Written Statement
Prepared For: U.S. Senate Banking
Subcommittee on Securities, Insurance and Investment
Re: Regulating Hedge Funds and Other Private Investment Pools

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Chairman Reed and members of the U.S. Senate Banking Subcommittee on Securities, Insurance and Investment, it is an honor and pleasure to provide this statement on behalf of the California Public Employees' Retirement System (CalPERS). Our mission is to advance the financial and health security for over 1.6 million public employees, retirees, and their families. CalPERS is the largest public pension system in the United States with a total fund market value of approximately $180 billion and annual payout obligations of over $10 billion to California pensioners.

Acting as fiduciaries first and foremost, the goal of the CalPERS investment program is to achieve the highest possible long-term, sustainable, risk-adjusted returns. To discharge that responsibility, we are inherently long-term investors in the capital markets, providing patient capital with a decades-long investment time horizon. Because of the sheer size of our fund and the need to diversify to provide sound investment returns, we are broadly invested throughout the capital markets in most asset class investment strategies including hedge funds and private equity funds.

We are vitally interested in the quality of regulation of financial services since effective investor protection is essential to creating and maintaining the trust necessary for investors to put their capital to work.

We applaud the Committee's leadership in holding this hearing to address options for regulating hedge funds and other private pools of capital. You have asked about the benefits of investing in these vehicles, the risks they pose to financial markets and the broader economy, how market participants and regulators can reduce these risks, without unduly limiting their benefits and what legislative changes are needed to assure that regulators have the tools they need to prevent fraud and reduce risks posed to the financial system.

1. **What benefits do private pools of capital – including hedge funds, private equity funds and venture capital funds – provide to financial markets, investors, and the broader economy? In particular, what benefits are not available through other financial structures?**

As the nation's largest public pension fund, CalPERS investments span domestic and international markets. The CalPERS Board of Administration has investment authority and sole fiduciary responsibility for the management of the System's assets. Our goal is to efficiently and effectively manage investments to achieve the highest possible return at an acceptable level of risk. In doing so, CalPERS has generated strong long-term returns. The CalPERS investment portfolio is diversified into several asset classes, so that over the long run any weaknesses in one area can be offset by gains in another. The CalPERS Board follows a strategic asset allocation policy that targets the percentage of funds to be invested across a broad array of asset classes and strategies, such as U.S. equity, international developed and emerging equity, fixed income securities including U.S. Treasury bonds, corporate bonds, mortgages, sovereign bonds, and high yield bonds, private equity, venture capital, real estate, hedge funds, and infrastructure.

Our target rate of return over the long term is 7.75 percent. The return enhancement attributes of private equity and the risk management characteristics of hedge funds make them indispensable elements of our investment program. CalPERS invests in private equity and hedge fund investment structures with the objective of diversifying its investment portfolio, managing risk, and adding value to the total fund. For example, private equity is an important asset class for CalPERS and other public pension funds because top-performing private equity funds consistently outperform other classes of investments, invest for the long term, and align their interests and incentives with those of their investors. Part of the above market return expected by private equity investors is compensation for the risk of holding illiquid securities. Public pension funds, by virtue of their long investment horizon are ideally suited to invest in private equity vehicles. The value of patient capital invested for the long term and not obsessed with short term performance is important to the health of the national economy.

Important benefits to CalPERS provided by investing in private equity and hedge funds include effective risk management and investment value creation through allowance for the diversification of our portfolio across a broad array of asset classes. We have been investing in private equity since 1990 and in hedge funds since 2002. Today, we have approximately $20 billion invested in private equity strategies and $6 billion invested in hedge fund investment strategies that combined represent just over 14% of CalPERS' total asset allocation. The 5 year hedge fund program annualized return is +3.89% versus +1.32% for all of Global Equity giving value added of 2.57% annually over the same period after expenses. As of March 31, 2009, the private equity portfolio at CalPERS has outperformed the public stock market index by over 1,000 basis points over a 10 year period.

This performance translates into substantial value added to the pension fund over a sustained time period. It makes realization of our target rate of return feasible. The consequences to our beneficiaries, their government employers and taxpayers of our not meeting this objective are substantial and real: lower wages, higher contribution rates and higher taxes. Can these performance benefits be delivered through other investment products? No. Sure, investors can boost returns from investing in publicly listed equities by borrowing to enhance returns, but that does not necessarily bring with it the long term focus of a partnership with an expected duration of 10 to 12 years. Some hedge fund returns can be duplicated with lower cost replication strategies, but, by definition, they only work for existing strategies, not the innovations that competitive markets constantly call forth.

In summary, hedge funds, private equity and other pools of private capital provide:

- Useful components of a diversified investment portfolio to enhance returns and add effective risk management tools.
- The ability to bring together like minded investors that have been committing long term capital to a number of investment areas.

- More flexibility to invest in accordance with opportunities in contrast to being limited to a particular category or "style."
- Benefits to the larger financial system including innovation, gains in growth and employment and the provision of capital for economic and technological advancement.

2. What risks do private pools of capital pose to financial markets and the broader economy?

The fundamental risk posed by private pools of capital is that they can choose to operate outside the regulatory structure of the United States. When these entities operate in the shadows of the financial system, regulatory authorities lack basic information about exposures, leverage ratios, counterparty risks and other information necessary to assure that overall risk levels in the financial system are reasonable. Moreover, without the disclosure, reporting and licensing requirements that accompany registration, investors may be deprived of the timely and accurate information they need to ascertain the suitability of an investment fund given their financial objectives and risk tolerance.

