**Investor Protection and the Regulation of Hedge Funds Advisers**

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Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

Thank you for inviting me to testify today to discuss the Commission's actions yesterday to propose a rule that would require hedge fund advisers to register with the Commission. I appreciate the opportunity to discuss the proposed rule and to share with you my own thoughts as to why this is such a critical initiative. I must emphasize that these are my personal views and not those of the Commission.

The proposed rule would implement the principal recommendation of the Commission's Division of Investment Management in its September 2003 report "Implications of the Growth of Hedge Funds," which discussed the need to address violations of the federal securities laws, including fraudulent activity, by hedge funds in a more proactive way than the SEC has done in the past.

After carefully reviewing more than two years of comprehensive and thorough analysis – including meetings with a variety of experts, consultants, academics and observers of the industry – and two days of testimony at an SEC-sponsored Hedge Fund Roundtable last year, there are several primary reasons why I am convinced that it would be irresponsible for the Commission not to consider appropriate regulatory oversight of the hedge fund industry.

First: The hedge fund industry is attracting a broader universe of investors and is growing at an extremely rapid pace. It is estimated that assets under management by U.S. hedge funds are approaching $1 trillion dollars.

Second: Because of their use of leverage, and rapid trading strategies, hedge funds can have a disproportionate impact on investors – large and small – in our markets and on the markets themselves relative to that almost $1 trillion dollars. In addition, a recent *BusinessWeek* article notes that at times a single hedge fund manager has been responsible for an average of 5 percent of the daily trading volume on the New York Stock Exchange.

Third: The SEC currently oversees and regulates mutual funds, broker dealers and many other investment advisers. The ability to oversee the increasing number of hedge fund advisers more effectively, through the registration process, would give the agency a much needed and more complete picture of the key players in our securities markets.

Fourth: As the Commission moves to become a more proactive agency – to ferret out where the risks lie – we must not only be in a position to know who the investment advisers of these funds are, but also whether those advisers are adhering to the federal securities laws. In so doing, through sophisticated risk analysis and oversight, we would be better able to identify violations of our securities laws and to anticipate areas of potential problems.

As you know, the SEC has the primary regulatory responsibility for protecting investors and the integrity of our securities markets. In an increasingly complex environment, we simply cannot afford to ignore this vital sector of our markets.

**Staff Study**

In preparing the proposed rule for the Commission's consideration, the Division of Investment Management reviewed key aspects of hedge fund operations – the structure and marketing of these vehicles, investment strategies, impact on other market participants, the current regulatory framework, and whether the regulatory framework should be modified and enhanced. As the capstone to the staff study of hedge funds, the staff issued a lengthy report on the implications of the growth of hedge funds – growth that has increased fifteenfold since 1993. Just last week, the *Wall Street Journal* reported that those who track the industry estimate that today there are close to 8,000 hedge funds with over $850 billion of assets under management. That same *Journal* article noted that last year alone, over $72 billion poured into hedge funds.

## **Investors' Increasing Exposure to Hedge Funds**

The Commission's Division of Investment Management has seen a boom in the development of a relatively new product, the fund of hedge funds, making hedge funds more broadly available to investors. A fund of hedge funds is a registered investment company that invests all, or substantially all, of its assets in underlying hedge funds. This product offers a means of increased availability of hedge funds to public investors. In January of 2002, the first fund of hedge funds became eligible to sell its securities to the public. Today – just over 2 years later – there are 40 registered funds of hedge funds that publicly offer or plan to offer their securities.

Currently, these funds have self-imposed minimum investment requirements of at least $25,000 – not the minimums of $1 million, $2 million or more that are so often associated with hedge funds – while also limiting their investors to accredited investors (that is, investors with an income for the last two years of $200,000 or net worth of $1 million). But there is currently no federal requirement for a fund of hedge funds to establish a minimum investment or for limiting eligible investors and, based on recent requests and inquiries to the staff, it is clear that funds will seek to lower these requirements, thus making these types of funds available to an even larger number of investors with less capital. Funds of hedge funds raise special concerns because they permit investors to invest indirectly in the very hedge funds in which they likely may not invest directly.

