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RECENT DEVELOPMENTS IN HEDGE FUNDS

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE RECENT DEVELOPMENTS IN HEDGE FUNDS (AN INVESTMENT COMPANY THAT USES HIGH-RISK TECHNIQUES, SUCH AS BORROWING MONEY AND SELLING SHORT, IN AN EFFORT TO MAKE EXTRAORDINARY CAPITAL GAINS), FOCUSING ON INVESTOR PROTECTION IMPLICATIONS, THE DIFFERENCES BETWEEN HEDGE FUNDS AND INVESTMENT COMPANIES, REGULATION UNDER FEDERAL SECURITIES LAWS, AND CONFLICTS OF INTEREST

APRIL 10, 2003

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C O N T E N T S

THURSDAY, APRIL 10, 2003

RECENT DEVELOPMENTS IN HEDGE FUNDS

THURSDAY, APRIL 10, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

Today, the Committee will be hearing from the SEC Chairman William Donaldson regarding the hedge fund industry. The immediate reason for this hearing is to get a progress report on the ongoing SEC oversight investigation of the hedge fund industry. I hope that this hearing will shed some light on developments within an industry that has been the subject of a great deal of surmise and opinion, but much less in the way of objective analysis.

Despite the recent bear market, America remains a Nation of investors. The Internet, cable, satellite TV, and a host of other technological innovations have made information regarding the marketplace available just about anywhere at any time. We are all familiar with the trappings of Wall Street. But at a time when the floor of the New York Stock Exchange doubles as a set for a television show, and market analysts are TV personalities, hedge funds remain the last frontier, an uncharted area of our capital markets.

Historically, hedge funds have been an outlier in the world of functional regulation. These investment pools have been, to borrow Winston Churchill's words regarding Russia, "A riddle wrapped in a mystery inside an enigma." Hedge funds are not household names, and their managers have usually gone to great lengths to avoid public attention. Hedge funds operate in relative obscurity because they are limited partnerships, financed through private placements. Like all market participants, hedge funds are subject to the antifraud provisions of the Federal securities laws. However, they are exempt from a regulatory regime like that applied to broker-dealers, investment-advisers, or publicly traded companies.

Most businesses are focused on their public image and branding; but hedge funds have not only avoided publicity, as privately placed offerings, but they are also prohibited from advertising to the public. As private placements, hedge funds are the domain of extremely wealthy individuals and institutional investors. The securities laws deem that such investors have the acumen and the negotiating power to fend for themselves to a degree that the ordinary investor cannot. This is not a hedge fund-specific exemption.

Events of the recent past have attracted unwanted attention to these funds. The 1998 collapse of Long-Term Capital Management put hedge funds on the front pages of the business news. In the intervening years, hedge funds have continued to attract media attention. Since the beginning of the recent bear market, much of that attention has focused on the "retailization" of hedge funds, the explosive growth in the number of hedge funds, and an equally explosive growth in the number of hedge fund closings.

During the recent bear market it appears that hedge funds have had positive, if not spectacular, results. However, positive returns have been enough to attract a flight of capital from more traditional market investments. And the generous fees that hedge fund managers earn has been enough to attract many of the best money managers. The desire to retain talent has led many mutual funds to establish affiliated hedge funds.

As we consider these issues today, I believe it is important to remain mindful of the important role that hedge funds continue to play in our capital markets. Hedge funds are a liquidity source that permits capital to seek higher rewards, regardless of the overall market environment. They can provide expert management for patient capital that understands, and can bear the risks associated with seeking higher returns. However, when these funds are made available to less sophisticated investors through mutual funds, investor protection concerns arise that deserve careful consideration. These so-called "funds of funds" must provide sufficient transparency and protection for their customers.

The growth of an indirect retail market and other recent trends in the industry pose a number of investor protection issues. For instance, are retail investors receiving sufficient disclosure regarding their investments in so-called "funds of funds." Is the conflict posed by comanagement of hedge funds and mutual funds being properly managed? Are any hedge funds using the opaqueness of the private placement to misuse or mismanage funds entrusted to them? The Committee looks forward to answers to this and other questions.

I commend the SEC for its efforts to undertake this important and timely review of the hedge fund industry and look forward to Chairman Donaldson's testimony before the Committee today.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I want to commend you for holding this morning's important hearing on hedge funds. I join with others in welcoming Bill Donaldson, the Chairman of the SEC.

I think this is your first opportunity to come back and testify before the Committee since your confirmation.

Chairman DONALDSON. It is, indeed.

Senator SARBANES. So let me extend a warm welcome to you, Mr. Chairman.

I also want to note that just yesterday, the Senate approved the SEC Civil Enforcement Act, which was incorporated into the Care Act of 2003. This Civil Enforcement Act will strengthen the SEC's authority to prosecute securities fraud violations and will augment investor protection. Chairman Donaldson was very strongly in support of it, and we appreciate that strong support.

This is legislation that the SEC's Enforcement Division has sought and it will contribute to their holding securities law violators accountable for their actions. We look forward to working it through the balance of the legislative process and providing those additional civil enforcement tools to the SEC.

Mr. Chairman, in September 1998, the collapse of Long-Term Capital Management drew international attention to hedge funds. *The Economist* called it, "One of the greatest financial failures of all time. The hedge fund's losses were spectacular: around $4 billion in 5 weeks. . . . The fund's implosion came perilously close to causing a catastrophic failure of the global financial system." That is *The Economist,* a staid, responsible magazine. Obviously, the collapse of Long-Term Capital Management raised very important issues of systemic risk and excessive leverage.

Since that time, hedge funds actually have grown tremendously. Industry sources reported that, "Since the turn of the century, the hedge fund industry has grown by 82 percent, from $324 billion to $592 billion," and, in the last 10 years, the number of hedge funds has grown from about 1,100 to 5,700. *Fortune* reported that Warren Buffet has said, "Hedge funds have become the latest Holy Grail." At the same time, according to *The Financial Times,* "Fifty percent of all new hedge funds closed down within about 3 years of starting up." The growth in the industry has been accompanied by an increase in fraud and in the number of SEC enforcement actions.

Hedge funds used to be investments for the very wealthy. Hedge fund managers sold only to, "accredited investors," those who earned more than $200,000 per year, or had more than one million dollars in assets, which enabled them to take advantage of an exemption in the securities laws.

However, the market for hedge funds has greatly expanded and spawned funds of funds. *Fortune* reported that, "Funds that make investments in hedge funds are peddling themselves to less accredited investors as well—dentists, school principals, and the like—for minimum stakes, as low as $25,000. What is more, a huge group of shareholders may be in hedge funds and not even know it—America's retirees, through their retirement plans."

This raises some concerns about investor protection. Chairman Donaldson, at his confirmation hearing before this Committee on February 5—and we keep going back to that transcript, Chairman Donaldson, as our reference text as we deal with the SEC—referred to "A distressing move toward what I would call the retailization of hedge funds, making them available to smaller and smaller investors . . . less sophisticated investors not realizing the risks inherent in the vehicle." And Chairman Donaldson went on to note that hedge funds are "pretty much totally unregulated."

The SEC and other Federal regulators have been looking at these issues for some time. In 1999, the President's Working Group on Financial Markets issued a report titled, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." In that report, the Working Group recommended that: First, hedge funds be required to "disclose additional, more up-to-date information to the public" through periodic reports. Second, public companies should publicly disclose "summaries of direct material exposures to significantly leveraged financial institutions." And third, financial regulators, including the SEC, should encourage improvements in the risk-management systems of securities firms.

More recently, the Commission initiated a major investigation into the hedge fund industry. And I appreciate and commend the attention and interest that Chairman Donaldson is now devoting to this area.

I gather that the SEC, in the middle of next month, is going to be holding a series of like roundtable discussions with respect to hedge funds.

Let me just note, there are many important issues to consider, particularly as they relate to retail investors. These include: The suitability of offers and sales of hedge funds to retail investors. The adequacy of information available to such investors about their investments and their fund managers. Regulation of hedge funds offered to retail investors. Conflicts of interest that may arise where a firm manages both mutual funds and hedge funds. Conflicts of interest that may result with the higher fees charged to investors in hedge funds.

There have been a number of articles about the problem with this, when you do both mutual funds and hedge funds and how, on the part of the managers, that raises important conflict questions.

Other issues which have been consistently raised by commentators include: The valuation of hedge funds and the reporting of fund performance. The leverage associated with hedge funds. The potential systemic risks associated with the failure of a large hedge fund. To go back to the Long-Term Capital Management situation, the adequacy of market surveillance to protect against potential market manipulation by hedge funds, again, I think an interesting and important question. The lack of information about the size and activities of the hedge fund industry, including the rate and causes of hedge fund failures. Possible preferential treatment that brokerage firms give hedge funds. And whether the minimum wealth levels of the exemption for sophisticated investors should be revised. And I think this is only the beginning of the questions that need to be asked.

Regarding the importance of hedge fund markets, *Fortune* magazine in a recent article entitled, "Where The Money Is Really Made," stated that, "The hedge fund boom has sweeping implications, not just for Wall Street traders and a few thousand well-heeled investors, but, increasingly, for every American business person, investor, and retiree."

We look forward to hearing and learning more about these potential "sweeping implications."

Mr. Chairman, I want to commend you again for scheduling this hearing and launching the Committee on oversight with respect to this important issue.

I simply close by going back to *The Economist's* description of the implications of the collapse of Long-Term Capital Management. We have to be alert to the risks that might occur on our watch. *The Economist,* said then, talking about Long-Term Capital Management, which they regarded as one of the greatest financial failures of all time—"The fund's implosion came perilously close to causing a catastrophic failure of the global financial system."

And of course, it is the responsibility of all of us, the Commission, this Committee, and other financial regulators, to make sure that we are not at risk of such consequences.

Thank you very much.

Chairman SHELBY. Senator Sununu.

COMMENTS OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Chairman Shelby. I just want to thank you for holding this very important hearing. I have no opening statement, Mr. Chairman. I am anxious to hear the Chairman's testimony.

Chairman SHELBY. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I have a formal statement for the record.

Chairman SHELBY. It will be made part of the record in its entirety, without objection.

Senator CORZINE. Thank you. Let me express my appreciation for your holding this hearing. And particularly, let me thank Chairman Donaldson for his attention to an issue that I think all of us would be well served to have an oversight and understanding of as it fits into our economic system.

As one that has benefited and participated along with an industry called the hedge fund industry, and seen its evolution from a pretty straightforward long/short structure of investing to maybe some of the most complicated elements of investing that have ever been put together, say as Long-Term Capital has been noted, this is really something that I think we need to understand in the context of our economic system today, the $600 billion number cited, the number of funds, the proliferation is really quite substantial.

And I think there are a number of issues that—and I heard Senator Sarbanes talk about investor protection issues, investor suitability, the retailization, funds of funds structure really changing the whole nature, fee structures on top of fee structures, that may or may not be understood by some of those that participate, market integrity issues, conflicts of interest that can come from mutual funds and hedge funds being managed by the same people.

Maybe one of the most serious issues is there is no standardization of evaluation. So how is it easy to compare one fund to another that I think deserve consideration and some transparency of discussion about.

We talked about market stability and potential for systemic risk. Anybody that was seriously close to the Long-Term Capital situation has to know that the derivative position really takes that $600 billion number and explodes it into an extraordinary amount of potential impact for markets.

If you looked at the notional amount, not necessarily the only way to look at exposures and financial systems. But when you add the notional amount of some of the derivative positions associated with a cash position of $600 billion, you are really talking in the trillions of dollars of impact in the marketplace in a realistic sense.

And I do not think that we can have such an important element of our financial system completely outside of some oversight and understanding by those that provide protection for the system.

I think this is a very useful beginning and the kinds of things that the SEC is doing with its roundtable discussion, are important. Getting the right balance so that we do not damage our system is equally important.

But we no longer have a very narrow, single-dimensional element in our hedge fund community. I am not exactly sure how you even define a hedge fund these days. And I think we need to have a better understanding of how they operate and their impact on the market.

I look forward to this hearing and continued discussion on improving the safety and soundness of our system. And I congratulate having this hearing and, again, Chairman Donaldson for his efforts along these lines as well.

Chairman SHELBY. Senator Dole.

COMMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Mr. Chairman, in the interest of time, I will submit my written statement for the record.

Chairman SHELBY. Your statement will be made a part of the record, without objection.

Senator Dodd.

COMMENTS OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, let me, just to move things along, apologize for racing in here. Let me catch my breath and ask for uninamous consent to add my statement to the record.

Chairman SHELBY. Without objection, it is so ordered.

Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I have no statement at this time.

Welcome, Chairman Donaldson.

Chairman SHELBY. Senator Allard.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I do have a statement that I would like to make a part of the record.

Chairman SHELBY. Without objection, it is so ordered.

Senator ALLARD. I would just comment that hedge funds have a specific purpose in controlling risk. But once we get beyond that and they are looked at as more of an investment portfolio, then I have some real concerns. It takes someone really knowledgeable to manage these sorts of derivatives.

I want to thank you for holding this hearing. It is very timely.

Chairman SHELBY. Senator Dodd.

Senator DODD. Mr. Chairman, just a couple of comments.

I think it is important with the schedules that we all keep around here, people coming and going, and we may not get the chance to express some of our general thoughts and comments on this. So, I thought I would take a minute, if I could, with the Committee's indulgence, just to share a couple of thoughts on the subject matter.

I want to thank you, Mr. Chairman, for doing this. This is exactly the kind of hearing that we should be holding and you are to be commended for placing this as high on the agenda and as early in the year as you have, and I thank you for doing that. It is tremendously helpful. We have to stay in touch with all of these critical issues. And this is a critical component of our financial markets, and so it is extremely important that we look at it.

I also want to thank Chairman Donaldson. This is your first appearance since your confirmation hearing before this Committee, and we thank you for being here with us today.

It is going to be appropriate and important for us to review our securities laws, including the various exceptions to those laws that are operating. And that is what we are going to be talking to you about today, in no small measure.

Hedge funds, as has been noted, play a very important role in our capital markets and I think all of us would agree with that. But given the unsupervised nature of the industry, it is necessary I think to closely examine two very important features.

First, is it possible for hedge funds to become so highly leveraged, to the point that they can create systemic risk? Or has the market and the regulators learned lessons from previous events?

Second, are hedge funds, which were intended to be used by the most sophisticated of investors, being inappropriately marketed to those who do not understand the nature of the risks associated with hedge funds?

While we want markets to continue to be creative and entrepreneurial, we at the same time bear a responsibility to protect the unsophisticated investors not only from fraud and deception, but also unsuitable financial investments. That is a difficult standard to meet, but certainly one that we should debate and discuss.

While there are other aspects of hedge funds that should be reviewed, I would urge the Chairman, in his ongoing examination of hedge funds, to pay particular attention to these points, at least from my perspective.

So with those points in mind, Mr. Chairman, I thank you again for doing this today. It is extremely worthwhile and important.

Chairman SHELBY. Chairman Donaldson, we again welcome you to the Committee and we believe that you will be coming back and helping us along on other issues.

Please proceed as you wish. Your written statement will be made a part of the record in its entirety.

STATEMENT OF WILLIAM H. DONALDSON
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman DONALDSON. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I would like to make just a brief statement here and then get to a number of the questions that have been implied.

I just want to thank you, first of all, for inviting me to discuss some of the investor protection implications of hedge funds and the Securities and Exchange Commission's ongoing fact-finding investigation into this area. I appreciate the opportunity to discuss this important subject with you.

Over the past few years, hedge funds have become more prominent and more popular. It is estimated that there are close to 5,700 hedge funds operating in the United States today, managing approximately $600 billion in assets. In contrast, in 1990, only about $50 billion was under management. There are frequent reports of high returns for hedge funds. Just as frequently, these reports highlight possible areas of concern, such as the potential conflicts of interest, valuation concerns, questionable marketing techniques, including, as you mentioned, the possible retailization of hedge funds, prime brokers, possible fraud in the hedge fund industry, and the market impact of hedge fund strategies.

Since June 2002, the SEC staff has been engaged in a review and investigation of the structure and practices of hedge funds. The Commission is still at the fact-gathering stage and have yet to reach any conclusions. But I want to report that I have ordered us to move to the next stage of our investigation, and we will be holding, as you noted, important public roundtables on May 14 and 15.

A little bit of history. Hedge funds have been around in some form since the establishment of the Jones Hedge Fund in 1949. The term "hedge fund" is undefined, including in the Federal securities laws. Indeed, there is no commonly accepted universal meaning. As hedge funds have gained stature and prominence, the term "hedge fund" has developed as a catch-all classification for many unregistered, privately managed pools of capital. These pools of capital may or may not utilize the sophisticated hedging and arbitrage strategies that traditional hedge funds employ, and many appear to engage in relatively simple equity strategies. Basically, many hedge funds are not actually hedged, and the term has become a misnomer in many cases.

The last time the Commission took a really good look at the hedge fund industry was in 1998, when, as you mentioned, the Connecticut-based hedge fund, Long-Term Capital Management, nearly collapsed.

Senator DODD. You had to say Connecticut, didn't you.

[Laughter.]

Chairman DONALDSON. Sorry, Senator.

[Laughter.]

There are lots in other States.

After that incident, the Commission, along with the Treasury Department, the Federal Reserve, and the Commodity Futures Trading Commission, as part of the President's Working Group on Financial Markets, issued a report on the risk management and transparency issues raised by Long-Term Capital Management, in particular, and by highly leveraged institutions in general. The President's Working Group looked at such issues as the firms' adherence to their own stated policies, their margin and collateral requirements, their use of leverage, and whether it was excessive, and how well their risk models functioned. The report made serious recommendations that were intended to improve how firms functioned in these areas; and, based on our examination of the major brokerage houses that service hedge funds, many institutions extending leverage to hedge funds seem to have taken these recommendations to heart.

In addition to this examination of the risk management and transparency issues, the Commission staff actively supported the work of the Multidisciplinary Working Group on Enhanced Disclosure and the subsequent Joint Forum Working Group on Enhanced Disclosure, which the Commission chairs, and is ongoing. Both groups address issues of enhanced disclosure for financial intermediaries, such as banks, securities firms, insurance companies, and hedge funds. We believe that many in the hedge fund industry are considering the recommendations of these two groups and contining to explore ways to improve some of their practices.

Nevertheless, the markets have continued to evolve, and I believe the time has come for us—the SEC and the President's Working Group, of which the SEC is a part—again to review these risk management, transparency, and public disclosure issues. As part of the SEC's ongoing investigation into the operations of hedge funds, we are also addressing issues from the perspective of investor protection and looking into other issues related to the overall market impact of hedge fund practices.

Our current investigation is proceeding. The SEC staff have obtained and reviewed documents and information from 67 different hedge fund managers representing over 650 different hedge funds and approximately $162 billion under management.

The staff has spoken to brokerage, compliance, risk management, legal, and other operational personnel of multibillion-dollar complexes with dozens of employees, as well as to their portfolio managers. And, at the other end of the scale, the staff has visited hedge funds where one employee serves as the marketer, the portfolio manager, the trader, the operations officer, and the risk manager.

