TESTIMONY OF JAMES CHANOS

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

HEARING ON ENHANCING INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS — PART II

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

I want to thank the Senators of this Committee for your efforts to develop and implement an approach to modernize financial regulation which would address the failures and inadequacies that contributed to the financial crisis confronting our country and our global economy. I am honored to have this opportunity to testify on behalf of CPIC and look forward to working with you and your staff in the months ahead.

I. Executive Summary

This is a difficult time for our nation. Overhauling our regulatory structure is necessary to regain investor confidence. Honesty and fair dealing are at the foundation of the investor confidence our markets enjoyed for so many years. A sustainable economic recovery will not occur until investors can again feel certain that their interests come first and foremost with the companies, asset managers, and others with whom they invest their money, and until they believe that regulators are effectively safeguarding them against fraud.

In recent years, prior to the current economic downturn, many observers of the financial system believed that hedge funds and other private pools of capital would be the source of the

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

next financial crisis. Of course, as we have all painfully learned, in fact, the greatest danger to world economies came not from those entities subject to indirect regulation, such as hedge funds, but from institutions such as banks, insurance companies, broker-dealers, and government-sponsored enterprises operating with charters and licenses granted by state and federal regulators and under direct regulatory supervision, examination, and enforcement. Indeed, Bernard Madoff used his firm, Bernard L. Madoff Investment Securities, LLC, — which was registered with the SEC as a broker-dealer and investment adviser and subject to examination and regulation — to perpetrate his Ponzi scheme.

Nonetheless, hedge funds and other private investment companies are important market players, and we recognize that a modernized financial regulatory system – one that addresses overall risk to the financial system and that regulates market participants performing the same functions in a consistent manner — will include regulation of hedge funds and other private pools of capital. We are ready to work with you as you seek to craft appropriate regulation for our industry.

With respect to the new regime for monitoring systemic risk, CPIC would like to offer the following principles upon which to base legislative and regulatory action:

- First, regulation must be based upon activities, not actors, and it should be scaled to size and complexity.
- Second, all companies that perform systemically significant functions should be regulated.
- Third, regulators should have the authority to follow the activities of systemically important entities regardless of where in the entity that activity takes place.

- Fourth, as complexity of corporate structures and financial products intensifies, so, too should regulatory scrutiny.
- Fifth, there should be greater scrutiny based upon the "Triple Play" — being an originator, underwriter/securitizer and investor in the same asset.
- Sixth, and above all, the systemic risk regulator must enforce transparency and practice it.

With respect to increasing the functional regulation of hedge funds, CPIC offers the following for your consideration:

- Simply removing exemptions from the Investment Company Act and the Investment Advisers Act upon which private investment funds rely will prove unsatisfactory.
- Any new regulation should provide for targeted controls and safeguards to provide appropriate oversight of private investment companies, but should also preserve the flexibility of their operations.
- More detailed requirements for large private investment companies would address the greater potential for systemic risk posed by such funds, depending on their use of leverage and their trading strategies.
- Regulation should address basic common-sense protections for investors in private investment companies, particularly with respect to disclosure, custody of fund assets, and periodic audits.
- Areas such as counterparty risk, lender risk, and systemic risk should be addressed through disclosures to regulators and counterparties.

With respect to hedge funds as significant investors in the capital markets, CPIC believes that maximum attention should be paid to maintaining and increasing the transparency and accuracy of financial reporting to shareholders, counterparties, and the market as a whole.

II. The State of the Hedge Fund Sector

Since I last testified before the Senate Banking Committee on May 16, 2006,[2] the hedge fund industry has undergone profound change in the face of unprecedented challenges. In 2006, the industry was continuing its rapid growth and evolution into new strategies and products, to offer qualified investors greater flexibility and opportunities for managing risks and achieving returns that exceeded equity and bond markets' performance. In 2006, the industry had an estimated $1.47 trillion in assets under management and there were an estimated 9,462 funds. A year later, total assets under management for an estimated 10,096 funds rose to about $1.87 trillion, culminating 18 years of growth since 1990 at a cumulated average annual growth rate (CAGR) of 25 percent. In several markets, hedge funds became the main players, accounting for more than 50 percent of trading in U.S. convertible bonds, distressed debt, and credit derivatives.[3] We experienced a host of new strategies to address investors' increasingly complex risk-management and asset growth demands, as the variety and complexity of financial instruments — and the global nature of those products — grew exponentially. The sheer variety of investment strategies that hedge funds employed strengthened capital markets, improved opportunities for price discovery, and facilitated the efficient allocation of capital.[4]

