 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

<sup>4</sup>Hearing on the Nomination of Bernard S. Bernanke to be Member and Chairman of the Federal Reserve Board, S. Comm. on Banking, Housing, and Urban Affairs; (Nov. 15, 2005) (statement of Bernard Bernanke) (unpublished transcript). Other financial regulators also view hedge funds as a positive force. For example, the United Kingdom’s Financial Services Authority, releasing a March 2006 report on hedge funds, reiterated its view that hedge funds are “a vital segment of the financial services industry. In particular they play a fundamental role in the efficient reallocation of capital and risk, and remain an important source of liquidity and innovation in today’s markets.” Press Release, FSA (Mar. 23, 2006) available at [www.fsa.gov.uk/pages/Library/Communication/PR/2006/026.shtml](http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/026.shtml)

<sup>5</sup>12 C.F.R. §§ 220, 221.

<sup>6</sup>17 C.F.R. §§ 242.200–203

<sup>7</sup>7 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).

<sup>8</sup>15 U.S.C. § 78j.

<sup>9</sup>17 CFR § 240.10b-5.

<sup>10</sup>See Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, at x, 68–72 (Sept. 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> (“Staff Report”).

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. Hedge funds typically file exemptive notices with the SEC and state securities commissioners under Regulation D, and many also file with the National Futures Association under the Commodity Exchange Act exemptions by which they operate (which impose their own, additional restrictions on sophistication and qualifications of investors).

These exemptions are not “loopholes” or accidental omissions from regulatory coverage, but are instead well-considered exemptions 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. The fact that hedge funds are not regulated as mutual funds and, therefore, not subject to the additional restrictions imposed by the 1940 Act—restrictions intended to protect the less wealthy and less experienced investors who invest in those traditional retail funds—not only gives investors (those who qualify under the various conditional exemptions imposed by the SEC) more choices, but adds to the diversity, depth and efficiency of the markets.

#### *The SEC’s New Hedge Fund Adviser Registration Rule*

Earlier this year, it was reported that more than 900 hedge fund managers newly registered with the SEC as a result of the hedge fund adviser rule.<sup>11</sup> SEC Chairman Cox more recently testified that, together with those who were registered prior to the rule’s adoption, there now are 2400 hedge fund managers registered with the SEC as investment advisers.<sup>12</sup> Thus, a substantial portion of the industry, as measured by assets under management, is now subject to SEC examination and oversight. However, in order to exclude managers of private equity funds from the adviser registration requirement, the SEC drafted the rule to exclude advisers to funds with lockup periods of 2 years or more, thus providing a relatively easy avenue for managers who wish to avoid registration.<sup>13</sup> We continue to believe that the Investment Advisers Act (the “Advisers Act”) is an awkward statute for providing the SEC with the information it seeks—since many fund managers still are not registering—and for dealing with the broader issues that are outside the Act’s purposes and which also cross the jurisdictions of several agencies.

#### **Key Issues for Policy Makers**

##### *Hedge Funds, Financial Markets, and Systemic Risk*

There are those who argue that hedge funds, as an industry, should not be considered as a factor in evaluating potential systemic risks to the U.S. and global financial system. While we agree that hedge funds do not warrant greater scrutiny than any other market participant—such as depository institutions, investment banks, insurance companies, mutual funds or exchanges—we do not believe that hedge funds should somehow be exempt from consideration. Moreover, we understand that key U.S. policymakers are adopting the approach of including hedge funds—as a group—in their ongoing oversight of the financial markets in order to evaluate the potential for problems that could affect the financial system more broadly. For example, Federal Reserve Board Chairman Bernanke, appearing before this Committee last November, testified that it is important for the Federal Reserve to be aware of what is going on in the market and to understand hedge fund strategies and positions by working through banks, which are the counter-parties of many hedge funds. He also said he believed that much had changed since the near-collapse of Long-Term Capital Management in 1998—and that the hedge fund industry has become more sophisticated, more diverse, less leveraged, and more flexible.<sup>14</sup>

Further, the Department of the Treasury also has noted the importance of understanding hedge funds and their impact on the financial markets. In March of this

<sup>11</sup> See Eleanor Laise and Rachel Emma Silverman, *Dissecting Hedge-Fund Secrets—Wealth Managers Say SEC-Required Revelations Won’t Replace Due Diligence*, *Wall St. J.*, Feb. 4, 2006 at B5.

<sup>12</sup> Cox Statement, *supra* n.2.

<sup>13</sup> Alternatives were suggested to the Commission. For example, comments filed by Kynikos on the proposed rule recommended that the SEC, by rule, make the safe harbor counting rule previously utilized by hedge fund managers under SEC Rules 203(b)(3)-1 and 222-2 under the Advisers Act, which implemented the client counting rules in Sections 203(b)(3) and 203A of the Advisers Act, contingent upon written receipt by the SEC of certain basic information about the fund, as well as certification by managers of the fund of certain key investor protections provided in the Advisers Act and related SEC rules.

<sup>14</sup> Bernanke Statement, *supra* n.4

year, Treasury Under Secretary Quarles announced that the Department is examining whether the growth of derivatives and hedge funds holds the potential to change the overall level or nature of risk in markets and financial institutions.<sup>15</sup> However, keeping this in perspective, he listed the growth of hedge funds, as well as private equity funds, as among a number of structural changes to be reviewed by Treasury.<sup>16</sup> We commend Under Secretary Quarles for emphasizing that Treasury will think about these changes not in a fragmented fashion, broken out by industry or product, as has been done in the past, but in a comprehensive way.

We also note that in one fast growing market—that for credit default swaps and other types of over-the-counter credit derivatives—hedge funds are playing a very significant role as purchasers and liquidity providers. Because of the unique nature of these products, this is one market where several regulators, including the Treasury Department<sup>17</sup> and the Federal Reserve Bank of New York,<sup>18</sup> are focusing attention and have recently taken steps to facilitate coordination among market participants. We also believe that the comments of the United Kingdom’s Financial Services Authority regarding potential risks in this market warrant consideration.<sup>19</sup> This market has become increasingly important for companies who access the credit markets, as well as for market participants, including hedge funds, that provide significant liquidity and pricing efficiency. We believe this is a market that merits the continued attention of regulators and policymakers.

#### *Rise of “Activist” Funds*

Well-known corporate lawyer Marty Lipton has warned about a group of “activist” hedge funds who are pressuring companies to make changes in order to increase their share prices.<sup>20</sup> He calls this activity a “replay of the attempt to drive American business to short-term results instead of long-term values,” and he terms this more dangerous than the “junk bond bust-up greenmail activity of the ’70s and ’80s.” While activist investors represent only a small part of the overall picture, they have had a higher profile due to press accounts of their activities at companies like Time Warner and Wendy’s International. The press also has been quick to report on management’s characterization of these investors as “raiders” or short-term investors, intent upon pushing a company to take actions to bump up share prices for quick profits.

