WRITTEN TESTIMONY OF
KENNETH D. BRODY,
TACONIC CAPITAL ADVISORS, LP
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Taconic Capital Advisors, LP ("Taconic Capital") appreciates the opportunity to testify before the House Committee on Financial Services on "Hedge Funds and Systemic Risk." The number of private pools of capital has grown in recent years, as have the aggregate amount of assets managed via private pools and the share of trading in U.S. public capital markets accounted for by private pools. The Treasury Department recently estimated hedge fund assets under management at $1.4 trillion, an increase of more than 400% since 1999.[1] The Securities and Exchange Commission ("SEC") has cited estimates that hedge funds account for approximately 10 to 20 percent of U.S. equity trading volume.[2]

These developments have led policymakers, in the United States and in other jurisdictions, to study their implications both for financial markets in general and for investors in private pools in particular. Issues of systemic risk and investor protection are perhaps receiving the greatest attention. Chairman Frank and the Committee on Financial Services are to be commended for taking part in this debate and for advancing the ongoing dialogue on the appropriate regulation of private pools of capital, including what are commonly referred to as "hedge funds."

[1] "Remarks of Treasury Under Secretary for Domestic Finance Robert K. Steel on Private Pools of Capital," Treasury Department Cash Room, Washington, DC (February 27. 2007).
[2] Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Rel. No. IA-2333, (December 2, 2004), at 4.

Background Information on Taconic Capital

Founded in 1999, Taconic Capital is registered with the SEC as an investment adviser. Taconic Capital manages seven hedge funds, totaling approximately $5 billion under management. Our staff of 60 includes 20 investment professionals. Taconic Capital's funds are primarily event-driven and its management philosophy is characterized by teamwork and collegiality. Taconic is a strategically conservative firm. It strongly supports a prudent risk taking mentality throughout the organization and adheres to stringent risk controls at all times in its investment portfolios.

Kenneth D. Brody is a co-founder of Taconic Capital. In addition, his relevant experience on hedge fund and capital market issues includes his service as Chairman of the Investment Committee of the University of Maryland and his position as a general partner and member of the management committee of Goldman, Sachs & Co. At the University of Maryland, he supervises the allocation of endowment funds among asset classes and investment strategies, including hedge funds.

Executive Summary

At least since the collapse of Long Term Capital Management in 1999, legislators and regulators in the United States and other jurisdictions have been grappling with the systemic risk and investor protection issues raised by the growth of private pools of capital, including hedge funds. Since that time, hedge funds have become even more important in the capital markets, as measured by their asset size and their share of trading in public securities. At the same time, the profile of investors in hedge funds has expanded from wealthy individuals to institutional investors such as endowments and finally to public and private pension funds.[3]

With regard to systemic risk, Taconic Capital believes that hedge funds in the aggregate reduce systemic risk in the global capital markets. Regulation of hedge funds with the intention of reducing systemic risk would do little to improve stability in capital markets and would run the risk of actually increasing instability by reducing the benefits that hedge funds contribute to markets. These benefits are well recognized. The President's Working Group on Financial Markets stated in 1999, "In general, active market participants such as hedge funds can provide benefits to financial markets by enhancing liquidity and efficiency. Additionally, they can play a role in financial innovation and the reallocation of financial risk."[4]

With regard to investor protection, Taconic Capital believes that mandatory registration of hedge fund managers as investment advisers with the SEC would promote self-policing and internal discipline. Taconic Capital is mindful that an effort by the SEC to require the registration of certain managers as investment advisers was overturned in court on the technical basis of whether the SEC could change the definition of "client" to embrace not just a fund but the investors in that fund.[5] Nonetheless, the enhancements to investor protection resulting from mandatory registration suggest that it is an appropriate policy option for Congress to consider. To best secure these benefits and produce the most effective form of regulatory oversight, Taconic Capital suggests that SEC regulation

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[3] "The investor base has changed from a largely high net worth, both on shore and off shore, to a more institutional investor base." Comments of Michael Neus of Andor Capital Management, SEC Hedge Fund Roundtable, Day 1, at 38.

[4] President's Working Group Report on Long Term Capital Management, at 2.

[5] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006). "The Commission cannot explain why 'client' should mean one thing when determining to whom fiduciary duties are owed…and something else entirely when determining whether an investment adviser must register under the Act."

and inspections of hedge fund managers focus on adherence to certain key elements described under "Discussion of investor protection" below.

