



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED FOR 10:00 A.M., July 25, 2006
CONTACT Jennifer Zuccarelli, (202) 622-8657

Testimony of Randal K. Quarles, Under Secretary for Domestic Finance U.S. Department of the Treasury

Before the Senate Committee on Banking, Housing and Urban Affairs

Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, good morning, it is a pleasure to be here today. I would like to thank you for holding this hearing and allowing the Treasury Department to present its views. I am pleased to be here today to contribute to a discussion of a topic that is of critical importance to our financial markets, namely the regulation of hedge funds.

In May, before a subcommittee of this panel, I presented testimony regarding the role that hedge funds play; that is, what hedge funds do for and in our financial markets. As I said then, if government addresses the question of regulation of any financial institution or activity without a clear understanding of the place it plays in our financial system, we run the risk of imposing unnecessary, excessive, or inappropriate legislation.

As we consider the regulation of hedge funds, we should keep in mind that the role they fulfill in our financial markets is continuously evolving; and in recent years it has been evolving rapidly. Therefore, before I turn to the subject of today's hearing, I would like to reiterate some of the key points from the testimony I gave in May 2006, in which I discussed some of the characteristics of hedge funds and some of the potential benefits and risks that they can present.

Background

Despite the fact that hedge funds are today the subject of everyday discussion in the financial press and among policymakers, there is no universally accepted definition of a hedge fund. A recent report by the International Organization of Securities Commissions

(IOSCO) on the results of a survey of the regulatory approaches toward hedge funds of 20 IOSCO members revealed that none of the survey respondents had a formal definition of “hedge fund.” In the late ‘90s, the President’s Working Group on Financial Markets (PWG) defined a hedge fund as “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.” Though this was a useful working definition for the PWG’s purposes, it is limited in how widely it can be applied, in large part because it does not distinguish hedge funds from other forms of unregistered capital pools that are generally recognized to have distinctive features, such as private equity funds and venture capital funds. In my May testimony I suggested that there are a number of features that can help to distinguish hedge funds from other capital pools, including: legal structure; investment objective and strategy; compensation scheme; investor base and capital commitment; and disclosure.

As I testified in May, hedge funds have experienced dramatic growth, especially in recent years. They have grown from an estimated \$50 billion in assets in 1988 to about \$300 billion in 1998 to over \$1 trillion in assets today.¹ Current estimates suggest that there are about 9,000 hedge funds.

Hedge funds employ a variety of investment strategies that vary considerably depending on the goals and needs of the investors and the types of instruments in which the fund invests. Much, if not all, of this growth has been market driven, and, as a consequence, it has been subject to a significant amount of market discipline. As hedge funds have grown, their investor base has evolved, bringing increasing levels of professional analysis to the investor side of the relationship. Each new group of investors has imposed certain forms of discipline on hedge funds, resulting in the hedge fund market becoming much more “institutionalized” as it has developed. In addition, since the failure of Long Term Capital Management (LTCM) in 1998 hedge fund investors – and creditors – have recognized the need for more discipline regarding the use of leverage and collateral, and hedge fund investors now demand more transparency of their fund managers. Therefore, while the hedge fund market has grown dramatically in the past twenty years, there is at least some reason to believe this growth has been subject to reasonable private sector discipline.

Hedge funds clearly provide certain benefits to the financial markets. At the same time, they can also put stresses on it that need attention. In my May testimony, I discussed at length many of the benefits and potential risks that can arise from the activities of hedge funds. Hedge funds impart potential benefits both to the financial marketplace, in general, as well as to investors.

In the financial marketplace, hedge funds provide liquidity, price efficiency, and risk distribution, and contribute to the further global integration of markets. Because of the varying strategies employed by hedge funds, they are often the willing buyers or sellers that provide additional liquidity to financial markets. Hedge funds contribute even more significantly to marketplace liquidity in less traditional markets. Many hedge funds seek

¹ The data about the hedge fund industry are not precise. Therefore, many of the figures noting the size and growth of the industry are estimates and Treasury has not independently verified them.

to create returns by targeting price inefficiencies, including wide bid/ask spreads. While this activity certainly benefits the hedge funds that are profiting from the trades, it has the salutary effect of creating narrower spreads and more efficient markets. Hedge funds can help mitigate market-wide concentrations of risk by transferring and distributing market risk through their willingness to be counterparties in derivatives trades. Today, there is no question that hedge funds are among the dominant participants in the re-distribution of market risk. In their search for the next profit opportunity, hedge funds often lead the way to identifying new and emerging markets. These markets often provide opportunities that no longer exist in more mature marketplaces. This, in turn, leads to further globalization of our marketplace which provides more choice for investors and greater efficiency of markets globally.