These arguments are not new but are similar to ones made during the wave of corporate takeover and restructuring activity in the 1980s. Yet, after a lengthy examination of that activity and dozens of studies, reports, and congressional hearings, neither the Congress, the SEC, nor any other government agency took steps to curb the activity, which many believed was beneficial. The 1985 Economic Report of the President stated that “mergers and acquisitions increase national wealth, [t]hey improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management.”<sup>21</sup> Active investors have helped to weed out deficient management, or unlock value by pressuring management to separate a firm’s productive units into independent operations that can produce goods, services and employment more efficiently than if they were otherwise bound together. A recent study also showed that activist institutional shareholders can cause CEO com-

<sup>15</sup> Quarles Remarks, *supra* n.3

<sup>16</sup> The other changes he identified include the greater systemic importance of a smaller number of large bank-centered financial institutions, the greater role played by non-bank financial institutions, the rapid growth of GSEs, greater operational demands on the core of the clearing and settlement structure, an increase in the complexity of risk management and compliance challenges, and the extent of global financial integration.

<sup>17</sup> Emil Henry, Treasury Assistant Secretary for Fin. Institutions, Remarks to the Federal Reserve Bank of Atlanta (Apr. 18, 2006), available at <http://www.treasury.gov/press/releases/js4187.htm>

<sup>18</sup> See *e.g.*, Ramez Mikdashi and Mark Whitehouse Derivatives Firms Tackle Backlog Wall St. J., Mar. 14, 2006, at C4.

<sup>19</sup> “Regulators watched with interest the recent, surprisingly significant (given the degree of anticipation of the event), impact of the credit rating downgrade of General Motors (GM) and Ford upon the hedge fund sector and related market participants. In this situation, no financial stability event developed, however, it was interesting to observe commonalities in losses by hedge funds pursuing similar strategies (together with losses in counterparties to these funds) and losses in individual funds or clusters of funds leading to investor redemption and enforced liquidation of assets. The full effects of this event may not yet have been felt, with possible changes to structuring, trading, risk management, liquidity and investment remaining a possibility (with potential implications for the long term viability of individual funds/fund managers.)” Hedge Funds: A discussion of risk and regulatory engagement; Discussion Paper 05/4; Financial Services Authority of the United Kingdom at 20–21 (June 2005), available at [www.fsa.gov.uk/pubs/discussion/dp05\\_04.pdf](http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf)

<sup>20</sup> Andrew Ross Sorkin, To Battle, Armed with Shares, N.Y. Times, Jan. 4, 2006 at C1.

<sup>21</sup> Economic Report of the President, 196 (Washington: U.S. G.P.O., Feb. 1985).

pensation to more closely track return on investment, rather than balloon with increases in firm size.<sup>22</sup> Activist investors offer ideas and business expertise that should not be dismissed by corporate managers.<sup>23</sup>

This is not to say that all such activity produces optimum business results. However, the beauty of our market system is that business owners—the shareholders—are free to make choices in the marketplace for competing ideas about how a business should be managed.

Jana Partner's Barry Rosenstein recently wrote that characterization of activists as “sharks,” “raiders,” and “short-term investors” versus CEOs defending the “long term” investors misses the point.<sup>24</sup> Of course activist hedge funds invest for profit—after all, that's the American way—and they seek to shake up poor performing managers in order to cause the stock price to reflect a company's real value, which is in the best interests of all shareholders. As Rosenstein points out, portraying managers as “defenders” of a corporation versus its “attackers” misrepresents the nature of these contests, which really are campaigns between managers and the activists for the support of the company's shareholders. As this Committee knows too well, corporate CEOs and managers often need “watchdogs” to monitor their actions. When those watchdogs are activist shareholders pushing managers to take steps to increase shareholder value, the ultimate beneficiaries of their activity are the shareholders—the owners—of the corporation. One of the goals of the Sarbanes-Oxley Act was to make management more responsive to shareholders. It is ironic that shareholders who are willing to engage themselves to push management to be more accountable should be so miscast.

#### *Unlawful Hedge Fund Activity*

Another criticism of hedge funds relates to charges of illegal activity by funds—a criticism often coupled with statements about the “unregulated” nature of hedge funds. As discussed above, although hedge funds are exempt from registration under the Investment Company Act, they are subject to a panoply of legal requirements and liability, including liability for fraud, insider trading, and market manipulation. Recent high profile cases have involved misappropriation of investor assets (*e.g.*, Bayou Funds, International Management Associates, LLC),<sup>25</sup> and cases such as those announced earlier this year where the SEC settled charges against three affiliated hedge funds and their portfolio manager for insider trading, wash trades and illegally using restricted stock to cover short sales.<sup>26</sup> While we do not have personal knowledge of these particular cases, CPIC strongly supports vigorous action by the SEC, and criminal authorities where appropriate, against any market participant engaged in these types of activities, which not only harm investors, but foster mistrust and lost of confidence in our markets.

That said, it would be inaccurate and unfair to suggest that unlawful activity in the hedge fund industry is disproportionate to that in other, more regulated, areas of the financial markets.<sup>27</sup> There are miscreants in every industry, and all participants in our markets—whether they are hedge fund managers, brokers, issuers, or accountants—need to do a better job of vigilance to assure that crooks do not undermine confidence in the integrity of our markets and the millions of honorable professionals who work in them. In addition, changes in practice, standards, and regulation can and should be made where appropriate to lessen the opportunities for

<sup>22</sup> Wright, Kroll, and Elenkov, Acquisition Returns, Increase in Firm Size, and Chief Executive Officer Compensation: The Moderating Role of Monitoring, *Academy of Management Journal*, v. 45, June 2002, available at [www.aomonline.org](http://www.aomonline.org)

<sup>23</sup> This was reported to be the case with Lear, a manufacturer of vehicle seats and interiors, which had earlier ignored the advice of a large shareholder to refinance its debt. Jesse Eisinger, Long and Short: Lear Case Shows Sometimes Investors Can Detect Crises Before Management, *Wall St. J.*, Mar. 15, 2006, at C1. After announcing recent restructuring efforts, its share value climbed almost 50 percent.

<sup>24</sup> Barry Rosenstein, Why activism is good for all shareholders, *Fin. Times*, Mar. 9, 2006.

<sup>25</sup> *SEC v. Samuel Israel III*, SEC Litigation Release No. 19406, 2005 WL 2397234 (Sept. 29, 2005) (According to the SEC, managers of a group of hedge funds known as the Bayou Funds grossly exaggerated claims regarding the funds' performance, when in fact, the funds had never posted a year-end profit); *SEC v. Kirk S. Wright*, SEC Litigation Release No. 19581 2006 WL 487825 Feb. 28, 2006) (According to the SEC, fund managers engaged in an ongoing fraud involving sales of interests in hedge funds, based upon false claims of profits and bogus account statements).

<sup>26</sup> *SEC v. Langley Partners, L.P.*, SEC Litigation Release No. 19607, 2006 WL 623053 (Mar. 14, 2006).

<sup>27</sup> See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333 (Dec. 2, 2004), 69 Fed. Reg. 72054, 72092—72096 (Dec. 10, 2004) (dissenting statement of Commissioners Glassman and Atkins).

abuse. In the discussion below, we note that the area of valuation is an area of concern.

*Valuation—Performance Reporting*

We believe valuation is an area of hedge fund activity 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. Performance reporting is another area of confusion and potential for abuse. Neither problem is addressed by the requirement that hedge fund advisers register with the SEC.