Aside from our inquiries directed to the specific hedge funds, the staff has met with a variety of experts in their respective fields to get their perspectives on the hedge fund industry. In addition to the legal and accounting experts, the staff has spoken with chief investment officers, risk managers, prime brokers, representatives from foreign regulators, trade industry representatives, and hedge fund consultants. Also, a number of foreign jurisdictions are revisiting their approaches to hedge funds, and we continue to benefit from discussions with our foreign counterparts.

In conclusion, let me just assure you that our goal in this exercise is to determine how we can better protect investors and our securities markets. By working together, I believe that we can achieve this goal.

And I want to thank you again for inviting me to speak on behalf of the Commission. It is a subject that interests me considerably, and I would be happy to answer any questions you have.

Thank you.

Chairman SHELBY. Thank you, Mr. Chairman.

Chairman Donaldson, your investigation at the SEC is looking at investment managers who handle both hedge funds and mutual funds. How common is it for managers to have both types of funds under their control?

Chairman DONALDSON. I think there is an increasing number of registered advisers who manage mutual fund complexes and so forth getting into the hedge fund industry in one form or another.

I do not think that that was particularly prevalent as recently as 5 or 6 years ago. But, as a number of trends have come into view, particularly the competition from the hedge fund industry with the mutual fund industry, I think that they have been forced to go into that business.

Chairman SHELBY. What type of disclosure do these investment firms typically make to investors in the mutual funds?

Chairman DONALDSON. Well, I am going to go to a few—if I can find it in my little book here——

Chairman SHELBY. Take your time.

Chairman DONALDSON. —the regulations. And I do not want to get into too much detail. But let me just try and categorize for you.

The hedge funds basically avoid regulation by meeting criteria that are laid out in four general exclusions or exceptions.

We have the Investment Company Act of 1940, and there is an exclusion there. And some of the managers that you are talking about, mutual fund managers, come under that Act. But there is an exclusion for the hedge fund part. There is an exemption from the registration under the Securities Act of 1933. There is an exception from registration by the hedge fund manager under the Investment Advisers Act. And there is an exception from reporting requirements under the Securities and Exchange Act of 1934.

Under each one of those categories, there are different ways that hedge fund managers can get themselves out from being regulated. I can go into more detail if you want, but it gets a little complex in terms of the numbers.

Chairman SHELBY. Sure, it does.

Chairman DONALDSON. But under Section 3(c)(1) of the Investment Company Act of 1940, there is an exclusion if a fund has no more than 100 investors and there is no public offering. If you can keep your number of investors under 100 and there is no public offering, you are excluded from regulation under that Act.

Another section of the Investment Company Act, 3(c)(7) has been more recently passed. There is no limit on the number of investors up to a practical level of about 500. But investors must be qualified purchasers, and they must be high net-worth individuals. And under Section 3(c)(7), only high net-worth individuals, generally individuals who own certain specific investments worth at least $5 million in investments may invest; and again, there can be no public offering.

Then there is the exemption under the Securities Act of 1933. And under that exclusion or exemption, hedge funds generally can sell their securities only to those who qualify as accredited investors; individuals, as you mentioned earlier, with a minimum of $200,000 annual income, or $300,000 taken into consideration with spouses, and a minimum of $1 million in net assets.

Might I add that, as time has gone on, those criteria which were set up a long time ago have moved a lot of people into those categories, if you will, who weren't there before.

Chairman SHELBY. Sure.

Chairman DONALDSON. Under the Investment Advisers Act, hedge fund managers, because they are providing advice about securities of others, fit into the definition of an investment adviser. However, an adviser with fewer than 15 clients and that does not publicize itself generally as an investment adviser is not required to register with the Commission. And that has the effect under our rules that the hedge fund itself counts as one client and not the number of investors in the fund.

So, you can have quite a few investors in that fund.

Chairman SHELBY. Mr. Chairman, are mutual fund investors apprised of the existence of a hedge fund affiliate? Are there existing requirements for this kind of disclosure under the securities laws?

Chairman DONALDSON. I do not want to give a definite answer to that.

Chairman SHELBY. Do you want to do it for the record?

Chairman DONALDSON. I would like to come back to you and give you an answer on that. I think that if it is there, it is pretty spotty.

Chairman SHELBY. Spotty, at best.

Chairman DONALDSON. Spotty.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

I have to say as I listen to Chairman Donaldson run through the litany of the various securities legislations and the exemptions and exceptions that exist, you have this uneasy sense of people laying these statutes out in front of them and then charting their course through the exemptions and the exceptions, and leaving us all with an uneasy feeling that there are ticking timebombs out there.

Therefore, again, I underscore the timeliness of this hearing. And I want to commend Chairman Shelby because he is obviously operating under the old adage that an ounce of prevention is worth a pound of cure. And I think we have to be very mindful of that in this instance.

Chairman Donaldson, *USA Today,* just in January, only a few months ago, reported that Harry Edelman, the CEO of Farmer Mac, had talked about possible market manipulation. He said, "We have no problem with the publication of legitimate research. But when short-sellers publish misinformation for the purpose of enhancing their positions, we find that objectionable." And he went on to accuse certain hedge funds of orchestrating a disinformation campaign.

The Wall Street Journal, in an article about the same date, entitled, "Regulators Review Complaints About Hedge Funds," identified additional companies which have complained that various hedge funds were working in concert to spread negative information about their stock.

What is the Commission doing to detect and to prevent market manipulation by hedge funds and other market participants?

Chairman DONALDSON. Under our Market Regulation Division and the Enforcement Division, we are constantly looking at allegations of market manipulation.

I think that the issue before the House today is how the market can be manipulated—there are cases of market manipulation obviously going on all the time, and I think we are on top of those.

The question is, how much of that can be attributed to the specific vehicle, the hedge fund? And as I have indicated, there is a pretty broad spectrum that we are talking about. I think the investigation we are doing now, and the focus that will come from our seminars and roundtables and so forth, will give us a lot better feel for how much can be attributed to hedge fund techniques.

Senator SARBANES. Are the roundtables the concluding step with respect to your study that can then lead to recommendations and action?

Chairman DONALDSON. We are certainly not having them to put into the volumes and put on the shelf. I think it is very important that we give an opportunity to all sorts of people who are involved in this business to talk about the way that they are operating their funds.

This is, I think you will see, a mix of people that we are bringing together. Some will be critical of the hedge fund industry. Some will be very defensive of their records. And we are trying to sort that out, and I think we are trying to get at that—and we do not expect that anybody will come before us and talk a lot about how they manipulate the market. So, we are going to have to depend upon our own investigative powers to get at whether hedge funds are manipulating the market.

Senator SARBANES. The NASD only a couple of months ago issued a Notice to Members entitled, "NASD Reminds Members Of Obligations When Selling Hedge Funds."

And they went on to say in that Notice: "As a result of a recent review of members that sell hedge funds and registered products, closed-end funds that invest in hedge funds, so-called funds of hedge funds, NASD staff is concerned that members may not be fulfilling their sales practice obligations when selling these instruments, especially to retail customers."

Now what was the conduct by stock brokers that led the NASD to issue this Notice? And what is the SEC doing about more closely monitoring sales practices, or taking other appropriate actions?

Chairman DONALDSON. As you know, an entire division of the SEC is charged with monitoring and reviewing the sales practices of registered broker-dealers.

I do not know of that specific instance that you referred to there, but I think we probably discovered evidence—or the NASD did—that made them feel that they should investigate and then caution.

I do feel that we are watching very closely—with an adherence to the regulations I just mentioned—to make sure that people who are not registered are properly taking advantage of those various exclusions.

Having said that, the ability to combine smaller and smaller investors into these pools has been enhanced. And I think that is right on point here; practices used to sell hedge fund investments to a less sophisticated person. You can get down to a pretty small amount of money—a relatively small amount of money—and still get into one of these funds.

Senator SARBANES. My time is expired. I presume we will have a second round.

Chairman SHELBY. We will.

Senator SARBANES. But just on this final point, I think we may have to close the door on some of those exceptions or exclusions, or define them in such a way that they accommodate what needs to be accommodated, but aren't utilized or manipulated for other purposes that may endanger the stability of our markets.

Presumably, the Commission is taking a look at that.

Chairman DONALDSON. I think you are absolutely correct that we have to reexamine the various levels and parameters of exclusions.

I will say that I believe we have to be careful in terms of the word risk because you can meet hedge fund managers who will explain to you why their hedging techniques accomplish just the opposite, how the risk parameters of what they are doing makes them less risky, let's say, than a common stock or a mutual fund.

Chairman SHELBY. But you cannot take the risk out of the marketplace, not all of it, anyway, can you?

Chairman DONALDSON. No. But in theory—and I am going to show my age now—I remember Mr. Jones way back in that period of time when he started the first hedge fund. His thought was that, if you are going out and analyzing companies and you find good companies to invest in, but, during that process, you find companies you think are not so good, if you put equal amounts of money into both sides and insulate yourself from overall market risk. And then added to that was leverage, and it took it on from there. But the idea was risk minimization, not risk acceptance.

Chairman SHELBY. But not elimination of risk.

Chairman DONALDSON. No. And, as we have seen in Long-Term Capital Management and so forth, the risk has been enhanced through leverage on that end of the spectrum.

Chairman SHELBY. Thank you.

Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. Chairman, it seems to me there are two broad concerns here. The first involves Long-Term Capital Management and what came out of that crisis. They were able to leverage themselves to a very large degree with the cooperation of public institutions. And there is a lot of discussion about the systematic risk that may or may not have come from their collapse.

But to the degree that there was systematic risk or potential for systematic risk, it was because they were allowed to leverage themselves up to such a high level with the cooperation of those public institutions and what their collapse might mean to the public institutions.

And the second is another set of issues that we have also been talking about, which is the degree to which retail investors, uninformed investors, "unsophisticated investors" described by the statutes, are being exposed to the risks that are inherent in some of these funds inherent to the markets, and that is what the Chairman was talking about.

These are both important issues to discuss and to understand, but I see them as somewhat distinct.

First, let me touch on the issue that grew out of Long-Term Capital Management. This was a case where we had not just some large Wall Street firms, but the largest, most prestigious, most well-regarded Wall Street firms providing a tremendous amount of leverage, a tremendous amount of debt to a fund manager. So, you could argue that these were the most sophisticated investors under any statute, and yet, they made some extremely poor business decisions with regard to leverage.

It seems to me that the one thing, or maybe the most important thing that came out of this was I guess the recognition that just because you have a Nobel Prize in economics or you have earned a lot of money on Wall Street, you are not going to necessarily make good investment or policy decisions no matter where you are working.

Second, the OCC then did take steps to establish guidelines for lending of financial institutions. Is that correct? And can you describe the guidelines that came out of this issue? I think they were posted in 1999.

Chairman DONALDSON. Yes, I think that, on the end of the spectrum that you are talking about, a great deal of progress has been made as a result of Long-Term Capital's near-demise and the work that was done after that by the President's Working Group.

I think that we feel that the firms, the investment banking firms and banks which supply leverage, if you will, have much tighter restrictions now.

Senator SUNUNU. And could I ask you to provide some description of those new guidelines that were put forward by the OCC for the record?

Chairman DONALDSON. Sure.

Senator SUNUNU. Just so that we have them in all of their glory.

With regard to the individual investors or smaller investors, however we want to describe them, I think it is important to frame this discussion as understanding that there are existing regulations.

There is the 1940 Act and we talk about exemption from regulation. But what we are really providing is a different set of regulations, regulations having to do with limits on income, the $200,000 threshold, limits on the assets, the million-dollar threshold.

I think, like anyone else on this Committee, as you were going through the different cases, when you have fewer than 100, fewer than 500, it is quite complicated. Perhaps too complicated. And that may be one of the problems, when you have so many different sets of circumstances, each with their own set of guidelines as to who is sophisticated and who is not sophisticated, yes, good minds, whether here in Washington or on Wall Street, will find a way to utilize those different rules effectively to arbitrage the regulations and to find a way to fit into the cracks.

I would hope that, to the extent that you are looking at these rules in a comprehensive way, we look at ways that we might simplify them so that you can apply them more consistently and more effectively.

One specific question about the million-dollar net worth provision that is covered under the Act of 1940. When was that million-dollar threshold established? Was that part of the original Act in 1940, or was it revised since then? I assume it was revised. But how old is that threshold?

Chairman DONALDSON. Much more recently 1982.

Senator SUNUNU. So, 1982. Which is important because, at least in terms of the framers of the statute, a million dollars in 1982——

Chairman DONALDSON. That is a long time.

Senator SUNUNU. I have never had a million dollars. Some Members of this Committee have had a million dollars. Some Members still have a million dollars.

[Laughter.]

But I do know enough to understand that a million dollars the year I graduated from high school is not the same as a million dollars today. So, I do think that that may bear some evaluation or consideration as you go through this process.

Last, in the reading that I have done, some of these hedge funds or partnerships, are registering with the SEC, which I was interested to find. By registering with the SEC, they are covered by yet another set of regulations. And I understand registering with the SEC actually allows them to accept an even lower contribution and reduces the income thresholds for investors even further. That seemed counterintuitive to me to go in and register with a regulatory body. But somehow, that allows you to become involved with investors. That actually increases the concerns or makes you have a greater exposure to some of the concerns that we just talked about.

What does registering a hedge fund with the SEC mean, and what does it get you if you are a fund manager?

Chairman DONALDSON. I think principally what it does is allow us, the SEC, to get inside the techniques that are being used. In other words, it opens the front door for us and allows us to come in and examine exactly what it is going on. It also puts disclosure parameters on those funds. In other words, disclosure of what their techniques are to the public. What they are doing, how they are doing it.

Senator SUNUNU. There is a firm public reporting requirement associated with that registration.

Chairman DONALDSON. That is generally what it allows us to do. And as a matter of fact, that probably is something that we must really examine in terms of the whole industry. Again, we have a lot of work to do on this, and I do not want to get ahead of the Commission or ahead of the staff. But I will say that, at the end of the day, we need to know more about what is going on in these institutions.

Senator SUNUNU. And I appreciate the concern for information. But I do believe that, at a certain level, the sophisticated investors, where you are talking about a limited partnership, the investment managers are selling their internal knowledge, their expertise, their investment capability.

To the extent that they have to disclose daily, weekly, even monthly, what their positions are, that takes away from the value of the advice that they are providing. Also, it can be counterproductive. And to that end, I ask a simple question. That is, with all of this discussion of manipulation, we usually go after the short-sellers. If you force everyone to disclose today their short positions in every stock that they held, every short position that they held, do you think that that would increase or decrease the likelihood of market manipulation? That is a yes or no.

Chairman DONALDSON. The kind of disclosure that I am referring to, in response to your earlier question, was and is that it allows us in the front door.

Senator SUNUNU. I understand that. And I am not suggesting that you support making everyone disclose their short position. However, my point is, I believe it makes the market more subject to manipulation. The point is disclosure does not always make for a better, more coherent market with a greater level of integrity, because exposing every player's position at a particular time can make them and the markets more subject to manipulation.

Chairman DONALDSON. I could not agree with you more.

Senator SUNUNU. Thank you, Mr. Chairman.

Chairman DONALDSON. Thank you.

Chairman SHELBY. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman. I am actually not aware of any rule that requires even registered broker-dealers to disclose their short position. I do not think that that is the kind of disclosure that is in the realm of the various degrees of what one could consider with regard to whatever the term regulation means. But I guess that is a point for a different time.

What oversight, what perspective does the SEC have at all with those companies that have, as Senator Sarbanes said, weaned their way through that maze of four or five regulation exclusions?

What is the SEC's ability to look into the activities? Or do you have to have a perceived or charged fraud to be able to take a look at the books and records? Are there any audit trails? What kind of authority does the SEC have today?

Chairman DONALDSON. Well, I would say, generally speaking, we do not have as broad authority as we would like. However, we have total authority in instances of fraud and manipulation and external manifestations of market manipulation, et cetera, to go in and do something about it.

Senator CORZINE. And how would you——

Chairman DONALDSON. What we do not have authority over in many instances is the accounting that is used in hedge funds, the way they are organized, the whole panoply of other things.

Senator CORZINE. Hedge funds required to maintain an audit trail, so that when you go in——

Chairman DONALDSON. We do not have the authority to audit or examine the audit of hedge funds under these exemptions, unless we can prove some fraud on investors.

Senator CORZINE. How do you, in a first instance, is it word of mouth that there is a potential fraud? Or how would you recognize it, that a fraud was taking place?

Chairman DONALDSON. There are a lot of different ways.

Clearly, we monitor the markets. The self-regulatory agencies monitor the markets. We are constantly on the look-out for market manipulation. People write or call the SEC. People complain all the time and we examine and follow-up those complaints of alleged manipulation. So, we have many, many sources, not unlike the sources we have on potential problems outside of the hedge fund industry.

Senator CORZINE. And within the regimen of the regulated elements of the industry, you are suggesting that that is the same way you find market manipulation or fraud? Or is it more likely to be done through the audit process, either of the self-regulatory agencies or the Agency?

Chairman DONALDSON. There are all sorts of definitions of manipulation. You are focusing in now on market manipulation. But there is the possibility that the accounting techniques that are used to value securities in a hedge fund——

Senator CORZINE. Is there a standard for——

Chairman DONALDSON. We do not have the authority now to get at that, unless from some other source we have been told that there has been fraudulent accounting being used in this investment vehicle. Then we can go after it.

Senator CORZINE. One final question. I am a little unclear on what the term, retailization, which I have used myself on occasion, what does that mean?

Chairman DONALDSON. Very catchy. What that means is, it analogizes large institutional investors investing in hedge funds to a wholesale market. It says that there is a retail market also, and that refers to people with lesser assets.

And what we are seeing through the more recent changes in the rules is the ability to package and register hedge funds for smaller investors.

Senator CORZINE. Can you give us some dimension of what you might think people have been able to access retail——

Chairman DONALDSON. These are still, I suspect, fairly large amounts of money to most people in America. Twenty-five thousand dollar participation is a lot of money to a lot of people. That may be retail to Wall Street, but it is a lot of money. So, you are still at that level. You are not down in the real mass market of $1,000, $5,000 investment.

Senator CORZINE. But well below $1 million set in the 1933 Act.

Chairman DONALDSON. Well below, yes.

Senator CORZINE. Or the $5 million set in—I think it was actually the 1996 Act.

Chairman DONALDSON. Yes.

Senator CORZINE. Thank you.

Chairman SHELBY. Senator Dole.

Senator DOLE. Mr. Chairman, has the SEC done any studies as to the extent to which retail investors are investing in registered investment companies which are investing in hedge funds? To what extent has any work been done to tell us the extent of this?

Chairman DONALDSON. Well, we are gradually getting a handle on it. The statistics have a tendency of being repeated over and over again as being true.

I use the statistic that there are 5,700 hedge funds out there. I am not sure that that is an exact figure. And so, we are zeroing in on that, and we are going to zero in, as best we can, with the resources we have, on just how much retail investment is either there or about to be there.

Senator DOLE. Okay. And how can these registered investment companies calculate valuations which are not required by the underlying hedge fund? Has this presented a problem for registered investment companies?

