COALITION OF PRIVATE INVESTMENT COMPANIES

TESTIMONY OF JAMES CHANOS

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

HEARING ON REGULATING HEDGE FUNDS AND OTHER PRIVATE INVESTMENT POOLS

JULY 15, 2009

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

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

Private investment company legislation should require registration of private funds with the SEC; provide that each such fund and its investment manager be subject to SEC inspection and enforcement authority, just as mutual funds and registered investment advisers are; require

[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.

custody and audit protections to prevent theft, Ponzi schemes and fraud; require robust disclosures to investors, counterparties and lenders; require that private funds provide basic census data in an on-line publicly available form; require that they implement anti-money laundering programs, just as broker-dealers, banks and open-end investment companies must do; and, for larger funds, require the adoption of risk management plans to identify and control material risks, as well as plans to address orderly wind-downs. CPIC believes that these statutory requirements would benefit investors by putting into place a comprehensive regulatory framework that enhances the ability of regulators to monitor and address systemic risks while providing clearer authority to prevent fraud and other illegal actions. Our approach strives for the highest standards of prevention without eliminating the beneficial effects of responsible innovation.

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

I. Benefits of Private Pools of Capital

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

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

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

[2] See, e.g., remarks of Bernard Bernanke, who called hedge funds a “positive force in the American financial system.” Hearing on the Nomination of Bernard S. Bernanke to be Member & Chairman of the Federal Reserve Board, S. Comm. on Banking, Housing and Urban Affairs; (Nov. 15, 2005) (statement of Bernard Bernanke)

In addition to the benefits provided by these flexibly structured pools of capital to investors and to the markets more broadly in terms of liquidity, efficiency, and price discovery, private investment funds are a potential source of private investment to participate with the government in addressing the current financial crisis.[3] It therefore is in the interests of investors, U.S. markets, and the broader economy that private investment funds continue to participate in our financial markets and have the flexibility to perform their unique roles.

II. Risks Posed by Private Pools of Capital.

In recent years, prior to the current economic downturn, some market observers believed that hedge funds and other private pools of capital would be the source of the next financial crisis. Of course, as we have all painfully learned, the greatest danger to world economies came not from those entities subject to indirect regulation, such as hedge funds, but from institutions such as banks, insurance companies, broker-dealers, and government-sponsored enterprises operating with charters and licenses granted by state and federal regulators and under direct regulatory supervision, examination, and enforcement. Indeed, Bernard Madoff used his firm, Bernard L. Madoff Investment Securities, LLC — which was registered with the SEC as a broker-dealer and investment adviser and subject to examination and regulation — to perpetrate his Ponzi scheme. The Stanford group of companies used an SEC-registered broker-dealer and

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(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.

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

SEC-registered investment adviser to market, among other products, certificates of deposit of an affiliated offshore bank.

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

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

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

liquidity and to post strong collateral, as compared to more heavily regulated financial institutions. For all these reasons, when a private fund fails, it is not as likely to set off a chain reaction, such as we saw when Lehman Brothers collapsed.

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

Congress has sought to ensure that hedge funds and other private funds deal appropriately with their investors by imposing conditions on the exemptions from registration under the Securities Act of 1933, the Investment Company Act of 1940 ("Investment Company Act"), and in some cases the Commodity Exchange Act ("CEA"), under which they operate.[5] To meet these exemptions, the laws require hedge funds to limit their offerings to private placements with high net worth sophisticated investors, who are able to understand and bear the risks of the investment. A private fund must either limit its beneficial owners to not more than 100 persons and entities (typically all or most of whom are "accredited investors"), or limit its investors to super-accredited "qualified purchasers," such as individuals with more than $5 million in investments and institutions with more than $25 million in investments. Private funds typically file exemptive notices with the SEC and state securities commissioners under Regulation D of the Securities Act of 1933. Many also file notices with the National Futures Association under

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

the CEA exemptions by which they operate (which impose their own additional restrictions on sophistication and qualifications of investors).

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

[6] 12 C.F.R. §§ 220, 221.

[7] 17 C.F.R. §§ 242.200-.203

[8] The Williams Act added Exchange Act §§13(d), 13(e), 14(d), 14(e) and 14(f), 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e) and §78n(f) in 1968. Related legislation added Section 13(g), §78m(g), in 1977.

[9] 15 U.S.C. § 78j.