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 a reported number, this tells 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 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. However, as discussed in a recent article coauthored by noted economist Burton Malkiel,<sup>28</sup> the main sources of comparative statistics on the performance of hedge fund managers are the data bases of private vendors, which he says have systematically overstated annual performance by hedge funds and funds of funds. He notes that managers can select a starting date for reporting to maximize returns, that the data bases have a “survivorship bias” (they do not take into account funds that have gone out of existence), and that the returns are non-standardized. Others have noted the temptation for some hedge fund managers to manage returns upward at year end in order to achieve performance-based incentive compensation—just as managers of registered investment companies may inflate year-end portfolio prices.<sup>29</sup>

Hedge funds are subject both to GAAP accounting standards, and to Federal and state anti-fraud restrictions in their performance reporting. The SEC Staff has issued a long series of letters delineating performance calculation, reporting and disclosure requirements for registered and exempt investment advisers, under the anti-fraud provisions of the Advisers Act, and SEC enforcement orders in this area further illuminate the expectations of the SEC on performance reporting.<sup>30</sup> Those managers who stray from the SEC's valuation and performance reporting precepts are subject to administrative enforcement actions and private civil liability under the anti-fraud provisions of the Federal securities laws. When investment managers miscalculate and misrepresent performance statistics they are engaging in fraud. They are like baseball players using corked bats and steroids to improve their statistics.

It is true that registered investment advisers are required to adopt policies and procedures on valuation issues, provide GAAP accounting statements, and follow SEC Staff guidance on performance reporting for their hedge funds. Unfortunately, SEC guidance on valuation of securities, derivatives and other assets for which a market quotation is not readily available was adopted decades ago in a different and less sophisticated era, and essentially requires the use of good faith estimates, not a clear and uniform methodology. Guesswork and proprietary models are what are available. GAAP is not much better, and FASB has been struggling of late to pro-

<sup>28</sup> Burton G. Malkiel and Atanu Saha, *Hedge Funds: Risk and Return*, *Fin. Analysts J.*, Vol. 61, No. 6 (2005), available at <http://www.cfapubs.org>

<sup>29</sup> Vikas Agarwal, Naveen D. Daniel, and Narayan Y. Naik, “Why Is Santa so Kind to Hedge Funds? The December Return Puzzle!” (Mar. 9, 2006), available at <http://ssrn.com/abstract=891169>

<sup>30</sup> Further, an academic and industry organization, the CFA Institute (formerly known as AIMR) headquartered in Charlottesville near the University of Virginia, promulgates widely followed but voluntary standards for performance reporting by investment managers.

mulgate clearer guidance on valuation issues.<sup>31</sup> As active trading vehicles, hedge funds that provide audited financial statements (as most do) are subject to accounting requirements that the values of all of their portfolio positions be calculated at current market or fair value (i.e. “marked to market”) for each reporting period. For many assets—including many of the newer or exotic derivatives that do not trade on an exchange—the standard is not mark to market, it may be instead mark to your best guess of current value.<sup>32</sup> Consequently, unscrupulous investment managers can exploit these deficiencies to artificially inflate both the value of their investments and their profitability. Indeed, registered investment companies have long been subject to detailed portfolio valuation requirements and performance reporting standards under the 1940 Act, and yet false and inaccurate valuation and performance reporting has remained a vexing problem for investors in registered funds.<sup>33</sup>

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.<sup>34</sup> 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.<sup>35</sup> In our view, the appropriate role for government in this area is to facilitate and encourage a dialog among experts from across the financial services industry, academia, the accounting profession, economists and others, on valuation issues and best practices. For example, the U.K.’s Financial Services Authority and the International Organization of Securities Commissions have a project underway to examine the valuation policies and procedures employed by hedge funds and their counterparties and to work with industry representatives to develop a global set of principles that will attract global consensus.<sup>36</sup>

We would also point out that 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 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.

#### *The “Retailization” of Hedge Funds*

An area of concern raised by both the SEC and state regulators has been the “retailization” of hedge funds,<sup>37</sup> meaning, the sale of hedge funds to a broader group of less wealthy, less sophisticated investors than in the past. The Federal securities laws and SEC rules have long recognized that sophisticated and high net worth in-

<sup>31</sup>See FASB Report: FASB Adds Project To Improve Fair Value Measurement Guidance, (June 30, 2003) (announcing project to codify and improve guidance for measuring fair value) and Project Updates: Fair Value Measurements (Jan. 30, 2006) (On January 25, 2006, FASB discussed issues raised by reviewers on an October, 2005 working draft of a final FASB Statement, Fair Value Measurements), available at [www.fasb.org/project/fv\\_measurement.shtml](http://www.fasb.org/project/fv_measurement.shtml)

<sup>32</sup>We note that the 2-year lock-up exemption from private fund manager registration under the Advisers Act lends itself best to funds that invest in illiquid assets—and illiquid assets are the ones for which valuation issues are most extreme. Therefore, the current hedge fund manager registration requirement is not particularly well targeted at improving valuation practices at these types of private investment funds in particular.

<sup>33</sup>See, e.g., In the Matter of FT Interactive Data, *f/k/a* Interactive Data Corp., Investment Company Act Release No. 26291 (Dec. 11, 2003); *SEC v. Heartland Group, Inc.*, Litigation Release No. 16938, 2001 WL 278474 (Mar. 22, 2001); *White v. Heartland High-Yield Mun. Bond Fund*, 237 F. Supp. 2d 982 (E.D. Wis. 2002); In the Matter of Piper Capital Mgmt., Inc., Investment Company Act Release No. 26167 80 S.E.C. Docket 2791 (Aug. 26, 2003); In the Matter of the Rockies Fund, Investment Company Act Release No. 26202 81 S.E.C. Docket 534 (Oct. 2, 2003).

<sup>34</sup>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.

<sup>35</sup>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](http://www.mfainfo.org/images/PDF/MFA2005SoundPracticesPublished.pdf)

<sup>36</sup>See Hedge Funds: A discussion of risk and regulatory engagement, Feedback Statement 06/2 Financial Services Authority of the United Kingdom, at 24–26 (March 2006) available at [www.fsa.gov.uk/pubs/discussion/dp05\\_04.pdf](http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf)

<sup>37</sup>See Investor Protector Implications of Hedge Funds before the S. Comm. on Banking, Housing, and Urban Affairs, (Apr. 10, 2003) (statement of William Donaldson, Chairman, SEC), available at [www.banking.senate.gov/03-04hr.04103.donaldsn.pdf](http://www.banking.senate.gov/03-04hr.04103.donaldsn.pdf)



vestors are able to bear greater risks than those with less sophistication or modest means. Thus, hedge funds generally accept investments only from “accredited investors” or “qualified purchasers,” as defined in SEC rules that set out minimum qualifications for individuals relating to their net worth and income. CPIC believes these same concepts should apply in the future, though they should be updated.