Chairman DONALDSON. I think that this is a real issue, which is, as I mentioned before, looking at the valuation techniques that are being used.

Again, you may have a fund of funds, a fund of hedge funds, if you will; and, within that fund of funds, there may be a spread of hedge funds from some very large ones with a lot of history into the more speculative end of the spectrum. Depending upon what kind of investments the more speculative end is making, the valuation aspect becomes increasingly important.

We have seen this in the derivatives market. We see that the issue of how you value what you own is a huge issue because it is in many ways in the eye of the beholder. If you own a huge amount of stock, and the last sale is $50 of that stock and you have a zillion dollars' worth of it, is it worth $50 for purposes of your statement or is it worth something below that if you had to sell it all at once? I think that is an issue that we see in the valuation of these more sophisticated instruments, not just common stocks.

Senator DOLE. Right. And some have argued that if subject to regulation, hedge funds would quickly "move" offshore. They would move out of U.S. markets. What is your view on that? And what do you believe the removal of hedge funds would mean to our securities markets?

Chairman DONALDSON. Well, I think that is an issue that gets brought up. I think I would go back to the fact that most of these hedge funds have their investors in the United States and they are investing in U.S. securities, and we have a good reach into that.

Insofar as the investments are made in offshore, non-U.S.-regulated companies, and, insofar as the investors are not U.S. citizens, we have no reach there, unless they somehow come into our markets and use our markets and buy and sell U.S. securities.

But I think that it is an issue that we have to be careful about because I think that what we need is more information. We need to remember, and I am not talking about the retail end of this, that some investors want to accept more risk. It is very hard to make a universal rule as to how you run a hedge fund because you defeat the very purpose of the fund.

So, we have to remember that there is a market out there for a riskier and potentially higher potential return investment. And getting at just exactly how we come out of all of this, I think we will be very mindful of what you are saying.

We do not want to drive the business out of this country.

Senator DOLE. Okay. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

Chairman Donaldson, welcome. How are you holding up in your new job?

[Laughter.]

Chairman DONALDSON. Sipping from the fire hose, as they say.

[Laughter.]

Senator CARPER. I have sipped from a few of those myself. It is not much fun. Hopefully, the volume will come down a little bit.

Thanks for your willingness to serve and we wish you well. What do we need to be doing here to help you in your job? You have been there a while. What more do we need to be doing to help you do your job well?

Chairman DONALDSON. That is a very good question. I appreciate this Committee's interest. I appreciate the opportunity that it gives us now, and I hope in the future to speak in a public forum about exactly what we are doing.

I think that to have this hearing is a good start for us, to give you a baseline as to where we are. And I think once we get done with our seminars and have a chance to continue the work that has been going on, I think we will be able to come back to you with the thoughts we have. And you can take it from there in terms of whether you like our thoughts and whether you might give us whatever we need to implement whatever we conclude.

Senator CARPER. How many weeks have you been on the payroll?

Chairman DONALDSON. Pardon.

Senator CARPER. How many weeks have you been on the payroll now at the SEC?

Chairman DONALDSON. Eight weeks and 2 days.

[Laughter.]

Senator CARPER. All right. But who's counting?

[Laughter.]

Senator SARBANES. Hours and minutes, too.

[Laughter.]

Senator CARPER. What have you learned so far that has surprised you?

Chairman DONALDSON. I am sorry, I did not hear you.

Senator CARPER. What have you learned so far that maybe surprised you a little bit?

Chairman DONALDSON. On the hedge fund side of things?

Senator CARPER. No, no, just broadly. More broadly.

[Laughter.]

Chairman DONALDSON. Have you got a few minutes, Senator.

Senator CARPER. About five.

[Laughter.]

Chairman DONALDSON. Well, I am constantly amazed and interested in the number of cases, enforcement cases that come before the Commission at the lowest level in terms of scams, manipulations, pyramid schemes, all things, involving large amounts of money perpetrated on unexpected investors.

I am amazed. Having been in the business all my life, I find it hard to recognize that that is out there, and it continues to be out there. You cut off the head of one and something pops up over here.

I think the Commission is doing an outstanding job of getting at that. And, if I might thank you, we are going to have more resources to do that.

Senator CARPER. I was going to ask, in terms of the resources that you need and what you are getting, is the balance getting better in terms of what your needs are for resources to go after some of those frauds?

Chairman DONALDSON. Do we need the resources?

Senator CARPER. No. Are you getting more of what you need?

Chairman DONALDSON. Yes, we are. We are moving ahead on our new authorizations. Our trick, if you will, or challenge, is to make sure that we hire well, that we put people in the right spots, that we look at our organization, and that we just do not go out and add a lot of people.

We are before another committee here, if I can put in a plug, trying very hard to get authorization so that we can hire accountants faster than we can right now.

Under an exception to the rule, we can hire lawyers immediately. Accountants, we are really slowed down. And we have had an agreement with our union. We have put it before the House Committee, and it will come before the Senate Committee. We hope that we will get a rule changed that will allow us to hire accountants and economists and so forth, faster than we are right now able to do.

Senator CARPER. When we created the new Department of Homeland Security, we included in it provisions authored by Senators Voinovich and Akaka which deal not just with personnel issues, accommodations for that new Department, but also more broadly.

I would just urge that you make sure that the people who work for you in the personnel area, the human resources area, are mindful of the kind of flexibilities that are provided for all agencies, including your own.

Let me ask one specific question, if I could, about hedge funds.

We spent a lot of time last year under the leadership of Senator Sarbanes trying to develop legislation that we now call Sarbanes-Oxley, that is designed, among other things, to make sure that investors have a better idea what they are buying.

When an investment analyst says buy, they mean buy. When they say sell, they mean sell. And when they say hold, they mean hold. When we read financial information from companies, publicly traded companies, they would not just take the money to the bank, but actually rely on the information being provided to us.

In a related area, how much information is currently available for hedge fund investors regarding the hedge fund managers, the people actually managing these funds? What do the investors know about the professional backgrounds of the hedge fund managers? What do they know about whether there have been any securities-related problems in the past with these hedge funds managers? And finally, does the SEC have, do you people have the sufficient information that you need about these fund managers?

Chairman DONALDSON. I think that the situation is rapidly changing. I think that because of some of the new exceptions that are allowed and the fact that we are seeing more funds registering voluntarily, if you will, there is more information coming down the pike in a certain segment.

On the other hand, I think a number of professional investors, large institutions, are going to demand a lot more information from people who are trying to get them to invest in their hedge funds.

I think you are going to find that some of the big pension funds and other professional investors who may have bought a hedge fund 10 years ago are going to demand now that they know a lot more about what is going on inside that hedge fund. That is a sign of a healthy market.

Senator CARPER. All right. Well, I hope that that demand will be met by supply in terms of information that investors need to make wise decisions.

Thank you, Mr. Chairman.

Chairman SHELBY. Chairman Donaldson, you referenced some legislation. We are going to move that as fast as we can. We are going to give you the resources at the Securities and Exchange

Commission under your leadership to do the job that has to be done in America.

Mr. Chairman, before we go to the second round, I also want to say that we appreciate that your investigation is ongoing, that many of the questions that we are perhaps asking you may not be answerable in great detail until you complete your study. You mentioned this earlier.

We would, at the proper time, after the study is complete, like for you to return to the Committee, and I hope you will.

But your interim report today on your progress and the issues you are considering in balance has been very helpful, I believe even today, looking at it as an interim report.

Having said that, I have some other questions as we start the second round.

Chairman DONALDSON. Sure.

[Laughter.]

Chairman SHELBY. In your discussion of the Long-Term Capital Management report's recommendations regarding margin, collateral leverage, and risk management, and I believe that in your written testimony, you stated that many institutions extending leverage to hedge funds seem to have taken these recommendations to heart. Some of us are concerned by the use of qualifying words like many and seem.

Should we read this testimony as indicating that the lessons of LTCM have been lost on some of the institutions that extend credit to hedge funds?

Chairman DONALDSON. Yes, I think that that is cautionary language. I think that we would hesitate to say that it has been solved across the board.

On the other hand, that cautionary language comes from the fact that we are zeroing in on areas where we think they haven't done what they should do. And I might add, our ability to do that is a resource-based thing in terms of our staff time and so forth.

I think the general trend is in the right direction. I believe that the very fact that you are having this hearing, the very fact that it has become such a prominent subject, heightens the awareness.

Chairman SHELBY. Absolutely. In the collapse of Long-Term Capital Management, as we look back at it, banks were willing to lend money with little information and basically no collateral.

Given the recent surge in hedge fund investment, what can you tell us about the lending practices of Wall Street and commercial banks to hedge funds? Is there any caution out there now?

Chairman DONALDSON. I am not going to cop out on that question. I am going to say that the lending practices of Wall Street investment banking firms clearly fall in our purview. The lending practices of commercial banks do not.

Chairman SHELBY. Absolutely. But how do the banking regulators and the SEC that you chair interact in terms of monitoring this type of activity? And if they do not, how could you?

Chairman DONALDSON. That is an excellent question, and it is a question that is of concern.

I think our President's Working Group has helped us in terms of talking to the other regulators. As you might know, and I am sure you do, as a result of Gramm-Leach-Bliley and the new authority that commercial banks have, there is a tension, a jurisdictional tension, as to who is regulating what part of the bank.

And I think we are having some very constructive conversations about that with the Federal Reserve and with the Treasury.

Chairman SHELBY. Chairman Donaldson, just to lay the predicate, hedge funds leverage, as we know. That is part of their deal.

How much they borrow compared to their capital allows them to earn greater returns, yet also increases the risk. What is the typical leverage position of hedge funds or the range of the leverage positions that the SEC has observed in its investigation?

Chairman DONALDSON. I think it is a difficult question to answer because the leverage borrowing, or rather, the danger of the borrowing, would depend upon how much hedging has been done. In other words, if you have a single security and you borrow against that versus a portfolio that is both long and short, perhaps you can borrow more against that than you might against a single security.

And it varies tremendously in terms of the focus of the hedge fund itself. In a Long-Term Capital situation, they were dealing with debt instruments, with all sorts of derivative instruments on top of that, as opposed to dealing with common stocks or something else, and their borrowings were very high.

Chairman SHELBY. In other words, is leverage in the hedge fund industry, and it is all about leverage, still a concern to the SEC? Are there sufficient safeguards against systemic risk here?

Chairman DONALDSON. I think we are feeling relatively better about the Long-Term Capital end of the scale, if I can say that. And I think we need to know a lot more about the middle ground as to whether we are concerned.

Chairman SHELBY. Investor protection, do these funds receive adequate information to protect the interests of their investors? Do you perceive that they are having trouble assessing all the information that they need? In other words, why would a fund of funds manager invest with a hedge fund that would not provide all of the information needed for due diligence purposes? Is it just because they are hoping for the greater return?

Chairman DONALDSON. I think that, personally, and I do not speak for the Commission now, there is a need for more information in terms of those funds that are using the exemptions, that are not registering and so forth. I think there is a need for more information. The market will demand it. In other words, as we have gone through a bad stock market and you put your money in a hedge fund and after a couple of years, you have lost a lot of money, you are going to be demanding that you have more information as to how that money was lost and what are you doing now than has been true in the past. In a bull market, people do not really care what you are doing, so long as you are making money for them.

Chairman SHELBY. Sure. Mr. Chairman, are these funds of funds subject to the same reporting and other requirements as a typical mutual fund?

Chairman DONALDSON. By and large, yes, they are in terms of reporting. Not restrictions as to the diversification and that sort of thing. But in terms of reporting, yes.

Chairman SHELBY. These funds are charged fees at the hedge fund level and at the fund of funds level. How are fees disclosed by these funds?

Chairman DONALDSON. That is a major issue. You do have fees upon fees.

Chairman SHELBY. Sure.

Chairman DONALDSON. And whether that is properly disclosed, I will be able to tell you a lot better as we get into this thing.

Chairman SHELBY. As you finish your study, yes.

Senator Sarbanes.

Senator SARBANES. Senator Schumer hasn't had his first round.

Chairman SHELBY. Excuse me. He slipped in over there.

Senator Schumer.

Senator SCHUMER. Quiet as a little mouse, as usual.

[Laughter.]

Chairman SHELBY. Do you have a statement, Senator Schumer?

COMMENTS OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman. I will be brief. I just have two questions and I thank you for your testimony.

The first question is this. The record of hedge funds in terms of performance has been better than the general mutual fund market. You hear comments from average investors who do not meet the threshold saying they would like to be able to take advantage. At the same time, you want to make sure that they have protections so that people aren't taken advantage of. And it is opposite sides of the same coin.

Do you have any thoughts, Mr. Chairman, on how we can extend hedge funds to be available to more average investors, less wealthy investors, but at the same time make sure that they are protected?

Chairman DONALDSON. Well, I think that is the bottom-line question—how do you get at what you are talking about? And how do you do that in a way that doesn't impede the free determination of what the investment objective of the fund would be?

And as I said earlier before you came, there is a market out there for people who want to take more risk to earn more. I think we have to be very careful that we do not come up with legislation that prescribes exactly how a fund can invest.

I think the first level here is a level of disclosure, a level of our having the ability to get inside these funds and find out what they are doing, and, if they are being sold to the public, that the disclosure is intelligible. And that is again something that we will come back to.

Senator SCHUMER. Now, my second question relates to the USA PATRIOT Act.

You know that there is an antimoney-laundering provision in the PATRIOT Act at Section 352. And can you tell us how you are working with the industry and other agencies to make sure that hedge funds are complying with the antimoney-laundering guidelines to make sure that someone is not figuring out, here is an unregulated area. Here is a way that I can get money to places that the law would prohibit.

Chairman DONALDSON. Yes. It is a matter of real concern.

As you know, there have been a number of laws that target pure laundering of money. And those laws originally pertained to the banking industry, commercial banking industry and the financial institutions where it is pretty obvious that there are big cashflows in and out, readily identifiable.

As we have moved in after September 11, I think there has been more thinking about other kinds of funds, where it is not so obvious where the money comes from and where it is going to, as it might be in a bank.

I think we are making good progress. The President's Working Group—the Chairman of the SEC, the Chairman of the Federal Reserve, the Secretary of the Treasury, the Chairman of the Commodities Future Corporation, and our staffs—is working on this.

Senator SCHUMER. Just one comment. This is not related to the hedge funds.

I know that yesterday, a white paper came out between the SEC, the FED, and the OCC about New York City and the location of alternative sites. I thought it was thoughtful, mindful of New York City's position as the financial capital of the world. I appreciate the change in course.

As you know, we have talked about it, as I have with Chairman Greenspan and the head of the OCC. I just hope when we do the second white paper, it will have the same thoughtful nature to it, mindful of New York's centrality as the world's financial capital. To undo that by some kind of regulation would not only hurt New York City—obviously, it would—but also the whole country.

Chairman DONALDSON. Thank you.

Senator SCHUMER. So, I appreciate your careful and thoughtful revisions there.

Chairman DONALDSON. Thank you.

Senator SCHUMER. Thank you, Mr. Chairman.

Senator SARBANES. Thank you, Senator Schumer.

Chairman Donaldson, I wanted to ask about how you address the assertion that there is an inherent conflict of interest with firms running both mutual funds and hedge funds, that the different fee and compensation structures for portfolio managers, analysts, and traders provide incentives for them to act differently when they are managing hedge funds alongside of mutual funds. We have gotten a number of comments from people about the problems in these areas. What is your view of that?

Chairman DONALDSON. I think there is the potential for people who are running pools of money in one investment organization—on the one hand, you have regular fees, mutual fund kind of fees. On the other hand, you have 20 percent of the profits and so on. And there is certainly the theoretical temptation to favor one side versus the other.

I think that any substantial investment institution that gives into that temptation and doesn't monitor it and doesn't have rules and regulations of a self-regulatory nature, it won't be in business very long. And if we have the right to go in and inspect, we check for it, and if we find it, we will take action against them.

I do not want to say any more than that, other than that we are aware of that potential conflict and it certainly is on our checklist, if you will.

Senator SARBANES. Mr. Chairman, to sharpen the issue, let me just read to you some of the communications we have received.

> One of the most important issues is firms that run hedge funds and mutual funds together. Many asset management firms have started hedge funds in the last few years due to the much higher fees and less stringent regulations, but run them side-by-side with mutual funds. They are often run by the same portfolio managers.
>
> The main reason mutual fund firms start hedge funds is to keep their star portfolio managers from leaving to set up their own fund. Some of the biggest mutual fund companies in the country are doing this. This practice presents incredible conflicts.
>
> Some firms use the visibility of their mutual funds on Wall Street to gain access to research, ideas, IPO's, et cetera, from the brokerage houses, but use the benefits in disproportion for their higher-fee hedge funds.

I am very much concerned about this—"Some firms have been known to short a stock in the hedge fund, hold on to it in their mutual funds because they are not allowed to sell short, and then sell the mutual fund position at a later date, thus, causing downward pressure on the stock price and making the short position more valuable. "

Then they go on about the use of soft dollars to pay for research and information service and skewing that to the hedge fund. What about this short position and the implications of that?

Chairman DONALDSON. You know, you bring a number of issues up there.

Let me just say this. On our regular inspections, under the Investment Advisers Act, we look at the allocation of stock purchases.

In other words, if a fund group buys a huge block of stock, we look at how they distribute that stock into the various funds that they are managing. And if we see something that is fraudulent about that, or favoring one account over another, we get on that.

I think that the same thing is true now as the hedge funds are in mutual fund groups. This is an age-old concern that is not just pertinent to hedge funds, an age-old concern of are you being fair in the allocation of your purchases.

Now on the shorting side, again, I cannot react to that specific allegation, but we are sure hearing you. And you can be sure that, if that is true, we will do something about it.

Senator SARBANES. Presumably, part of the problem is this explosive growth in the hedge fund industry at a time when the SEC's ability to monitor was not keeping pace because of the shortage of resources.

Now, you have gotten a very hefty boost in your budget this year and we hope for a further substantial increase next year. I know you testified before the Appropriations Committees on the budget, which would take you to about, I think, $842 million from $468 in a fairly short period of time.

So, we are very encouraged that we can deliver that for the Commission. I want to just echo Chairman Shelby's statement that I know the House is working on that legislation on the hiring process. And as soon as it comes over here, I am sure we will be ready to move it ahead.

Chairman SHELBY. Absolutely.

Senator SARBANES. How are you doing on the pay parity issue? I will leave aside the hiring of new people because I know that is related in part to the legislation.

Chairman DONALDSON. Right.

Senator SARBANES. But you have the authority and now you have the money to do pay parity for your existing employees. And that is important I think for morale and for not losing good people, and also the money to upgrade the information technology.

Chairman DONALDSON. Right.

Senator SARBANES. How are you doing on those fronts?

Chairman DONALDSON. Okay.

Senator SARBANES. After 8 weeks, 2 days, and—I do not know if I begin your day at 8 a.m.——

Chairman SHELBY. Twenty-seven minutes.

[Laughter.]

Senator SARBANES. Three hours and 37 minutes, yes.

[Laughter.]

