TESTIMONY OF JAMES CHANOS
CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON HEDGE FUNDS
AND SYSTEMIC RISK IN THE FINANCIAL MARKETS

March 13, 2007

Chairman Frank, Ranking Member Bachus, and members of the Committee on Financial Services. My name is James Chanos, and I am President of Kynikos Associates, a New York private investment management company that I founded in 1985.[1] I am appearing today on behalf of the Coalition of Private Investment Companies ("CPIC" or "the Coalition"), whose members and associates manage or advise more than $60 billion in assets.[2] I would like to thank the Chairman and Ranking Member for inviting us to participate in today's important hearing.

The Coalition welcomes the attention of this Committee on our industry. Rapid growth in all alternative investment funds – whether they call themselves hedge funds, private equity or venture capital – has brought significant rewards to investors and the financial markets. But, to paraphrase the great Stan Lee, with great growth comes great

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 Our members are diverse in size and in the investment strategies they pursue. While most of our members are multi-strategy funds that trade a range of financial instruments, some are long-short equity funds, some pursue strategies that are event-driven, and several are fundamental short funds.

responsibility. This responsibility derives from the industry's more prominent role in various parts of the financial markets, its visibility in leading more activist shareholders who are willing to challenge management plans at public companies, and, perhaps most importantly, the trust placed in our managers to properly invest the assets of our investors, including pension funds and endowments – institutions whose ultimate beneficiaries are not themselves wealthy individuals.

Consequently, hearings such as this present a unique opportunity for our industry to explain the way it works, dispel some of the myths and misconceptions that surround it, and make clear our commitment to work with policymakers in the Congress and in the financial regulatory agencies, in order to improve those areas where the system of oversight may not be keeping pace with the growth of this sector.

Overview / Summary

CPIC would like to suggest a few ideas that may be useful in thinking about the issues associated with private pooled investment vehicles.

First, almost all private investment pools – whether a hedge fund, venture capital fund or private equity fund – share many common characteristics in terms of their disclosures to their investors and counterparties without detailed government mandates. Consequently, we would suggest that policymakers, instead of creating distinctions between these types of entities, treat all private pooled investment vehicles similarly, regardless of their underlying investment strategies. Even though we may all use the term "hedge fund" in the context of today's hearing, the most accurate phrase is not "hedge fund" as much as "private investment company."

Second, in terms of investment activity – the buying or selling of securities or commodities or derivatives or foreign currency – hedge funds are but one type of many market participants engaged in the same activity. For example, in order to gain the most complete understanding of the collateralized debt obligation ("CDO") market – to use one of the examples from the letter of invitation – one should not focus solely on a single segment of the market but should look at all of the participants engaged in that activity. Looking at CDOs solely through the prism of hedge funds, without looking at banks, investment banks, insurance companies, and other types of dealers and investors will create a distorted picture of how and why that market operates as it does. A focus on the *activity* rather than the *actor* is more likely to yield the information desired by policymakers in assessing the appropriate level of oversight and regulation.

Third, the phrase "lightly regulated," which typically is applied to hedge funds and other alternative investment vehicles, is somewhat misleading, as it really only applies to governmental regulation of the relationship between the fund (and its manger/advisor) and its investors. In this area, sophisticated or institutional investors are deemed by the government to have the capacity and equal footing to obtain the requisite information from fund managers on their own, instead of relying on standardized government-mandated disclosures, such as those required for registration of securities under the Securities Act of 1933,[3] or relying upon the mandates of the Investment Company Act of 1940[4] and its governance of the relationship between advisers and the pools of capital they manage. In almost all other aspects of the U.S. financial system,

[3] 15 U.S.C. § 77a *et seq.*

[4] 15 U.S.C. § 80a-1 *et seq.*

hedge funds are subject to the same web of statutory and regulatory requirements as all other institutional market participants engaged in the same activities.

Fourth, the so-called secrecy surrounding hedge funds is actually a consequence of both the proprietary nature of the investment strategies employed, and of the mandates of the Securities and Exchange Commission ("SEC" or "Commission") itself. The SEC's restrictions on general solicitations and public offerings, under which all hedge funds operate, prohibit fund managers from discussing their strategies and performance in any venue or in any way that could be construed as a solicitation of investment from the general public. Certainly, it means that fund managers must limit the content of or access to their websites and limit public interviews about their funds and investment strategies that could be viewed as designed to attract the interest of the general public to invest in the funds. Accordingly, most fund managers prefer to err on the side of less public discussion, rather than risk running afoul of the SEC.