Hedge funds can have a direct positive impact on the investing community. Speaking broadly, hedge funds can provide investors with opportunities for diversification, “alpha” or excess returns, and capital protection in down markets. Hedge funds provide investors with more choices of both instruments and investment strategies. More choices allow investors the ability to diversify their investment portfolios, which is a common goal of many investors. In contrast to conventional investment vehicles employing traditional “go-long” strategies, the flexibility in the hedge fund structure enables strategies that attempt to produce positive returns in both bull and bear markets; that is, providing opportunities for generating “alpha” or excess returns, even in thriving years, and for capital protection (or better) in declining markets. It is worth noting that as the hedge fund industry grows and becomes more mature and institutionalized, excess returns have become harder to find. In addition, a common technique employed by many hedge funds attempting to generate excess returns is employing leverage, which, of course, presents its own specific set of concerns.

While hedge funds can provide benefits to investors and the overall marketplace, they present some risk as well. There are risks that hedge funds’ aggregate employment of large amounts of leverage or over-concentration of certain positions could have negative consequences for the marketplace. Certain valuation risks also are present in the hedge fund industry. Other risks involve operational challenges associated with the over-the-counter (OTC) clearance and settlement systems. Many of these risks, however, are not unique to hedge funds.

Leverage refers to the use of repurchase agreements, short positions, derivative contracts, loans, margin, and other forms of credit extension to amplify returns. With increased leverage, of course, comes increased risk. As discussed by the PWG in its report after the LTCM failure, excessive leverage can greatly magnify negative effects of market conditions. Linked closely with the issue of leverage and the potential for impaired liquidity in a period of market stress is the issue of concentration of market positions or “crowded trades.” Sometimes referred to as “herding,” crowded trades can arise to the extent that hedge fund managers are inclined to pursue the same or similar investment strategies. If numerous market participants establish large positions on the same side of a trade, especially in combination with a high degree of leverage, this concentration can contribute to a liquidity crisis if market conditions compel traders simultaneously to seek

to unwind their positions. The risk, of course, is market disruption and illiquidity, possibly exacerbating the risk of a systemic financial market crisis.

As hedge funds become larger, their valuation policies and procedures become more important to the marketplace as a whole. Valuation is often dependent on complex proprietary models, but because of their proprietary nature, these models have not been subject to broad-based scrutiny and there is a concern that there could be unanticipated changes that might only present themselves in certain market conditions. Moreover, valuation concerns are exacerbated in the hedge fund industry because hedge fund adviser compensation is tied to period returns which, of course, requires periodic asset valuations. With respect to OTC settlement and clearance systems, hedge funds as a group do not pose a greater operational risk than any other group of market participants. However, operational risks can be posed by certain market conditions and certain technological conditions in certain *products*, particularly *new* products, where technological and legal infrastructures tend to lag product development and volume growth. These acute “growing pains” have developed most recently in the credit derivatives market across a wide spectrum of participants.

Thus, hedge funds, or any other group of participants, potentially could have a disruptive impact if there were concentrations of positions or attempted mass liquidation in illiquid markets. However, many of these issues and concerns have been or are actively being addressed – outside of a formal scheme of direct regulation of hedge funds – both by policymakers and by private sector groups.

In its report on LTCM, the PWG cautioned that problems can arise when financial institutions do not employ sufficient discipline in their credit practices with customers and counterparties. To this end, the PWG made several recommendations designed to help buttress the market-discipline approach to constraining leverage. Numerous public and private sector groups, such as Counterparty Risk Management Group II (also known as the Corrigan Group), also took up the cause of enhancing counterparty credit risk management, and many have continued to focus on emerging developments such as the growth of products containing embedded leverage. These efforts and others have had the positive effects that I alluded to earlier.

Valuations and correlations also can change rapidly in unexpected ways and these changes can have a ripple effect in the marketplace, especially if the instruments are concentrated and illiquid. In July 2005, the Corrigan Group issued a number of “guiding principles” and recommendations for all types of participants. It recommended that: 1) investment in risk management systems should continue, with full model testing and validation and independent verification; and 2) analytics should include stress testing, scenario analysis, and expert judgment, with special attention to the inputs and assumptions.

The Federal Reserve Bank of New York, Counterparty Risk Management Group II, Bank for International Settlements, International Swap and Derivatives Association, The Bond Market Association, and Depository Trust & Clearing Corporation all have made

recommendations or undertaken efforts to strengthen the technological and legal aspects of the settlement and clearance systems for all market participants. The International Monetary Fund has also raised issues generally related to market concentrations and illiquidity and the potential for systemic risk in its recent “Global Financial Stability Report,” and member countries and regulators continue to develop and coordinate policies and approaches to deal with these issues globally.