Chairman DONALDSON. On the pay parity side, I think the news is good in terms of our turnover, of people we are losing. I forget the exact figures, but before pay parity, we were losing people with something like a 20-percent attrition rate. Since pay parity has come in, our attrition rate is down to about 4 percent. That may not be exact.

Senator SARBANES. Now, you are encompassing parity on benefits as well as just salaries, aren't you, in your concept of pay parity?

Chairman DONALDSON. Yes, I believe that is so.

Senator SARBANES. I certainly hope it is so because benefits are a very important part of the compensation package. I think if you do not include that in, there is still going to be a significant discrepancy between what the SEC is doing and what other Federal financial regulatory agencies are doing.

This is only pay parity between Federal regulatory agencies. It doesn't even touch the issue of how much more the private sector can offer. But, of course, we have always had to contend with that. You should not be losing people to other Government agencies because they have been authorized to give pay parity and the SEC has not delivered on it.

Chairman DONALDSON. No. I think pay parity has helped a lot. I might add that perhaps the economy's softness makes it not quite as easy to leave, or desirable to leave, in terms of trying to be realistic about this.

On the other hand, I think the challenges facing the SEC now are such that that heightens the public service instinct of a lot of very good people out there who want to come to work in an agency that is doing something good. I think we are seeing that, and we definitely are seeing it on the legal side in terms of the caliber of people that are available to us now.

This gets back to the fact that we want to hire people and not just all lawyers. We want to hire these other disciplines. And there we are at the competitive disadvantage because we cannot move swiftly. And so we need some help there.

But I think, clearly, that pay parity has helped a lot.

Senator SARBANES. I will just close with this.

I think I am encouraged to hear that. I think you, as Chairman, should seize on the opportunity in terms of attracting talent of, I do not know, maybe visiting law schools and Ph.D. programs and saying, it is a new day at the SEC. Look at what the Congress has done for our budget.

I even had a hearing the other day before the Senate Appropriations Subcommittee that deals with my budget and the Chairman of the Subcommittee said to me, the check is in the bank.

[Laughter.]

I hope he's right. We will see.

Chairman DONALDSON. I heard that. I did hear that.

Senator SARBANES. Yes. Well, it was a nice thing to hear.

And so you can say to them, we are doing very exciting things at the SEC. There is a real challenge. And if you really want to serve the public interest and strengthen the American economy and the integrity of our markets, which has been such an important part of our economic strength, here is an opportunity for you to come to a refurbished, dynamic SEC and make an important contribution.

I think you, as the new Chairman, are in a position to really make that case and really enhance the attractiveness of the SEC to people. So, on the one hand, you strengthen the context for the people you have, which of course, I relate very much to pay parity, and on the other, the new leadership being provided, and then reach out in terms of attracting new people to the Commission.

I wish you the very best in that endeavor.

Chairman DONALDSON. Thank you.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Chairman, I want to add before I recognize Senator Sununu again, I appreciate how you are asserting the authority you and your staff of the SEC that had been, a lot of us thought, abdicated in recent years, and I commend you for that.

Chairman DONALDSON. Thank you.

Chairman SHELBY. Because if you are not assertive, somebody else will assert the authority and fill the vacuum, as I am sure you well know.

Senator SARBANES. Mr. Chairman, I may leave. Could I just say, as I understand it, you indicated to Chairman Donaldson that when they complete the study that is underway——

Chairman SHELBY. We will have him back.

Senator SARBANES.We want him to come back and present the findings to the Committee.

Chairman SHELBY. Absolutely.

Senator SARBANES. Is that correct?

Chairman SHELBY. Well, we would. We would like that, Mr. Chairman.

Chairman DONALDSON. I would be delighted to come back.

Chairman SHELBY. I think that that would be in order.

Thank you, Senator Sarbanes.

Senator Sununu.

Senator SUNUNU. Thank you.

Chairman Donaldson, I very much want you to succeed and want you to be able to retain good people and I am willing to do a lot of things in order to help you achieve that goal. But depressing the economy is not one of them. We will fund you, we will encourage your organization, but I think we are all rooting for a strong economy. I know you are.

On these registered investment companies, I want to be clear, I understand what that term means. How many of them are there in total, registered investment companies, if I may use that term?

Chairman DONALDSON. Registered hedge funds or registered investment companies?

Senator SUNUNU. Feel free to make the distinction and give me the number of both.

Chairman DONALDSON. Six thousand registered investment companies and 60 registered funds of hedge funds.

Senator SUNUNU. Sixty?

Chairman DONALDSON. Six thousand and 60. Sixty registered funds of hedge funds.

Senator SUNUNU. Six zero. Sixty registered funds of hedge funds?

Chairman DONALDSON. Yes.

Senator SUNUNU. Sixty hedge funds that are registered investment companies. And we have been talking a lot about funds of funds. Do they need to be registered investment companies?

Chairman DONALDSON. Yes. Generally speaking, most of them, I suspect, are registering now.

I think that the companies that are promoting funds of funds and so forth, are generally financial institutions that will register before——

Senator SUNUNU. And have registered the funds, one of the 60.

Chairman DONALDSON. Yes.

Senator SUNUNU. What is the minimum investment for one of these registered hedge funds or for a registered investment company? Is it the same thing?

Chairman DONALDSON. Well, it varies. In terms of the minimum investment, I am told, in some of the more recent ones, you can get down as low as $25,000, I think.

Senator SUNUNU. Is there any limitation put on someone's salary or net worth for investing in one of these registered hedge funds?

Chairman DONALDSON. Again, we have to be specific because there are so many different levels of qualification.

Senator SUNUNU. You have only 60 hedge funds, though.

Chairman DONALDSON. There are 60 funds of hedge funds that are registered.

Senator SUNUNU. There is no minimum contribution. No minimum salary requirement. No minimum asset requirement.

Chairman DONALDSON. Excuse me.

Senator SUNUNU. Sure. Take your time.

[Pause.]

Chairman DONALDSON. There is no, at this point, regulatory minimum. But some of the fund groups have their own minimum.

Senator SUNUNU. Sure. They elect a minimum. But I am talking about the regulations. Those that aren't registered, unless I have misheard the testimony, if you are not registered, you have a salary minimum of $200,000 per year and an asset minimum of a million dollars.

Chairman DONALDSON. That is in terms of your ability to invest.

Senator SUNUNU. Yes.

Chairman DONALDSON. But that does not address how much money you can invest. And how much money you can invest would be a minimum that would be set by the fund itself.

Senator SUNUNU. I understand. But what is the salary and the asset threshold for a registered hedge fund? Again, the answer that I think I heard was zero.

Chairman DONALDSON. None. None right now.

Senator SUNUNU. I think that is an important distinction to make because a lot of the concerns—again, we get back to these concerns that the Chairman and the Ranking Member and others have shared about these investment vehicles. And to the extent that we are not providing enough information and retailizing—I appreciated Senator Corzine's question because that was a question I had myself. What does that really mean?

To the extent that these concerns are prevalent, it seems to me they are most prevalent in the one area where, in theory, we have the greatest regulatory leverage, which is those firms that are registered. And that seems to me to be a very great paradox, not that we should be surprised. Where the Federal Government is concerned, we have these kinds of unexpected consequences or problems that are sometimes created by our effort to do good.

So, I think that that is an important distinction to make. And I know from your previous answers that is one of the things you are going to be addressing in your review.

Did you want to make an additional comment?

Chairman DONALDSON. No. I think that, generally speaking, some of the funds that have been around the longest are ones that are getting on the cutting edge of voluntarily registering.

I think that some of the funds that are being started within the context of existing banks or mutual fund complexes or whatever, are going to register. I do not believe they can run an unregistered fund side-by-side in a big investment fund complex. So, I think there is voluntary and accepted registration going on.

Senator SUNUNU. I guess to conclude my point on this topic, I would want to make sure as a policymaker, and as you come out with your report, that registering is a good thing for consumers. And to be blunt, I haven't been convinced that it is a good thing for consumers at this point because they are registering, which may give you more access to information as you go about your job as a regulator within the SEC regarding disclosure.

But there may not be—may not be—protections or information provided to consumers. They are not necessarily seeing any direct advantage of the registration process.

My final question. Do you have to be a registered investment adviser to manage a mutual fund?

Chairman DONALDSON. Yes.

Senator SUNUNU. And do you have to be a registered investment adviser to manage a hedge fund?

Chairman DONALDSON. No.

Senator SUNUNU. Even if the hedge fund is a registered investment company?

Chairman DONALDSON. If it is registered, you do.

Senator SUNUNU. So if it is a registered investment company, you do. But otherwise, you do not.

Thank you.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Chairman Donaldson, we appreciate your appearance today. We look forward to working with you and we look forward to this report when it is finished.

Chairman DONALDSON. Thank you.

Chairman SHELBY. Mr. Chairman, thank you.

The hearing is adjourned.

[Whereupon, at 11:48 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JON S. CORZINE

Mr. Chairman, thank you very much for holding this important hearing. Chairman Donaldson, I thank you for joining us today, and let me commend you for what has been, by all accounts, a successful early tenure at the SEC.

The hedge fund industry has changed dramatically since A.W. Jones created the first hedge fund in 1949. Originally created by Jones as an alternative investment strategy, hedge funds today represent a $600 billion industry that employs a wide variety of complex and often risky investment strategies. When one considers the use of leveraging and derivative instruments, the actual impact of hedge funds on our financial markets and on underlying commodities is potentially huge.

In recent years, the importance of hedge funds has grown substantially as a much broader range of investors have sought out these funds, largely because their average returns have exceeded those of the S&P, the Dow, and the Nasdaq.

Once the exclusive domain of wealthy, and presumed highly sophisticated investors, today's hedge fund investors include teachers, firefighters, nurses and retirees, as well as public and private pensions funds, universities, and endowment funds.

Yet while hedge funds promise higher returns, the pursuit of those rewards also comes with increased risks. As hedge funds have grown, so too have hedge fund closures. In addition, we have seen an increase in hedge fund fraud.

The retailization of hedge funds and the increasing impact of hedge funds on our financial markets make it important that we carefully examine this industry and the many public policy issues at stake.

The SEC has begun such an examination, and I commend Chairman Donaldson for his interest in this matter. This Committee also has an important responsibility to address these issues, and I commend Senator Shelby for holding this hearing.

We need to consider a host of issues.

What does the growth of the hedge fund industry mean for investors and financial markets? Do those who invest in these funds have sufficient information to evaluate their risks? What challenges do the practices of hedge funds and fund managers pose to those charged with ensuring the integrity of our markets? And, 5 years after the collapse of Long-Term Capital Management, what has been learned—and, more importantly, done—to mitigate the systemic risks posed by these funds?

It is my sense that the current system of hedge fund regulation is inadequate given the rapid change this industry has undergone. Some improvements may be able to occur through administrative action. Others, however, may well require legislation. Hopefully, the report that comes out of the SEC investigation will shed light on the areas of most urgent need.

Chairman Donaldson and Chairman Shelby, I am committed to working with both of you to ensure that the SEC has the tools it needs to protect investors and our financial markets, while promoting the continued growth of this industry.

I look forward to today's testimony, and again thank you, Chairman Donaldson, for joining us.

PREPARED STATEMENT OF SENATOR ELIZABETH DOLE

I would like to express my appreciation to you for holding this hearing on recent developments in hedge funds. Approximately $600 billion is currently invested in hedge funds. The hedge fund industry represents both an important component to the capital market structure and a useful investment option. In addition, the industry provides important liquidity to the organized exchanges as well as the over-the-counter and less liquid markets.

Back in 1998, we all gained a quick education about the perils of hedge funds when Long-Term Capital Management created a market crisis that wound up affecting all sorts of people with no previous knowledge of hedge funds. Long-Term Capital Management was run by an unusually distinguished group of money managers, from long-time Wall Street professionals to Nobel Prize-winning academics. The end result showed that regardless of knowledge or skill, many have overestimated their understanding of the markets and paid the price. However, we were fortunate that major Wall Street firms were convinced to act together so as to minimize further detrimental impacts on the financial markets.

Hedge funds are in many ways the opposite of mutual funds. While hedge funds are limited to those wealthy and sophisticated in the market, many investors of different incomes can invest in a mutual fund. While many mutual funds are very large billion dollar operations, hedge funds are known to be smaller. Mutual funds have investment limitations, disclosure requirements, and allow investors to move their money in and out as they choose. Hedge funds, on the other hand, have very little—if any—disclosure features, and require investors to keep their money with the fund for a specified period.

Because of the requirements in the securities laws that hedge fund investors be "sophisticated," the people whose money is at risk in these funds are not the people I worry about in our economy. However, one recent trend of concern is registered investment companies which invest in hedge funds. These investment companies do not require the investor to be "sophisticated" or necessarily wealthy. It is the less sophisticated or lower income investors whom we should be concerned about since they cannot afford to lose their investment, and they may not understand the risks which hedge funds can take. I believe it is this trend that Chairman Donaldson spoke about at his February 5 confirmation hearing when he cited, "A distressing move toward the 'retailization' of hedge funds."

I am pleased that Chairman Donaldson has taken time out of his busy schedule to join us here today and share his thoughts and views on this subject. I look forward to hearing his testimony and discussing these issues with him.

Thank you.

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Shelby for holding this important hearing to learn about the recent developments in the Securities and Exchange Commission's Hedge Fund Study.

The ability to produce positive returns despite the condition of the market makes the practice of hedging a unique tool for asset growth in the United States. In the past, hedge funds have proven to be an extremely successful vehicle for the well-educated, advanced investor. Recently, the search for capital and promising investment vehicles have increased the retailing of hedge fund products, and similarly, increased the participation of investors with smaller portfolios.

This growth of hedge fund participation raises potential concerns for the protection of the investor and the impact of hedge funds on U.S. markets. The Securities and Exchange Commission has a difficult task before them in determining their role in regulating the industry and educating the investor.

Thank you, Chairman Donaldson, for coming before the Committee today to discuss what will be an issue of increasing importance in the U.S. financial markets. I look forward to your testimony.

PREPARED STATEMENT OF WILLIAM H. DONALDSON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

APRIL 10, 2003

Chairman Shelby, Ranking Member Sarbanes, and distinguished Members of the Committee, thank you for inviting me to testify today to discuss hedge funds generally and the Securities and Exchange Commission's ongoing fact-finding investigation into hedge funds. I appreciate having the opportunity to discuss this important subject with you.

Over the past few years, hedge funds have become more prominent and more popular. Sources have estimated that there are close to 5,700 hedge funds operating in the United States today with approximately $600 billion under management. To put this number in perspective, today there are approximately $6.3 trillion of assets under management in the mutual fund industry. In 1990, it is estimated that only $50 billion was under management in hedge funds, demonstrating the rapid increase in a relatively short period of time. There have been frequent reports of high returns of hedge funds that outperform registered investment companies. But, just as frequently, these reports highlight possible areas of concern, such as potential conflicts of interest, questionable marketing techniques, valuation concerns, and market impact of hedge fund strategies.

As you know, the SEC staff has been engaged in an investigation of the structure and practices of hedge funds since June 2002. Because hedge funds continue to grow in status and increase the ranks of their investors, our investigation grows more important every day. We at the Commission are still at the fact-gathering stage and have yet to reach any conclusions. But I want to report that we are moving to the next stage of our investigation. As part of the investigation's advancement, the Commission will be holding public roundtables on May 14 and 15. As I said before this Committee at my confirmation hearing, I believe there are many unanswered questions related to hedge funds, and I am anxious to take a deeper look at both their risks and rewards.

Hedge funds have been around in some form since the establishment of the Jones Hedge Fund in 1949. The term "hedge fund" is undefined, including in the Federal securities laws. Indeed, there is no commonly accepted universal meaning. As hedge funds have gained stature and prominence, though, "hedge fund" has developed into a catch-all classification for many unregistered privately managed pools of capital. These pools of capital may or may not utilize the sophisticated hedging and arbitrage strategies that traditional hedge funds employ, and many appear to engage in relatively simple equity strategies. Basically, many "hedge funds" are not actually hedged, and the term has become a misnomer in many cases.

The last time the Commission took a good look at hedge funds was in 1998, when Long-Term Capital Management nearly collapsed. As you may recall, LTCM was a Connecticut-based hedge fund whose investment strategy employed a tremendous amount of borrowed money, or leverage. This strategy caused it to suffer approximately $1.8 billion in losses in August 1998, when Russia devalued the ruble.

After LTCM's near collapse, the Commission, along with the Treasury Department, the Federal Reserve, and the Commodity Futures Trading Commission, as part of the President's Working Group on Financial Markets, issued a report on the risk management and transparency issues raised by LTCM in particular and of "highly leveraged institutions" in general.[1] The President's Working Group looked at such issues as firms' adherence to their own stated policies, their margin and collateral requirements, their use of leverage and whether it was excessive, and how well their risk models functioned. The report made serious recommendations that were intended to improve how firms functioned in these areas; and, based on our examination of the major brokerage houses that service hedge funds, many institutions extending leverage to hedge funds seem to have taken these recommendations to heart.

In addition to this examination of the risk management and transparency issues, the Commission staff actively supported the work of the *Multidisciplinary Working Group on Enhanced Disclosure (MWGED).* The MWGED and the subsequent *Joint Forum Working Group on Enhanced Disclosure (JFWGED),* which the Commission chairs, both address issues of enhanced disclosure for financial intermediaries (i.e., banks, securities firms, insurance companies, and hedge funds). The MWGED issued its report in April 2001, and the work of the JFWGED is ongoing, but we believe many in the hedge fund industry are considering the recommendations of these two groups and continuing to explore ways to improve some of their practices.

Nonetheless, the markets have continued to evolve, and I believe the time has come for us—the SEC and the President's Working Group—again to review these risk management, transparency, and public disclosure issues.[2] As part of the SEC's ongoing investigation into the operations of hedge funds, we are also addressing issues from the perspective of investor protection. These issues include the recent growth of the industry; the "retailization" of hedge funds—meaning the increasing availability of these products and how and to whom they are available; an apparent increase in reported fraud involving hedge funds; and conflicts of interests. Additionally, I am interested in looking into other issues related to the overall market impact of hedge fund practices.

The Commission also has been very active in working with our colleagues at Treasury, the Federal Reserve, and other financial regulators to explore and address the potential use of hedge funds as vehicles for money laundering and terrorist financing. As mandated by the USA PATRIOT Act, Treasury, the Federal Reserve, and the SEC issued a report to Congress that addressed the regulation of investment companies, including hedge funds, as it related to money laundering.[3] Additionally, Treasury, in coordination with the CFTC, the Federal Reserve, and the SEC, has proposed regulations that would require certain unregistered investment companies, including hedge funds, to establish anti-money laundering programs.[4]

[1] "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," April 1999.

[2] Certainly, we must be cognizant of how the lack of public information about hedge funds also plays a critical part in a hedge fund's investment strategy. Many hedge funds are concerned about third parties uncovering their strategies. For example, an investor knowing that a hedge fund holds a large short position in a security could use that information to the detriment of the hedge fund by trading against that short position.

[3] "A Report to Congress in Accordance with Section 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act)," December 31, 2002.

[4] The proposed regulation was issued September 26, 2002 [67 FR 60617].