Fifth, if there are gaps in the system of regulatory oversight, there should be ways to address them, consistent with the Principles and Guidelines recently issued by the President's Working Group on Financial Markets.[5] Such deficiencies can be addressed without trying to shoehorn this institutional business into statutes that were designed primarily for the interaction of investment professionals and the general public. In this regard, we have some suggestions for consideration that we will describe later in the testimony.

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5 Press Release, Dep't. of Treasury, Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, (Feb. 22, 2007) *available at* http://www.treasury.gov/press/releases/reports/hp272_principles.pdf).

Importance of the Hedge Fund Industry to the Financial Markets

The financial and capital markets in the U.S. and in the developed world have been stunningly successful in providing capital and financing for economic growth and development, both in the U.S. and abroad. Our markets benefit from a wide diversity of players -- investment bankers and broker-dealers, commercial banks and savings institutions, mutual funds, commodity futures traders, exchanges and markets of all types, traders of all sizes, and a variety of managed pools of capital, including venture funds, private equity funds, commodity pools, and hedge funds, among others. While hedge funds are but one category of market participant, they serve a vitally important role in the U.S. and global markets -- a role repeatedly acknowledged by the President's Working Group on Financial Markets, as well as all of its members individually: the Commodity Futures Trading Commission ("CFTC"), the SEC, the Department of the Treasury, and the Federal Reserve Board.

As the SEC has said, there is no statutory or regulatory definition of the term "hedge fund." The term generally is used to refer to privately-offered investment funds that invest primarily in liquid securities and derivatives, that are managed by professional investment managers, that in many cases use leverage, short-selling, active trading and arbitrage as investment techniques, and that are exempt from registration under the Investment Company Act. Interests in these funds are sold in private offerings, primarily to high net worth individuals and institutions.

Hedge funds are as diverse as the individual managers who run them. They may invest in or trade a variety of financial instruments, including stocks, bonds, currencies, futures, options, other derivatives and physical commodities. Although funds that invest primarily in illiquid assets such as real estate, venture capital and private equity generally are not considered "hedge funds," some hedge funds invest to some degree in private, illiquid investments. Some invest in securities and hold long term; some are fundamental short funds; and some are long-short funds. Some are strictly traders. Many serve as important counterparties to other players in the market who wish to offset risk. Others may become "activists" and use a large equity position in a company to encourage management to make changes to increase shareholder value. Hedge funds, as a group, add to the depth, liquidity, and vibrancy of the markets in which they participate. Indeed, some of the most talented individuals in the financial markets are hedge fund managers, who bring their research and insight to bear on the value of various assets, thereby adding to the price discovery and efficiency of the markets as a whole.

Regulation of Hedge Funds

One of the greatest misconceptions about the hedge fund industry is that fostered by the media, which calls hedge funds "lightly regulated." This description really only applies to one aspect of any hedge fund's business. In terms of the interaction and flow of information between the hedge fund and its investors, it is true that the regulatory requirements are less than those mandated elsewhere by the federal securities laws. However, as a substantive matter, we believe that the "average" hedge fund investor or prospective investor has as good an understanding of the risks and rewards associated with his or her investment, including the costs and fees involved, as does the average investor in any other private placement or in any mutual fund, or even the average shareholder gleaning information from the reports required of public companies.

This is, in fact, the way the system is supposed to work. By limiting hedge fund investors to those who can be presumed to have the requisite investing skills themselves or the capacity to hire expert advice, hedge funds are, by-and-large, held to very high standards by those investors.

The conditional exemptions under which hedge funds operate in offering their securities to this limited class of investors were enacted by Congress and implemented by the SEC and CFTC, through carefully crafted rules, developed in notice and comment rulemakings and in recognition of the importance and functions of private investment funds to investors and to the markets.[6] With respect to their actual trading or other investment activities, hedge funds are subject to the same restrictions as most other securities investors, including such requirements as the margin rules[7] (which limit their use of leverage to purchase and carry publicly traded securities and options), SEC Regulation SHO[8] (which regulates short-selling), the Williams Act amendments to the Securities Exchange Act of 1934[9] and related SEC rules (which regulate and require public reporting on the acquisition of blocks of securities and other activities in

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6 Hedge funds are regulated by the terms of certain exemptions from registration under the Securities Act of 1933, the Investment Company Act, and in some cases the Commodity Exchange Act ("CEA"), under which they operate. To meet these exemptions, they must limit their offerings to private placements with sophisticated investors, who are able to understand and bear the risks of the investment. The hedge fund must either limit its beneficial owners to not more than 100 persons and entities (typically all or most of whom are "accredited investors"), or limit its investors to super-accredited "qualified purchaser" individuals with over $5 million in investments and institutions with over $25 million in investments. Many hedge funds file exemptive notices with the SEC and state securities commissioners under Regulation D. Many also file notices with the National Futures Association under the CEA as to any exemptions under which they operate (which exemptions impose their own, additional restrictions on the qualifications of investors).