[10] 17 C.F.R. § 240.10b-5.

also are subject to the anti-fraud provisions in Section 206 of the Advisers Act, which applies to both registered and unregistered investment advisers.[11]

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

III. Approaches by Market Participants and Regulators to Limit Risks Without Unduly Limiting Benefits.

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

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[11] 15 U.S.C. § 80b-6.

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

As a report by the Government Accountability Office ("GAO") in May 2009 noted, "hedge fund advisers have improved disclosure and become more transparent about their operations … ."[13]

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

In my view, one of the most important recommendations of the report of the Asset Managers' Committee ("AMC Best Practices") is that managers should disclose more details — going beyond Generally Accepted Accounting Principles — regarding how their funds derive income and losses from Financial Accounting Standard (FAS) 157 Level 1, 2 and 3 assets.[15] Another recommendation is that a fund's annual financial statements should be audited by an independent public accounting firm that is subject to PCAOB oversight. Still another recommendation would assure that potential investors are provided with specified disclosures relating to the fund and its management before any investment is accepted. This information should include any disciplinary history and pending or concluded litigation or enforcement actions, fees and expense structure, the use of commissions to pay broker-dealers for research ("soft dollars"), the fund's methodology for valuation of assets and liabilities, any side-letters

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

[14] *See, e.g., Best Practices for the Hedge Fund Industry: Report of the Asset Managers' Committee to the President's Working Group on Financial Markets* (Jan. 15, 2009) (*available at* http://www.amaicmte.org/Asset.aspx).

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

and side-arrangements, conflicts of interest and material financial arrangements with interested parties (including investment managers, custodians, portfolio brokers, and placement agents), and policies as to investment and trade allocations.

Congress may wish to give legal effect to many of these recommendations; in fact, I believe any private investment company legislation should do just that. But, I would urge that Congress carefully tailor legislation in this area, in order to preserve the flexibility of private funds and their capacity for innovation that has benefited investors and the capital markets over the years.

IV. What Legislative Changes Are Needed?

Current Advisers Act and Investment Company Act Framework

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

[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 exemptions under these laws, because it determined that highly restrictive requirements applicable to publicly-offered mutual funds and advisers to retail investors were not appropriate for funds designed primarily for institutions and wealthy investors.

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

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investment companies are generally excepted from registration under the Advisers Act by relying upon Section 203(b)(3), because a fund counts as one client.

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

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

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

When I testified before this committee in 2004, I expanded upon these points and recommended that the SEC require, as a condition to a hedge fund's exemption under the Advisers Act, that hedge funds file basic information with the SEC and certify that they met the standards outlined above. Testimony before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on Regulation of the Hedge Fund Industry (Jul. 15, 2004) (*available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=79b80b77-9855-47d4-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

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

The Advisers Act and the Investment Company Act (which applies primarily to the retail mutual fund sector), are both designed primarily for retail investor protection in individual accounts that invest in publicly-traded stocks and bonds. Neither has specific provisions designed to protect funds' counterparties or control systemic risk. Many requirements of the Advisers Act are irrelevant, or would be counterproductive, if applied to private investment companies. For example, Advisers Act restrictions on transactions with affiliates conducted as principal that require client consent on a transaction-by-transaction basis may work against investors' needs by impinging on a fund's ability to seize rapidly emerging opportunities, particularly in the cases of private equity and venture capital funds. Such funds routinely

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"census" data it has long said it needs; it also would have provided a basis for SEC enforcement action against any fund failing to meet the above standards. Had the SEC adopted this recommendation, the agency would have avoided the legal challenge to the rule it adopted later that year to change its interpretation of the term "client" under the Advisers Act in order to require hedge fund managers to register. See *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

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

conduct transactions as principal or as a co-investor alongside affiliated funds, and transaction-by-transaction consents from large numbers of private fund investors are, as a practical matter, not possible to collect.

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

Moreover, the Advisers Act is generally silent on methods for winding down an investment fund or client account, an area which the law should address in some detail for large

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[19] These instruments are privately-issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, as well as shares of mutual funds, which, under current law, can simply be titled in the name of the private investment fund care of the manager, and the evidence of ownership held in a file drawer at the manager of the private investment fund. The issuers of those assets are permitted to accept instructions from the manager to transfer cash or other value to the manager. This gaping hole in current Advisers Act custody requirements can allow SEC-registered advisers easily to abscond with money or other assets and falsify documentation of ownership of certain categories of assets, and makes it difficult for auditors, investors and counterparties to verify the financial condition of advisory accounts and private investment funds. Requiring independence between the function of managing a private investment fund and controlling its assets, by requiring that *all assets* be titled in the name of a custodian bank or broker-dealer for the benefit of the private fund and requiring *all cash flows* to move through the independent custodian, would be an important control. Similarly, requiring an independent check on the records of ownership of the interests in the private investment fund, as well as imposing standards for the qualification of private investment fund auditors ─ neither of which currently is required by the Advisers Act ─ would also greatly reduce opportunities for mischief.