Treasury and the PWG can contribute significantly to these policy debates in the first instance by facilitating communication in the official sector and with industry participants and academics regarding credit risk management, concentration of risks, valuation techniques and models, and clearance and settlement systems. While the PWG continues to discuss these issues and formulate and coordinate actions and plans, we are encouraged by these positive developments noted above.

Regulation of Hedge Funds

The PWG’s position on direct regulation of hedge funds

In its 1999 report on LTCM, the PWG was mainly concerned about the systemic risks posed by hedge funds and other highly leveraged institutions. Specifically, the PWG was concerned that excessive and unconstrained leverage could, in an episode of unusual market stress, lead to a general breakdown in the functioning of the financial markets. Accordingly, the PWG made a series of recommendations designed to encourage hedge funds, hedge funds’ counterparties, and regulators to focus on enhancing market-wide practices for counterparty risk management. A number of the private sector initiatives I have already mentioned were initiated in direct response to the PWG’s recommendations.

One recommendation the PWG did not make, however, was for the direct regulation of hedge funds. The PWG stated that, “if further evidence emerges that indirect regulation of currently unregulated market participants is not working effectively to constrain leverage,” then direct regulation of hedge funds, among other measures, “could be given further consideration to address concerns about leverage.” Even with that caveat, the PWG took care to emphasize that it believed its recommendations “would best address concerns related to systemic risk without the potential attendant costs of direct regulation of hedge funds.” To date, the PWG has not observed evidence that “indirect” methods of constraining leverage are not working effectively.

SEC Hedge Fund Adviser Registration Rule

In late 2004, the Securities and Exchange Commission (SEC) issued a final rule that required hedge fund advisers to register with the Commission, mainly out of a perceived need to address increasing instances of hedge fund fraud and a concern that less sophisticated investors were becoming increasingly exposed to hedge fund investments, either directly or indirectly through their pension plans. The rule went into effect on February 1, 2006, prompting more than 1,100 previously unregistered hedge fund advisers to register with the SEC.

Neither Treasury nor the PWG ever took a formal position on the rule. We did work with the SEC, however, both bilaterally and through the PWG, to make sure we understood

the SEC's rationale for their rule, and what their goals and expectations were regarding its implementation. Although we did not formally comment on the SEC's proposed rule, we did ask the SEC to work with the Commodity Futures Trading Commission (CFTC) to avoid potential duplicative registration requirements for CFTC-registered commodity pool operators and commodity trading advisers.

This past June, the U.S. Court of Appeals for the D.C. Circuit ruled that the SEC's hedge fund adviser registration rule was arbitrary in the way it redefined the term "client" so as to bring hedge fund advisers under the registration requirements of the Investment Advisers Act, and the court therefore vacated the rule. SEC Chairman Cox, in his statement on the Court's decision, expressed a very pragmatic approach to dealing with this decision. He noted that the SEC will continue to work with the PWG as it reevaluates its approach to hedge fund activity and as the SEC considers alternative courses of action. We look forward to working with Chairman Cox and the SEC staff on these issues.

Conclusion

Thank you again for allowing the Treasury Department to participate this afternoon. As I have mentioned, the question of the regulation of hedge funds must be carefully considered in light of the important role they play in our financial markets.

It is for that reason that Treasury is examining in detail the issues I have discussed this morning, with a view to evaluating whether the growth of hedge funds – as well as other phenomena such as derivatives and additional alternative investments and investment pools – hold the potential to change the overall level or nature of risk in our markets and financial institutions. This examination will involve bringing key government officials together to review their approaches to these financial market issues. The first such meeting was held last week, chaired by Assistant Secretary of the Treasury Emil Henry, and will be followed by further discussions in the future. We are also beginning a broad outreach to the financial community to help us examine these questions. As part of this comprehensive review chaired by the Treasury, we will be working with the SEC – both bilaterally and through the PWG – as Chairman Cox and the Commission consider alternative courses of action following the D.C. Circuit Court's recent decision.

Looking forward, we will be focused on seeking to understand in the most comprehensive way possible whether and how changes in the structure of the financial services industry – of which the rapid growth of new forms of capital accumulation, such as hedge funds, is just one example – have materially affected the efficiency with which markets intermediate risk, whether risk is pooled in different ways or in different places than it has been in the past – and if so, what appropriate policy responses might be. We will seek to be forward looking and to think about these changes not in a fragmented fashion, but in a comprehensive way. At the moment it is too soon to say what initiatives will result from this focus, but this is the lens through which we will filter the various ideas and efforts with which we will all be grappling over the next few years.