7 12 C.F.R. §§ 220.1 *et seq*., 221.1 *et seq*.

8 17 C.F.R. §§ 242.200-.203.

9 Exchange Act §§13(d), 13(e), 14(d), 14(e) and 14(f); 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e) and 78n(f).

connection with takeovers and proxy contests), and the NASD's "new issues" rule 2790 (which governs allocations of Initial Public Offerings). Hedge funds must also abide by the rules and regulations of the markets in which they seek to buy or sell financial products. Those hedge fund managers that are registered under the Investment Advisers Act[10] also are subject to a range of additional disclosure and other requirements. Perhaps most important, hedge funds are subject to anti-fraud and anti-manipulation requirements, such as Section 10(b) of the Securities Exchange Act of 1934[11] and Rule 10b-5,[12] as well as insider trading prohibitions, both in the funds' investment and portfolio trading activities, and in the funds' offers and sales of units to their own investors. In addition to SEC regulation, many hedge funds are also subject to regulation by the Commodity Futures Trading Commission ("CFTC"). Funds that invest in exchange-traded futures and options on futures are subject to the requirements of the Commodity Exchange Act ("CEA"), which may include registration and reporting obligations administered by the CFTC.[13]

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10 15 U.S.C. § 80b-1 *et seq.*

11 15 U.S.C. § 78j.

12 17 C.F.R § 240.10b-5.

13 Also, through its Large Trader Reporting System, the CFTC oversees futures markets in order to ascertain that they are operating openly, competitively and free of manipulation. In addition, under the CEA, all futures exchanges must affirmatively and effectively supervise trading, prices, and trading positions for abusive practices. *Role of Hedge Funds in U.S. Capital Markets: Hearing Before the S. Banking Subcomm. on Securities & Investments* (May 16, 2006) (Statement of James A. Overdahl, Chief Economist, U. S. Commodity Futures Trading Commission), *available at* http://banking.senate.gov/_files/overdahl.pdf.

<u>Areas for Continued Oversight</u>

Systemic Risk

The recent Principles and Guidelines issued by the President's Working Group on Financial Markets effectively stated the basis of current oversight of all private investment companies with respect to systemic risk:

> The vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors. Market discipline most effectively addresses systemic risks posed by private pools of capital. Supervisors should use their existing authorities with respect to creditors, counterparties, investors, and fiduciaries to foster market discipline on private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.[14]

The total amount of assets managed by the entire hedge fund industry, even at its highest estimate of $1.6 trillion dollars under management, is dwarfed by almost any other class of asset manager, from mutual funds to investment banks to life insurance companies to commercial banks.[15] Indeed, the largest hedge fund is a fraction of the size of the leading financial institutions. Even so, there remains concern among regulators and policy makers about the potential impact of the failure of one or more large funds as a triggering event in which counterparties -- those entities that provide hedge funds with funding or which are on the other side of various transactions -- would be at risk.

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14 Press Release, *supra* n. 5.

15 For example, the mutual fund industry manages $10.5 trillion dollars. *See* Investment Company Institute: Trends In Mutual Fund Investing (Jan.2007) *at* http://www.ici.org/stats/mf/trends_01_07.html. The Securities Industry Association estimated, as of 2005, total assets to be in excess of $5 trillion. *See* http://www.sia.com/research/html/quarterly_securities_results.html). Assets managed by the life insurance industry are estimated by the American Council of Life Insurers at over $4.5 trillion. *See* Life Insurers Fact Book (http://www.acli.org/ACLI/Tools/Industry+Facts/Life+Insurers+Fact+Book/Default.htm). The FDIC estimates total assets of the banking industry at $11.86 trillion. *See* FDIC Quarterly Banking Profile *available at* http://www2.fdic.gov/qbp/2006dec/all2a.html.

Ever since the Long Term Capital Management crisis, it has been U.S. policy to focus on maintaining proper risk management techniques at the institutions that are counterparties to hedge funds and other private investment pools and that provide them with funding, clearing, and other services. If these regulated entities, including banks and prime brokers, manage their exposure properly, then the possibility of any hedge fund or private equity fund threatening the whole financial system is greatly diminished.

To that end, a number of important developments have occurred since 1998. The President's Working Group on Financial Markets in 1999 issued a lengthy report[16] that set the benchmark for prudent risk management. Those recommendations were put into practice by the Counterparty Risk Management Policy Group I and II,[17] which provided very specific sets of practices for prime brokers to follow.