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[2] 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. May 16, 2006. Available at: http://banking.senate.gov/public/_files/ACF82BA.pdf.

[3] Kambhu, John, Schuermann, Til and Stiroh, Kevin J., Hedge Funds, Financial Intermediation, and Systemic Risk. Economic Policy Review, Vol. 13, No. 3, December 2007 (*available at* SSRN: http://ssrn.com/abstract=1012348).

[4] Knowledge@Wharton, "Hedge Funds Are Growing: Is This Good or Bad?" June 29, 2005. Available at: http://knowledge.wharton.upenn.edu/article.cfm?articleid=1225&CFID=4349082&CFTOKEN=6202640. Jeremy

The attraction of hedge funds was a function, too, of their performance. According to Hedge Fund Research, Inc., hedge funds have returned an average of 11.8 percent annually during the period 1990 through 2008, and an average 15.9 percent in the 12 months following the five largest historical declines.[5]

As Andrew W. Lo, a professor at the MIT Sloan School of Management, testified on November 13, 2008, "[t]he increased risk-sharing capacity and liquidity provided by hedge funds over the last decade has contributed significantly to the growth and prosperity that the global economy has enjoyed."[6] It is a point that Treasury Secretary Timothy F. Geithner made as Federal Reserve Bank President and CEO in speeches in 2004 and 2005.[7]

Despite the rapid growth and size of hedge funds ($1.41 trillion), their relative size with the financial sector is small, accounting for 0.7 percent of the $196 trillion invested in equities,

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Siegel, Professor of Finance at the Wharton School of the University of Pennsylvania, observes that short selling contributes to the market's process of finding correct prices, and it's valuable to have hedge funds doing this. Sebastian Mallaby, "Hands Off Hedge Funds," *Foreign Affairs*, January/February 2007. Available at: http://www.foreignaffairs.org/20070101faessay86107/sebastian-mallaby/hands-off-hedge-funds.html. The importance of hedge funds has been acknowledged by the President's Working Group on Financial Markets, the Commodities Futures Trading Commission, the Securities and Exchange Commission, two chairs of the Federal Reserve Board, and members of Congress.

[5] Hedge Fund Research, Inc. "Investors Withdraw Record Capital from Hedge Funds as Industry Concludes Worst Performance Year in History." Press Release. Available at: https://www.hedgefundresearch.com/pdf/pr_01212009.pdf .

[6] Written Testimony of Andrew W. Lo, *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008,* Prepared for the U.S. House of Representatives Committee on Oversight and Government Reform November 13, 2008 Hearing on Hedge Funds.

[7] Mr. Geithner stated: "Hedge funds play a valuable arbitrage role in reducing or eliminating mispricing in financial markets. They are an important source of liquidity, both in periods of calm and stress. They add depth and breadth to our capital markets. By taking risks that would otherwise have remained on the balance sheets of other financial institutions, they provide an importance source of risk transfer and diversification." Available at: http://www.ny.frb.org/newsevents/speeches/2004/gei041117.html. Mr. Geithner also stated "Hedge funds, private equity funds and other kinds of investment vehicles help to disperse risk and add liquidity." *See* Keynote Address at the National Conference on the Securities Industry: Hedge Funds and Their Implications for the Financial System (November 17, 2004). Remarks at the Institute of International Bankers Luncheon in New York City (October 18,2005). Available at: http://www.ny.frb.org/newsevents/speeches/2005/gei051018.html.

tradable government and private debt, and bank deposits, according to McKinsey Global Institute.[8]

