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SUB-COMMITTEE ON SECURITIES AND INVESTMENT

The Role of Hedge Funds in Our Capital Markets

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INTRODUCTION

Good afternoon. I am Kurt Schacht, the Executive Director of the CFA Centre for Financial Market Integrity, the advocacy arm of CFA Institute. I would like to thank Senator Hagel, Senator Dodd, and other members of this committee for the opportunity to speak to you this afternoon on the role of hedge funds. It has come to dominate much of the financial services industry discussion recently and we are supportive of your committee taking a closer look.

First, some background about CFA Centre and its parent organization, CFA Institute. CFA Institute is a non-profit professional membership organization with over 82,000 members in 126 countries. Its mission is to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation that I share with nearly 68,000 investment professionals worldwide. I direct the advocacy efforts of CFA Institute through the newly created CFA Centre for Financial Market Integrity, which develops research, education projects and promotes ethical standards within the investment industry. The CFA Centre has been actively involved in the hedge fund debate for several years and has developed a number of initiatives related to the industry from the investor's perspective.

For the record, CFA Institute is a staunch proponent of self-regulation. This approach is embodied not just in our Code of Ethics, but also in a number of additional guidelines and standards we have established in areas such as performance reporting and asset manager conduct. As discussed herein, these standards may provide useful models for how to address some of the issues before the Subcommittee today.

In most cases, we believe that self-regulation is a preferred alternative to government-imposed regulation, which adds complexities and increases the costs of capital, which are ultimately shouldered by investors large and small. This, of course, is a view shared by regulators and standard-setters themselves, which is why we frequently have worked closely with these groups, including the Securities and Exchange Commission, to develop such standards.

OUR PERSPECTIVE ON HEDGE FUNDS

Our organization comes at this topic from a number of perspectives but primarily as an investor advocate with an interest in promoting appropriate professional standards in this industry. We advocate before investor groups, industry associations and the world regulators. Our focus includes industry ethics, asset manager conduct and performance reporting.

As with most membership organizations in the financial services area, we have a growing proportion of our own membership, estimated at approximately 6 percent (about 5,000), directly involved in the industry as hedge fund or fund of funds participants, not to mention the many others in our membership who are involved as buyers or consumers of hedge fund products.

Our work in this area includes a comprehensive set of standards for hedge fund operators. We have been meeting with regulators around the world to discuss hedge fund and manager regulation and recently completed a survey and study of the hedge fund industry in the Asia Pacific region. We continue to review and comment on the issues of hedge fund performance reporting and investor education as well. I will cover each of these aspects below.

THE ROLE OF HEDGE FUNDS

First, the role of hedge funds in overall portfolio construction and management is evolving. Generally, such investment vehicles are sought for high, uncorrelated historical returns, their attractiveness relative to other investment alternatives and returns in excess of growing liability streams as expected pension portfolio returns have begun to fall short of these growing liabilities. These uncorrelated returns reduce portfolio volatility and actually "hedge" other portfolio exposures. Perhaps most importantly, hedge funds offer access to some of the premier asset managers in the world.

Conversely, hedge funds are not a panacea and there are most certainly a large number of operators that will fail to deliver sustained performance, net of fees. The level of investor knowledge is also a concern when discussing the role of hedge funds. That role is prone to being oversold to retail investors and certain institutions looking to chase the latest hot strategy and quick returns. The appropriate role of hedge funds is therefore subject to being misunderstood and misapplied in certain cases.

THE CURRENT STATE OF THE INDUSTRY & REGULATION

The current industry is a jumble of contradictions we have seldom witnessed. We have huge and growing demand for the products with assets under management approaching $1.5 trillion and huge and growing supply with nearly 9,000 funds. We have an all out media frenzy concerning the industry with 100 stories per day in 2005, according to one study. Meanwhile, we continue to hear about shaky investor confidence, while every regulator we talk to is increasingly suspicious of what is going on with these funds. They are often described as, mysterious and largely unregulated investment vehicles of the wealthy, sophisticated investor. It is a rather combustible mixture.

To be sure, it is a highly misunderstood industry that is often mistaken for a single asset class, leaning in one direction and prone to a systemic melt down. In reality, the collective industry represents the universal exposure; to all assets, in all directions, in all markets. U.S. Treasury Undersecretary Randal Quarles referred to them recently as part of the evolution to "complete markets." We would agree. There are legitimate regulatory concerns related to the extent of leverage by certain funds and the level and interplay of counterparty exposures on OTC positions. In our view however, this is not a house of cards poised for systemic disruption, rather a broad based, universal market exposure with pockets of concern.

We are uncertain as to how to address this aspect of the hedge fund concern but would encourage a less prescriptive approach focused on greater disclosure by regulated counterparty entities that will reveal any serious imbalances in a market. The Financial Services Authority in the U.K. is currently reviewing whether regulators can get at the issue of potential systemic risk through more detailed and aggregated disclosures from the counter-party firms they already regulate.