In May 2006, Federal Reserve Board Chairman Ben Bernanke gave an address entitled "Hedge Funds and Systemic Risk" in which he summarized the view of the Federal Reserve – the financial regulator charged with managing systemic risk in the financial sector – with respect to the sufficiency of the resulting counterparty risk management system. Chairman Bernanke asked whether the current system was still working. His answer was, in a word, yes.

> Has the approach proposed by the President's Working Group worked? Any answer must be provisional, but, to date, it apparently has been effective. Since the LTCM crisis, ongoing improvements in counterparty risk management and the resultant strengthening of market discipline appear to have limited hedge fund leverage and improved the ability of

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16 President's Working Group on Financial Markets, Report on Hedge Funds, Leverage and the Lessons of Long Term Capital Management, *at* https://www.treasury.gov/press/releases/reports/hedgfund.pdf.

17 See the original July 1999 report at http://www.mfainfo.org/washington/derivatives/Improving%20Counterparty%20risk.pdf and the second round report from July 2005 at http://www.crmpolicygroup.org/docs/CRMPG-II.pdf.

> banks and broker-dealers to monitor risk, despite the rapidly increasing size, diversity, and complexity of the hedge fund industry. Many hedge funds have been liquidated, and investors have suffered losses, but creditors and counterparties have, for the most part, not taken losses. The general perception among market participants is that hedge funds are less highly leveraged today than in 1998 though, to be sure, meaningful and consistent measurements of leverage are not easy to come by and many newer financial products embed significant leverage in relatively nontransparent ways.
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> According to bank supervisors and most market participants, counterparty risk management has improved significantly since 1998. Some of this progress is due to industry-led efforts, such as two reports by the Counterparty Risk Management Policy Group (CRMPG) that lay out principles that institutions should use in measuring, monitoring, and managing risk. Reviews conducted by bank supervisors in 2004 and 2005 indicated that banks have become more diligent in their dealings with hedge funds.[18]

What members of Congress can draw comfort from in this speech is not that Chairman Bernanke expressed confidence in the status quo, but that he did so based upon "reviews conducted by bank supervisors" over a two-year period prior to his speech last May. The SEC has the authority to conduct similar reviews for the entities under its supervision, although it is not clear from Chairman Donaldson's comments in 2004 and 2005 whether the SEC did so in conjunction with the review conducted by the bank regulators.

It is regulators' systematic and rigorous monitoring and examination of the adherence of counterparties to prudent risk management standards that is the backbone of this system of risk mitigation. It cannot be said that regulators have asked for voluntary compliance and then have done nothing to ensure that those best practices are in place.

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[18] Hon. Benjamin Bernanke, Chairman of the Board of Governors of the Federal Reserve System, Hedge Funds and Systemic Risk, Speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006).

They have worked diligently to monitor the activities of regulated entities under their supervision.

To date, CPIC believes that this remains the most effective means of reducing the systemic risk that could be deemed to flow uniquely from hedge funds and other private pools of capital. Of course, the purpose of this system is not to prevent losses from occurring – even large losses such as those at Amaranth, LLC last year – but to ensure that such losses by individual market participants do not cause the financial system as a whole to cease functioning.

Retailization

While we believe the issue of systemic risk is one best addressed through coordinated review and consultation among the members of the President's Working Group, the issue of investor protection is properly addressed primarily by the SEC. The SEC has been vigorous in bringing enforcement actions against hedge fund managers who violate the law, but its regulatory agenda has had setbacks, such as the Distinct of Columbia Circuit's decision last year overturning the SEC's hedge fund adviser registration rule.[19] However, we continue to believe the SEC has adequate authority to protect investors in pooled investment vehicles. For example, last December, the SEC issued for comment a rule that would effectively raise the qualifications for individuals who want to make investments in private investment companies such as hedge funds, private equity funds and some venture capital funds.[20] The SEC's proposal would add to the current income and net worth tests for individual accredited investors a new standard

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19 Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

20 *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Pooled Investment Vehicles. 72 Fed. Reg. 400 (Jan. 4, 2007) Release Nos. 33-8766, IA-2576.

that requires the individual to possess at least $2.5 million in investible assets -- creating a new category of "accredited natural person" for purposes of investments in private placements of pooled investment vehicles.[21] The SEC also proposed a new anti-fraud rule under the Investment Advisers Act, which, if adopted, would prohibit investment advisers, whether registered or not, from making false or misleading statements to, or otherwise defrauding, investors in pooled investment vehicles.[22]

The Commission and its staff in recent years have voiced a range of investor protection concerns regarding hedge funds, such as in the 2003 Staff Report on the *Implications of the Growth of Hedge Funds* (the "Staff Report")[23] and the SEC's release accompanying its proposed hedge fund adviser registration rule.[24] The SEC's proposal to modernize the accredited investor standard appears to be aimed at the "retailization" concern, described in the Staff Report as the phenomenon of "significant numbers of less sophisticated investors … investing in hedge funds."[25]

The Coalition recognizes that the accredited investor standard functions to achieve a public policy objective – where the government can presume an investor's

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21 Proposed Rules 509 and 216; 72 Fed. Reg. 403-408.