Perhaps even more significant is the number of investors who have exposure to hedge funds through public and private pension funds, as well as universities, endowments, foundations and other charitable organizations that have increased or accelerated their allocations to hedge funds. By best industry estimates, approximately 20 percent of corporate and public pension plans in the United States were using hedge funds in 2002, up from

15 percent in 2001. Other data indicate that pensions' investments in hedge funds have increased from $13 billion in 1997 to more than $72 billion so far in 2004, an increase of more than 450 percent.

From the smallest to the largest, institutions are deciding to invest in or are increasing their investments in hedge funds. For example: Alabama's Auburn University plans to hire funds of hedge funds to fill its 20 percent allocation to absolute return strategies; the City of Philadelphia Board of Pension and Retirement System has put 5 percent of its assets into hedge funds for the first time; and the Commonwealth of Virginia's Retirement System plans to invest $1 billion, or 3 percent of its assets, in hedge funds. And the list goes on and on.

One would think that, because these institutions are investing so heavily, they are provided or can easily attain the information they need to invest wisely. At the Commission's Hedge Fund Roundtable, however, the chief investment officer for the nation's largest pension plan – CalPERS – noted that even he could not get all of the information that he desired from hedge fund managers. Registration of hedge fund advisers, however, will provide investors basic, fundamental information regarding their hedge fund advisers, including information about how those hedge fund advisers manage conflicts of interest.

It is an inescapable fact that today hedge funds are being purchased by intermediaries on behalf of millions of beneficiaries. These individuals and institutions are dependent on the knowledge and information provided by the advisers of the hedge funds in which they invest. We must explore, through our rulemaking process, the registration of these hedge fund advisers and how to do so in the least intrusive way.

**<u>Impact on the "Other Side of the Transaction"</u>**

The Commission and staff have been concerned about hedge funds for quite some time, due to the malfeasance we have seen by some hedge fund advisers. This, in part, led to the staff's study. However, recent events have crystallized our concerns. Our recent enforcement investigations into the role that hedge funds have played in the late trading and market timing abuse scandals have only served to highlight the significant role that hedge funds played in the scandals and underscore the need for more scrutiny of this industry. We have recently sanctioned persons charged with late trading of mutual fund shares on behalf of groups of hedge funds and against mutual fund advisers or principals for permitting market timing by hedge funds. Often, hedge funds entered into arrangements with mutual funds whereby they agreed to invest in other hedge funds or mutual funds managed by the adviser in exchange for permission to engage in market timing of mutual funds. Our staff estimates that these recent enforcement actions and investigations have included as many as 40 different hedge funds that may have engaged in inappropriate market timing or late trading, including hedge funds managed by Canary Investment Management, LLC. These frauds against mutual funds, of course, harmed the investors in those mutual funds – investors who, in many cases, were not the very wealthy. I refer to this as "investors on the other side of the transaction." Strikingly, none of the hedge funds identified to date as being involved in the late trading and market timing abuses were managed by advisers that were required to register with, or voluntarily registered with, the Commission.

## Growth in Hedge Fund Fraud

The involvement of hedge funds in the late trading and market timing abuses has deepened the staff's and my concern about hedge funds' impact on those with whom they transact business. As we have seen the rapid growth in the number of hedge funds and their assets under management, we also have seen a corresponding growth in hedge fund fraud. In the past five years, the Commission has brought 46 enforcement cases asserting that hedge fund investors have been defrauded of an estimated $1 billion by their advisers. The types of fraud we have seen include gross overstatement of performance by hedge fund advisers (at times when investors were actually losing money), payment of unnecessary and undisclosed commissions, and misappropriation of client assets by using parallel unregistered advisory firms and hedge funds. Approximately 80 percent of those cases involved hedge fund advisers that were not registered with the Commission. Another concern is improper valuation of hedge fund assets by hedge fund advisers. A recent study of hedge funds identified valuation problems as playing a primary or contributing role in 35 percent of hedge fund failures and fraud as the underlying cause for more than half of such failures.