In the summer of 2007 and throughout 2008, financial markets began to unravel. Major regulated financial institutions collapsed or went bankrupt as the U.S. Treasury administered life support through both capital infusions and U.S.-backed guarantees to prevent the demise of banks, insurance companies, and others who were deemed "too big to fail," and thereby stave off an imminent global economic collapse comparable to that of the Great Depression. A chain of interlinked securities – including derivatives and off-balance sheet vehicles – sensitive to housing prices triggered a death spiral in financial markets worldwide, demonstrating the scale and intensity of interdependence in the global economy and the vulnerability it causes.[9] As the problems became more severe, the crisis mushroomed beyond subprime debt to threaten less risky assets. Credit markets dried up, and equity markets in 2008 posted one of their worst years since the 1930s. As a result, the value of financial assets held at banks, investment firms, and others collapsed, jeopardizing their survival as they sharply curtailed activities. Institutional investors rushed to the sidelines, seeking safe havens in cash investments. The downturn spread throughout our economy and worldwide, fueling job losses, prompting bankruptcies, and causing household wealth to erode. That is a greatly distilled and simplified recounting of the events in 2007-2009. And, as might be expected with those events, the hedge fund industry experienced a sharp reversal.[10]

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[8] McKinsey Global Institute, Mapping Global Capital Markets: Fifth Annual Report. October 2008. Available at: http://www.mckinsey.com/mgi/reports/pdfs/fifth_annual_report/fifth_annual_report.pdf .

[9] There are many research papers and studies that examine the source of the financial crisis. One example: Gary B. Gorton, "The Panic of 2007." August 25, 2008. *Yale ICF Working Paper No. 08-24*. Available at: http://ssrn.com/abstract=1255362.

[10] I would encourage you to read the trenchant analysis by Lord Adair Turner, Chairman of the U.K. Financial Services Authority ("FSA"), in which he eloquently recounts how developments in the banking and the near-bank

As a consequence of the financial crisis, as was the case with other sectors of the financial services industry, the amount of money managed by hedge funds plummeted, reflecting an amalgam of sharp declines in asset values, the rise in client redemptions, and regulatory closures of margin accounts. Last year was easily among the worst in the industry's history, with total assets under management falling to $1.41 trillion – a decline of $525 billion from the all-time peak of $1.93 trillion reached mid-year 2008, with more than 1,471 funds – a record in one year — liquidating. Investors withdrew a record $155 billion.

Hedge funds on average in 2008 posted their worst performance since 1990. The HFRI Fund Weighted Composite Index dropped 18.3 percent for all of last year, which was only the second calendar year decline since 1990.[11] That said, though, hedge fund losses on average were less than those of the S&P500, with 24 different hedge fund strategies performing better than the S&P 500 benchmark.

III. Mitigation of Systemic Risk

The financial crisis of the past two years has raised many questions about the extent to which systemic risks are effectively contained and ameliorated within the U.S. and global economies. As globalization has led to better risk sharing and increased market liquidity, shocks originating in one market are more quickly transmitted to other markets. Regulators and central banks say they need more information to understand the sources of risks and potential impact on

system caused serious harm to the real economy. Lord Adair Turner, Chairman, FSA. "The financial crisis and the future of regulation." January 21, 2009. *The Economist's* Inaugural City Lecture (*available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml. A more extensive discussion is provided in: *The Turner Review: A Regulatory Response to the Global Banking Crisis*. March 18, 2009 (*available at* http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/037.shtml).

[11] According to Hedge Fund Research, Inc. "during 2008, the industry experienced a period of six consecutive months of declines between June and November, interrupted only by December's 0.41 percent gain, including a concentrated, volatile two-month period in September and October in which the cumulative decline approached 13 percent." *See supra* n. 5.

markets and economies. Consensus is emerging among U.S. policy makers and in other countries for the need to strengthen systemic risk regulation. Towards that end, allow me to outline some basic principles to guide the thinking about establishing a regulator with responsibility for addressing systemic risks and the attendant laws and regulations to accomplish that objective.