22 Proposed Rule 206(4)-8; 72 Fed. Reg. at 404.

23 *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (Sept. 29, 2003), (*available at* http://www.sec.gov/spotlight/hedgefunds.htm) ("*Staff Report*"). The Staff Report noted concerns not only with the test for "accredited investor" status, but also with the retail offering of registered funds-of-hedge-funds and the exposure that individual investors may have to hedge funds through investments in pension plans. Other concerns described by the Report included the protection of hedge fund investors from fraud or deficient disclosure, the methods employed by hedge funds to solicit investors, conflicts of interest arising from side-by-side management of hedge funds and other client accounts, the potential existence of *quid pro quo* arrangements between hedge funds and prime brokers, questionable valuations by advisers of hedge fund portfolios, and a lack of transparency with respect to advisers' valuation policies. *Id. at* 79-87.

24 Registration Under the Investment Advisers Act of Certain Hedge Fund Advisers, 69 F.R. 45172 (July 28, 2004) Investment Act Release No. IA-2266.

25 Staff Report, *supra* n. 23.

knowledge or capacity to hire expert advice in making investment decisions – rather than a pure economic standard. As such, we support the SEC's proposal to modernize the standard, although the comment letter we filed with the SEC observes that there are a number of ways in which the SEC could do this, The Commission's 2003 Staff Report stated that the SEC had "not uncovered evidence of significant numbers of retail investors investing directly in hedge funds,"[26] and there is no information in the SEC's recent rulemaking release to indicate that this situation has changed. Thus, the SEC's concern that the accredited investor standard may no longer suffice to protect investors is *prospective* in nature. The proposed rule change therefore presents challenges in that it represents only the SEC's best guess as to what an appropriate standard might be, rather than one based upon empirical data.

The Availability of Data on Hedge Funds

One of the most common refrains heard by policy makers today about hedge funds is that "we don't know who's out there." It is difficult to get an accurate assessment of the total number of funds that are currently in existence, even though many hedge fund managers are registered under the Investment Advisers Act. Before the SEC implemented its mandatory registration rule, it estimated that between one-third and one-half of hedge fund managers were registered, and that those managers represented a majority of the assets managed by the industry. Several months after the now vitiated rule went into effect, SEC Chairman Christopher Cox estimated that nearly 2400 fund managers were registered with the SEC.[27] Even now, eight months after the rule was

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[26] *Id.* at 80.

[27] *See* A Review of Current Securities Issues Before the S. Comm. on Banking, Housing & Urban Affairs (Apr. 25, 2006) (statement of Christopher Cox, Chairman, SEC) (unpublished transcript).

overturned, it is safe to estimate that most of those hedge fund managers who previously registered remain registered as investment advisers.

If the SEC believes it needs to gather "census" information about hedge funds and their advisers, it has the authority to obtain significant information, without resort to a requirement for registration under the Investment Advisers Act. In the comment letter we filed with the SEC in connection with its recent rulemaking, we observed that the SEC could amend the forms filed by pooled investment vehicles[28] when they engage in private offerings of their securities under Regulation D. The Commission could require the submission and periodic updating of the information currently required, such as the name and address of the issuer, the names of its senior management and control persons, the types of securities being issued, and the number of investors and amounts of their investments in each state, as well as information identifying the issuer as a pooled investment vehicle. Other information about pooled investments that would be particularly useful to investors and the Commission would be:

- The identities of the Fund's manager, custodians, and independent auditors;
- The Fund's fee structure and expense information;
- The Fund's assets under management;
- The Fund's general categories of investment strategies and assets;
- Information as to any exemptions that the Fund relies upon under the Company Act and/or Commodity Exchange Act; and
- The Fund's policies as to the use of "soft dollars" and brokerage allocations.

Other information that would be helpful for investor and law enforcement purposes also could be required, such as the issuer's prior names (if any) and the issuer's disciplinary

[28] As a coalition of private investment companies, we do not take a position on whether the Commission needs additional Form D information on issuers other than pooled investment vehicles.

history. All this basic census data could be supplied through a modified, web-based version of Form D that could be shared with, or be accessible to, other appropriate regulatory authorities, such as the members of the President's Working Group on Financial Markets, state securities regulators, the National Association of Securities Dealers and the National Futures Association.