I am not suggesting that hedge funds or their advisers engage disproportionately in fraudulent activities. The frauds we see in hedge funds generally are not unique to hedge funds. However, hedge funds present us with a unique challenge. Hedge funds usually employ a compensation structure whereby they are paid based on performance. This unique structure provides an incentive to the unscrupulous and the would-be unscrupulous adviser to perhaps engage in fraudulent activity. Because a large number of hedge fund advisers currently are not registered with us, the SEC is limited in its ability to detect fraud and other problems before they result in harm to investors or the securities markets. Registration of hedge fund advisers would substantially increase the SEC's ability to detect and prevent fraud in this area.

**The Commission's Responsibility**

As the only governmental agency that is charged with protecting U.S. investors under the federal securities laws, it is imperative that the Commission be proactive and have the means to detect and prevent emerging, but as of yet unforeseen, harms and abuses that could work against those newly exposed to hedge funds and those on the other side of transactions with hedge funds. I want to make clear that hedge funds can, and in certain cases do, play a vital role in our financial markets and I would reject any regulatory proposal that would in any way impede the legitimate operations of hedge funds. Hedge funds can contribute to market efficiency and liquidity; they can play an important role in allocating investment risks by serving as counterparties to investors who seek to hedge risks; and they can provide investors with greater diversification of risk by offering them exposure uncorrelated with market movements.

However, given the fast pace with which hedge funds are growing, given the increasing number of smaller investors with exposure to hedge funds, given the exposure of those that transact with hedge funds and given the important role hedge funds play in our markets, we simply must have more information and regulatory oversight over those who manage hedge funds.  Assets invested in hedge funds are too large and growing too fast for us not to take action.

While some critics maintain that hedge fund investors do not need the protection of the Commission, the SEC's mission is to protect <u>all investors, large and small</u>.   Rather than question whether hedge fund investors deserve the SEC's protection, it seems more appropriate to determine the most effective means of providing hedge fund investors with the SEC's protection.

As more and more baby boomers reach retirement age, the fact that an increasingly larger percentage of their retirement dollars are invested in hedge funds simply cannot be ignored.

## <u>Risk Assessment</u>

When I testified before you in April, I discussed the Commission's new risk assessment program.  This new program is designed to increase the Commission's ability to assess risks, and identify and map risks, focusing on early identification of new or resurgent forms of fraudulent, illegal, or questionable activities.  Through the leadership of our new Office of Risk

Assessment, together with the ongoing efforts throughout the SEC, we will be better able to identify and manage risk in all segments of our securities markets.

The Commission's risk assessment initiative is critical to the SEC's ability to effectively fulfill its oversight responsibilities by helping to ensure a process whereby the Commission has the information necessary to make better, more informed decisions and to proactively adjust operations and resources to address new challenges, whether we are talking about our current registrants such as mutual funds, broker-dealers and those investment advisers already registered with us, or any new registrants we may bring into our regulatory scheme such as hedge fund advisers. As part of this process, the staff is evaluating the examination program to see if it can be enhanced by tools adapted to the unique services that each of our registrants offers so that we can deploy our resources in the most effective way possible.

I believe that this should also be our goal when we consider how we would go about examining hedge fund advisers. For example, our examination staff could conduct mini sweeps of hedge fund advisers to garner critical information about hedge fund services. The information that we glean through this process could then be applied to our other inspection responsibilities.

Consequently, I have asked the staff to develop an enhanced risk-based approach to oversight and examination of our investment adviser registrants, including hedge fund advisers. Toward that end, we have formed a working group within the Commission, which is comprised of senior staff from different offices and divisions within the Commission, to explore how the Commission goes about overseeing investment adviser registrants, including hedge fund advisers.

Development and refinement of the Commission's approach to risk assessment regarding investment advisers is proceeding on a parallel track to the proposal to require registration of hedge fund advisers. One should not be a prerequisite to the other.

As I have said before – critics cannot have it both ways. They cannot demand that the Commission be proactive in detecting and preventing emerging, but as of yet unforeseen harms, while at the same time trying to circumvent our ability to obtain information that facilitates our identification of such harms.