First, regulation must be based upon activities, not actors, and it should be scaled to size and complexity. Regulatory scrutiny should be triggered based upon any of the following: the overall scale of market participants, relative importance in a given market or markets, complexity of corporate structure, and complexity of financial instruments used for investment or dealer purposes. All participants undertaking a similar activity should be treated equally; for example, proprietary trading by financial institutions should not be treated in a different manner than trading by any other kind of entity. While the regulator should have broad and flexible authority to determine the basis upon which it wants to include systemically significant entities, it should be clear and transparent in disclosing the criteria upon which it seeks to include a specific market participant.

Second, all companies that perform systemically significant functions should be regulated. The regulator should have the authority to examine and discipline market players such as credit rating agencies and financial guarantors, based on the importance of the integrity of their functions to the entire financial system.

Third, the regulator should have the authority to follow the activities of systemically important entities regardless of where in the entity that activity takes place. No matter where the activity takes place in a corporation, regulators should be allowed to look into those activities. This point speaks against assigning regulators specific discrete parts of entities to cover and for an evolution of functional regulation.

Fourth, as complexity of corporate structures and financial products intensifies, so, too should regulatory scrutiny. Greater regulatory scrutiny should be borne by complex enterprises — not just in the sense of adding additional functional regulation for each new piece of a diversified company but also in the sense of materially increasing the federal regulatory oversight exercised by any new systemic regulator. Entities should come under the ambit of a systemic regulator based upon the complexity, opacity, and system-wide interdependent nature of the instruments that they underwrite, produce, deal in or invest.

Fifth, there should be greater scrutiny based upon the "Triple Play" — being an originator, underwriter/securitizer, investor in the same asset. Greater regulatory scrutiny should be borne by those entities that endeavor to achieve the trifecta: that is, to own the "means of production" of an asset, to act as a dealer in financial instruments created from those assets, and to be a direct investor in those instruments or assets. In other words, if a company were a mortgage originator, a dealer in mortgage-backed securities, and an investor for its own account in mortgage-backed securities, that “triple play” would trigger oversight by the systemic regulator not only of the individual activities but also the management of the inherent conflicts of interest between those vertically integrated pieces.

Sixth, and above all, a systemic risk regulator must enforce transparency and practice it. The regulatory structure should include reviews of how accurately entities make required disclosures of their true financial condition to their shareholders and/or counterparties and investors. The regulator, too, must be transparent; it should annually disclose the entities under its regulatory umbrella and the reason for their inclusion. The regulator should be accountable to Congress and the public. Although the markets alone are not up to the task of identifying and containing systemic risk, it is also the case that the government alone is not up to the task. The combined efforts of government regulators and market discipline brought about by transparent disclosure of risks are needed in any plan for future operation of our financial markets. Further, consideration should be given to modeling disclosure of regulatory or enforcement activity on those of the SEC or CFTC, rather than some of the other, more opaque, federal regulatory agencies.

IV. Hedge Funds and Functional Regulation

Private investment companies of all types play significant, diverse roles in the financial markets and in the economy as a whole. Venture capital funds, for instance, are an important source of funding for start-up companies or turnaround ventures. Other private equity funds provide growth capital to established small-sized companies, while still others pursue "buyout" strategies by investing in underperforming companies and providing them with capital and/or making organizational changes to improve results. These types of funds may focus on providing capital in the energy, real estate, and infrastructure sectors. Hedge funds trade stocks, bonds, futures, commodities, currencies, and a myriad of other financial instruments on a global level. These flexibly structured pools of capital provide substantial benefits to their investors and to the markets more broadly in terms of liquidity, efficiency, and price discovery. In addition, they are a potential source of private investment to participate with the government in addressing the current financial crisis.[12] It, therefore, is in all of our interests that private investment funds continue to participate in our financial markets.

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

While it often is said that private investment companies are "unregulated," they are, in fact, subject to a range of securities anti-fraud, anti-manipulation,[13] margin,[14] and other trading laws and regulations that apply to other securities market participants.[15] They also are subject to SEC enforcement investigations and subpoenas, as well as civil enforcement action and criminal prosecution if they violate the federal securities laws. However, private investment companies and their advisers are not required to register with the SEC if they comply with the conditions of certain exemptions from registration under the Investment Company Act of 1940 (the "Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act").[16]

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

[14] 12 C.F.R. §§ 220, 221, 224.