Definition of hedge fund

For discussion of the systemic risk and investor protection issues raised by hedge funds to be meaningful, one must first set out a definition of "hedge fund" as distinguished from public or other private pools of capital. Taconic Capital suggests the following definition of "hedge fund" and will adopt it for purposes of this testimony. Taconic Capital considers a hedge fund to be:

- A private pool of capital – one raised without a public offering of securities;
- That invests primarily in publicly-traded securities and publicly-traded instruments other than securities, such as futures and currencies;
- That is managed by a professional manager – one engaged principally in the management of financial assets;
- Where the managers are entitled to compensation in the form of a share of the profits they generate on behalf of the pool; and
- Where the size of the pools advised by the manager aggregates to more than $25 million.

The hedge funds that would be encompassed by this definition are diverse in nature and it is difficult to make generalizations about them. Some use mathematical models to determine investment strategies while others rely on human judgments on which securities to buy or sell. Some sell securities short while others do not. Some use significant leverage while many do not use leverage. The differences that exist among hedge funds are too numerous to list.

Discussion of systemic risk

From the collapse of Long Term Capital Management in 1999 to the collapse of Amaranth in 2006, public dialogue regarding hedge funds has included discussion of systemic risk. Some suggest that the growth of hedge funds in itself has raised the level of risk in the global financial system. Others express concern that the collapse of a hedge fund could initiate shock waves that would travel throughout the financial system, causing the failure of intermediaries or other financial institutions via ripple effect. The use of leverage by hedge funds is often cited as a principal factor increasing the risks of a systemic disturbance.[6]

On the other hand, regulators identify many other and more significant areas of potential systemic risk. For example, the most recent Financial Stability Report issued by the Bank of England identified six main sources of vulnerability in the financial system. The growth of hedge funds was not among them. The Bank's Deputy Governor, Sir John Gieve, has stated that he believes that hedge funds would not have been listed even had the report covered the next six sources as well.[7] He has further stated that central bankers and financial regulators believe that the greatest risk to stability is posed by the key intermediaries at the center of the financial system. The substantial role played by hedge

[6] "Hedge funds vary greatly in their use of leverage. Nevertheless, compared with other trading institutions, hedge funds' use of leverage, combined with any structured or illiquid positions whose full value cannot be realized in a quick sale, can potentially make them somewhat fragile institutions that are vulnerable to liquidity shocks." President's Working Group Report on Long Term Capital Management, at 5.

[7] Speech by Sir John Give, Deputy Governor, Bank of England, HEDGE 2006 Conference (October 17, 2006).

funds in today's sophisticated markets, allowing for the transfer of risk from parties who do not want it to parties that do, reduces systemic risk.

The benefits of hedge funds have been further elaborated by SEC Chairman Cox, who testified last year that hedge funds "provide investors and our national securities markets with tangible benefits. They contribute substantially to capital formation, market efficiency, price discovery, and liquidity."[8] Taconic Capital believes that these contributions would be undermined by the imposition of direct regulatory requirements, such as capital levels or leverage ratios, on hedge funds. In addition, hedge funds may choose to organize outside the United States to avoid such requirements.[9]

Taconic Capital agrees with the recent conclusion of the President's Working Group that "market discipline most effectively addresses systemic risks posed by private pools of capital."[10] Hedge funds' creditors and counterparties tend to be sophisticated financial institutions. These institutions have the ability and the incentive to limit their exposures in case of default, which in turn reduces the likelihood that a hedge fund's default could endanger the stability of the financial system as a whole. In addition, the risk management systems and operational capabilities of these intermediaries are subject to oversight by Federal banking and securities regulators. Federal regulators show every sign of vigorously monitoring these aspects of the firms they supervise. The President's Working Group issued the following specific injunction:

> Supervisors should clearly communicate their expectations regarding prudent management of counterparty credit exposures, including those to private pools of

[8] Testimony of SEC Chairman Cox before the Senate Committee on Banking, Housing and Urban Affairs, July 25, 2006, at 2.
[9] "…if the expense of regulation becomes too great relative to reducing opportunities, then I think you'll see people seek other locations or jurisdictions… Remarks of Robert Steel of Goldman Sachs & Co., SEC Hedge Fund Roundtable, Day 2, at 69-70.
[10] Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, at Paragraph 2.