Best Practices to Protect Investors Against Fraud; SEC Authority

As mentioned earlier, the level of due diligence performed by most investors contemplating placing money with a hedge fund manager is considerable. In the case of my funds, for example, investors or their financial managers generally require us to provide answers to detailed questions regarding our background, strategies and research, personnel, returns, compliance programs, risk profile, and accounting and valuation practices. Prospective investors also review terms such as liquidity restrictions, management and performance fees, and any applicable lockup periods. Depending upon the nature of the investor, our personnel may meet an institution's portfolio managers or compliance officers. Some investors also ask to speak to our lawyers, auditors and prime brokers for references. The process usually also includes any number of on-site visits by the potential investor or their representatives. The right to on-site visits continues after the investment is made, as well as continued oral and written communications on a regular basis so that the investor can assure him/herself that the representations that we made at the outset are being honored.

The Coalition believes that these practices are the rule rather than the exception for the industry. Moreover, we fundamentally believe that a government policy which places responsibility for due diligence in the hands of the motivated, institutional or sophisticated investor acting in their own financial interest yields more transparency and information than a system of mandated government disclosures. Nevertheless, no system is so good that it cannot be improved upon, nor is there any single system that can protect all investors (or fund managers for that matter) from "fools and frauds" – to borrow a phrase coined by one of the Coalition's members.

For example, CPIC notes that the increasing amount of interest in investing in hedge funds by pension funds and others with fiduciary responsibilities to plan beneficiaries or endowments may well produce new industry initiatives to create some type of accreditation clearinghouse for use by investors to assure themselves that certain disclosures and best practices are followed.[29] In addition, there are other ways for the SEC to improve practices important for fraud prevention by all investment advisers to pooled investment vehicles who are not registered under the Advisers Act.

In 1960, Congress amended the Advisers Act to make the antifraud provisions applicable to all investment advisers, whether registered or not, and to give the Commission express rulemaking authority over unregistered advisers in subsection 206(4).[30] The Commission recently utilized this rulemaking authority in proposing new Rule 206(4)-8 to prohibit investment advisers, whether or not they are required to be registered, from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in pooled investment vehicles.[31] Using this authority -- to "prescribe means reasonably designed to prevent" fraudulent and deceptive acts,

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29 See, for example, the recent comments by former SEC Chairman Harvey Pitt at http://www.corpct.com/articles/2007/0227/pitt.php.

30 Pub. L. No. 86-750 § 9, 74 Stat. 885 (1960).

31 72 Fed. Reg. 400.

practices or courses of business[32] -- the Commission may write other rules for the prevention of fraud without resort to creation of a registration regime. For example, the Commission has the power to promulgate minimum protections against fraud for hedge fund investors -- protections that are "best practices" for any reputable hedge fund manager and which reduce the opportunities for unscrupulous managers to abscond with investor funds or defraud investors with misvaluations.[33]

The SEC has used this authority in the past to write prophylactic rules applicable to unregistered, as well as registered, investment advisers. However, it limited a number of its anti-fraud rules to SEC-registered advisers after Congress enacted Title III of the 1996 National Securities Market Improvement Act ("NSMIA") (the "Investment Advisers Supervision Coordination Act"), which, in brief, delegated the responsibility for regulating smaller advisers to state securities authorities. [34] Nonetheless, because the Advisers Act exempts investment advisers with fewer than fifteen clients from registration, an investment adviser with a small number of clients (including pooled investment vehicles) that manages large amounts of investor assets could, depending on the requirements of applicable state law, operate without being subject to the minimal

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[32] The statutory provision states, in full: "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly--

> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 80b-6.

[33] *See e.g.* SEC v. Samuel Israel III, SEC Litigation Release No. 19,406, 2005 WL 2397234 (Sept. 29, 2005) (managers of a group of hedge funds known as the Bayou Funds grossly exaggerated claims regarding funds' performance, when in fact, the funds had never posted a year-end profit, and misappropriated funds); SEC v. Haligiannis, SEC Litigation Release No. 18,853, 2004 WL 1908196 (Aug. 25, 2004) (fund and its general partners systematically defrauded investors by misrepresenting performance to investors and potential investors and distributing phony account statements that showed fictitious gains and account balances).

[34] 72 Fed. Reg. at 402. *See also* Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. 1633, 62 Fed. Reg. 28,112 (May 22, 1997).

types of investor protections that laws such as the Advisers Act might otherwise afford.[35] Thus, it may be appropriate for the SEC to examine the extent to which investors in private investment pools are not protected by federal or state requirements and whether the industry cannot, on its own, adopt best practices in critical areas. The SEC could then consider whether it should exercise its rulemaking authority and apply certain base-level requirements to advisers of funds who may "fall between the cracks."

