TESTIMONY OF JAMES CHANOS
PRESIDENT
KYNIKOS ASSOCIATES, LP

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

HEARING ON REGULATION OF THE HEDGE FUND INDUSTRY

JULY 15, 2004

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee. My name is James Chanos and I am the President of Kynikos Associates, a New York private investment management company that I founded in 1985.[1] I am honored to have the opportunity to participate in today's hearing on proposed regulation of the hedge fund industry. I would like to commend the Chairman and this Committee for undertaking a thorough review of all of the issues surrounding any new regulation of the hedge fund industry.

On behalf of our clients, Kynikos Associates manages a portfolio of securities we consider to be overvalued. The portfolio is designed to profit if the securities it has sold short fall in value. Kynikos Associates selects portfolio securities by conducting a rigorous financial analysis and focusing on securities issued by companies that appear to have an unsustainable or operationally flawed business plan, and/or appear to have materially overstated earnings and/or engaged in outright fraud. In choosing securities for its portfolios, Kynikos Associates also relies on the many years of experience in the equity markets that our team has accumulated.

While the term "hedge fund" originally was meant to describe a private investment company that is market-neutral, Kynikos Associates falls under a definition used today that encompasses almost any form of private investment fund that is not registered under the Investment Company Act of 1940.[2]

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

[2] For a more lengthy discussion of the definition of "hedge fund" see, for example *Implications of the Growth of Hedge Funds,* Staff Report to the United States Securities and Exchange Commission ("SEC Staff Report"), September, 2003, p.3; see also, *White Paper on Registration of Hedge Fund Advisors under the Investment Advisors Act of 1940,* Managed Funds Association, July 7, 2003; p.4-5 ("MFA White Paper")

No longer a "cottage" industry, the hedge fund industry includes an estimated 6,000 funds with assets under management of approximately $800 billion – and growing. This growth, and the importance of hedge funds to investors and to the capital markets more broadly, has focused debate on the adequacy of the existing regulatory framework governing hedge funds.

There is little question that hedge funds play a vitally important role in the U.S. capital markets. That role has been acknowledged by Federal Reserve Board Chairman Alan Greenspan, the President's Working Group on Financial Markets, the Chairman of the Commodity Futures Trading Commission, and most recently, by the Securities and Exchange Commission itself.

With that important role comes a responsibility on the part of the hedge fund industry to the legitimate public policy needs of the Federal Government. While any new regulation should be considered cautiously and carefully, we, in the industry, have a responsibility not to simply reject the idea of regulation outright. Instead, we should consider the basis upon which the government, or more accurately, the Commission, is proposing new regulation.

There are two opposite positions in the debate on hedge fund regulation, and, so far, both sides have talked past each other more than to each other. At one end of the spectrum are those who maintain that any government scrutiny is unwarranted and undeserving of consideration – a position that does not accurately reflect the economic influence of the hedge fund industry. At the other end are those who argue that hedge funds and their advisers should be subject to the full panoply of Investment Company Act and Investment Advisers Act regulation. This position ignores the unique characteristics of hedge funds and their investors and would place unnecessary burdens on the industry, undermining the benefits hedge funds provide to the capital markets. It also would divert the resources of the SEC from the inspection of registrants who more directly impact retail investors.[3]

There is a middle ground. Today, I would like to offer a framework that falls between these two positions and which is designed to address the important public policy goals articulated by the SEC. Our proposal seeks to achieve these goals in a simpler and

---

[3]See, for example, the concerns expressed by the U.S. Senate Committee on Banking, Housing, and Urban Affairs on passage of what later became the National Securities Markets Improvement Act of 1996: "The Committee is concerned about the lack of adequate oversight of the growing number of investment advisers and the impact inadequate regulation may have on investors and American consumers. This is particularly troublesome since many investment advisers hold themselves out to the public as `REGISTERED WITH THE SEC,' a statement that may give investors a false sense of confidence--particularly if the investment adviser has never actually been inspected by the SEC and is in little danger of any imminent inspection." Senate Report 104-293, accompanying passage of S.1815, "The Securities Investment Promotion Act of 1996," (June 26, 1996.)

less burdensome manner than envisioned under the SEC proposal, which would require registration of most hedge fund managers.