> capital and other leveraged counterparties, who are increasingly utilizing complex instruments, including certain over-the-counter derivatives and structured securities, such as collateralized debt obligations. Because key creditors and counterparties to pools are organized in various jurisdictions, international policy collaboration and coordination are essential.[11]

The Working Group went on to say that regulators should review their guidance and revise their policies to take into account developments in financial markets and advances in best practices.[12]

Discussion of investor protection

Under current law, hedge fund managers may be able to rely on the "private adviser exemption." The Investment Advisers Act of 1940 exempts from registration any adviser who "has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser" to a registered investment company.[13] Taconic Capital believes that nearly all large hedge fund managers run fewer than fifteen separate hedge funds and therefore are not currently compelled to register. However, many remain registered with the SEC voluntarily.

While the application of the private adviser exemption to hedge fund managers may have promoted public policy objectives in past years, changes in the financial markets make it appropriate for policymakers to review this application. In particular, the changing profile of hedge fund investors has raised legitimate investor protection concerns. Direct investments in hedge funds remain off-limits for retail investors. The

[11] Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, at Paragraph 10.
[12] Id. at Paragraph 10.1.
[13] 15 U.S.C. Sec. 80b-3(b)(3).

SEC has recently proposed changes to the definition of "accredited investor" with the stated intent of ensuring that retail investors not access hedge funds directly.[14]

Investor protection concerns arise, however, because the indirect participation of individuals in hedge funds has increased through pension fund investments. This in turn raises concerns about the protection of the ultimate beneficiaries of such institutional investors. The President's Working Group recently placed emphasis on the sound practices and due diligence responsibilities of the fiduciaries that manage vehicles such as pension funds.[15]

While it is appropriate to insist that fiduciaries meet their responsibilities, mandatory registration of hedge fund advisers with the SEC as investment advisers would further enhance investor protection at an acceptable cost, primarily by promoting self-policing and internal discipline. Taconic Capital believes that the following key elements of the current investment adviser registration regime promote investor protection:

- Requirement that adviser designate a chief compliance officer. Every registered investment adviser is required to designate a chief compliance officer.[16] The chief compliance officer must administer the firm's compliance policies and procedures. The SEC specified that the chief compliance officer "should be competent and knowledgeable regarding the Advisers Act and should be

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[14] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Rel. No. 33-8766 (December 27, 2006). "...many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments." Id. at 17.
[15] Id. at Paragraph 5.
[16] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IA-2204 (December 17, 2003).

empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm."[17]

- Requirement of written compliance polices and procedures. The rule also requires every registered investment adviser to adopt written compliance policies and procedures.[18] An adviser's policies and procedures must take into account the nature of the firm's operations. At a minimum, the SEC requires that the policies and procedures address portfolio management processes; trading practices; proprietary trading of the adviser and personal trading activities of supervised persons; the accuracy of disclosures made to investors, clients and regulators; safeguarding of client assets; the accurate creation and maintenance of required records; the marketing of advisory services including the use of solicitors; the process of valuing client holdings and assessing fees based on those valuations; safeguards for the privacy protection of client records and information; and the adoption of a business continuity plan
- Code of ethics. SEC rules require registered investment advisers to adopt codes of ethics setting forth standards of conduct that will apply to advisory personnel.[19] Among other things, codes of ethics must be drafted to (i) set forth standards of conduct and compliance with securities laws expected of advisory personnel that reflect the investment adviser's fiduciary obligations, (ii) safeguard material nonpublic information about the adviser's securities recommendations and client holdings and transactions, and (iii) require that "access persons" of an investment adviser report their personal securities transactions.

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[17] Id. at 10.
[18] Id. at 5.
[19] 17 C.F.R. 275.204A-1.

- Filing of Form ADV. All registered investment advisers are required to maintain a two-part Form ADV and to deliver Part II of the Form in satisfaction of Rule 204-3 under the Advisers Act (the "brochure rule"), which requires a registered investment adviser to provide certain written disclosures to prospective and existing clients at specified times. These rules benefit investors because they receive more complete information about fees, expenses and conflicts of interest than they might otherwise receive. The Form ADV also enables a prospective client to easily access information about an adviser's ownership structure and about the regulatory history of the investment adviser and its associated persons.
- Independent custodian requirements. The Advisers Act custody rule requires registered advisers that have custody of client funds and securities to maintain controls intended to protect those assets from loss, misuse or misappropriation.[20] The custody rule further states that an investment adviser to a pooled vehicle who also serves as a general partner to that pooled vehicle is deemed to have custody of that vehicle's assets. All client assets of registered investment advisers are required to be held by a qualified custodian -- a bank, trust company, broker-dealer, futures commission merchant or foreign financial regulatory institution. In addition, the custody rule effectively requires that pooled vehicles be audited in accordance with Generally Accepted Accounting Principles on an annual basis, because most advisers to pooled vehicles that are subject to the custody rule choose to have those vehicles audited in order to avoid the more burdensome reporting requirements imposed by the rule.