Differences Between Hedge Funds and Investment Companies

In order to fully understand the many questions associated with hedge funds, we must first examine the characteristics that distinguish them from registered investment companies. Unlike registered investment companies, investors in hedge funds usually must commit their money to hedge funds for extended periods of time and cannot redeem an investment without prior notice. In fact, some hedge funds permit investors to redeem only once or twice per year. Moreover, hedge funds are not subject to the diversification requirements imposed on registered investment companies and, therefore, may concentrate their portfolios in a handful of investments, thereby increasing their potential exposure to market fluctuations.

Hedge funds typically do not have boards of directors. Hedge funds also do not have to report their results in a standardized format. And while registered investment companies generally pay an advisory fee based on a percentage of assets under management, hedge funds typically pay both an asset-based fee (typically one to two percent of assets) as well as a performance fee. The performance fee is typically 20 percent or more of the hedge fund's annual profits (realized or not) but often may be paid only if the hedge fund's performance exceeds a benchmark set forth in the fund's offering documents.

Hedge funds are not subject to borrowing and leverage restrictions that apply to registered investment companies. Thus, a hedge fund may leverage its portfolio beyond the extent that a registered investment company may do so. On the other hand, many hedge funds employ investment strategies with limited or no leverage.

One of the most significant differences between hedge funds and registered investment companies, for our purposes, is that because hedge funds typically are not registered with the Commission, they are not directly subject to examination and inspection by the Commission.

Regulation of Hedge Funds Under the Federal Securities Laws

The exclusions from registration under the Federal securities laws that apply to hedge funds and their securities offerings are central to the questions that currently surround hedge funds. The exclusions define the investment strategies that hedge funds may pursue, the types of investors who generally may invest in hedge funds, and how hedge fund securities may be sold. Hedge funds are able to avoid regulation by meeting criteria that are laid out in four general exclusions or exceptions: (1) the exclusion from registration of the fund under the Investment Company Act of 1940, (2) the exemption from registration of the fund's securities under the Securities Act of 1933, (3) the exception from registration of the hedge fund manager under the Investment Advisers Act of 1940, and (4) the exception from reporting requirements under the Securities Exchange Act of 1934.

EXCLUSION FROM REGISTRATION UNDER THE INVESTMENT COMPANY ACT OF 1940

Hedge funds typically do not register with the SEC. They rely on one of two exclusions under the Investment Company Act of 1940 to avoid registration. The first exclusion under Section 3(c)(1) of the Investment Company Act limits investors in the hedge fund to 100 persons, while the second exclusion under Section 3(c)(7) of the Investment Company Act, which was added to the Investment Company Act in 1996, imposes no numerical limit on the number of investors.[5] Instead, it generally looks to the size and nature of the investments of an individual. Thus, investors in funds that utilize the 3(c)(7) exemption generally must be "qualified purchasers." Qualified purchasers are defined to include high net worth individuals (generally individuals who own certain specified investments worth at least $5 million) and certain companies. The theory is that wealthy investors do not need the full protections of the registration provisions of the Federal securities laws.

EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933

Importantly, both of these exclusions require hedge funds to sell their securities in non-public offerings. Thus, most hedge funds rely on one of a handful of exemptions under the Securities Act in order to avoid making a public offering. In order to be classified as a non-public offering, the hedge fund securities may not be offered for sale using general solicitation or advertising. Additionally, hedge funds generally sell their securities only to those who qualify as "accredited investors." The term "accredited investor" includes individuals with a minimum of $200,000 in annual

[5] Although there is no specific numeric limitation on the number of investors in a Section 3(c)(7) fund, the Federal securities laws generally require any issuer with 500 or more investors and $10 million of assets to register its securities and to file public reports with the Commission. Most hedge funds do not wish to register their securities, and therefore they stay below the 500 investor level.

income or $300,000 in annual income with their spouses, or a minimum of $1,000,000 in net assets. It also includes most organized entities with over $5,000,000 in assets, including registered investment companies.[6]

Because these limitations under the Securities Act apply at lower levels than the "qualified purchaser" exemption for 3(c)(7) funds, these 3(c)(7) funds may only be offered or sold to investors who are qualified purchasers, as well as accredited investors. Other hedge funds, that do not qualify as 3(c)(7) funds, may be offered and sold to accredited investors, whether or not they are also qualified purchasers. Finally, a fast-growing group of funds of hedge funds are registered under the Securities Act and may be publicly offered and sold.

EXCEPTION FROM REGISTRATION UNDER THE INVESTMENT ADVISERS ACT OF 1940

Managers of hedge funds meet the definition of "investment adviser" under the Investment Advisers Act of 1940 because they are in the business of providing investment advice about securities to others. Under this Act, an investment adviser with fewer than 15 clients that does not publicize itself generally as an investment adviser is not required to register with the Commission. Because Commission regulations count each hedge fund, rather than each investor in the hedge fund, as one client, some hedge fund managers may not be required to register with the Commission.[7] Unregistered advisers are not directly subject to the Commission's examination and inspection program. But it is important to note that all hedge fund managers—whether registered as investment advisers or not—are subject to the antifraud provisions of the Investment Advisers Act.

EXCEPTION FROM REPORTING REQUIREMENTS UNDER THE SECURITIES EXCHANGE ACT OF 1934

Hedge funds generally are not subject to the reporting requirements of the Securities Exchange Act because they are operated so as not to trigger registration of their securities under that statute. However, if a hedge fund holds large public equity positions, the manager, like any other large institutional manager, must publicly disclose those positions. This disclosure, however, does not necessarily provide significant insight into any particular hedge fund's portfolios or strategies because the manager is permitted to aggregate all clients' holdings into one report. In addition, disclosure is not required of short and debt positions.

The Commission's Investigation of Hedge Funds

Our investigation has been primarily focused on the investor protection implications of the growth in hedge funds. Once we have concluded that work, we plan to share our conclusions with other members of the President's Working Group so that we jointly can consider whether to review other market issues, including market impact, leverage, and counterparty risk. Furthermore, let me assure you that the SEC will continue to use the full extent of its authority to examine the risk assessment policies and procedures of broker-dealers, especially those of the larger firms, which are more likely to have counterparty exposure to hedge funds or otherwise be exposed to risk from hedge fund investments. Because many of these firms are affiliated with other types of financial institutions, such as banks, that may also have hedge fund exposure, firms' credit practices may also be subject to examination by other financial regulators. While our current investigation is not yet complete, I want to share with you some of the issues on which we have been focusing, including: (1) conflicts or interest, (2) retailization, (3) prime brokers, and (4) fraud.

CONFLICTS OF INTEREST

Side-by-Side Products

Investment advisers to registered investment companies increasingly are offering hedge fund investments to their clients—both to satisfy clients who are seeking alternative investments, and to provide opportunities for their most talented investment managers who otherwise might defect to higher paying positions with hedge funds. The result, that the advisers manage hedge funds alongside registered investment companies, raises the potential for conflicts of interests.

[6] This exemption also permits a private issuer to sell to up to 35 nonaccredited investors, but in that case, those investors must be "sophisticated" persons—meaning that they must be capable of evaluating the merits and risks of their investment—and the issuer must provide disclosure to those investors comparable to that in public offerings.

[7] We understand that some hedge fund managers voluntarily register with the Commission because some investors, particularly many foreign investors, prefer their managers to be registered. Others register because they also advise registered investment companies, which are required to be advised only by registered investment advisers.

For example, hedge fund managers often have large stakes in the hedge funds that they advise and/or they collect performance fees from their hedge fund clients. Consequently, there is the potential that a hedge fund manager may be tempted to favor its hedge fund clients over its registered investment company clients in allocating lucrative trades.

Hedge fund investments may be managed differently than they are in a registered investment company. For performance and other reasons, a hedge fund manager may determine to sell a security short in a hedge fund's portfolio, while holding the same security long in a mutual fund's portfolio.

I stress that these types of potential conflicts are the same as those that exist for any investment adviser that manages both registered investment companies and private client accounts.

Valuation

Other potential conflicts of interest are inherent in hedge funds alone. Registered investment companies must price their portfolio securities at market or, if there is no market, at their current "fair value"—determined in good faith by the fund's board of directors. Hedge funds are not subject to these requirements. Thus, for example, hedge funds may determine that the appropriate price of a security is its inherent price, a price that looks to the future. Or it may substitute its determination of the value of a security for a market price.

These valuation determinations are, of course, subject to the antifraud provisions of the Federal securities laws, but otherwise they are permissible. Ultimately, it may be impossible for an investor to know the actual value of a hedge fund's portfolio securities.

"RETAILIZATION" OF HEDGE FUNDS

Another primary focus of our investigation involves the "retailization" of hedge funds.

"Middle Class" Hedge Funds

I earlier mentioned the term "accredited investor." This qualification is the standard measure used by some private hedge funds to determine who may invest in their offerings, and it is a hedge fund's basis for meeting the standards of one of the four general exemptions from registration. The monetary amounts used to determine accredited investor status essentially have remained the same since 1982. With the sustained growth in incomes and wealth in the 1990's, however, more investors meet this standard, despite recent economic downturns. Although the Commission is not aware of any systematic investor losses or other failures caused by the current accredited investor standard, we could of course consider adjusting it, if appropriate. A global change to the standard, however, could impact significantly the availability of securities registration exemptions to other companies. In particular, we would carefully consider the effect of any adjustment to the standard on the opportunities for small business capital formation before proposing any change.

In addition, the Internet has changed forever how companies communicate with their current and prospective investors. Just plugging the term "hedge fund" into any search engine will elicit hundreds of responses. If hedge fund sponsors fail to follow the law, every investor with access to the Internet could easily obtain materials that could constitute an offering of securities to the public, triggering registration and other requirements under the securities laws. Appropriate regulation of Internet offerings is a challenge for the Commission, as it is for other regulatory agencies. The Commission staff watches how the Internet is used to offer securities to the public, including offerings by hedge funds. Our policy goal is to strike a balance between encouraging use of the Internet for legitimate capital formation and at the same time preventing fraud and abuse. If we become concerned that our rules and guidelines need to be changed, or enforcement action needs to be taken, to prevent abuse by hedge funds or others engaged in purported capital formation activity, we will act accordingly.

Funds of Hedge Funds

Registered investment companies that invest all, or substantially all, of their assets in an underlying pool of hedge funds are another means of increased availability of hedge funds to public investors. These funds are a recent phenomenon, evolving from the laws governing the structure of 3(c)(7) funds. The Commission's Division of Investment Management has seen a boom in these funds. In summer 2002, the first fund of hedge funds became eligible to sell its securities to the public. Subsequently, there have been 17 other funds of hedge funds cleared for the public market. All of these funds currently are subject to fund-specific minimum investment requirements of at least $25,000. However, there is now no Federal requirement for a minimum investment, and it is possible that funds might seek to lower this requirement making these types of funds available to a greater number of investors with even less capital. These possibilities also implicate the need to focus on suitability determinations and sales practices of those marketing hedge funds.

Funds of hedge funds raise special concerns because they permit investors to invest indirectly in the very hedge funds in which they likely may not invest directly due to the legal restrictions. Because of the influence that accompanies the large size of their investment, registered funds of hedge funds can compel the underlying hedge funds to provide more information to investors than they would typically get. However, even funds of hedge funds do not get the same volume and frequency of information as investors in a registered investment company or mutual fund.

PRIME BROKERS

The growth in the number of hedge funds has also highlighted another aspect of the hedge fund industry that we need to better understand. Hedge funds generally use one or more broker-dealers, known as "prime brokers," to provide a wide variety of services.

Prime brokerage is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades for substantial retail and institutional customers who are active market participants. Prime brokerage involves three distinct parties: The prime broker, the executing broker, and the customer. The prime broker is the broker-dealer that clears and finances the customer trades executed by one or more executing broker-dealers at the behest of the customer. The prime broker is responsible for all applicable margin and Regulation T requirements for the customer.

Generally, customers, such as hedge funds, believe a prime brokerage arrangement is advantageous because the prime broker acts as a clearing facility for the customer's securities transactions wherever executed, as well as a central custodian for all the customer's securities and funds.

Prime brokers offer certain other services to hedge funds that are typically offered to other substantial customers such as margin loans and risk management services, but prime brokers may offer other services that are particularly directed to their hedge fund customers. For example, some prime brokers provide "capital introduction" services to hedge funds. These services, which range from sponsoring investor conferences to arranging individual meetings and preparing informational documents, are aimed at bringing hedge fund managers together with potential investors. We are looking into these services and the way they are disclosed to investors.

HEDGE FUND FRAUD

Fraud is, of course, always a primary concern to us. I emphasize that I do not intend to imply that hedge funds or their managers generally engage in nefarious or illegal activities. I have no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else. Nevertheless, there have been complaints by some issuers that hedge funds have acquired large short positions in their stocks and have then attempted to drive the share price down through the issuance of highly critical and allegedly inaccurate reports on their finances.

The Division of Enforcement will continue to investigate allegations of manipulative short selling by hedge funds as it deems warranted. From a regulatory perspective, the Commission recognizes that, while short selling can add important benefits to the market, such as facilitating liquidity, hedging, and pricing efficiency, it also may be used as a tool for manipulation. In this regard, the Commission will consider amendments to existing short sale regulation, as necessary, to curb potential manipulation by all market participants, including hedge funds, without unnecessarily restricting liquidity.

More generally, we have recently experienced a sharp increase in the number of hedge fund frauds that we have investigated and that have resulted in enforcement action. In fact, last year we instituted twice the number of enforcement actions against hedge funds or their managers than we instituted in any of the four previous years.

Examples of charges filed by the Commission include: Making false or misleading statements in offering documents; misappropriating assets; market manipulation in a variety of guises; reporting false or misleading performance, including with respect to valuation of securities; insider trading; and fraudulently allocating investment opportunities.

These charges generally are not unique to hedge funds. But hedge funds present us with a unique challenge. Because hedge funds typically are not registered with us, we are limited in our ability to detect problems before they result in harm to investors or the securities markets.

Market Impact

In addition to the risk management and transparency issues addressed by the President's Working Group and the investor protection aspects that the Commission has been primarily focused on to this point, I believe the Commission's investigation should explore other market impact issues specifically in the context of hedge funds because of the substantial assets under their management. We would, of course, consider these market impact issues with other members of the President's Working Group. The Commission already aggressively enforces the anti-manipulation provisions of the Federal securities laws. It may be that there are other, more subtle or nuanced results of hedge fund activity that merit attention.

Among the matters that I believe we should look at is the impact of hedge fund trading. There is nothing inherently nefarious about hedge fund trading strategies, including short selling. However, they may disproportionately affect the market or certain issuers. This is a special concern because we don't know enough about the activities of these hedge funds.

I think we need to determine whether the information firewalls of hedge fund industry participants are adequate and whether information flow within or among hedge fund managers is an area that merits attention. Our understanding is that prime brokers' policies include strict information firewalls, but there may be other aspects of information flow that should be considered.

The nature of managers' returns on hedge funds, either through investments in the funds or through carried interests, also may affect trading behavior. While some of the resulting issues relating to risk-taking are properly issues of disclosure and investor protection, it is also possible that there are resulting market impacts that merit attention, and I believe our investigation should consider that possibility.

The Progress of the Investigation

Our current investigation is proceeding well. The Commission's Division of Investment Management, alongside our Office of Compliance Inspections and Examinations, has been gathering information on investor protection issues to assist the Commission in its investigation and in preparation for the roundtables in May. The staff has obtained and reviewed documents and information from 67 different hedge fund managers representing over 650 different hedge funds and approximately $162 billion under management.

The staff has also visited and engaged in discussions with a number of different hedge fund managers. When the staff visited these managers, they inquired into various aspects of their business, depending on their size and level of sophistication. The staff talked to brokerage, compliance, risk management, legal, and other operational personnel of multi-billion dollar complexes with dozens of employees, as well as to their portfolio managers. At the other end of the spectrum, the staff visited hedge funds where one employee serves as marketer, portfolio manager, trader, operations officer, and risk manager.

Aside from our inquiries directed to specific hedge funds, the staff has met with a variety of experts in their respective fields to get their perspectives on the hedge fund industry. In addition to legal and accounting experts, the staff has spoken with chief investment officers, risk managers, prime brokers, representatives from foreign regulators, trade industry representatives, and hedge funds consultants. Also, a number of foreign jurisdictions are revisiting their approaches to hedge funds, and we continue to benefit from discussions with our foreign counterparts.

Hedge Fund Roundtable

As you know, we are taking our investigation to the next step. As part of this we have scheduled two full days of hedge fund roundtable discussions to take place in Washington on May 14 and 15. These discussions will focus primarily on the investor protection issues mentioned earlier. Leading experts in the world of hedge funds will provide their views on hedge funds and the issues that concern us. In addition, we will solicit comments from the general public to secure their views. At the end of this process, my current goal is to produce a report that will summarize what we have found and where we should go. I believe we should make public what we have found and what conclusions we have reached.

Investor Education Efforts

Before I close, I would like to tell you about efforts that we and others are making to provide the public with tools to help to evaluate the potential risks of hedge funds and funds of hedge funds. Since the creation of the Commission's website at *www.sec.gov,* we have used the website to educate and alert investors to issues relating to securities. Among other things, the website generally discusses hedge funds and funds of hedge funds. We have also used that website to provide investors with a laundry list of questions they should ask before investing in these products.

In addition, Commission staff developed a website advertising a simulated hedge fund, Guaranteed Returns Diversified, Inc. (GRDI or greedy, for short). This website demonstrates how easy it is to be taken in by false statements and seeks to sensitize investors to their vulnerability. The Commission's website provides a link to the fake scam, although we have discovered that most are finding it by surfing the Internet looking for quick and easy returns. Since we launched this website on February 13, 2003, we have had over 70,000 hits on it!

Finally, the NASD has increased its efforts to ensure that investors are not steered to unsuitable investments. At the beginning of this year, the NASD issued a Notice To Members that reminds broker-dealers of their obligations when selling hedge funds and funds of hedge funds. These obligations include steps to ensure that proper disclosures are made to customers about these products and that broker-dealers consider the suitability of these products for their customers.

Conclusion

In conclusion, let me assure you that our goal in this exercise is to determine how we can better protect investors and our securities markets. By working together, I believe that we can achieve this goal.

Thank you again for inviting me to speak on behalf of the Commission and the investing public. I would be happy to answer any questions that you may have.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM WILLIAM H. DONALDSON

Q.1.a. Your investigation is looking at investment managers who handle both hedge funds and mutual funds. How many firms have personnel (that is, fund managers) that are responsible for both types of funds? How many individual managers have responsibility for both types of funds?

A.1.a. The Commission doesn't collect data on hedge funds. We do, however, collect data on advisers registered with the Commission, and we know that 1,431 advisers registered with the Commission advise both investment companies and some kind of an unregistered pooled investment vehicle, which would include funds typically referred to as hedge funds. This number represents just over 18 percent of all SEC-registered advisers and is based on the responses to Items 5D(4) and 5D(6) of Form ADV (the registration form advisers file with the Commission).

We do not, however, ask advisers specific questions about their internal management activities with respect to hedge funds or other unregistered pooled investment vehicles. Consequently, we do not have data on the number of individuals employed by investment advisers who have responsibility for both registered and unregistered funds.