Clearly, the buildup of massively leveraged positions was enabled by the absence of any effective regulatory oversight. Combined with misaligned compensation practices that, among other things, encouraged excessive risk taking by rewarding short term success without penalty for subsequent losses, the result was an unprecedented degree of risk in the system. The harm that has ensued as overleveraged investors have had to unwind their positions extends far beyond them and their investors, to other market participants and ultimately to the national economy as a whole.

3. What approaches by market participants and regulators can best reduce these risks, without unduly limiting the benefits of such funds?

Policy makers, investors, regulators and the public need to accept that risk is inevitable and necessary; return without risk is like love without heartache—they go together. If risk cannot be avoided then it has to be managed.

One of the powerful lessons of the crash for us was the limited value of many quantitative risk management tools. So an obvious imperative for us is to improve our quantitative and qualitative comprehension of the risks in our portfolio. In addition to better risk management, investors can improve the depth and detail of their due diligence, adhere scrupulously to best practices in decision making, and make timely disclosures of their investment policies, holdings and performance.

Regulators need new tools and authority to deal effectively with the gaps exposed by the crash. But not all of the regulatory shortcomings we see so clearly now are the product of gaps and omissions. Regulators also failed to use the authority they possessed to protect investors and assure the integrity of markets, exchanges and investment providers. Enforcement is not the only tool of effective regulatory systems, but its absence can dangerously weaken the credibility of those systems. Regulatory agencies need resources, support and leadership to make the most of the authority granted to them so they can fulfill their mission.

Institutional investors also need the flexibility to invest, consistent with their fiduciary responsibilities, in an unconstrained investment opportunity set. This is critical to enable public pension funds to meet our obligations. Limitations on the universe of available investments will potentially reduce our ability to generate the needed returns and may increase the risk of the plan.

4. What possible legislative changes are needed to ensure that activities of private pools of capital are sufficiently transparent, and that regulators have the tools they need to prevent fraud and reduce risks posed to the financial system?

Today's hearing coincides with the release of a report by the Investors' Working Group on U.S. Financial Regulatory Reform: The Investors' Perspective. I was a member of the group which was formed by the Council of Institutional Investors and the CFA Institute Centre for Financial Market Integrity. The IWG report focuses on four major areas that the credit crisis has revealed to be fundamentally flawed:

- Strengthening and reinvigorating existing federal agencies responsible for policing financial institutions and markets and protecting investors and consumers.
- Filling the gaps in the regulatory architecture and in authority over certain investment firms, institutions and products.
- Improving corporate governance at U.S. financial companies.
- Designating a systemic risk regulator, with appropriate scope and powers.

A number of the recommendations of the IWG are relevant to the issues posed by private pools of capital. These include:

A. Strengthening Existing Federal Regulators

- Congress and the Administration should nurture and protect regulators' commitment to fully exercising their authority.
- Regulators should have enhanced independence through stable, long-term funding that meets their needs.
- Regulators should acquire deeper knowledge and expertise.

B. Closing the Gaps for Products, Players and Gatekeepers

OTC Derivatives

- Standardized derivatives should trade on regulated exchanges and clear centrally.
- OTC trading in derivatives should be strictly limited and subject to robust federal regulation.
- The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should improve accounting for derivatives.
- The SEC and the CFTC should have primary regulatory responsibility for derivatives trading.

- The United States should lead a global effort to strengthen and harmonize derivatives regulation.

Securitized Products

- New accounting standards for off-balance sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted.
- Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance sheet asset-backed securities.
- The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products.
- Asset-backed securities sponsors should be required to retain a meaningful residual interest in their securitized products.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

- All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight.
- Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction.
- Investment managers should have to make regular disclosures to regulators on a real-time basis, and to their investors and the market on a delayed basis.

- Investment advisers and brokers who provide investment advice to customers should adhere to fiduciary standards of care and loyalty. Their compensation practices should be reformed, and their disclosures should be improved.
- Institutional investors—including pension funds, hedge funds and private equity firms—should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance.

Nonbank Financial Institutions

- Congress should give regulators resolution authority, analogous to the FDIC's authority for failed banks, to wind down or restructure troubled, systemically significant nonbanks.

Mortgage Originators

- Congress should create a new agency to regulate consumer financial products, including mortgages.
- Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements.
- Mortgage regulators should develop suitability standards and require lenders to comply with them.
- Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines.

C. Corporate Governance

- In uncontested elections, directors should be elected by a majority of votes cast.
- Shareowners should have the right to place director nominees on the company's proxy.
- Boards of directors should be encouraged to separate the role of chair and CEO, or explain why they have adopted another method to assure independent leadership of the board.
- Exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management.
- Companies should give shareowners an annual, advisory vote on executive compensation.
- Federal clawback provisions on unearned executive pay should be strengthened.

D. Systemic Risk Oversight Board

- Congress should create an independent governmental Systemic Risk Oversight Board.
- The board's budget should ensure its independence from the firms it examines.
- All board members should be full-time and independent of government agencies and financial institutions.
- The board should have a dedicated, highly skilled staff.
- The board should have the authority to gather all information it deems relevant to systemic risk.

- The board should report to regulators any findings that require prompt action to relieve systemic pressures**,** and should make periodic reports to Congress and the public on the status of systemic risks.
- The board should strive to offer regulators unbiased, substantive recommendations on appropriate action.
- Regulators should have wide latitude to implement the oversight board's recommendations on a "comply or explain" basis.

In closing, we appreciate your consideration of CalPERS' perspective as a large public plan, institutional investor, and fiduciary to the financial interests of hard working pensioners and their families. Independent robust regulatory and enforcement authority over hedge funds and other unregulated investment pools that emphasizes transparency and accountability is vitally important to CalPERS as a long-term participant in the capital markets. We encourage you to move forward with care and skill to bring about comprehensive financial regulatory reform.

Thank you.