When Regulation D, the SEC’s private offering exemption, was adopted over twenty years ago, its definitions of “accredited investor” included individuals whose annual income exceeded \$200,000, or whose net worth (or joint net worth with that of a spouse) exceeded \$1 million. Those standards remain unchanged today. Meanwhile, as the SEC has acknowledged, inflation and growth in income levels have led to a substantial increase in the number of investors who are now “accredited,” though not necessarily financially sophisticated.<sup>38</sup>

In general, the investment strategies of private investment funds involve substantial risk and illiquidity, and they are not appropriate for the average investor. It may be time to re-examine the accredited investor standard. When Congress enacted an expansion of the qualified purchaser exemptions in 1996, it used the criteria of \$5 million in “investible assets”—a more selective barrier than that used to define “accredited investor”—as the presumptive basis for market sophistication. Other approaches might include a higher net worth requirement together with a limit on investment in a fund to a percentage of an individual’s net worth (some states, such as California and North Carolina, historically have used a cap on privately placed investments at 10 percent of the investor’s net worth as a rough benchmark or limit, while others have used a 20 percent limit).<sup>39</sup>

#### *Funds of Hedge Funds*

Another aspect of the retailization issue is the growth of “funds of funds”—the term used to describe an investment company that invests in hedge funds rather than individual securities. Some of these funds of hedge funds have registered their securities with the SEC, enabling them to sell shares to retail investors. The SEC Release accompanying its private fund registration rule stated that, although “[m]ost funds of hedge funds are today offered only to institutional investors . . . there are no statutory limitations on the public offering of these funds.”<sup>40</sup> The SEC Staff Report on hedge funds also noted the Staff’s concern that investors may not understand the impact of multiple layers of fees in funds of hedge funds, or that funds of hedge funds may expose them to levels and types of risks that are not appropriate.<sup>41</sup> We note that some of the more publicized funds of hedge funds being marketed to the “retail” investor are being sold by large broker-dealers with significant retail distribution networks. The Staff Report also expressed concern with “the reliability of registered [funds of hedge funds] calculations of net asset value [because] [t]here are no readily available market prices for hedge fund securities.”<sup>42</sup>

We suggest that the SEC consider some of the measures suggested by the Staff in its hedge fund report. In particular, the SEC may wish to consider rules prohibiting registered investment companies from investing in hedge funds unless their directors have adopted procedures designed to ensure that the funds value those assets consistently with the requirements of the 1940 Act.<sup>43</sup>

#### *Role of Short Sellers*

Let me say a brief word about short selling, which is one of the strategies used by hedge funds. The SEC and self-regulatory organizations repeatedly have recognized that short sellers bring important liquidity and a sense of skepticism to the marketplace.<sup>44</sup> Short sellers test the ideas put forward by management; they often help the marketplace and enforcement agencies ferret out genuine fraud. In fact,

<sup>38</sup> Staff Report, *supra* n.10, at 80.

<sup>39</sup> Compare 10 Cal. Code Regs. Tit. 10, § 260.140.01; 18 N.C. Admin. Code 6-1206 (2006); with 003-14-006 Ark. Code R. § 504 (Weil 2006).

<sup>40</sup> Registration of Certain Hedge Fund Advisers, *supra* n.27 at 72057.

<sup>41</sup> Staff Report, *supra* n.10 at xii, 68–72.

<sup>42</sup> *Id.* at 81.

<sup>43</sup> *Id.* at 99.

<sup>44</sup> Staff Report at 40. According to the SEC staff, “Short selling . . . can contribute to the pricing efficiency of the markets. . . . When a short seller speculates on . . . a downward movement in a security, the transaction is a mirror image of the person’s who purchases the security based upon speculation that the security’s price will rise . . . . Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.”

some of the most spectacular corporate frauds—Enron, Tyco, Conseco, and Sunbeam, to name just a few—were first uncovered by short sellers.

But notwithstanding these benefits, short selling is subject to significant regulatory restraints and costs, as well as attacks from issuers and other market participants who have a stake in seeing the price of a security go up. Short sellers must borrow stock that is sold short, must post collateral, pay interest, carry the costs of borrowing often for months or longer, risk upward price movement, post additional collateral requirements if the price of the stock moves against them, and bear the risk that borrowed shares will suddenly be recalled by the lender. Short sellers are subject to potential “short squeeze” manipulation. Short selling is costly, and risky—prompting one commentator to write, “It’s a wonder anyone does it at all.”<sup>45</sup>

The SEC has an ongoing examination program to determine compliance with Regulation SHO, which became effective less than 2 years ago, and Chairman Cox has stated that he will recommend changes in the rule if the exams demonstrate the need for such modifications. The SEC also has been aggressive in bringing enforcement actions against market participants who use short selling strategies to manipulate and drive down the price of a security.<sup>46</sup> We support these actions by the SEC and believe they are essential to protect investors and ensure the integrity of the markets as a whole, as well as to assure that short sellers who play by the rules will continue to perform the important role they have played in bringing healthy skepticism and liquidity to the markets.

*The Importance of the Financial Press and Independent Research and Analysis*

Bearing these principles in mind, I want to take this opportunity to discuss an important issue, which was highlighted by the controversy over SEC-issued subpoenas to financial reporters earlier this year.

Just as the U.S. and global financial and securities markets benefit from a wide diversity of market participants with competing views and trading and investing strategies, they also benefit from a vigilant, hard-working, and skeptical financial press.

Earlier this year, the SEC enforcement staff sent subpoenas to certain financial reporters requiring the production of any evidence of communications between the reporters and certain stock analysts and short-selling funds that had expressed criticism of particular companies and their management. The subpoenas were quickly recalled, and SEC Chairman Cox issued the following statement, “The sensitive issues that such a subpoena raises are of sufficient importance that they should, and will be, considered and decided by the Commission before this matter proceeds further.”<sup>47</sup>

In an interview in the Wall Street Journal appearing the following day, Chairman Cox cited the “symbiosis” between the work of the SEC and the business media, and explained that in order not to chill the disclosure of information that both government and reporters should promote, such subpoenas would be “extraordinary.” Chairman Cox noted that the SEC’s “regulatory mission in major part requires us to ensure all material information is divulged in the first instance. Unless it is publicized . . . markets cannot function. We don’t want to do anything therefore to chill that activity.”<sup>48</sup>

On April 12, the SEC expanded on these concepts in a policy statement, stating “Effective journalism complements the Commission’s efforts to ensure that investors receive the full and fair disclosure that the law requires, and that they deserve. Diligent reporting is an essential means of bringing securities law violations to light and ultimately helps to deter illegal conduct.”<sup>49</sup>

These statements demonstrate an awareness of the legitimate role of the business press and the critical need for the free interchange of information and opinion in the nation’s securities markets. Indeed, the principal theory behind the First

<sup>45</sup> Jesse Eisinger, Long and Short: It’s a Tough Job, So Why Do They Do It? The Backward Business of Short Selling, Wall St. J., Mar. 1, 2006, at C1.

<sup>46</sup> See, e.g., *SEC v. Langley Partners, L.P.*, SEC Litigation Release No. 19607, 2006 WL 623053 (Mar. 14, 2006); *SEC v. Andreas Badian*, SEC Litigation Release No. 19639, 2006 WL 859248 (Apr. 4, 2006).

<sup>47</sup> Press Release, SEC, Statement by Securities and Exchange Commission Chairman Christopher Cox Concerning Subpoenas of Journalists, (Feb. 27, 2006), available at <http://www.sec.gov/news/press/2006-24.htm>

<sup>48</sup> Kara Scannelli, Cox Knocks Journalist Subpoenas, Wall St. J., Feb. 28, 2006, at C1.