While the Commission has proposed registration and regulation of hedge fund managers under the Investment Advisers Act, we suggest that the current exemption under Section 203(b)(3) of the Investment Advisers Act for advisers with less than 15 clients be retained, but that the SEC, by rule, impose a series of conditions designed to obtain the information on hedge funds it needs and which will help protect investors from potential abuse.

We believe our suggestion, first made at the SEC's Roundtable on Hedge Funds in May of 2003, will reduce the risk of undue reliance by investors on SEC oversight, conserve important SEC resources, and reduce the risk that registration will grow, over time, into a creaky and burdensome form of regulation that robs the capital markets of the innovations, insights, liquidity and efficiencies that the hedge fund industry currently brings.

The 2003 SEC Staff Report ("SEC Report") described the need for the SEC to "collect basic and meaningful information about the activities of hedge fund advisers and hedge funds, which are becoming increasingly influential participants in the U.S. financial markets."[4] We agree that the SEC should have this information. All hedge fund managers that are not otherwise registered with the SEC or CFTC should provide the SEC, on an initial basis and periodically thereafter, certain basic information to enable the SEC to understand who they are, where they are, who runs them, what they do, and the amount of assets under management.

The SEC Report also stated that the SEC should "require hedge fund advisers to disclose information about issues important to investors, such as conflicts arising from side-by-side management of hedge funds and other client accounts and hedge fund advisers' relationships with prime brokers."[5] We fully support such disclosures to investors – and more, including disclosure of financial arrangements with all interested parties, and disclosure of investment allocation policies and valuation standards.

Further, the SEC Report recommended that the minimum investment requirement for direct investments in certain hedge funds be raised.[6] If, in the future, the SEC decides to move forward with this recommendation, we would support it as well. Hedge funds are a unique investment vehicle. They never were intended as an alternative to other forms of more regulated investment vehicles for investors who cannot afford to bear the risk.

The SEC yesterday proposed that most hedge fund managers must register with the SEC as investment advisers in order to subject them to regular SEC inspections and

---

[4] SEC Staff Report at xi-xii.
[5] Id. at xii.
[6] Id.

examinations.[7] While we strongly support the SEC's objectives, we respectfully disagree with its proposed approach. We challenge the notion that the SEC, even with an expanded examination staff, could effectively inspect and examine the thousands of additional investment advisers that would result from requiring registration of hedge fund managers, and at the same time fulfill the SEC's responsibilities to examine the many thousands of registered advisers for which it now has responsibility. We propose what we believe is a better means to achieving the SEC's goals. In brief:

Instead of using investment adviser registration as a means to gain regulatory control over hedge fund managers, we recommend that the SEC, by rule, make the exemption enjoyed by hedge fund managers under Section 203(b)(3) of the Investment Advisers Act of 1940[8] and SEC rules 203(b)(3)-1 and 222-2 under the Act (17 C.F.R. §§ 275.203(b)(3)-1 & 275.222-2)[9] contingent upon written receipt by the SEC of basic information about the fund, its operations and its managers, including:

- Name of the Fund, address and telephone number(s);
- Name of Chief Compliance Officer and telephone number of said person; and,
- Total Assets under management at the end of the most recent calendar month preceding notice.