Q.1.b. What type of disclosure do these investment firms typically make to investors in the mutual fund?

A.1.b. Investment advisers to registered investment companies, including advisers to mutual funds, increasingly are offering hedge fund investment opportunities to their clients. When an adviser manages a hedge fund alongside a registered investment company, it raises potential conflicts of interests. Notably, however, the nature of these conflicts is similar to those for an adviser managing a registered investment company alongside a private client account or accounts—a practice which is relatively commonplace in the fund industry.

The relevant registration forms do not expressly require that these potential conflicts be disclosed as a specific principal risk of investment in the fund. Put another way, the forms are not designed to mandate which specific risks must be disclosed. Rather, the forms require that all material risks be disclosed. The forms also set out where in the registration statement the more significant material risks must be disclosed.

Most mutual fund managers, of course, do not also manage hedge funds. But when that is the case, the mutual fund must analyze the potential conflicts raised by that dual role and determine whether or not disclosure to fund shareholders is necessary. Disclosure might not be necessary, for example, where the particular mutual fund and hedge fund use very different investment strategies or are otherwise unlikely to make investment decisions regarding the same investments.

The staff typically does not see mutual funds disclosing these potential conflicts as a specific material risk of investment. Investors, however, do receive important related information in connection with a fund's brokerage allocation procedures. The applicable registration forms for open- and closed-end funds expressly call for disclosure relating to the fund's brokerage allocation procedures in the fund's statement of additional information. Funds sometimes disclose securities allocation procedures involving the fund and other accounts of the adviser (whether those other accounts are private client accounts, other registered investment vehicles, or hedge funds).

A mutual fund also must describe in its prospectus the adviser's experience, as well as the recent business experience of the portfolio manager. This disclosure would require general information regarding hedge funds managed.

Finally, and regardless of any disclosure obligations, it is very important to note that an adviser to a mutual fund is subject to the antifraud provisions of the Investment Advisers Act of 1940, and has a fiduciary duty to treat all clients fairly pursuant to that Act. Accordingly, during our examinations of investment companies, we scrutinize the adviser's procedures in this area to ascertain whether the fund is being managed in an appropriate manner along with other accounts, including hedge funds, managed by the adviser.

Q.1.c. What safeguards do investment firms have in place to guard against preferential treatment of the hedge fund?

A.1.c. Advisers that manage hedge funds and other pools of assets or individual accounts have substantial conflicts of interest when a hedge fund pays a performance fee. Investment advisers, even those exempt from registration with the Commission, owe their clients fiduciary duties that prohibit the adviser from acting on such conflicts to harm clients. Although it is difficult to generalize across the industry, many investment advisers have also established the policies and procedures designed to prevent these types of conflicts from harming clients, including:

- Establishing written compliance policies that, among other things, provide for the fair allocation of investment opportunities among clients.
- Adopting written codes of ethics that proscribe illegal, unethical, or inappropriate conduct by the adviser's employees.
- Establishing supervisory procedures designed to prevent employees from causing the adviser to breach its fiduciary duties by favoring hedge fund clients, including monitoring for patterns of trading that, although effected in accordance with compliance procedures, indicate a possibility of abuse.
- Structuring portfolio manager compensation to ameliorate incentives to act on conflicts.

These are policies and procedures similar to those advisers use to guard against other types of conflicts of interest. Our experience is that larger advisory firms are more likely to have written, formal procedures than smaller organizations.

Q.2.a. The securities fraud laws that the SEC enforces apply to hedge funds. According to some press reports, the SEC has brought about two dozen cases against hedge funds since 1998. Have these all been antifraud cases?

A.2.a. From 1998 through 2002, the Commission has brought approximately 28 enforcement actions relating to hedge funds. All but one of these actions included charges of securities fraud; some of these actions alleged additional violations of other provisions of the Federal securities laws. The remaining enforcement action charged violations of the registration provisions of the Securities Act and the Investment Company Act, and of the books-and-records provision of the Investment Advisers Act.[1]

Q.2.b. What was the nature of the fraud?

A.2.b. The fraud charges in these hedge fund cases were based primarily on allegations that the hedge funds and/or their advisers made misrepresentations concerning: (i) the past, present, or future performance of the fund; (ii) the risk associated with investing in the fund; (iii) the adviser's qualifications or experience; (iv) the current value of the fund or an investor's interest in it; (v) the fund's trading strategy; (vi) use of fund assets; and/or (vii) the extent of losses. In many of these cases, the fund or its adviser misappropriated investors' monies.

Q.2.c. How did the SEC become aware of the fraud?

A.2.c. While we cannot report how the fraud was learned of in each of these cases, the Commission frequently learns of frauds such as these from investors who have suffered losses or who are solicited to invest. We also may learn of hedge fund misconduct from a third-party that conducts business with the fund, such as a brokerage firm or auditor.

Q.2.d. Are we seeing evidence of more abuses in this industry or are we just seeing more cases because the industry has grown?

A.2.d. It is difficult to identify the cause (or causes) of the recent increase in cases relating to hedge funds. It may relate to the growth in the industry. It is also likely that as public awareness of hedge funds has increased, those intent upon defrauding investors are using the allure of hedge funds to attract victims. In these situations, the violators may have no intention of establishing a legitimate hedge fund, but simply market the fraudulent investment opportunity as a hedge fund.

Q.2.e. Given the ability of less sophisticated investors to access hedge funds, will the SEC be re-evaluating its enforcement program?

A.2.e. The Commission aggressively combats all types of fraud, including fraud relating to hedge funds. As the hedge fund industry continues to grow and hedge funds become more available to retail investors, the enforcement program's focus on hedge fund fraud will grow more acute.

Q.3.a. Hedge funds typically own assets that are difficult to value—either because they are not broadly traded or because of unique characteristics of the assets. What are the typical guidelines for valuation and reporting for hedge funds?

A.3.a. *Valuation.* The Federal securities laws generally do not require hedge funds to value their assets in any particular manner. Hedge funds, however, typically disclose to their investors how they value their assets.

[1] *See* In the Matter of Prime Advisors, Inc., et al., Release No. 7560, July 31, 1998.

The manager of a hedge fund typically values the fund's assets. As a general matter, however, hedge funds ordinarily use: (a) market prices to value securities for which the market quotations are readily available, and (b) "fair value" to value securities and other assets for which market quotations are not readily available. Although there is no uniform methodology for determining fair value, fair value generally is the price that the fund might reasonably expect to receive for a security or other asset upon its current sale. Many hedge funds use pricing information from pricing services, such as Bloomberg, Reuters, and FT Interactive Data, to value their assets. Some hedge funds value the securities of nonpublicly traded companies at cost and generally do not revalue them until a public trading market exists for the securities or the issuer engages in a subsequent round of equity financing. Some hedge funds also utilize "side pocket" accounting, whereby illiquid assets are essentially not considered when determining the funds' net asset values (NAV) until the funds sell the assets.

Hedge fund financial statements typically are prepared in accordance with generally accepted accounting principles (GAAP). GAAP generally requires the use of fair values when market prices are not readily available. Hedge funds, however, are not subject to the requirements of Regulation S–X under the Securities Act of 1933, which specifies the form and content of financial statements and standards concerning auditor independence.

Independent public accountants typically audit the year-end financial statements of hedge funds. Most auditors attempt to verify the accuracy of hedge funds' securities valuations by comparing them with values they obtain from pricing services. For certain assets for which prices are not readily available, however, auditors generally review and assess the reasonableness of the hedge fund manager's valuation process; most auditors do not attempt to verify the actual prices of the assets.

Reporting. The Federal securities laws generally do not require hedge funds to provide reports to the Commission or to their investors. Many hedge funds, however, provide their investors with quarterly, semi-annual, or annual reports. Hedge funds also commonly provide their investors with copies of their year-end audited financial statements. Some hedge funds also provide their investors with monthly or quarterly account statements. In addition, some hedge funds post performance and other information on password-protected websites that are available to their investors.

Q.3.b. Are intermediary "funds of funds" making sure that they receive fair valuations?

A.3.b. A small but growing number of funds of hedge funds (FOHF's) have registered with the Commission in the past several years. These funds are required by the Investment Company Act of 1940 to value their portfolio securities by using: (a) the market value of the securities when market quotations are "readily available" and (b) the fair value of the securities when market quotations are not readily available. As there generally are no readily available market prices for interests in the underlying hedge funds in which registered FOHF's invest, the FOHF's are required to value such interests at their fair value.

Registered FOHF's generally disclose to their investors how they value their interests in hedge funds. The disclosure typically sets forth the steps that the FOHF's and their managers take to ensure that they value their assets fairly. Registered FOHF's often disclose in their offering documents that, prior to investing in a hedge fund, their managers conduct due diligence reviews of the valuation methodologies used by the hedge fund. Such reviews typically include examining the hedge fund's offering documents and obtaining additional relevant information from the fund's manager. Many registered FOHF's rely on valuation information provided to them by the hedge funds in which they invest. Registered FOHF's also typically disclose that they generally lack access to the information that would be needed to confirm independently the accuracy of valuation information provided by the underlying hedge funds. In addition, registered FOHF's typically disclose that, in the event that they have information that causes them to question the valuation information reported by a hedge fund, they will fair value their interest in the hedge fund based on any relevant information, including the reported valuation information, available to them.

The financial statements of registered FOHF's must be audited annually by independent public accountants, and the financial statements of many hedge funds also are audited annually by independent public accountants. These audits may provide some degree of assurance that registered FOHF's are valuing their assets appropriately. As noted above, auditors generally review and assess the reasonableness of a hedge fund's valuation process when auditing the fund's financial statements.

Q.3.c. If retail investors are involved in hedge funds, what can be done to ensure that the value of their investments is reported appropriately?

A.3.c. Retail investors generally may invest in FOHF's registered under the Investment Company Act and whose securities are registered under the Securities Act. Four elements can help to ensure the value of retail investors' investments in registered FOHF's are reported appropriately: (1) review by the Commission's staff of the funds' offering documents and financial statements; (2) examinations of FOHF's by the Commission's examination staff; (3) audits of the FOHFs' financial statements by independent public accountants; and (4) oversight by the FOHF independent directors of the valuation process.

The Investment Company Act places the responsibility for fair value pricing of portfolio securities on the investment company's board of directors.[2] Therefore, investment company directors should demand sufficient information to be comfortable that the valuations of underlying hedge fund investments are accurate.

The Commission's staff closely reviews the offering documents of FOHF's seeking to register as investment companies to ensure that their valuation policies and procedures are fully consistent with regulatory requirements. Examinations by the Commission's staff of the actual valuation practices of registered FOHF's and their financial statements also should help to ensure registered FOHF's

[2] Section 2(a)(41) of the Investment Company Act.

are valuing their portfolio securities in a manner consistent with regulatory requirements and their disclosures to investors.

Finally, audits of the financial statements of registered FOHF's and hedge funds by independent public accountants should also provide some assurance that registered FOHF's and hedge funds are valuing and reporting their investments appropriately.

Q.3.d. Should there be a requirement for independent verification of the valuations?

A.3.d. Given our limited experience with these vehicles, it is difficult to determine, at this time, whether there should be a requirement for independent verification of hedge funds' valuations. We are aware that some FOHF's will invest only with underlying hedge funds that agree to provide information to an independent third party to value the hedge funds' assets and report to the FOHF. At least one jurisdiction, Hong Kong, generally requires independent verification of hedge funds' valuations. We are studying these recently adopted requirements and intend to consult with the Hong Kong Securities and Futures Commission concerning the operation of these requirements for hedge funds and FOHF's in Hong Kong.

Q.4.a. Hedge funds are well-known as an option for the sophisticated or "accredited" investor, currently defined as someone with $1 million in net worth or annual salary of $200,000. These values have not changed in many years. Do these levels need to be adjusted to accommodate changes in income and wealth since they were adopted?

A.4.a. The monetary amounts used to determine accredited investor status essentially have remained the same since 1982. With the sustained growth in incomes and wealth in the 1990's, however, more investors meet this standard, despite recent economic downturns. It may, therefore, be appropriate to consider whether the definition should be updated to increase the levels of income or net worth.

The Commission would, of course, consider adjusting the "accredited investor" definition, if appropriate. Before proposing any adjustments, the Commission must consider a number of factors. First, the Commission is not aware of any systematic investor losses or other failures caused by the current accredited investor standard. Second, the Commission may wish to reconsider using the definition as a surrogate for investor sophistication, and that concept also may be worthy of consideration. Third, a global change to the accredited investor standards, however, could impact significantly the availability of securities registration exemptions to other companies. In particular, the Commission would consider carefully the effect of any adjustment to the standard on the opportunities for small business capital formation before proposing any change.

Q.4.b. What is the current industry practice regarding minimum levels for investing in funds of funds?

A.4.b. Your inquiry raises two separate, but related, questions. First, has an industry practice developed around the minimum initial investment required by registered FOHF's? And, second, have investors in these funds been required to meet certain other investor eligibility requirements?

All of the FOHF's registered with the Commission to date as investment companies have registered as closed-end funds under the Investment Company Act. Some also have registered their securities under the Securities Act. Notably, none of these registered FOHF's currently trades on an exchange.

With regard to the first question, all of these registered FOHF's subject investors to fund-specific minimum initial investments of no less than $25,000. Some require a $25,000 initial minimum, others $50,000, and a few impose much greater initial minimums (in some cases, $1 million). A few also disclose that they will reduce, or reserve the right to waive, the required minimum in limited circumstances, such as when the investor already is an existing client of the adviser with substantial assets under management, or when the investor is an officer or employee of the adviser.

However, there is no Federal requirement that FOHF's impose any minimum initial investment.[3] A registered FOHF, therefore, could lower its minimum initial investment so as to make itself available to a greater number of investors with less capital.[4] The emergence of these products implicates the need to focus on the suitability determinations and sales practices of those marketing the registered FOHF's, as well as the underlying hedge funds.

With regard to the second question, as we noted above, the underlying hedge fund investments typically limit their U.S. investors to those who satisfy specific eligibility standards. All of the FOHF's currently registered with the Commission have imposed specific eligibility standards, regardless of whether those standards are required under Federal law. All of these registered FOHF's restrict their sales to investors that *at least* satisfy the "accredited investor" standard, even those funds engaged in a public offering and thereby required to register their securities under the Securities Act and their funds under the Investment Company Act. In addition to certain institutional investors, "accredited investors" are defined generally as natural persons with individual or joint net worth of $1,000,000, or individual income in each of the last 2 years in excess of $200,000, or joint income for the same period in excess of $300,000.

But those registered FOHF's charging a performance-based fee (that is, a fee based on the capital gains or capital appreciation of the fund or a client's account) are required to impose specific eligibility standards pursuant to the Investment Advisers Act. Such funds must limit their investors to "qualified clients." That term generally is defined as investors with individual or joint net worth exceeding $1,500,000, or with assets under the adviser's management of at least $750,000, or investors who are "qualified purchasers" for purposes of the Investment Company Act (defined as, among other things, an investor with at least $5,000,000 in investments).

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[3] Some foreign jurisdictions, such as Hong Kong, France, and Australia, do require a minimum investment in the FOHF's they regulate.

[4] In fact, one FOHF whose registration statement is pending with the staff proposes to trade its shares on an exchange without any minimum initial investment requirement. That fund also would not impose other common investor eligibility standards, such as those we discuss later in this answer.

Therefore, with respect to minimum initial investments, a FOHF need not impose any specific eligibility standards if it does not charge a performance-based fee or register its securities under the Securities Act. However, not imposing these standards voluntarily would raise suitability and sales practices concerns.

Q.4.c. Alternatively, should there be a floor set on the minimum level at which retail investors can buy into hedge funds through the "funds of funds" structure?

A.4.c. As noted above, there is no Federal requirement that registered FOHF's impose a minimum initial investment on investors. Further, investors in some of the currently offered FOHF's need not satisfy, as a matter of law, specific eligibility standards. Nevertheless, all current registered FOHF's voluntarily impose minimum initial investments and specific eligibility standards.[5]

With respect to eligibility standards, this result primarily is due to changes made to the Federal securities laws in the National Securities Markets Improvement Act of 1996 (NSMIA). Those changes provided greater leeway for the creation of registered FOHF's and expanded the kinds of hedge funds that could be offered (primarily through enactment of Section 3(c)(7) of the Investment Company Act). Further, after NSMIA, a hedge fund in which a FOHF invests need not "look through" the FOHF, to its investors, to determine who is a "qualified purchaser" for purposes of Section 3(c)(7).[6]

In a FOHF, the adviser's expertise and sophistication, in effect, is substituted for that of each investor. The investors are protected through the purchase of a registered product. The adviser to a registered FOHF must register with the Commission and is subject to regulation under the Advisers Act. Investors also are protected through comprehensive regulation of the registered fund and Commission oversight under the Investment Company Act. Moreover, if the fund conducts a public offering and registers its securities under the Securities Act, additional statutory provisions protect the investors.

As important, investment advisers and broker-dealers who recommend FOHF's must ensure that such recommendations are suitable for the particular investor. Advisers are fiduciaries owing their clients a duty to provide only suitable investment advice.[7] To do this, advisers must make reasonable determinations that their advice is suitable for a particular client based on that client's financial situation and investment objectives. This duty is enforceable under Section 206 of the Advisers Act.

The Federal securities laws and the rules of various self-regulatory organizations (SRO's) require a broker-dealer to have a reasonable basis for believing its recommendations are suitable for a particular investor. Recently, one SRO, the National Association of

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[5] It the absence of a legal mandate, suitability and related considerations (discussed below) may be major factors in why these funds are adopting such policies.

[6] Put another way, the registered FOHF (or a mutual fund) would be the "qualified purchaser" for Section 3(c)(7) purposes in the unregistered hedge fund, regardless of the *bona fides* of the investors in that registered FOHF or mutual fund. However, Rule 2a51–3 under the Investment Company Act provides that a fund shall not be deemed to be a qualified purchaser if it was formed for the specific purpose of acquiring the securities of a 3(c)(7) fund, unless each of the top fund's beneficial owners is a qualified purchaser.

[7] *See* Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (March 16, 1994).

Securities Dealers, issued a Notice to Members reminding its broker-dealers of their suitability and sales practice obligations concerning the sale of FOHF's and hedge funds.[8]

Investor net worth has long been a useful proxy for suitability and sophistication generally. For example, if a prospective investor in a FOHF has $750,000 invested elsewhere with an adviser, or has considerable other assets, those facts, though perhaps not dispositive, would be relevant to the investment's suitability and the investor's ability to withstand the loss of the entire investment in the FOHF. It is not so clear that a minimum initial investment requirement has the same efficacy as a proxy for suitability or sophistication. For example, an investor might seek to diversify his/her small investment portfolio with a small investment in a FOHF. The investor might not be terribly savvy or wealthy, since he/she might satisfy that fund's voluntarily imposed accredited investor eligibility standard primarily because of the net worth of the investor's house. Requiring that investor to make a $50,000 minimum initial investment would not seem to advance the cause of investor protection. Rather, imposition of such a minimum could have potentially perverse results—the loss of the entire investment likely would have dire consequences to the investor.