[20] 17 C.F.R. Sec. 275.206(4)-2(a).

- SEC on-site inspection and examination. Given the performance fee compensation that hedge fund managers stand to earn, they may have an incentive to inflate the value of their assets. Inflating asset values may also allow managers to hide losses. The possibility that the SEC will conduct an on-site examination will tend to discourage unscrupulous managers from mispricing securities, inflating asset values or falsifying performance information provided to investors. Consequences of unlawful conduct include fines, disgorgement, and industry suspensions and bars. While it will not deter all fraud, the prospect of an examination will discourage wrongdoers. The inspection and examination process also incentivizes registered investment advisers to follow their compliance policies and procedures and to keep them updated.
- Retention of books and records. SEC rules require a registered investment adviser to make and maintain a number of books and records, with the objective of promoting fair treatment of the adviser's clients.[21] These include records of all receipts and disbursements of cash; memoranda of each order for the purchase or sale of any security; certain communications sent to clients; and certain books and records used to calculate performance or rate of return.

At this point, it should be clear that Taconic Capital believes that hedge fund managers should be registered with the SEC under a robust investment adviser regulatory regime. However, Taconic Capital also believes that the current regime can be improved. In general, we believe a more "principles-based" approach would increase regulatory efficiency and thereby promote investor protection. As Treasury Secretary Paulson stated in a recent speech before the Economic Club of New York:

[21] 17 C.F.R. Sec. 275.204-2.

> "The advantage of a principles-based system is that it is flexible and sensible in dealing with new or special situations. A rules-based system typically gives more specific guidance than a principles-based system, but it can be too rigid and may lead to a 'tick the box' approach."[22]

The nature of hedge fund investors – wealthy individuals and institutions – suggests a different regulatory framework than that which is appropriate for advisers with retail clients only. A one-size-fits-all regulatory approach that does not take into account such elements as a fund's client base, investment focus or other potential risk factors is neither flexible nor effective. The SEC can and should adopt a more prudential approach, working with regulated entities to improve compliance. This would promote investor protection by increasing attention on areas of greatest importance. It could also increase the deterrent effect of SEC examinations by making inspections more efficient and thus more numerous. Of course, a vigorous enforcement regime for those who violate regulatory principles remains essential.

Taconic Capital wishes to make clear that it does not believe the SEC should, through the investment adviser regulatory process, evaluate the investment strategies of hedge fund managers. As the President's Working Group noted, hedge funds and other private pools often "involve complex, illiquid or opaque investments." So long as hedge funds remain unavailable to retail investors, it is appropriate that hedge fund investors themselves bear responsibility for identifying and assessing the risks of investing in a particular fund and their appetite for bearing these risks. SEC regulation and inspection of hedge fund managers registered as investment advisers should focus on adherence to key principles of investor protection. As may be inferred from the list of investor protection elements described above, these include compliance systems designed to

[22] "Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets," Economic Club of New York, New York, NY (November 20, 2006).

prevent fraud and conflicts of interest; adequacy of adherence to those compliance systems; and accuracy of disclosures to investors.

Conclusion

Pools of capital – from mutual funds to insurance companies – have generally been subject to regulation under Federal or State law. Hedge funds have historically been exempt from direct regulation because of their private nature. Taconic Capital believes that direct regulation of hedge funds is unlikely to reduce systemic risk and would threaten to undermine the benefits of efficiency, liquidity and risk transference that hedge funds bring to capital markets. Taconic Capital further believes that registration of hedge fund managers as investment advisers would promote investor protection, an appropriate goal given the growth of hedge funds and the increasing role of pension funds as hedge fund investors. Taconic Capital stands ready to work with the Committee, the Congress, and the Executive Branch to develop appropriate public policy regarding hedge funds.