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

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

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

Section 203(b)(3) of the Advisers Act exempts from registration any investment adviser that, during the course of the preceding twelve months has had fewer than fifteen clients and that does not hold itself out as an investment adviser nor act as an investment adviser to any investment company. Advisers to hedge funds and other private investment companies are generally excepted from registration under the Advisers Act by relying upon Section 203(b)(3), because a fund counts as one client.

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

Congress created exemptions under these laws because it determined that highly restrictive requirements of laws designed to regulate publicly-offered mutual funds and investment advisers to retail investors were not appropriate for funds designed primarily for institutions and wealthy investors.

To date, legislative proposals to regulate private investment companies have been directed at removing the exemptions from regulation of private investment companies under the Investment Company Act and Advisers Act and thus subjecting private investment companies to the requirements of those Acts. But, for policy makers who believe private investment companies and their managers should be subject to greater federal oversight, I would argue that simply eliminating the exemptions in either or both of these statutes will prove unsatisfactory.[17]

[17] In my testimony before the SEC's public roundtable on hedge funds in 2003, I recommended that, as a further condition to exemption under the Advisers Act, hedge funds should be subject to specific standards relating to investor qualifications, custody of fund assets (an issue on which there now is significant focus as a result of the Madoff scandal), annual audits and quarterly unaudited reports to investors, clear disclosure of financial arrangements with interested parties (such as the investment manager, custodian, prime broker, and others -- in order to address conflicts issues), clear disclosure of investment allocation policies, and objective and transparent standards for valuation of fund assets that are clearly disclosed, not stale, and subject to audit. Statement of James Chanos, President, Kynikos Associates, SEC Roundtable on Hedge Funds (May 15, 2003) (*available at* http://sec.gov/spotlight/hedgefunds/hedge-chanos.htm).

When I testified before this committee in 2004, I expanded upon these points and recommended that the SEC require, as a condition to a hedge fund's exemption under the Advisers Act, that hedge funds file basic information with the SEC and certify that they met the standards outlined above. Testimony before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on Regulation of the Hedge Fund Industry (Jul. 15, 2004) (*available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=79b80b77-9855-47d4-a514-840725ad912c). *See also* Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) (*available at* http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf). This would have provided the SEC with hedge fund "census" data it has long said it needs; it also would have provided a basis for SEC enforcement action against any fund failing to meet the above standards. Had the SEC adopted this recommendation, the agency would have avoided the legal challenge to the rule it adopted later that year to change its interpretation of the term "client" under the Advisers Act in order to require hedge fund managers to register. See *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

As this committee knows, the SEC's hedge fund adviser registration rule was struck down in 2006, (*id.*) and the SEC decided not to appeal. Some hedge fund managers that had registered with the SEC under the rule withdrew their registrations. I decided that my firm should remain registered as an investment adviser (which we are still today), but, as I testified in 2006 before this Committee, the Advisers Act is "an awkward statute for providing the SEC with the information it seeks … and for dealing with the broader issues that are outside the Act's purposes." Testimony of James Chanos, CPIC, before the Senate Committee on Banking, Housing and Urban Affairs, The first lesson we all learned in shop class is you need to use the right tool for the job. Although you can use a pipe wrench to pound in a nail, or a claw hammer to loosen up a pipe, it is not a good idea to do so. Neither the Investment Company Act nor the Advisers Act is the right tool for the job of regulating hedge funds and other private investment companies. They do not contain the provisions needed to address the potential risks posed by the largest large private investment companies, the types of investments they hold, and the contracts into which they enter. At the same time, those laws each contain provisions designed for the types of businesses they are intended to regulate — laws that would either be irrelevant to oversight of private investment companies or would unduly restrict their operation. If Congress determines that legislation is needed, I believe a more tailored and targeted law should be drafted in order to address current public policy concerns about investor protection and systemic risks. Yet, Congress should avoid trying to shoehorn private investment companies into laws designed for retail investors.