We certainly are not opposed to funds imposing such minimums on their own initiative, nor are we opposed to investment advisers or broker-dealers looking to such minimums, in conjunction with all other relevant factors, in reaching a suitability determination in a given instance. However, we question whether investment minimums alone adequately protect less sophisticated investors.

Q.5.a. Britain's Financial Services Authority (FSA) does not allow hedge funds to be marketed to retail investors—although they are considering options for opening up hedge funds to retail investors. They are also trying to limit the amount that hedge funds can borrow in order to prevent any systemic risks. Is the SEC reviewing the FSA's work in this area?

A.5.a. The Commission is currently reviewing and considering how other jurisdictions, including the United Kingdom, regulate hedge funds. An examination of the regulation of hedge funds in other jurisdictions may assist the Commission in determining whether the U.S. regulatory regime for hedge funds and hedge fund managers should be amended.

With respect to the FSA's work, hedge funds, as a general matter, currently may not be marketed and sold to retail investors in the United Kingdom. The FSA, however, recently solicited comments on whether hedge funds should be permitted to be marketed and sold to retail investors in light of considerable changes both to the hedge fund market and the structure of regulation in the United Kingdom.[9] The comments received by the FSA generally indicated that hedge fund product providers and investment managers do not have a great desire to produce or to sell retail hedge

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[8] Notice to Members 03–07 (February 2003). This notice emphasized a broker-dealer's obligation to: Provide a balanced disclosure in promotional efforts; perform a reasonable-basis suitability determination; perform a customer-specific suitability determination; and provide adequate training and supervision of persons selling these products.

[9] FSA Discussion Paper 16 (August 2002), available at *http://www.fsa.gov.uk/pubs/discussion/16/*.

fund products in the United Kingdom and there is no significant demand from retail investors for access to such products. After reviewing the comments, the FSA concluded that its current regulatory regime is appropriate and that no changes are required.[10] The FSA stated that it would continue to monitor the hedge fund market to determine whether to amend the regulations for hedge funds.[11]

The FSA also requested comments on the appropriateness of its regulatory regime for hedge fund managers. Hedge fund managers based in the United Kingdom must be authorized by the FSA even if the funds that they manage are offshore. The comments received by the FSA generally indicated that the FSA's current regulatory regime for United Kingdom-based hedge fund managers is appropriate. The FSA concluded that it would not be appropriate to introduce rules specifically to regulate hedge fund managers. The FSA stated that it would continue to monitor the hedge fund market to determine whether to amend the regulations that apply to hedge fund managers.

Q.5.b. What have other countries with mature capital markets done?

A.5.b. Most jurisdictions permit hedge funds to be marketed and sold to sophisticated investors or institutional investors without requiring the hedge funds to be authorized by the securities regulator in the jurisdiction. Most jurisdictions, however, do not permit hedge funds to be marketed and sold to retail investors. A few jurisdictions, such as Hong Kong, Singapore, and Switzerland, do permit hedge funds to be marketed and sold to retail investors.

In jurisdictions that permit hedge funds to be marketed and sold to retail investors, hedge funds are subject to various restrictions that are designed to address the retail investor protection issues. For example, each jurisdiction requires a minimum investment in a hedge fund.[12] Each jurisdiction also requires specific disclosures in hedge fund prospectuses and marketing materials regarding fund policies, strategies, and risks.[13] In two of the three jurisdictions, the prospectus also must contain information about the

[10] FSA Feedback Statement on DP 16 (March 2003), available at *http://www.fsa.gov.uk/pubs/discussion/fs16/*.

[11] The FSA noted that there were several significant obstacles to changing the regulatory regime to permit the marketing and sale of hedge funds to retail investors. For example, few hedge funds currently are established in the United Kingdom because the tax regime is unfavorable, especially compared to certain offshore jurisdictions. In addition, existing regulations would limit the type of hedge funds that could be authorized in the United Kingdom to those that meet certain key investor protections, such as risk spreading, independent depository, regular valuation, rights of redemption, limitations on borrowing, and disclosure.

[12] Hong Kong, Singapore, and Switzerland require a minimum investment in a hedge fund of $50,000 (or, for a capital guaranteed hedge fund, with no minimum investment), approximately $58,000, and approximately $11,000 respectively.

[13] In Hong Kong, the prospectus must disclose the types of investment instruments permitted, the extent of diversification and leverage, and the risk implications to investors. The prospectus also must contain a disclaimer regarding the risk of price fluctuations during the payout period, which can last as long as 90 days. In Singapore, all marketing material must disclose fees and charges, refer to the risks of investing in the fund, and include disclaimers that: (1) investment in a hedge fund carries special risks and may not be suitable to investors averse to such risks; (2) if not a capital guaranteed fund, that investors may lose all or a large part of their investment; or if a capital guaranteed fund, that investors are subject to the credit risk of the guarantor or the default risk of the issuer; and (3) hedge funds may not be suitable for all types of investors and are not intended to be a complete investment strategy for any investor. In Switzerland, the prospectus must disclose all special risks, the redemption procedures, and include a glossary of terms.

fund's valuation procedures.[14] Hedge funds must have external audits by independent auditors in at least two jurisdictions.[15] At least two jurisdictions require regular reports to investors.[16] In addition, in all three jurisdictions, hedge fund managers must meet certain experience and expertise requirements.[17]

Many jurisdictions permit funds of hedge funds to be marketed and sold to retail investors.[18] Funds of hedge funds are subject to various restrictions that are designed to address retail investor protection issues. In most jurisdictions that permit funds of hedge funds to be marketed and sold to retail investors, the prospectus and marketing material must contain information describing the risks of such an investment.[19] In most, if not all, foreign jurisdictions that permit funds of hedge funds to be marketed and sold to retail investors, the regulator scrutinizes the experience and competence of a manager before authorizing that manager to manage a fund of hedge funds.[20] Most jurisdictions that permit funds of hedge funds to be marketed and sold to retail investors require investors to make a minimum investment in a fund of hedge funds.[21]

[14] In Hong Kong, the prospectus must disclose the valuation methods, frequency of valuation and the identity and qualifications of the valuation agent, which must be independent. In Switzerland, the prospectus must disclose the valuation method.

[15] In Switzerland, the external auditors must demonstrate professional expertise in the area of alternative investments in which the hedge fund invests. In Hong Kong, an auditor that is independent of the management company and the trustee/custodian must audit the annual report of the fund.

[16] In Hong Kong, the hedge fund manager must issue a quarterly narrative report to holders on the fund activities during the reporting period. The report must be distributed within one month of the end of the period it covers. In Switzerland, an annual report must be issued discussing the development of the fund's investment style and strategy, as well as the valuation of any difficult-to-value investments.

[17] In Hong Kong, a hedge fund manager must have $100 million in assets under management that follows hedge fund strategies, 5 years of general experience in hedge fund strategies and 2 years of experience in the same strategy as that of the proposed hedge fund. In Singapore, a hedge fund manager must demonstrate expertise in managing hedge funds, and at least two executives of the manager must have 5 years of experience in hedge fund management. In Switzerland, a hedge fund manager must have 5 years of experience in the investment area concerned and have a minimum capital of approximately $755,590. In all of these jurisdictions, the regulator has the authority to prohibit the public offering of a hedge fund if the fund manager does not have the proper experience or expertise.

[18] Australia, Bermuda, Cayman Islands, Hong Kong, Ireland, Italy, Japan, Luxembourg, Singapore, Switzerland, and the United Kingdom. In the United Kingdom, funds of hedge funds that invest on a conventional long-only basis may be listed on exchanges. Germany currently does not permit funds of hedge funds to be marketed and sold to retail investors, but it is planning to allow such access in the future.

[19] In France, marketing material must contain a disclaimer that the fund is illiquid and intended only for investors who do not require immediate liquidity. In Hong Kong, funds of hedge funds must provide a disclaimer that some or all of the underlying funds and their fund managers are not subject to regulation by the securities regulator. In Ireland, a fund of hedge funds must disclose special information on risks including certain disclaimers, and the fund must disclose its diversification policies and information about the underlying funds and their fees. In Singapore, a fund of hedge funds must meet the same requirements as a hedge fund with regard to disclosure of risks and disclaimers. *See supra* footnote 13. In Switzerland, the prospectus of a fund of hedge funds must include a disclaimer that the fund can lose up to 100 percent of its investment in a single underlying fund.

[20] In Australia, fund of hedge fund managers must demonstrate expertise and experience as well as financial resources to be licensed. In Hong Kong, fund of hedge fund managers must: (1) be regulated in a jurisdiction with an acceptable regulatory regime; (2) have $100 million in aggregate assets under management that follows hedge fund strategies; and (3) have 5 years of experience in managing hedge funds strategies and 2 years of experience managing funds of hedge funds. Fund of hedge fund managers must demonstrate appropriate expertise and provide information to the Central Bank of Ireland regarding appropriate controls to be authorized in Ireland. In Luxembourg, the regulator pays particular attention to expertise and financial standing of the managers of hedge funds when considering their applications for authorization. In Singapore, fund of hedge fund managers must have expertise in managing such funds.

[21] Luxembourg has no explicit minimum investment requirement, but the regulator may impose one if the fund of hedge funds is perceived to be risky. Minimum investments in Australia can be as low as $1–$2,000, while other jurisdictions (Hong Kong, Ireland, the Netherlands, Singapore, and Switzerland) generally require a minimum investment of $10–$15,000.

Q.5.c. To what extent is the SEC looking at how the international community governs hedge funds?

A.5.c. The Commission has been a participant in the Financial Stability Forum (FSF) since it was convened in April 1999, to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. The FSF has been studying the implications for global economic stability of highly leveraged institutions (which include hedge funds).[22] In addition, the Commission participates in meetings of the International Organization of Securities Commissions (IOSCO). Over the past few years, IOSCO's Technical Committee, as well as Standing Committee 5 on Investment Management have examined the regulations governing hedge funds in the international community.[23] Most recently, the Commission hosted speakers from the United Kingdom and France at its Hedge Fund Roundtable in May 2003, which was convened to investigate the structure and practices of hedge funds. The Commission seeks to benefit from the experience of other jurisdictions in examining the issue of regulation of hedge funds.

Q.6.a. Press Reports have focused a great deal of attention on hedge funds because of their extensive use of short selling, particularly in what has been a downward trending market. Does the SEC monitor short selling? How? Does the SEC monitor short selling by hedge funds? How?

A.6.a. As you are probably aware, short selling in itself is not an illegal activity, although there are rules in place governing the way in which short sales are carried out. For example, Rule 10a–1(a)(1) under the Securities Exchange Act of 1934 (Exchange Act) provides that, subject to certain exceptions, an exchange-listed security may be sold short: (i) at a price above the price at which the immediately preceding sale was effected (plus tick), or (ii) at the last sale price if it is higher than the last different price (zero-plus tick). Conversely, short sales are not permitted on minus ticks or zero-minus ticks, subject to narrow exceptions. The operation of these provisions is commonly described as the "tick test." A similar "bid test" applies to short sales effected in Nasdaq National Market Securities, and prohibits NASD members, subject to certain exceptions, from effecting short sales at or below the best bid when the best bid displayed is below the preceding best bid in a security.

In addition, the self-regulatory organizations, such as the New York Stock Exchange and the National Association of Securities Dealers, have adopted rules to help ensure delivery of securities sold short by settlement date. These rules generally require that, prior to effecting short sales, member firms must affirm that they will receive delivery of the security from the customer, or that the firm can borrow the security on behalf of the customer or on its

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[22] The FSF has published three papers: "Recommendations and Concerns Raised by Highly Leveraged Institutions (HLI's): An Assessment" (March 2002); "Progress in Implementing the Recommendations of the Working Group on HLI's" (May 2001); and "Working Group on Highly Leveraged Institutions" (April 2000).

[23] For example, in 1999, IOSCO's Technical Committee issued a report entitled, "Hedge Funds and Other Highly Leveraged Institutions," and in 2003, it published a paper entitled "Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds of) Hedge Funds."

own behalf for delivery by settlement date. Short sellers are also subject to other costs, such as margin requirements, net capital requirements for broker-dealers, capital and risk management standards, and costs imposed by the equity lending market.

The SRO's conduct surveillance regarding compliance with short sale regulation. In addition, the Commission's Office of Compliance Inspections and Examinations also conducts examinations for potential violations with respect to exchange-listed securities. While a hedge fund that is not registered with the Commission as either a broker-dealer or investment company would not be subject to examination, the Commission could and does examine broker-dealers effecting short sales on behalf of hedge funds.

Q.6.b. Has the SEC discovered any evidence of the abuse of short selling?

A.6.b. There have been press reports documenting complaints by issuers that they were the victims of attacks by hedge funds. These issuers have alleged that the hedge funds accumulated large short positions in their stocks, and then sought to drive the share price down through the issuance of highly critical and allegedly inaccurate reports on their finances. The Commission has also recently investigated and brought actions against certain parties engaging in manipulative naked short selling as part of what is commonly called a "death spiral" scheme. In these schemes a party providing financing receives from a public company debentures that are later convertible into the stock of the issuer, typically at a discount to the current market price. The parties providing financing, which in some instances may be operating as hedge funds, and may engage in extensive, naked short selling designed to lower the price of the issuer's stock, thus realizing profits upon the conversion of the debentures.

The Division of Enforcement will continue to investigate allegations of manipulative short selling by hedge funds as it deems warranted. From a regulatory perspective, the Commission recognizes that while short selling adds important benefits to the market, such as facilitating liquidity, hedging, and pricing efficiency, it also may be used as a tool for manipulation. In this regard, the Commission will consider amendments to existing short sale regulation, as necessary, to curb potential manipulation by all of the market participants, including hedge funds, without unnecessarily restricting liquidity.

Q.6.c. To what degree are some of the standard mutual funds, or other "buy side" market participants now using short selling?

A.6.c. As a general matter, mutual funds engage in short selling to a very limited extent. While many mutual funds reserve the right to engage in short selling as part of their overall investment strategies, many of these funds infrequently or never engage in short selling. Recent annual and semi-annual reports filed with the Commission indicate that, during a recent reporting period, approximately 230 mutual funds engaged in short sales, as did approximately 30 closed-end funds. The press also has reported that there are approximately 50 specialized mutual funds with combined assets of $6 billion that consistently employ short selling and related hedging strategies.[24] The NYSE and Nasdaq publicly disclose monthly open short interests for their listed companies.

Q.7.a. In a down market environment, hedge funds are more attractive to pension fund investors who need the positive returns to meet their commitments. To what extent are the pension funds involved in the hedge fund market?

A.7.a. Press reports suggest that pension plans generally are not heavily invested in hedge funds, but that many plans are exploring the possibility of making investments in hedge funds. Because the Commission regulates neither pension plans nor hedge funds, we do not maintain data on the extent to which pension plans have invested in hedge funds.

Q.7.b. Do you believe that the pension fund managers are asking for and receiving the type of disclosure that they need to understand the risks involved?

A.7.b. We generally have insufficient information to determine whether pension plan managers are requesting and receiving the type of disclosure that they need to understand the risks involved in investing in hedge funds. Under ERISA, however, pension plan managers generally have a fiduciary duty to exercise prudence in investigating, evaluating, and making investments for their plans. As a result, we believe that pension plan managers should be asking for and receiving the information that they need to understand the risks involved in investing in particular hedge funds.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM WILLIAM H. DONALDSON

Q.1. In 1999, the President's Working Group on Financial Markets under the Clinton Administration issued a report titled, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." In that report, the Working Group made a number of recommendations.

Which of the 1999 Working Group's recommendations are currently supported by the SEC and by the Bush Administration's Working Group? Which of the regulatory recommendations of the 1999 Working Group have been adopted? Which have not? Please be specific and give the rationale for any given regulation within the SEC's jurisdiction which has not been implemented.

A.1. The Commission continues to support the recommendations made by the President's Working Group on Financial Markets. As described below, the recommendations that fall within the jurisdiction of the Commission have been implemented or are the subject of further study in order to develop an implementation strategy that best furthers the goals of the President's Working Group.

Recommendation 1—Disclosure and Reporting

The President's Working Group recommended that public companies be required to provide disclosures concerning their material exposures to significantly leveraged financial institutions.

[24] *See* "Fund Trackers Mull Categories for Hedge Techniques," *Ignites* (*www.ignites.com*), May 28, 2003.

Since the report, Commission staff participated in the Multidisciplinary Working Group on Enhanced Disclosure also known as the Fisher Group (Fisher Group). The Fisher Group was established by the Basel Committee on Banking Supervision, the Committee on the Global Financial System of the G10 central banks, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions. In April 2001, the Fisher Group issued a final report with recommendations for improving public disclosure practices of financial institutions and suggested that hedge funds be encouraged to make similar disclosures—when material—to investors, counterparties, and creditors. The recommended disclosures included intraperiod market risk exposures, qualitative discussions of funding liquidity risk with quantitative supporting information, and counterparty credit exposures categorized by business line, credit quality, and maturity. Public securities firms, in large part, are complying with the recommendations through the disclosures they make in their regulatory filings and annual reports. The Fisher Group also recommended that regulators and market participants collaborate further on improving market and counterparty credit risk disclosures. SEC staff currently is chairing a multinational group—the Joint Forum Working Group on Enhanced Disclosure—that is studying these issues as a follow up to the report and recommendations of the Fisher Group.

Recommendation 2—Supervisory Oversight

The President's Working Group recommended that bank, securities, and futures regulators monitor and encourage improvements in the risk management systems of regulated entities.

This recommendation is consistent with Commission practice. The Commission's Office of Compliance, Inspections and Exams (OCIE) conducts internal controls and risk management exams of broker-dealers. These reviews focus on a firm's systems, procedures, resources, and overall performance in the assessment, monitoring, and control of all risks at the firm. The examiners look for areas where a firm's controls are weak or inadequate and make findings as appropriate. OCIE also conducts targeted exams that focus on specific risks. For example, it currently is conducting a series of examinations of broker-dealers that are significantly involved in businesses and services related to hedge funds.

In addition, the Commission's Division of Market Regulation has staff committed to a Risk Assessment Program (RAP), which focuses on broker-dealer holding companies. The RAP staff monitors the financial condition and operating results of 160 broker-dealer holding companies. This includes obtaining quarterly reports that contain detailed information on the legal structure of the holding company and consolidating financials. This information is not routinely provided to other regulators and allows for analysis of the leverage, capital adequacy, risktaking, and business of each legal entity that is included in the holding company structure. The information provided by the reporting firms generally does not include external counterparty credit risk exposure.

The RAP staff also meets monthly with the independent risk managers at the five independent broker-dealers most active as dealers in financial derivatives. It also meets quarterly with risk managers at several bank-owned broker-dealers that are significant participants in this area. Several of these firms also are among the dominant providers of prime brokerage services to hedge funds. The information provided at these meetings is the same information used by the firms internally to manage their market and counterparty credit risk exposures. These meetings give the RAP staff perspective on how securities firms manage these risks firmwide. They also provide the RAP staff with intra-period information on significant market and external counterparty credit risk exposures. The analysis of the risk exposures at these firms provides a unique perspective into market trends with respect to risk exposures and capital allocation. Although the meetings are voluntary, the participating firms have been very cooperative in helping the RAP staff understand their risks.