<sup>49</sup> Press Release, SEC, Policy Statement of the SEC Concerning Subpoenas to Members of the News Media (Apr. 12, 2006), available at <http://www.sec.gov/news/press/2006/2006-55.htm>

Amendment itself is that its protections recognize the value of a “marketplace of ideas.”<sup>50</sup>

The ability of business journalists to communicate with sources is of paramount interest to the functioning of the markets, as is the ability of securities analysts to disseminate their views free from retaliation by issuers. Independent analysts, who sell their research and analyses to customers who pay for their services, whether by subscription or by individual report, offer a particularly valuable service to our markets. They are not associated with investment banking firms and do not face the temptation to issue overly bullish analyses in order to acquire other business. As this Committee is all too aware, the pervasive conflicts of interest among securities analysts employed by major investment banks led to the adoption of Title V of the Sarbanes-Oxley Act of 2002 and subsequent rulemaking proceedings, as well as enforcement actions by the SEC, the self-regulatory organizations, and state securities regulators—all designed to reduce or eliminate the source of their conflicts within investment banking firms and make analysts reports more objective and useful to investors who rely on them. Hearings before this Committee in 2002 revealed that, not only were analysts induced to write favorable reports by receiving compensation from their firms for their role in capturing investment banking business, but they faced retaliation from issuers for negative coverage.<sup>51</sup>

The Sarbanes-Oxley Act does not address retaliation by issuers. Nonetheless, in a letter to Senator Ron Wyden in September 2005, Chairman Cox stated that it was a matter of concern, and that the SEC was contemplating action to protect stock analysts from retaliation by issuers. In a memorandum accompanying the letter, the SEC staff related that it had contacted nine unidentified “multi-service” broker-dealers and found that at least six believed they had experienced retaliation from issuers for negative reports. This is all the more troubling, in that such “multi-service” firms are, most likely, investment banking powerhouses with the clout and deep pockets to defend themselves.<sup>52</sup>

Independent securities analysts can offer a refreshingly skeptical view of particular companies, but they too face threats and intimidation, including the threat of lawsuits by issuers, who seek to discredit negative analyst reports. Harassing tactics employed by issuers (at shareholder expense, I should note) have even included spying by private investigators and rummaging through the trash of the offending party.<sup>53</sup>

The reforms of the research practices of major investment and commercial banks as a result of Sarbanes-Oxley and the Global Research Analyst Settlement are important and should not be allowed to be undermined by issuer intimidation. We strongly believe that all analysts should be free to express their views without fear of intimidation by issuers or over-zealous government agents, regardless of where they are working. If there is any doubt about the beneficial role that such hard-hitting independent research plays in the financial marketplace, it should be put to rest by testimony in the trial of Ken Lay and Jeff Skilling over the past 2 months in Houston. In that testimony, a former Enron executive described a critical research piece written by an independent analyst that questioned the company’s financials and practices—practices that have already led to the conviction for fraud of several top officers of the company. The report concluded that the company’s shares should be valued at half their then-going price. With Ken Lay present, Skilling’s reaction to this report was: “They’re on to us.”<sup>54</sup>

Financial reporters, analysts, and active market participants all provide an important counterweight to overly optimistic or sugar coated statements made by public companies and their financial advisers. In seeking to compel production of evidence of communications between business journalists and their sources, the SEC sub-

<sup>50</sup> See J.S. Mill, *On Liberty*, (1859); *Abrams v. United States*, 250 U.S. 616, 630, 40 S.Ct. 17, (1919) (Holmes, J., dissenting).

<sup>51</sup> Thomas Bowman, President and CEO of the Association for Investment Management and Research, testified that “[i]ssuers . . . bring lawsuits against firms and analysts personally for negative coverage. But more insidiously, they ‘blackball’ analysts by not taking their questions on conference calls or not returning their individual calls to investor relations or other company management. This puts the ‘negative’ analyst at a distinct competitive disadvantage, increases the amount of uncertainty an analyst must deal with in doing valuation and making a recommendation, and disadvantages the firm’s clients, who pay for that research.” [S. Rep. No. 107–205, at 38 (2002)]

<sup>52</sup> Letter from Christopher Cox, Chairman, Securities and Exchange Commission, to the Honorable Ronald Wyden, U.S. Senate, (Sept. 1, 2005). Unfortunately, issuer retaliation appears to be a continuing problem. See Michael Mayo, *Why Independent Research Is Still Rare*, CFA Magazine, May/June 2006, at 8–9.

<sup>53</sup> See, e.g., Roddy Boyd *Trash Stalkers*, N.Y. Post, Mar. 3, 2006.

<sup>54</sup> Mary Flood, *Skilling Told Team “They’re On to Us,” Witness Says*, Houston Chronicle, Mar. 3, 2006.

poenas had the potential to chill communications between reporters and significant sources of expert analysis, thus limiting the information available to investors.<sup>55</sup> We believe all investors will benefit from the action taken by the SEC Chairman in making it clear that such subpoenas will be considered only in extraordinary circumstances.

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**PREPARED STATEMENT OF JOHN GAINES**

PRESIDENT, MANAGED FUNDS ASSOCIATION

MAY 16, 2006

As the largest and most diverse U.S.-based association representing the hedge fund industry, Managed Funds Association (“MFA”) is pleased to provide this testimony to the Senate Subcommittee on Securities and Investment regarding the Role of Hedge Funds in the Capital Markets.

The hedge fund industry has experienced significant growth in recent years, with assets under management estimated at \$1.5 trillion.<sup>1</sup> MFA believes this is a direct result of the demand largely from institutional investors for investment vehicles that offer a diversity of investment styles and that help them meet their future funding obligations and other investment objectives. As former Federal Reserve Chairman Alan Greenspan has noted, hedge funds have “become increasingly valuable in our financial markets.”<sup>2</sup> Hedge funds enhance market liquidity and contribute to pricing efficiency and market stability. Hedge funds also foster financial innovation and risk sophistication among the market participants with which they deal.

MFA recognizes that with the growth and evolution of the hedge fund industry have come new responsibilities and challenges. The hedge fund industry and policy-makers currently face an important challenge, namely to preserve the benefits offered by hedge funds while addressing legitimate investor protection issues presented by the growth in hedge fund investments.

**Background on MFA**

Founded in 1991, MFA is the U.S.-based global membership organization dedicated to serving the needs of the professionals who specialize in the alternative investment industry. MFA’s over 1,000 members include professionals in hedge funds, funds of funds, managed futures funds, and other financial and commodity-linked investments. They also include financial and commodity trading advisors, pool operators, and trading managers. MFA members manage a substantial portion of the estimated \$1.5 trillion invested in these investment vehicles. Members include representatives of a majority of the 50 largest hedge funds groups in the world. MFA membership also includes the sponsors, investment managers and brokers for substantially all of the financial and commodity pools marketed on either a public or private basis in the United States. The larger hedge fund managers represented within MFA collectively manage in excess of \$500 billion in assets and pursue a wide range of investment strategies.