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

private investment companies. In sum, the Advisers Act, which was adopted in largely its current form in 1940, is not well suited to today's investment structures, strategies, and qualified investors' needs.

Neither is the Investment Company Act suited for regulation of private funds. As an example, requirements for boards of directors set by the Investment Company Act are designed to protect the large numbers of retail investors in mutual funds, and are a poor fit for vehicles that are offered only to select groups of high net worth and institutional investors. Similarly, the Investment Company Act generally provides for either daily liquidity (mutual funds for which investors can redeem shares every business day), or no liquidity (closed-end funds for which investors can rarely be redeemed out), while private investment funds are able to adopt a flexible range of redemption dates to address the liquidity of the assets in which the particular fund invests.

Scope of S. 1276

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

The legislation further amends existing section 211 of the Advisers Act to enhance the SEC's authority to adopt different sets of rules to address different types of advisers. Under this authority, the SEC could, for example, write a set of rules under the Advisers Act applicable only to advisers to private funds and tailored for those advisers. The bill, therefore, offers a creative and flexible approach to regulation of private investment fund managers and oversight of the funds themselves.

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

We therefore recommend that Congress consider developing a Private Investment Company Act, which would contain targeted controls and safeguards needed for oversight of private funds, while preserving their operational flexibility. More detailed requirements could be considered for large private investment companies (or families of private investment companies) in order to address the greater potential for systemic risk posed by such funds, depending upon their use of leverage and their trading strategies. If you choose not to develop a separate act for private funds and use the approach of S. 1276 regulating private investment funds under the Advisers Act, we suggest that the legislation further direct the SEC to use its authority under Section 211 and tailor the requirements of the Advisers Act to impose appropriate requirements on private investment funds. We believe the legislation should specify those requirements.

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

Consideration of a Private Investment Company Act

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

- Registration Requirements / SEC Examination and Inspection Authority.

As stated above, private funds (or their advisers) should be required to register with the SEC. Registration — whether under the Advisers Act or under a new Private Investment Company Act — should entail requirements for the filing of basic census data in an on-line publicly available form. Registration will bring with it the ability of the SEC to conduct

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

examinations and bring administrative proceedings against registered advisers, funds, and their personnel. The SEC also will have the ability to bring civil enforcement actions and to levy fines and penalties for violations.

- Prevention of Theft, Ponzi Schemes, and Fraud.

Any new private fund legislation should include provisions to reduce the risks of Ponzi schemes and theft by requiring money managers to keep client assets at a qualified custodian, and by requiring investment funds to be audited by independent public accounting firms that are overseen by the PCAOB.[22] Custody requirements should be extended to all investments held by covered funds. Fund assets should be held in the custody of a bank, registered securities broker-dealer, or (for futures contracts), a futures commission merchant. While the SEC has adopted custody rules for registered advisers pursuant to its antifraud authority under the Advisers Act (and recently proposed amendments to those rules), we believe Congress should provide specific statutory direction to the SEC to adopt enhanced custody requirements for all advisers.

- Transparency for Investors.

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

- Reduction of Risks Through Transparency for Counterparties and Lenders.

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

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

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

[24] *See* n. 15 *supra*.

- Implementation of Anti-Money Laundering Measures.

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

- Special Requirements for Large Private Investment Funds.

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

V. Conclusion

Private investment companies have operated remarkably well in the absence of direct government oversight and subject to the due diligence of large and sophisticated investors. CPIC nonetheless supports the call for enhanced oversight, with the SEC as the primary functional regulator. But, simply imposing new regulation without properly tailoring it to address the relevant risks would add to the burdens of hard-working, but already overstretched agency staffs. Moreover, simply requiring registration under the Advisers Act or Investment Company Act could degrade investor due diligence by causing undue reliance upon SEC regulation under statutes that are insufficiently robust to address the unique characteristics of private funds. We believe that the twin goals of improved investor protection and enhanced systemic oversight could be better achieved with a stand-alone statute, tailored for private investment funds. If this

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

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

Subcommittee determines, however, to bring private funds under SEC oversight by requiring fund managers to register under the Advisers Act, we believe that any such legislation should include the key provisions discussed above.

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