Further, the manager of the fund would be required to provide a certification of the following:

- Minimum investor qualifications at or above current accredited investor levels (to be established by the SEC; to address the retailization issue);
- Minimum threshold of assets under management (to be established by the SEC);
- Custody of private investment fund assets in an identified broker-dealer or bank and compliance with SEC interpretations on constructive custody (to address misappropriation of assets, fraud and transparency issues);
- Annual audit and delivery of financial statements to investors, with the audit conducted by an accounting firm that would be independent from the hedge fund manager under the SEC's auditor independence rules (to address fraud and transparency issues);
- Quarterly unaudited financial reports to investors (to address transparency issue);

---

[7] Agenda for SEC Open Meeting, July 14, 2004: Registration Under the Investment Advisors Act of Certain Hedge Fund Advisors.

[8] Section 203(b)(3) excepts from the registration requirements of the Act advisers that have had fewer than 15 clients during the preceding 12 months and do not hold themselves out to the general public as investment advisers or serve as an investment adviser to a registered investment company.

[9] SEC Rule 203(b)(3)-1 under the Act defines "client" of an investment adviser and provides that an adviser may count a legal organization (which would include a hedge fund) as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual investment objectives of its owners.

- Clear disclosure of financial arrangements with interested parties such as investment manager, custodian, prime broker, portfolio brokers, placement agents and other service providers, both in terms of description and with some periodic historic quantification of amounts paid to each category and benefits received (to address conflict-of-interest, transparency and fraud issues);
- Clear disclosure of investment allocation policies (to address conflict-of-interest, transparency and fraud issues);
- Adoption of written supervisory procedures; and
- Clear, objective and transparent valuation standards, that are clearly disclosed, not stale, and subject to audit, for use in calculating current unit values for investor reports, admissions and withdrawals and calculations of performance and volatility information (to address valuation, transparency and fraud issues).

We emphasize the importance of this last element, which we believe is critical to addressing the concerns raised by Chairman Donaldson concerning hedge fund mis-valuations – concerns that we share. Among the required certifications in our proposal, a hedge fund manager would be required to certify to its valuation standards, which should be clear, objective, and transparent, and clearly disclosed to investors and subject to audit by the fund's independent auditors.

As part of its rulemaking, we believe the SEC should provide that no certification would be needed if the fund manager or fund is currently registered with the Commodity Futures Trading Commission under the Commodity Exchange Act as either a Commodity Pool Operator or a Commodity Trading Adviser. Within 180 days from the promulgation of final rules to this effect, the SEC and CFTC should sign a memorandum of understanding to allow the sharing of information between the agencies on hedge funds.

For consistency with the current Federal/State division of authority adopted under the National Securities Markets Improvement Act of 1996, hedge fund managers who have $25 million or more under management who choose this qualified exemption should not be subject to state adviser registration.

Because the above proposal does not contemplate registration under the Investment Advisers Act, it should be made clear that a hedge fund manager's election of the new contingent exemption would *not* constitute registration under the Act for the purposes of ERISA. Thus, pension fund assets would continue to be managed primarily by registered investment advisers.

Lastly, we believe that mandatory registration may create a false sense of security amongst investors that could cause them to lessen their own due diligence in favor of SEC regulation. Our proposal avoids this unintended consequence.

Too little regulation or too much regulation of hedge funds can be damaging to the capital markets and investors. Striking the right balance is the challenge we all face. These suggested conditions to exemption impose significant new disclosure and investor protection requirements that should address the major concerns identified in the SEC proposed rulemaking.

Chairman Shelby, these hearings can play the pivotal role in this debate. During consideration of the Investment Advisors Act in 1940, Banking Committee Chairman Robert Wagner, noted that an impasse had developed between an unregulated industry – the investment advisors – and the Commission. He stated, however, that "at the conclusion of the hearings...representatives of the investment advisor organizations and the Securities and Exchange Commission, at the suggestion of the subcommittee, conferred with a view to drafting proposals which would have the support of the [industry] and the Commission..."[10] Sixty-four years ago, the Commission and the industry met that challenge from Congress. I believe that we can achieve the same today.

[10] Senator Robert Wagner, Congressional Record, p. 10076; August 8, 1940.