As further explained below, MFA’s activities include educational outreach to and representation before the Securities and Exchange Commission (“SEC”), Commodity Futures Trading Commission (“CFTC”), Federal Reserve, Treasury Department, State and international regulatory agencies, and Congress. MFA also participates in a number of private sector initiatives, including development of industry sound practices, participation in Treasury-sponsored advisory committees, and work with the major dealers in improving credit derivative market practices.

**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, except 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

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<sup>55</sup>To be distinguished, of course, are cases where journalists participate in some scheme relating to the very transactions that they report. See *Carpenter v. United States*, 484 U.S. 19, 108 S. Ct. 316, 98 (1987).

<sup>1</sup>Based on reported estimates by Hedge Fund Intelligence (London).

<sup>2</sup>Remarks by Chairman Alan Greenspan, “Risk Transfer and Financial Stability,” to the Federal Reserve Bank of Chicago’s Forty-first Annual Conference on Bank Structure, Chicago, Illinois, May 5, 2005.

“Investment Company Act”).<sup>3</sup> It is thus a term that is susceptible of different meanings to different people. 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 return.<sup>4</sup> In this regard they are similar to venture capital, private equity, leveraged buyout, oil and gas, and real estate funds, although MFA does not intend to capture them within its definition of “hedge fund.”

#### *Investment Profiles*

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 their returns do not depend on, nor are they benchmarked against, the long-term return of the markets or the assets in which they invest. In other words, hedge funds seek to achieve positive returns based on the skill or strategy of the manager rather than 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.

Major hedge fund investment strategy classifications include the following:

- Long/short strategies for trading in equities.
- “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.
- “Market-neutral,” “relative value,” 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.
- Event-driven strategies, which seek to profit from anticipated events or special situations, such as mergers, restructurings, distressed securities.
- Regional strategies, which concentrate on a particular geographic region (such as emerging markets).
- Sector strategies, which focus on a particular industry.
- 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.
- Dedicated short sale equity strategies focusing on selling short securities that are deemed to be overvalued.
- Specific asset class strategies (such as currencies, commodities, interest rates).

The significance of these 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 thus actually comprised of many sub-industries, 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. The diversity of strategies employed by hedge funds also presents important considerations for policymakers seeking to accurately understand the scope of potential challenges as well as the efficacy of potential remedies.

#### *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 it consists of 5,000 to 7,000 funds with total assets of approximately \$1.5 trillion. A small number of these hedge funds are part of large organizations with assets over \$1 billion and performance records extending 10 years or more. At the other end of the market-

<sup>3</sup>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.

<sup>4</sup>This is in keeping with the definition used by the President’s Working Group on Financial Markets, of “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.” President’s Working Group on Financial Markets Report, “Hedge Funds, Leverage and the Lessons of Long-Term Capital Management,” April 1999, at 1.

place, there are thousands of small firms managing hedge fund assets under \$50 million each.<sup>5</sup>

### **Beneficial Role of Hedge Funds in Capital Markets**

#### *Diversification for Institutional Investor*

Much of the growth in hedge funds since the 1980s can be attributed to the increasing recognition by institutional 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 has come from endowments and foundations. From 2004 to 2005, endowments increased their hedge fund allocations from 7.3 percent to 8.7 percent on average.<sup>6</sup>

According to a study by the Bank of New York, “the hedge fund industry is midway through an important transition in its source of capital.”

Five years ago, hedge funds derived virtually all of their assets from wealthy individuals. Institutional interest was limited to a small number of endowments and foundations. Over the next 5 years, institutions (including pension funds) are likely to provide an additional \$250 billion of hedge fund capital, accounting for 35 percent of net new flows in this period.<sup>7</sup>

Corporation and public pension plan investments in hedge funds continue to grow both through direct investments and through fund of hedge funds vehicles.<sup>8</sup> 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.<sup>9</sup>

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 less than in publicly traded indices. Academic research recognizes that hedge fund investments can reduce overall risk of investment portfolios for investors such as endowments and public and private pension plans.<sup>10</sup>

#### *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. . . . the 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.”<sup>11</sup>

#### *Increase in Efficiency*

By trading based on 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:

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.

<sup>5</sup> See Robert Jaeger, *All About Hedge Funds*, McGraw-Hill (2003), at 57.

<sup>6</sup> 2005 NACUBO Endowment Study.

<sup>7</sup> Bank of New York and Casey, Quick and Acito, “Institutional Demand for Hedge Funds: New Opportunities and New Standards” (September 2004).

<sup>8</sup> A Morgan Stanley Prime Brokerage report suggests that corporate pension plans prefer direct allocations to hedge funds while public pension plans prefer indirect allocations.

<sup>9</sup> Remarks by Chairman Alan Greenspan, “Risk Transfer and Financial Stability,” to the Federal Reserve Bank of Chicago’s Forty-first Annual Conference on Bank Structure (May 5, 2005), at 6.

<sup>10</sup> 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.

<sup>11</sup> “Renomination of Alan Greenspan as Chairman of the Federal Reserve Board of Governors: Hearing Before the Senate Banking, Housing, and Urban Affairs Committee” (testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve) (June 15, 2004).

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.<sup>12</sup>

#### *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.<sup>13</sup>

#### **Regulation of Hedge Funds**

Under the Investment Company Act, any company that is engaged primarily in investing in securities must register as an investment company, unless an exemption or exclusion is available. To be excluded from this registration requirement, hedge funds rely on one of two exceptions from the definition of investment company.

The first, Section 3(c)(1) of the Investment Company Act, was part of the Act as enacted in 1940. It provides that an investment fund will not be required to register as an investment company if: (a) it has no more than 100 investors, and (b) it does not offer its shares publicly. In order to comply with the latter requirement, a fund sponsor will effectively limit the offering of fund shares to “accredited investors,” as defined in the SEC’s Regulation D.<sup>14</sup> In addition to banks and other institutional investors, accredited investors include natural persons with individual or joint net worth of \$1 million or individual income in each of the last 2 years in excess of \$200,000, or joint income for the same period of \$300,000.

The second, Section 3(c)(7) of the Investment Company Act, was enacted as part of the National Securities Markets Improvement Act of 1996.<sup>15</sup> It exempts funds from registration as investment securities if each investor in the pool is a “qualified purchaser” and the pool does not undertake a public offering. The term qualified purchaser includes institutional investors; natural persons who have at least \$5 million in investments; persons who, acting for themselves or the accounts of other qualified purchasers, in the aggregate own and invest on a discretionary basis not less than \$25 million in investments; and certain qualifying trusts. The Senate report on the legislation provided the following rationale:

The qualified purchaser pool reflects the Committee’s recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act’s protections. Generally, these investors can evaluate on their own behalf matters such as the level of a fund’s management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.<sup>16</sup>

That hedge funds are not registered does not mean that their activities are unregulated. Hedge funds and their managers are subject to a variety of regulations and are required to furnish significant information and reports to regulators in connection with their trading activities.

#### *SEC Registration of Hedge Fund Advisers*

The SEC has recently implemented rule requiring registration of many hedge fund advisers that were not previously required to register. Section 203(b)(3) of the

<sup>12</sup> President’s Working Group Report at 2–3.

<sup>13</sup> “Hedge Funds and Financial Market Dynamics,” Occasional paper 166, International Monetary Fund (May 1998), at 29.