For example, any investment adviser to a pooled investment vehicle should hold the assets that they control at, and make transfers of such assets only through, a bank or trust company, broker-dealer, futures commission merchant, or certain well-regulated foreign banks and broker-dealers. This is a sound practice that is currently required of investment advisers that are registered or required to be registered under the Advisers Act.[36] Before the SEC amended its custody rules in 1997, the SEC's then-existing custody rule was applicable to unregistered advisers as well. Such a custody requirement should not impose any undue regulatory burdens. It is simply reflects good practice by any reputable adviser to a pooled investment vehicle.

Similarly, using its antifraud rulemaking authority, the SEC could consider extending to unregistered advisers certain of the key investor protections that presently apply only to investment advisers that are registered or required to be registered with the SEC. As with the custody rule, some of these requirements were previously applied, in some fashion, to advisers that are not registered with the SEC. More importantly, they

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35 Specifically, Section 203 exempts from registration any investment adviser who during any twelve-month period has fewer than fifteen clients and that does not holds itself out to the public as an investment adviser or act as an adviser to any mutual fund. 15 U.S.C. § 80b-3.

36 Advisers Act Rule 206(4)-2; 17 C.F.R. § 275.206(4)-2.

are fundamentally sound ways of doing business that would not impose substantial burdens on legitimate private investment funds or their advisers. These include:

- Requiring private investment pools -- whether or not their advisers are required to register with the SEC -- to undergo an annual audit by an independent accounting firm and to provide their investors with audited financial statements on a yearly basis, and un-audited financial reports on a quarterly basis.[37] Such requirements would serve to detect and deter fraud and would give investors assurance that the financial information that they receive from a Fund is fair and accurate.
- Requiring that prospective fund investors receive information relating to the adviser's disciplinary history and financial condition, similar to the disclosures required by Rule 206(4)-4.[38]
- Requiring advisers, whether or not registered, to adopt and disclose written supervisory and compliance policies and procedures and codes of ethics.[39] Such policies and procedures, at a minimum, would address the disclosure of financial arrangements between advisers and other interested parties such as prime brokers, the disclosure of an adviser's allocation policies so investors know how an adviser with multiple clients allocates investment opportunities, and disclosure of objective standards for the calculation of unit values for investor reports, fees, admissions and withdrawals.[40]

The requirements generally discussed above would be non-intrusive, consistent with best practices and impose little or no burden on advisers. We raise them here, because we believe they are important practices to prevent fraud by investment advisers, and we believe the SEC has authority to implement them without resort to a requirement

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37 *See* Rule 206(4)-2; 17 C.F.R. § 275.206(4)-2.

38 17 C.F.R. § 275.206(4)-4.

39 *See* Rules 204A-1, 206(4)-7; 17 C.F.R. §§ 275.204A-1, 275.206(4)-7.

40 *See generally* Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204, 68 Fed. Reg. 74,714, 74,716 (Dec. 24, 2003). We do not suggest that all the rules that apply to investment advisers that are registered or required to be registered with the Commission should be extended to hedge fund managers. Rather, the SEC should consider select protections that would help prevent flagrant or criminal misconduct, such as theft. To illustrate, we believe that hedge fund advisers should not have to adopt and disclose proxy voting policies, as do investment advisers that are registered or required to be registered. Rule 206(4)-6; 17 C.F.R. § 275.206(4)-6. This requirement does not serve the purpose of preventing flagrant misconduct, and if investors in private placements care for such information, they may always ask for it.

that all hedge fund managers register under the Investment Advisers Act. However, they should be considered and proposed only after significant input from investors, the hedge fund industry, and others, and considered in connection with a concept release or a separate SEC rulemaking.

Other Issues

There are other issues that we believe warrant the attention of policy makers and regulators. When we testified last May before the Senate Subcommittee on Securities,[41] we raised as a concern the issue of valuation of illiquid and over-the-counter securities. We continue to believe that valuation is an area of activity by pooled investment vehicles open to abuse -- both as to the potential for outright fraud, and as to the lack of or failure of adequate models or policies and procedures to conduct valuation of derivatives, other illiquid assets, or securities for which market prices are not readily available.