Over the last year, we have been meeting with global regulatory authorities about investment management practices and hedge fund practices in particular. The additional concerns we hear regarding hedge funds are as follows:

- There are concerns with side letters issued by hedge fund managers that give priority for favored clients on things like early exit or allow problem investments to be concealed.
- There are concerns that prime brokers have created hedge fund "incubator" shops that are inducing very high trading volumes and portfolio turnover in exchange for free office space and operations support. There may be arrangements to get

hedge fund managers preferred access to issuers and breaking information. These relationships are increasingly being viewed as too cozy as hedge funds begin to dominate trading activities in the stock market.

- Hedge fund promotion has become more attractive for pension consultants due to the better fee structures. This may result in conflicts with client knowledge and suitability.
- There are concerns with investor protection for retail investors as products become more generally available.
- There are growing concerns about market integrity: such as market manipulation, poor internal controls, and fraud by hedge funds.

The recent move in the U.S. to require registration of certain hedge fund managers under the Investment Advisers Act of 1940 may have addressed some of these concerns and we viewed such registration as an appropriate step. Registration does provide some level of deterrence and allows regular examination of managers directly. It also requires a documented compliance framework. However, it does little to address the primary systemic imbalance concern.

INVESTOR EDUCATION AND HEDGE FUND MANAGER CONDUCT

Our organization has been discussing the importance of investor education in the context of hedge funds. Investors must understand that they have a serious and significant responsibility to understand all investments, but in particular those that are less liquid and transparent. We have been working with other groups to address educational needs in the hedge fund sector and to provide investors with templates for reviewing, selecting and monitoring these managers. These include *Hedge Funds 101* [http://www.cfainstitute.org/investors/hedgefunds101.html] that outlines five keys for would be hedge fund investors, including rules for investigating credentials, track record, the investment strategy and fee structure and the process for valuation and performance reporting. There are many other excellent resources available including: *Best Practices in Hedge Fund Investing: Due Diligence for Global Macro and Managed Futures Strategies*, developed by Greenwich Roundtable.

Another key component of investor education is to understand what the manager of a hedge fund product should offer in terms of professional conduct and ethics to their investors. Investors in these funds need some assurance that they are being dealt with fairly and honestly. While we do not see any more prevalent fraud in this sector than in other areas of financial management, it remains the case that this is a less regulated, more independent sector of the funds management business. This is due to the fact that the hedge fund sector has traditionally been limited to more "knowledgeable and sophisticated" investors that understand the risks and engage in appropriate due diligence. We are not sure this is always the case and wanted to assist investors with their responsibility to know what they are getting into and what to look for.

The *Asset Manager Code of Professional Conduct* (http://www.cfainstitute.org/cfacentre/positions/pdf/asset_manager_code.pdf) sets forth a comprehensive template for what we believe every investor should expect and demand from their hedge fund manager. Its purpose is to promote an honest and verifiable approach to hedge fund management and to promote a self-regulatory approach to concerns being expressed by investors and regulators. It covers client loyalty, trading practices and compliance procedures, as well as a comprehensive process for disclosures, portfolio valuation and performance reporting.

HEDGE FUND PERFORMANCE REPORTING

On the issue of performance reporting, we have done much work. One of the more "mischief prone" areas in investment management is performance reporting and that certainly applies to the hedge fund industry as well. Recently, there have been a significant number of studies and articles on the topic of hedge fund performance numbers and calls for its regulation. On the matter of regulating performance reporting, we encourage caution. First, the performance data that people are generally critical of are broad-based, voluntary, private services that have all sorts acknowledged statistical shortcomings. Commentators claim these data significantly overstate hedge fund performance by 100 to 600 basis points and are misleading to investors. Second, we doubt whether many hedge fund investors are making investment decisions based on this information. A more appropriate solution is investor education. Any serious investor will understand that these are merely a general proxy for hedge fund performance. They will understand the critical importance of performance reporting at the individual fund level and the quality of the due diligence the investor must conduct to confirm and verify this performance.

The Asset Manager Code provides a template for investors and managers to understand the various procedures needed to calculate and verify performance and promotes The *Global Investment Performance Standards* or GIPS® standards [http://www.cfainstitute.org/cfacentre/ips/gips/pdf/GIPS_2006.pdf]. We believe the industry benchmark for historical performance reporting is the GIPS standards, which has been in development and use for nearly 10 years. The GIPS standards have become the industry standard in nearly 30 countries around the world. The broad GIPS standards do provide a framework for calculating and reporting hedge fund performance. For example, section 4.A.5, requires firms to disclose the presence, use and extent of leverage or derivatives (if material), including a sufficient description of the use, frequency and characteristics of the instruments to identify risks. In all, the GIPS standards provide a consistent and verifiable process that is comparable across managers. We believe this self-regulatory approach to industry standards has been very constructive.

CONCLUSION

Again we commend the members of the Subcommittee for your continued vigilance and leadership on this important industry topic. We fully expect hedge funds to continue to evolve and become a mature feature of the overall investment industry. Their ongoing regulation and oversight should match the pace of this evolution, with a view to foster flexibility and creativity but not at the expense of market integrity and confidence. We would encourage the Subcommittee and Congress to allow the new advisor registration to settle in and determine if further regulation of managers or funds is warranted.