<sup>14</sup> The SEC staff has confirmed in a series of no-action letters that hedge funds and other private investment vehicles that conduct offerings pursuant to Regulation D can rely on Section 3(c)(1). Santa Barbara Securities, SEC No-Action Letter (Mar. 8, 1983).

<sup>15</sup> P.L. No. 104-290, 110 Stat. 3416, 3432–33 (1996). The legislation followed a 1992 report by the SEC’s Division of Investment Management that recommended the adoption of a new exception for private funds sold exclusively to “qualified purchasers.” SEC, Division of Investment Management, “Protecting Investors: A Half Century of Investment Company Regulation” (1992), at 104–05.

<sup>16</sup> S. Rep. No. 104-293, at 10 (1996).

Investment Advisers Act of 1940 (the “Advisers Act”) provides that an investment adviser may be exempt from SEC registration requirements if such adviser (i) had fewer than 15 “clients” during the preceding 12 months; (ii) does not hold itself out generally to the public as an investment adviser; and (iii) does not act as an adviser to any registered investment company.

The new hedge fund adviser rule requires a hedge fund adviser to count each “owner” of a “private fund”<sup>17</sup> it advises as a “client” for purposes of determining the adviser’s eligibility for the private adviser exemption cited above. The term “private fund” was intended to capture advisers to hedge funds and not other private investment vehicles, such as private equity or venture capital funds. Under this new rule, hedge fund advisers are required to “look through” clients that are private funds and count the underlying investors to determine the number of clients to whom the adviser provides investment advisory services. If, after taking into account the aggregate number of investors in the private funds it advises, an adviser has 15 or more clients in the prior 12 months, and has in the aggregate at least \$30 million in assets under management, then the adviser will be required to register with the SEC as an investment adviser. Hedge fund advisers that advise “private funds” were required to comply with this new rule by February 1, 2006.

#### *CFTC Regulation*

Many hedge fund managers are also registered with the Commodity Futures Trading Commission as commodity pool operators (“CPOs”). Such registration is required under the Commodity Exchange Act for managers of hedge funds that trade futures and options contracts on a futures exchange. A hedge fund manager that provides advice to a hedge fund regarding such futures and options contracts may also become subject to regulation as a commodity trading advisor (“CTA”). CPOs and CTAs are subject to registration, recordkeeping, and reporting requirements and fraud prohibitions under the Commodity Exchange Act and the regulations of the CFTC and the National Futures Association. In 2004, 63 of the 100 largest hedge funds were registered with the CFTC and subject to its reporting and recordkeeping requirements. Hedge funds that are significant traders in the futures markets may also become subject to the CFTC’s large trader reporting system, which requires the reporting of certain information on exchange-traded contracts to the CFTC for purposes of market surveillance.

#### *NASD Regulation*

Broker-dealers that sell interests in hedge funds are subject to NASD regulation. NASD requires broker-dealers to comply with suitability requirements that, among other things, require the broker-dealer to have both a reasonable basis for believing that the product is suitable for any investor and to determine that its recommendation to invest in a hedge fund is suitable for the particular investor.

#### *Reporting Requirements*

As with other market participants, hedge funds are required to comply with certain reporting requirements designed to increase market transparency. These requirements include various SEC equity ownership and portfolio reporting requirements and large position and other reporting requirements of the Treasury Department and the Federal Reserve in connection with government securities and foreign exchange transactions. The Treasury Department requires weekly and monthly reports for certain large participants in the foreign exchange markets and imposes reporting requirements on entities, including hedge funds, that have large positions in recently issued or to-be-issued Treasury securities.<sup>18</sup>

#### *Antifraud and Insider Trading Prohibitions*

As the SEC has explained, hedge fund advisers, whether or not registered under the Advisers Act, are subject to the antifraud and anti-manipulation provisions of the Advisers Act, the Securities Act of 1933, and the Securities Exchange Act of

<sup>17</sup>Under Investment Adviser Act Rule 203(b)(3)-2, a “private fund” is defined as a company that: (i) would be an investment company under the Investment Company Act of 1940, as amended, but for an exception from the definition of “investment company” provided under either Section 3(c)(1) or 3(c)(7) thereunder; (ii) permits an investor to redeem its investment within 2 years of investment; and (iii) is offered based on its adviser’s expertise. A pooled investment vehicle that does not meet any one of the above three elements is not a “private fund.” Advisers to unregistered funds that are not “private funds” may continue to rely on the language of Rule 203(b)(3)-1 that permits an adviser to count these unregistered funds as a single client. This would include advisers to hedge funds that have redemption periods for their investors that are longer than 2 years.

<sup>18</sup>For further information on regulatory filings required of these hedge funds, please see MFA’s “2005 Sound Practices for Hedge Fund Managers” at Appendix II.



1934, as well as to prohibitions on insider trading under the U.S. securities laws. In addition, there are safeguards covering the activities of hedge funds to the extent that they interact with regulated third parties such as registered broker-dealers and banks and, to the extent that they engage in futures trading, with futures commission merchants. Hedge funds are also subject to State antifraud provisions, just as are other providers of financial services.

There is no fraud crisis with regard to private investment vehicles. The 2003 SEC staff report entitled “Implications of the Growth of Hedge Funds” stated there is “no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity.”<sup>19</sup> Former SEC Chairman William Donaldson testified that there is “no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else.”<sup>20</sup>

### **Current Issues Regarding Hedge Funds**

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 initiatives on which MFA is focusing.

#### *Compliance With Hedge Fund Adviser Registration Rule*

As described above, MFA’s membership encompasses both registered investment advisers as well as those managers that are exempt from the SEC’s hedge fund adviser registration rule. Prior to adoption of the rule, MFA raised concerns that the costs of the rule would outweigh its benefits.<sup>21</sup> However, since promulgation of the rule on October 26, 2004, MFA has worked with its members to prepare for implementation of the rule and has offered recommendations to the SEC staff to help develop internal agency training programs on hedge fund subject areas. This work is ongoing and MFA hopes to continue its positive interaction with the SEC staff.

Over the past 18 months, MFA has hosted six educational seminars to help its members prepare for the compliance with this new rule.<sup>22</sup> At each seminar held last year, an SEC Commissioner or senior staff member delivered the keynote address or served as moderator. MFA is continuing its dialog with the SEC staff to address any issues that may arise now that the new hedge fund adviser registration rule has gone into effect. We discuss with our members how they are complying with the rule and their observations about SEC examinations.

#### *Growth in Credit Derivatives and Concerns of Systemic Risk*

The growth in the use of derivatives products has been widely reported. According to the International Swaps and Derivatives Association (“ISDA”), the outstanding notional value of credit derivative contracts rose from an estimated \$4 trillion at year-end 2003 to an estimated \$17 trillion at year-end 2005. The International Monetary Fund devoted an entire chapter of a recent report to examining the influence of credit derivatives on financial stability.<sup>23</sup>

Last year, the rising use of credit derivatives attracted the attention of regulators in the United States and overseas.<sup>24</sup> Of particular concern was 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 United States feared that problems could emerge as a result of the high number of unsigned confirmations of nova-

<sup>19</sup> Staff Report at 73.

<sup>20</sup> Testimony of William Donaldson, Chairman of the SEC, “Recent Developments in Hedge Funds,” Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (April 10, 2003).