Proper valuation of fund assets is an extremely important component of investor protection. Valuations serve many crucial functions, and it therefore is important that they be accurate and performed in an unbiased, consistent and transparent manner. Valuations of assets and liabilities are used to determine the value of the units of the fund owned by investors. As reported numbers, they tell the investor what his or her investment is worth at a given point in time. These numbers also determine the price at which new units are issued and existing units are redeemed. To avoid dilution and unfairness, these numbers must be accurate and unbiased. Valuations are used to determine the compensation of the hedge fund's managers -- which typically is a

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41 *Hedge Fund Industry: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking, Housing, and Urban Affairs* (May 16, 2006) (statement of James Chanos, Chairman, Coalition of Private Investment Companies), *available at* http://banking.senate.gove/_files/ACF82BA.pdf.

percentage of the asset value of the fund during a month, quarter or year, and a percentage of the increase in value of the fund of the past year. Valuations are also used to calculate performance reporting numbers, to inform investors how the fund is performing over time, both in absolute return terms, relative to the relevant market index benchmarks, and under various statistical measures of volatility and tracking that are designed to measure risk and the degree to which the fund manager sticks to its investment strategy.

The consistency and uniformity of performance reporting also is an area of concern. It goes to the heart of an investor's ability to choose wisely among a myriad of financial and investment products -- giving the investor an "apples vs. apples" choice -- a true comparison.

Despite the existing requirements on valuations and performance reporting, there is substantial room for improvement in this area by hedge funds, mutual funds and other investment management vehicles.[42] We believe that valuation and performance reporting issues are appropriate governmental concerns -- but first and foremost, they should be the concern of any fund manager or other market participant, as well as hedge fund investors.[43] Valuation issues cannot be solved by the SEC acting alone. Valuation of over-the-counter derivatives or other types of illiquid investments is a topic that rightly

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42 The situation is most acute for positions in complex and illiquid assets, for which there is not a reporting market providing a transparent daily consensus valuation. By necessity, estimates and pricing models must be used to value these types of fund portfolio positions, and there is much opportunity for mischief. In the derivatives area in particular, hedge funds should delineate their unrealized derivative gains and losses by breaking them out on the income statement and balance sheet. This will aid transparency and is simply good public policy.

43 The Managed Fund Association, for example, in its publication "MFA's 2005 Sound Practices for Hedge Fund Managers," addresses the importance of hedge fund managers establishing valuation policies and procedures that are fair, consistent and verifiable, and it discusses a number of steps hedge fund managers should take in pricing assets and performing valuations. *Available at* www.mfaininfo.org/images/PDF/MFA2005SoundPracticesPublished.pdf.

must involve all of the members of the President's Working Group, and in particular, the Board of Governors of the Federal Reserve System, to ensure consistency and harmony. In our view, the appropriate role for government in this area is to facilitate and encourage a dialogue among experts from across the financial services industry, academia, the accounting profession, economists and others, on valuation issues and best practices.

Conclusion

The Coalition again thanks Chairman Frank, Ranking Member Bachus and the members of the Financial Services Committee for the opportunity to testify this morning. We strongly believe that this type of open discussion of the issues confronting our financial markets is an excellent antidote to the misconceptions and misinformation that exists about this vital industry. We further believe that it provides a salutary benefit of keeping the industry itself mindful of the need to continue improving upon its practices, so that hedge funds will remain an appropriate investment choice for institutions such as pension funds and endowments. I would be happy to answer any questions that the Committee may have.

Coalition of Private Investment Companies

James S. Chanos
Chairman

Jim Chanos is the Chairman of the Coalition of Private Investment Companies ("CPIC"), a coalition of hedge funds with an aggregate of over $60 billion in assets under management. Mr. Chanos is the founder and Managing Partner of Kynikos Associates. As the largest exclusive short selling investment firm, Kynikos provides investment management services for both domestic and offshore clients. Through investment funds, partnerships, corporations and managed accounts, both domestic and offshore, Kynikos Associates maintains private portfolios of securities for clients. The funds, Ursus Partners, as well as Ursus International for non-U.S. clients, attempt to profit from the unusually high alphas found on the short side of the U.S. equity market.

Mr. Chanos opened Kynikos Associates in 1985 to implement investment strategies he had uncovered while beginning his Wall Street career as a financial analyst with Paine Webber, Gilford Securities and Deutsche Bank. Throughout his investment career, Mr. Chanos has identified and sold short the shares of numerous well-known corporate financial disasters; among them, Baldwin-United, Commodore International, Coleco, Integrated Resources, Boston Chicken, Sunbeam, Conseco and Tyco International. His celebrated short-sale of Enron shares was recently dubbed by *Barron's* as "the market call of the decade, if not the past fifty years."

Born and raised in Milwaukee, Wisconsin, Mr. Chanos currently lives in New York with his four children and is active in many charitable foundations and educational institutions. Mr. Chanos received his BA in economics and political science in 1980 from Yale University.