For example, the Investment Company Act and Advisers Act are designed purely for investor protection, and have no provisions designed to protect counterparties or to control systemic risk. Similarly, these acts are generally silent on methods for winding down an investment fund or client account, an area which the law should address in some detail for large private investment companies. Further, the Advisers Act custody provisions exclude certain types of instruments that are commonly owned by private investment funds, an exclusion that would deprive investors in those funds of the protection that a custody requirement provides.

Subcommittee on Securities and Investment; Hearing on the Hedge Fund Industry, *at 7* (*available at* http://banking.senate.gov/public/_files/ACF82BA.pdf).

At the same time, many requirements of the Investment Company Act and the Advisers Act are irrelevant, or would be counterproductive, if applied to private investment companies. For example, current restrictions on mutual funds from engaging in certain types of transactions, such as trading on margin and short selling, would severely inhibit or foreclose a number of hedge fund trading strategies that are fundamental to their businesses and the markets.[18] As another example, requirements for boards of directors imposed by the Investment Company Act and compensation restrictions imposed by the Advisers Act are not particularly well suited to the regulation of managers of investment pools with high net worth and institutional investors. Such investors are fully capable of understanding the implications of performance-based fees, and do not need regulatory attention to protect themselves. Likewise, client-trading restrictions under the Advisers Act that require client consent on a transaction-by-transaction basis are unduly burdensome for private fund management. In sum, the Investment Company Act and Advisers Act, which were adopted in largely their current forms in 1940, are not well suited to being adapted for a new use in regulating investment structures and strategies developed primarily over the last twenty years.

Congress should think carefully as it considers the right tool for the task of regulating private investment companies. In my view, whatever legislation is developed should contain targeted controls and safeguards needed to provide appropriate oversight for the regulation of such entities, yet retain the flexibility of their operations. Congress may wish to consider more detailed requirements on large private investment companies (or families of private investment

[18] For example, convertible bond arbitrage relies on selling short the underlying equity security while buying the bond. This strategy provides an essential support for the convertible bond market, upon which many corporations rely for capital.

companies) in order to address the greater potential for systemic risk posed by such funds, depending upon their use of leverage and their trading strategies.

Congress also may wish to consider giving legal effect to certain measures that were identified as "best practices" for fund managers in a report issued earlier this year by the Asset Managers' Committee ("AMC Best Practices") — a group on which I served at the request of the President's Working Group on Financial Markets.[19] For example, one of the most important of these recommendations is that managers should disclose more details — going beyond Generally Accepted Accounting Standards — regarding the portion of income and losses that the fund derives from Financial Accounting Standard (FAS) 157 Level 1, 2 and 3 assets.[20] Another recommendation is that a fund's annual financial statements should be audited by an independent public accounting firm that is subject to PCAOB oversight. Still another recommendation would assure that potential investors are provided with specified disclosures relating to the fund and its management before any investment is accepted. This type of information should include any disciplinary history and pending or concluded litigation or enforcement actions, fees and expense structure, the use of commissions to pay broker-dealers for research ("soft dollars"), the fund's methodology for valuation of assets and liabilities, any side-letters and side-arrangements, conflicts of interest and material financial arrangements with interested parties (including investment managers, custodians, portfolio brokers, and placement agents), and policies as to investment and trade allocations.

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[19] *Report of the Asset Managers' Committee: Best Practices for the Hedge Fund Industry* (January 15, 2009) (available at http://www.amaicmte.org/Asset.aspx).

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

Congress also should require safeguards that I have advocated for many years — simple, common-sense protections relating to custody of fund assets and periodic audits.

As I mentioned earlier, there are areas of importance to the financial system that the Investment Company Act and Advisers Act do not address, including counterparty risk, lender risk, and systemic risk . These types of issues can be addressed through required disclosures to regulators and to counterparties. Of course, Congress also will need to choose a regulator, and since the SEC already has regulatory responsibility over publicly-offered funds, the SEC is the logical choice. If Congress decides to establish an overall systemic risk regulator, that regulator also may have a role in overseeing the largest, systemically important funds.