<sup>21</sup> See Letter to Jonathan Katz from John Gaine, “Registration Under the Advisers Act of Certain Hedge Fund Advisers,” September 15, 2004.

<sup>22</sup> “Guidance on the SEC’s New Regulatory Framework for Hedge Fund Advisers,” held January 12, 2005 (New York, NY) and February 9, 2005 (Key Biscayne, FL); “Practical Guidance for Hedge Fund CCOs,” held May 5, 2005; “The SEC’s New Hedge Fund Rules and Implications for Managers in Europe,” held July 12, 2005 (London); “MFA’s 2005 Sound Practices for Hedge Funds Managers—A Practitioner’s Guide to Strong Internal Controls in Today’s Regulatory Environment,” held September 29, 2005 (New York); and “A New Era Begins: Hedge Fund Advisers and Today’s SEC Regulatory Environment,” held February 7, 2006 (Key Biscayne, FL).

<sup>23</sup> IMF, Global Financial Stability Report (April 2006), Chapter II, pp. 51–84.

<sup>24</sup> See Speech by Timothy Geithner, Remarks at the Institute of International Finance, Inc.’s Annual Membership Meeting in Washington, D.C., September 25, 2005; and, Financial Services Authority, “Hedge Funds: A Discussion of Risk and Regulatory Engagement” (Discussion Paper 05/4).

tions transactions. These concerns were also expressed in the Counterparty Risk Management Policy Group II in their 2005 Report.<sup>25</sup>

Last fall, MFA members who are active participants<sup>26</sup> in the credit derivatives markets took part in discussions with representatives of ISDA, the 14 major derivatives dealer firms (the “Fed 14”), 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. Overall, that experience demonstrated that meaningful buy-side participation can be essential to ensuring the success of these industry-wide initiatives to curb operational or systemic risk. In this instance, focused and constructive dialog among both buy-side and sell-side representatives led to a positive result.

As an outgrowth of the dialog between the hedge fund and derivative dealer communities that occurred in late 2005, MFA continues its dialog with representatives of the Fed 14 and ISDA. MFA continues its work with the Fed 14 representatives to share its views, along with those of other traditional asset managers, on the Fed 14’s proposed strategy for reducing confirmation backlogs in credit derivatives.

MFA has pledged its support to work with the Fed 14 in the development and implementation of their targeted objectives for improving credit derivatives market practices. MFA appreciates the dealers’ commitment to work with hedge funds and other buy-side representatives to develop and implement standard processing guidelines for credit derivatives. MFA has also expressed its support for improved transparency to reduce the backlog of unexecuted confirmations and the development of automated solutions for the processing of standardized products. Our statement made recommendations to the Fed 14 on how to achieve these goals and emphasized that, above all, meaningful buy-side input is essential for achieving improvements in these market practices.

MFA is now working on the development of industry-wide electronic platforms to warehouse credit derivative transactions, as well as on standards for transactions not eligible for electronic processing. MFA is committed to educating its members and keeping them informed regarding the latest operational developments in derivatives. 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.

#### *Investor Eligibility Standards or “Retailization”*

In recent years, a concern has grown among regulators and others that hedge funds are becoming investment vehicles open to the retail public. 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 an investment vehicle for institutional investors and high-net worth individuals. 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 Advisers Act, 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.

To the extent that retail investors may be exposed to hedge fund investments without the intermediation of an institutional investor, Congress might want to inquire into the impact of inflation over the past quarter century on the SEC’s Regulation D. Regulation D defines “accredited investors” to include natural persons with individual or joint net worth of \$1 million or individual income in each of the last 2 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. The SEC might want to consider raising the Regulation D thresholds for investments in private funds.

MFA believes that concerns regarding investor qualification for participation in hedge funds should be addressed directly by raising the Regulation D standards. If

<sup>25</sup>The Report of the Counterparty Risk Management Policy Group II, “Toward Greater Financial Stability: A Private Sector Perspective,” July 27, 2005.

<sup>26</sup>Hedge funds make up only a small percentage of the credit derivatives market, approximately 7–16 percent, according to a September 2004 study released by the British Bankers’ Association. See British Bankers’ Association Credit Derivatives Report 2003/2004 (available at <http://www.bba.org.uk>).

the concern about the number of investors qualifying as “accredited investors” is valid, it is one the SEC should address through changes to Regulation D. MFA has expressed support for doubling the minimum net worth and minimum annual individual income standards from their current level, so that the monetary thresholds reflect the inflation in wealth and incomes since 1982.<sup>27</sup>

While investments in hedge funds by public and private pension funds appear to be growing, it is 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 percent of their portfolio assets were invested in hedge funds.<sup>28</sup> By comparison, U.S. pension investments in real estate and private equity have been estimated at 3.4 percent and 3 percent of pension fund assets respectively.<sup>29</sup>

Publicly offered funds of hedge funds are subject to the full range of protections afforded by SEC registration and oversight, as they are registered with the SEC as investment companies and sold in registered public offerings. In addition, advisers of 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 by these registered funds.

#### *Continued Development of MFA’s Sound Practices*

MFA has a longstanding and ongoing commitment to promoting sound practices in the hedge fund industry. “Sound Practices for Hedge Fund Managers” were first published by industry participants in 2000 in response to a 1999 recommendation by the President’s Working Group on Financial Markets 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, MFA published MFA’s 2005 Sound Practices for Hedge Fund Managers. The 2005 iteration of MFA’s Sound Practices were 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. Our document provides relevant guidance on areas that are often of concern to regulators. These include hedge fund managers’ internal trading controls, responsibilities to investors, valuation, risk management, regulatory compliance, transactional practices and business continuity and disaster recovery. New recommendations address guidance for developing compliance manuals, codes of ethics, and certain transactional practices including best execution and soft dollar practices.

Our document has been widely praised by regulators and industry participants alike, including in the Counterparty Risk Management Policy Group II Report. MFA continues to encourage hedge fund managers to incorporate its recommendations into their particular internal policies and procedures. As new industry practices develop, particularly under the new regulatory framework and with the rise of even more complex derivative instruments, MFA will update and expand its document within the next 12 to 18 months.

#### **Conclusion**

The hedge fund industry has experienced significant growth in recent years. Much of this growth can be attributed to institutional investors seeking to diversify their returns and thereby reduce the overall risk of their investment portfolios. This growth has enabled hedge funds to serve as source of liquidity in global capital markets, increasing efficiency and decreasing risks.

With the growth and evolution of the hedge fund industry have come new responsibilities and challenges. On behalf of its members, MFA is committed to working with Congress, regulatory agencies, and on private sector initiatives to ensure an appropriate regulatory framework for the industry that allows the benefits to continue while addressing legitimate investor protection concerns. MFA appreciates the opportunity to share its views with the Subcommittee and will continue its work with both the SEC and its members to promote implementation of and compliance with the hedge fund adviser registration rule, as well as its efforts to reduce systemic risks and promote sound practices.

<sup>27</sup> See MFA “White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds” (July 7, 2003).

<sup>28</sup> Greenwich Associates, “Alternative Investments May Disappoint Dabblers” (January 21, 2004).

<sup>29</sup> Greenwich Associates, “The Alternative Balancing Act” (December 31, 2003).