**The SEC's Proposed Rule**

Recognizing the balance between fulfilling our responsibility to protect investors while at the same time protecting hedge funds' vital role in our financial markets, the Commission recommended a very moderate and reasonable action yesterday by proposing to require registration with the Commission of hedge fund advisers under the Investment Advisers Act of 1940. Registration under the Advisers Act will provide the Commission with important regulatory tools – such as the collection of basic data regarding hedge funds and an ability to conduct examinations of the hedge fund advisers' activities so we may better detect and prevent fraud – while at the same time imposing only minimal burdens on hedge fund advisers.

Registration with the Commission not only will encourage hedge fund advisers to better police themselves, but also should allow for better-informed hedge fund investors. Further, the mere "potential" of a Commission examination in many cases would have the desired effect of causing many advisers to be more attentive to fulfilling their fiduciary and other obligations under the federal securities laws. The prospect of a Commission examination helps to deter potential wrongdoers.

Adviser registration imposes few regulatory burdens on registrants, none of which should in any way impede the operation of a legitimate hedge fund. Unlike provisions in the Investment Company Act that apply to mutual funds, the provisions of the Investment Advisers Act do not require or prohibit any particular investment strategies, nor do they prohibit or limit specific investments. The Investment Advisers Act's most significant provisions – which require full and fair client disclosure and prohibit fraud – apply regardless of whether the adviser is registered.

No one in the hedge fund industry who was contacted during the course of the staff's study of hedge funds identified any significant impediments stemming from registration that would interfere with the legitimate operation of a hedge fund. In fact, many hedge fund advisers *voluntarily* register with the Commission in order to attract investment from clients, such as pension plans, that prefer or require registration. I cannot imagine that these advisers would voluntarily assume burdensome, inflexible or costly regulatory obligations.

Let me address the costs of registration, which are relatively low, and are today met by thousands of small advisory firms that have substantially less cash flow than many hedge fund advisers. The initial cost of registration is the fee associated with filing Part 1 of Form ADV electronically with the Commission and the preparation of Part II of Form ADV for delivery to clients. Filing fees range from $800 to $1,100 initially, with annual costs thereafter ranging from $400 to $550. Of course, there are costs associated with preparing the Form for filing, but these also should be low.

The principal ongoing cost is the development and maintenance of compliance policies and procedures, with which hedge fund advisers – whether or not registered – already need, in large measure, to comply under the Investment Advisers Act. In any event, on average per hedge fund adviser, we estimate the costs to establish this infrastructure to be approximately $20,000 in professional fees and $25,000 in internal costs, including staff time.

While the costs associated with registration are minimal, the benefits of registration would give the Commission the ability to conduct better oversight of hedge fund advisers. For example, the requirements to adopt compliance policies and procedures, to designate a compliance officer, and to maintain books and records will require hedge fund advisers to establish a culture of compliance and should heighten their sensitivity to existing fiduciary obligations. Again, thousands of our smaller investment adviser registrants, many of whom do not manage hedge funds, are able to adhere to these compliance requirements without excessive costs and burdens. The availability of basic information about these advisers through the disclosure on the Commission's Form ADV should make it much easier for investors to make informed judgments about hedge funds by giving investors access to information about the adviser's experience and disciplinary history that is currently either unavailable or available only by undertaking significant investigative burdens.

**Conclusion**

In conclusion, requiring hedge fund advisers to register with the Commission will allow the Commission to protect investors and our securities markets and improve compliance with the federal securities laws, while at the same time imposing minimal burdens and impediments on how hedge funds operate. The registration process is a very simple, basic step that will provide the Commission data as to the size of the hedge fund industry and how fast it is growing. The benefits of registration will be immediate and meaningful. Indeed, since the staff issued its report last September, there has been an increase in the number of hedge fund advisers who have voluntarily registered with us. And, with the information gathered we will be better able to target – through our risk assessment initiatives – our examination resources to deal with fraud and potential fraud before it occurs.

As the rulemaking process moves forward, the Commission will carefully consider the views put forth by the public. This input is critical to ensuring that the Commission strikes the correct balance with proposed regulations.

Thank you again for the opportunity to share my insights on the Commission's recent activities relating to hedge fund advisers. I would be happy to answer any questions that you may have.