

COALITION OF PRIVATE INVESTMENT COMPANIES

TESTIMONY OF JAMES CHANOS

CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON SECURITIES AND INVESTMENT

HEARING ON THE HEDGE FUND INDUSTRY

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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 1985.¹ 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

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

with over \$1 trillion under management² -- 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.³

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 policy makers 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 U.S. and in the developed world have been stunningly successful in providing capital and financing for economic growth and development,

² See A Review of Current Securities Issues before the S. Comm. On Banking, Housing & 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.

³ 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>

both in the U.S. 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 U.S. 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 Commission, 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."⁴

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

⁴ Hearing on the Nomination of Bernard S. Bernanke to be Member & 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.

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 counter-parties 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 rules⁵ (which limit their use of leverage to purchase and carry publicly traded securities and options), SEC Regulation SHO,⁶ (which regulates short-selling), the Williams Act amendments to the Securities Exchange Act of 1934⁷ 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 1934⁸ and Rule 10b-5,⁹ 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.¹⁰ To meet these exemptions, they must limit their offerings to private placements with sophisticated investors, who are able to understand and bear the risks of the investment. The hedge fund must either limit its beneficial owners to not more than 100 persons and entities (typically all or most of whom are “accredited investors”), or limit its investors to

⁵ 12 C.F.R. §§ 220, 221.

⁶ 17 C.F.R. §§ 242.200-.203

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).

⁸ 15 U.S.C. § 78j.

⁹ 17 CFR § 240.10b-5.

¹⁰ *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”).

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.¹¹ 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.¹² Thus, a

¹¹ See Eleanor Laise & 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.

¹² Cox Statement, *supra* n.2.

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 two years or more, thus providing a relatively easy avenue for managers who wish to avoid registration.¹³ 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

¹³ 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.

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 counterparties 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.¹⁴

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 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.¹⁵ 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.¹⁶ 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

¹⁴ Bernanke Statement, *supra* n.4

¹⁵ Quarles Remarks, *supra* n.3

¹⁶ 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.

market where several regulators, including the Treasury Department¹⁷ and the Federal Reserve Bank of New York,¹⁸ 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.¹⁹ 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 policy makers.

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.²⁰ 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 70's and 80's." While activist investors represent only a small part of

¹⁷ 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>

¹⁸ *See e.g.*, Ramez Mikdashi & Mark Whitehouse *Derivatives Firms Tackle Backlog* Wall St.J., Mar. 14, 2006, at C4.

¹⁹ "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.

²⁰ Andrew Ross Sorkin, *To Battle, Armed with Shares*, N.Y. Times, Jan. 4, 2006 at C1.

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."²¹ 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 compensation to more closely track return on investment, rather than balloon with increases in firm size.²² Activist investors offer ideas and business expertise that should not be dismissed by corporate managers.²³

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

²² Wright, Kroll & 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.

²³ 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 & 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%.

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.²⁴ 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

²⁴ Barry Rosenstein, *Why activism is good for all shareholders*, Fin. Times, Mar. 9, 2006.

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),²⁵ 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.²⁶ 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.²⁷ 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

²⁵ *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).

²⁶ *SEC v. Langley Partners, L.P.*, SEC Litigation Release No. 19607, 2006 WL 623053 (Mar.14, 2006).

²⁷ *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).

regulation can and should be made where appropriate to lessen the opportunities for 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,²⁸ the main sources of comparative statistics on the performance of hedge fund managers are the databases 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 databases 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.²⁹

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.³⁰ 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

²⁸ Burton G. Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, Fin. Analysts J., Vol. 61, No. 6 (2005), available at <http://www.cfapubs.org>.

²⁹ Vikas Agarwal, Naveen D. Daniel, & 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>.

³⁰ 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.

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 promulgate clearer guidance on valuation issues.³¹ 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.³² Consequently, unscrupulous investment managers can exploit these deficiencies to artificially inflate both the value of their investments

³¹ 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

³² We note that the two-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.

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.³³

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.³⁴ 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.³⁵ In our view, the appropriate role for government in this area is to facilitate and encourage a dialogue among experts from across the financial services industry, academia, the accounting profession, economists and others, on valuation issues and best practices. For example, the UK'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

³³ 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).

³⁴ 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.

³⁵ 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/MFA2005_SoundPracticesPublished.pdf.

counterparties and to work with industry representatives to develop a global set of principles that will attract global consensus.³⁶

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,³⁷ 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 investors 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,

³⁶ 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.

³⁷ See Investor Protector Implications of Hedge Funds before the S. Comm. on Banking, Housing & Urban Affairs, (Apr. 10, 2003) (statement of William Donaldson, Chairman, SEC), available at www.banking.senate.gov/03-04hr.04103.donaldsn.pdf

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.³⁸

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% of the investor’s net worth as a rough benchmark or limit, while others have used a 20% limit).³⁹

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.”⁴⁰ 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

³⁸ Staff Report, *supra* n.10, at 80.

³⁹ 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).

⁴⁰ *Registration of Certain Hedge Fund Advisers, supra* n.27 at 72057.

that funds of hedge funds may expose them to levels and types of risks that are not appropriate.⁴¹ 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.”⁴²

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.⁴³

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.⁴⁴ Short sellers test the ideas put forward by management; they often help the marketplace and enforcement agencies

⁴¹ Staff Report, *supra* n.10 at xii, 68-72.

⁴² *Id.* at 81.

⁴³ *Id.* at 99.

⁴⁴ 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.”

ferret out genuine fraud. In fact, 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.”⁴⁵

The SEC has an ongoing examination program to determine compliance with Regulation SHO, which became effective less than two 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.⁴⁶ 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.

⁴⁵ Jesse Eisinger, *Long & 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.

⁴⁶ 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).

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.”⁴⁷

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

⁴⁷ 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>.

first instance. Unless it is publicized ... markets cannot function. We don't want to do anything therefore to chill that activity."⁴⁸

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."⁴⁹

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 Amendment itself is that its protections recognize the value of a "marketplace of ideas."⁵⁰

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--

⁴⁸ Kara Scannelli, *Cox Knocks Journalist Subpoenas*, Wall St.J., Feb. 28, 2006, at C1.

⁴⁹ 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>.

⁵⁰ See J.S. Mill, *On Liberty*, (1859); *Abrams v. United States*, 250 U.S. 616, 630, 40 S.Ct. 17, (1919) (Holmes, J., dissenting).

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.⁵¹

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.⁵²

⁵¹ 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).

⁵² Letter from Christopher Cox, Chairman, Securities and Exchange Commission, to the Honorable Ronald Wyden, United States 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.

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.⁵³

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 two 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."⁵⁴

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

⁵³ See e.g., Roddy Boyd *Trash Stalkers*, N.Y. Post, Mar. 3, 2006.

⁵⁴ Mary Flood, *Skilling Told Team 'They're On to Us,' Witness Says*, Houston Chronicle, Mar. 3, 2006.

between business journalists and their sources, the SEC subpoenas had the potential to chill communications between reporters and significant sources of expert analysis, thus limiting the information available to investors.⁵⁵ 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.

⁵⁵ 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).