V. Hedge Funds as Financial Investors

One of the most important roles that hedge funds play in our economy is that of investor. Perhaps no other role played by hedge funds and other private investment vehicles, like venture capital funds, is more important to a return to economic growth than this one. From the point of view of an investor that provides capital to corporations by buying equity or debt, or of a potential purchaser of asset-backed securities in the secondary market, certain principles will be essential to encouraging investment in products that do not carry an explicit government and taxpayer guarantee against loss. One key principle is a generally accepted and respected valuation of assets.

Mark-to-market ("MTM") accounting is not perfect, but it does provide a compass for investors to figure out what an asset would be worth in today's market if it were sold in an orderly fashion to a willing buyer. Before mark-to-market accounting took effect, the Financial Accounting Standards Board (FASB) produced much evidence to show that valuing financial instruments and other difficult-to-price assets by “historical” costs, or “mark to management,” was folly.

The rules now under attack are neither as significant nor as inflexible as critics charge. Mark-to-market accounting is generally limited to investments held for trading purposes, and to certain derivatives. For many financial institutions, these investments represent a minority of their total investment portfolio. For example, Bloomberg columnist David Reilly reports that of the 12 largest banks in the KBW Bank Index, only 29% of the $8.46 trillion in assets are at MTM prices.[21]

Why is that so? Most bank assets are in loans, which are held at their original cost using amortization rules, minus a reserve that banks must set aside as a safety cushion for potential future losses.

MTM rules also give banks a choice. MTM accounting is not required for securities held to maturity, but you need to demonstrate a “positive intent and ability” that you will do so. Further, an SEC 2008 report found that “over 90% of investments marked-to-market are valued based on observable inputs.”[22]

[21] David Reilly, *Elvis Lives and Mark to Market Rules Fuel Crisis* (Mar. 11, 2009), Bloomberg (*available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aD11FOjLK1y4). “Of the $8.46 trillion in assets held by the 12 largest banks in the KBW Bank Index, only 29 percent is marked to market prices, according to my analysis of company data. General Electric Co., meanwhile, said last week that just 2 percent of assets were marked to market at its General Electric Capital Corp. subsidiary, which is similar in size to the sixth-biggest U.S. bank. What are all those other assets that aren’t marked to market prices? Mostly loans -- to homeowners, businesses and consumers. Loans are held at their original cost, minus a reserve that banks create for potential future losses. Their value doesn’t fall in lockstep with drops in market prices. Yet these loans still produce losses, thanks to the housing meltdown and recession. In fact, bank losses on unmarked loans are typically bigger than mark-to-market losses on securities like bonds backed by mortgages.”

[22] SEC, Office of the Chief Accountant, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* (*available at:* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf). The report concludes: “The Staff observes that fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008. Rather, bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed.” *At* 4.

Obfuscating sound accounting rules by gutting MTM rules will only further reduce investors' trust in the financial statements of all companies, causing private capital — desperately needed in securities markets — to become even scarcer. Worse, decreased clarity will further erode confidence in the American economy, with dire consequences for many of the financial institutions who are calling for MTM changes.

Greater transparency is also necessary in the over-the-counter derivatives markets. These markets play a critical role in the establishment of prices in almost every public or regulated market, from determining interest rates to share prices. Reducing the need for reliance on a few opaque counterparties, increasing regulatory access to price and volume and other transactional information, and fostering integrity in the price discovery function for OTC products that affect the borrowing costs of individual companies, are all objectives that should be aggressively pursued as part of this Committee's modernization of our financial regulatory structure.

VI. Conclusion

Honesty and fair dealing are at the foundation of the investor confidence our markets enjoyed for so many years. A sustainable economic recovery will not occur until investors can again feel certain that their interests come first and foremost with the companies, asset managers, and others with whom they invest their money, and until they believe that regulators are effectively safeguarding them against fraud. CPIC is committed to working diligently with this Committee and other policy makers to achieve that difficult but necessary goal.