In addition to these efforts, Commission staff members represent the Commission on a number of multinational working groups that have studied, or are studying, counterparty credit risk issues, including the aforementioned Joint Forum Working Group on Enhanced Disclosure and the Fisher Group, as well as the Financial Stability Forum (FSF).

Recommendation 3—Enhanced Private Sector Practices for Counterparty Risk Management

The President's Working Group recommended that financial institutions implement improved risk management procedures.

Securities firms have implemented this recommendation. The market and counterparty credit risk procedures of the securities firms most involved with hedge funds have been substantially augmented and improved since 1998. These firms have devoted significant resources to hiring qualified risk managers. They also have purchased and developed highly innovative technological tools for measuring and aggregating risk, booking transactions, and tracking documentation. On the industry-wide level, they formed the Counterparty Risk Management Policy Group (CRMPG). In June 1999, CRMPG issued a report titled "Improving Counterparty Risk Management Practices." The recommendations in this report have provided firms with useful guidance in improving counterparty credit risk procedures.

Recommendation 4—Capital Adequacy

The President's Working Group has recommended that prudential supervisors and regulators promote the development of more risk-sensitive approaches to capital adequacy.

The Commission has taken necessary steps toward making its broker-dealer capital rule more risk-sensitive. In 1997, the Commission adopted rules that allow securities firms to establish special broker-dealer affiliates that operate as over-the-counter derivatives dealers. These firms are permitted to calculate market and credit risk charges using internal models. The Commission is drawing on this experience in implementing rules for investment bank holding companies under the Gramm-Leach-Bliley Act.

Recommendation 5—Expanded Risk Assessment for the Unregulated Affiliates of Broker-Dealers and Futures Commission Merchants

The President's Working Group recommended enhancing the current authority of the Commission to require financial information about the unregulated affiliates of broker-dealers.

The Commission has authority to collect certain information about material affiliates of broker-dealers. This authority has been implemented through the RAP described above. The mandatory reporting required under the RAP generally does not include external counterparty credit risk exposures; it is limited to credit exposures among affiliates. On the other hand, the voluntary reporting by several of the largest securities firms provides RAP staff with information on firm-wide external counterparty credit exposures. Gramm-Leach-Bliley authorized the Commission to implement recordkeeping rules at the securities firm holding company level. However, firms would elect to be subject to these rules; they would not be mandatory. If the recommendation was implemented, it would enhance the Commission's authority to obtain information about market and external counterparty credit risk exposures at the broker-dealer holding company level. The voluntary disclosures made by the larger broker-dealers at the monthly RAP meetings would serve as a valuable template for implementing such authority. The goal would be to limit the reporting to the most useful information for assessing systemic risk issues. This would entail a flexible approach and one that did not cause an influx of less relevant information.

Recommendation 6—Bankruptcy Code Issues

The Working Group recommended changes to the U.S. bankruptcy code to improve close-out netting provisions.

The proposed changes would expand the categories of financial contracts eligible for netting and permit netting across different types of contracts. The proposals also would clarify that a U.S. court could apply U.S. bankruptcy code protections in an ancillary proceeding. This would prevent a judicial stay from halting netting and liquidation rights recognized under U.S. law. Netting and liquidation rights are integral to prudent risk management by financial institutions. Accordingly, the Commission supports passage of a bill that accomplishes them.

Recommendation 7—Offshore Financial Centers and Tax Havens

The Working Group recommended that the U.S. regulators work with foreign counterparts to encourage offshore financial centers to adopt internationally agreed upon standards to reduce the incentive for hedge funds to move their operations abroad.

While some hedge funds may move offshore for regulatory purposes, their assets and the collateral they pledge generally remain in the United States. Therefore, locating offshore does not necessarily increase credit risk. However, international borders and secrecy havens, in particular, do further complicate the already limited ability of U.S. regulators to obtain access to hedge fund information and records. Therefore, removing incentives for hedge funds to move offshore is helpful. Commission staff efforts through IOSCO, the Financial Action Task Force and the FSF have contributed to a reduction in the number of incentives for a hedge fund to move offshore. In addition, through the G7 and other political avenues, Commission staff encouraged a number of other jurisdictions to join in the effort to strengthen, among other things, the supervisory systems and standards of offshore financial centers. Multilateral initiatives have focused on removing the "opacity" incentive for hedge funds to move operations to an offshore financial center or "non-cooperative" jurisdiction. Through the IOSCO, FATF, and FSF, Commission staff continues to encourage the implementation of laws, regulations, and practices that follow international standards. A majority of offshore financial centers have enhanced their regimes for regulatory oversight, including reporting, recordkeeping, and information sharing requirements.

The President's Working Group specifically noted that the ability of offshore financial centers to join IOSCO and Basel-sponsored working groups should be made contingent on progress toward implementation of international supervisory standards. This factor continues to be a membership criterion for IOSCO.

Q.2.a. It is my understanding that much of what is known about hedge funds is not precise. For example, it is not known exactly how many hedge funds there are; what is the size of the market, who are the investors, who are the managers; and how they impact the market. What information does the SEC routinely collect about hedge funds? How often is this information collected? Does the SEC have the authority it needs to collect adequate information to protect retail investors?

A.2.a. The Commission does not routinely collect any data about hedge funds. Because hedge funds typically qualify for exemptions from the Investment Company Act of 1940 and the periodic reporting requirements of the Securities Exchange Act of 1934, the Commission does not have authority to collect information from hedge funds under those statutes. The Commission does have authority to collect information about hedge funds from their advisers under the Investment Advisers Act of 1940, although most hedge fund advisers currently qualify for exemption from registration under Section 203(b)(3) of the Advisers Act because they manage fewer than fifteen funds and do not hold themselves out as an investment adviser. We believe that the Commission has administrative authority to require all hedge fund advisers to register under the Advisers Act, and thus could use this authority to collect information to protect hedge fund investors.

Q.2.b. It is my understanding that much of what is known about hedge funds is not precise. For example, it is not known exactly how many hedge funds there are; what is the size of the market, who are the investors, who are the managers; and how they impact the market. What information does the SEC routinely collect about hedge funds? How often is this information collected? Does the SEC have the authority it needs to collect adequate information to determine the impact of hedge fund trading activities on the securities markets?

A.2.b. Many hedge funds use broker-dealers to execute their securities transactions and maintain custody of their assets, and a few hedge funds are registered as broker-dealers. Also, the RAP staff monitors the counterparty credit risk exposures of the largest investment banks. Thus, the SEC, through its oversight and examination authority, can review hedge fund activities to the extent that they involve broker-dealers or registered investment advisers. However, as discussed above, the Commission does not have the authority to collect information directly from hedge funds or managers who are not registered with the Commission, except through subpoena. Accordingly, the Commission's ability to determine the impact of hedge fund trading on the securities markets is limited.

Q.3. With respect to funds of hedge funds, how are they valued? What is the frequency of such valuations? How reliable is the valuation? How does the SEC protect retail investors in funds of hedge funds from receiving inaccurate valuations of their shares?

A.3. A small but growing number of FOHF's have registered with the Commission in the past several years. These funds are required by the Investment Company Act of 1940 to value their portfolio securities by using: (a) the market value of the securities when market quotations are "readily available," and (b) the fair value of the securities when market quotations are not readily available. As there generally are no readily available market prices for interests in the underlying hedge funds in which registered FOHF's invest, the FOHF's are required to value such interests at their fair value.

Registered FOHF's generally disclose to their investors how they value their interests in hedge funds. The disclosure typically sets forth the steps that the FOHF's and their managers take to ensure that they value their assets fairly. Registered FOHF's often disclose in their offering documents that, prior to investing in a hedge fund, their managers conduct due diligence reviews of the valuation methodologies used by the hedge fund. Such reviews typically include examining the hedge fund's offering documents and obtaining additional relevant information from the fund's manager. Many registered FOHF's rely on valuation information provided to them by the hedge funds in which they invest. Registered FOHF's also typically disclose that they generally lack access to the information that would be needed to confirm independently the accuracy of valuation information provided by the underlying hedge funds. In addition, registered FOHF's typically disclose that, in the event that they have information that causes them to question the valuation information reported by a hedge fund, they will fair value their interest in the hedge fund based on any relevant information, including the reported valuation information, available to them.

Registered FOHF's are required to provide a valuation of their assets at least semi-annually. Many registered FOHF's effect purchases and redemptions on a quarterly basis and, therefore, value their assets for those events. In addition, some registered FOHF's calculate their valuations more frequently, such as monthly, for purposes of calculation fees.

The financial statements of registered FOHF's must be audited annually by independent public accountants, and the financial statements of many hedge funds also are audited annually by independent public accountants. These audits may provide some degree of assurance that registered FOHF's are valuing their assets appropriately. As noted above, auditors generally review and assess the reasonableness of a hedge fund's valuation process when auditing the fund's financial statements.

Q.4. Have the number of hedge fund related complaints received by the SEC increased over the past few years? What is the nature of these complaints? Please be as specific as possible.

A.4. Prior to this year, the SEC's Office of Investor Education and Assistance did not separately count how many investor contacts discussed hedge funds. Instead, our data system collected information about the nature of the conduct discussed in the investor's letter. Earlier this year, as hedge funds began to be marketed more heavily to retail investors, we added a code to track the number of investor contacts involving hedge funds. Our records show that 37 people, 7 of whom wished to remain anonymous, contacted the SEC this year (since January) concerning hedge funds. What follows are details about these contacts.

Eighteen investors raised the possibility of fraud. Five of the eighteen expressed concern that their money may have been stolen, rather than put into a hedge fund. Six investors contacted the SEC because they had been unable to withdraw funds from hedge funds. Six investors alleged that various hedge funds were illegally shorting stocks, or otherwise manipulating the market. Two investors contacted the SEC to ask about the status of SEC investigations into hedge funds in which they were invested. One person forwarded an article that alleged insider trading in a hedge fund and asked that we investigate the matter. Whenever an investor raises credible allegations of fraud, our Office practice is to refer the matter to Enforcement.

One investor complained to the SEC that a securities salesperson from a firm where she holds an account approached her and tried to get her to invest in a hedge fund that was too risky. Whenever an investor raises credible allegations of sales practice abuses, we refer the matter to Enforcement.

Four investors suggested that the SEC needed to intensify regulation over hedge funds. Two asked that the SEC not regulate hedge funds further.

One investor asked for a copy of materials referenced in the discussion during our roundtable on hedge funds held on May 14 and 15, 2003.

One person wrote to the SEC requesting the regulations and requirements governing the origin, funding, and operation of a hedge fund, plus any applications for registration and licensing as may be necessary.

Three investors contacted our Office to check the backgrounds and/or addresses of particular hedge funds.

Q.5. In your surveillance of the securities markets have you considered identifying companies whose stocks have exhibited unusual trading patterns to determine whether hedge fund trading has played a prominent role in this trading activity?

A.5. There have been press reports documenting complaints by issuers that they were the victims of attacks by hedge funds. These issuers have alleged that the hedge funds accumulated large short positions in their stocks, and then sought to drive the share price down through the issuance of highly critical and allegedly inaccurate reports on their finances. The Commission has also recently investigated and brought actions against certain parties engaging in manipulative naked short selling as part of what is commonly called a "death spiral" scheme. In these schemes a party providing financing receives from a public company debentures that are later convertible into the stock of the issuer, typically at a discount to the current market price. The parties providing financing, which in some instances may be operating as hedge funds, may engage in extensive naked short selling designed to lower the price of issuer's stock, thus realizing profits upon conversion of the debentures.

The Division of Enforcement will continue to investigate allegations of manipulative short selling by hedge funds as it deems warranted. From a regulatory perspective, the Commission recognizes that while short selling adds important benefits to the market, such as facilitating liquidity, hedging, and pricing efficiency, it also may be used as a tool for manipulation. In this regard, the Commission will consider amendments to existing short sale regulation, as necessary, to curb the potential manipulation by all market participants, including hedge funds, without unnecessarily restricting liquidity.

Q.6. At the Committee hearing, I read from one communication we have received regarding the conflicts that mutual funds appear to have when they also run hedge funds. According to another source:

> The conflicts are in several areas: (1) The different fee and compensation structures for portfolio managers, analysts, and traders incent them to act differently when managing hedge funds alongside mutual funds. Firms are not required to put up a Chinese wall between the two operations. It is often not feasible to do so due to expense constraints. This is compounded when mutual fund firms allow their portfolio managers to open hedge funds as a retention device to prevent them from leaving the firm. To maximize their compensation and that of their team, they tend to devote considerably more energy to managing the hedge fund than their mutual funds. (2) The ability to short stocks in a hedge fund also causes conflicts with investment teams running long only money. There are many instances where a decision to short a stock in a hedge fund is made simultaneously with a decision to sell in the long fund. The hedge fund investors naturally benefit when the mutual fund sales are done. (3) There is also the case where the benefits of running mutual funds, such as access to research through use of commission dollars from the mutual fund business, is transferred disproportionately to the hedge fund investor.

Does the SEC probe these issues in their regular examinations? Has the SEC heard similar allegations and, if so, how is it addressing them?

A.6. When the Commission's examination staff conducts examinations of registered investment advisers that manage both mutual funds and hedge funds, the staff pays particular attention to the types of conflicts of interest to which this question refers. The Commission's ongoing investigation of the hedge fund industry also has focused on these conflicts of interest. These conflicts of interest, however, are not new, nor are they unique to side-by-side management of mutual funds and hedge funds. These types of conflicts may exist whenever an investment adviser: (i) manages accounts that pay performance-based fees in addition to accounts that pay asset-based fees; and (ii) sells a security short on behalf of a client when another client sells a long position in that same security.

The Commission's risk-based approach to examinations considers investment advisers that manage both mutual funds and hedge funds as posing a higher level of regulatory risk due to, among other things, the presence of conflicts of interest. Such entities can expect to be examined by the Commission's staff more frequently than lower-risk mutual funds and investment advisers. The Commission's examinations generally focus on how registered investment advisers manage these conflicts of interest, and whether the conflicts are disclosed to mutual fund boards of directors and mutual fund investors. For example, the examinations focus on the separation of duties (for example, the use of information barriers) and other internal controls that are designed to manage conflicts of interest in such entities. The examinations also focus on whether the investment advisers' conduct in relation to the mutual funds and hedge funds is consistent with their fiduciary duties and in compliance with their obligations under the Federal securities laws.

The Commission also addresses conflicts of interest by instituting enforcement cases in appropriate instances when the conflicts of interest result in unlawful activity. For example, the Commission has instituted enforcement actions against investment advisers that preferred their performance fee-paying clients over their other clients in the allocation of "hot" initial public offerings.[1]

The Commission is continuing to explore what additional measures can be taken to isolate the conflicts of interest resulting from side-by-side management of mutual funds and hedge funds. The staff intends to address these and other issues in a report to the Commission, to be completed later this year, that will summarize the staff's findings and make recommendations with respect to the investor protection implications of the growth in the hedge fund industry.

Q.7. In the *Fortune* article that was dated March 31, 2003 *"Where the Money's Really Made"* it stated, "The hedge fund boom has sweeping implications not just for Wall Street traders and a few thousand well-heeled investors, but increasingly for every American businessperson, investor, and retiree."

Please comment on this statement and the potential "sweeping implications" for retail investors that are raised.

A.7. The *Fortune* article states that the "hedge fund boom" has implications for many U.S. investors. We agree that the growth of the hedge fund industry has a number of implications for U.S. investors, including:

- Institutional investors that historically have not invested in hedge funds, such as pension plans, may now be investing in hedge funds. As a result, retirement and other assets may be subject to the risks associated with hedge funds.
- An increasing number of potentially less sophisticated investors have become eligible to invest, and may be investing, in hedge

[1] *See In the Matter of F.W. Thompson Company, Ltd.,* Investment Advisers Act Release No. 1895 (September 7, 2000); *In the Matter of McKenzie Walker Investment Management, Inc.,* Investment Advisers Act Release No. 1571 (July 16, 1996).

funds, subjecting themselves to the risks associated with hedge funds.

- A small but growing number of registered investment companies invest all or a significant portion of their assets in hedge funds.[2] Since these funds of hedge funds are increasingly registering their securities under the Securities Act, they can be sold to retail investors who would then be subject to the risks associated with hedge funds.
- More assets are invested in hedge funds, which are generally not subject to the investor protection provisions of the Federal securities laws, and the managers of many of those hedge funds are not subject to the regulatory oversight of the Commission.
- Hedge funds engage in strategies, such as short selling, that may have a significant impact on the financial markets.

The Commission staff has been gathering, and is continuing to gather, information relating to the implications of hedge fund growth in the course of its ongoing investigation of the hedge fund industry. While we have reached no conclusions yet, the staff is considering these implications and will report to the Commission whether the existing regulatory framework continues to be appropriate in light of the growth of the hedge fund industry.

Q.8. I am aware that since June 2002, the SEC has been conducting an investigation of the hedge fund industry's structure and practices. What safeguards are in place to reduce the likelihood of another failure of the type of Long-Term Capital Management? What risks do large hedge funds pose to the financial system?

A.8. Since the near collapse of the LTCM in 1998, there have been significant changes in the hedge fund industry. The large macro hedge funds of the 1990's (Soros, Tiger) have scaled back or ceased operations. While assets under management at hedge funds have continued to grow, the majority of funds are relatively small entities. Broker-dealers that extend credit to hedge funds have substantially improved their counterparty credit risk management in light of the LTCM. Most exposures to hedge funds are fully collateralized, including excess collateral. Moreover, broker-dealer credit-risk departments have been upgraded and credit procedures strengthened and refined. In enhancing their procedures, broker-dealers have adopted recommendations of the CRMPG in its June 1999 report titled, "Improving Counterparty Risk Management Practices." Nonetheless, there is still room for improvement. The CRMPG report recognized the difficulty in quantifying the credit risk associated with leveraged counterparties. In certain circumstances, large degrees of leverage may pose very little risk while a counterparty with little leverage may cause great exposure. Multinational working groups, such as the Fisher Group, continue to study the issue of counterparty credit risk exposure.

[2] Following amendments to the Investment Company Act enacted in 1996, certain hedge funds may sell their securities without regulation under the Federal securities laws to up to 499 qualified purchasers, including to most registered investment companies. Among other things, a qualified purchaser generally includes "any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments." Section 2(a)(51)(A)(iv) of the Investment Company Act.

The LTCM experience is helpful in analyzing the risks posed by a large hedge fund. The LTCM employed maximum leverage to profit on inefficiencies in the global financial markets. The LTCM used its market power to exact favorable transaction terms from its counterparties. In particular, it was able to enter into securities repurchase agreements with very little margin required. When the market value of the collateral dropped, counterparties called for additional collateral more quickly. In order to meet these collateral calls, the LTCM in many cases sold its most liquid assets first leaving the less liquid assets to meet future liquidity demands. The value of the less liquid assets dropped as the LTCM moved to liquidate them. This contributed to volatility, which put stress on other entities holding similar positions. Broker-dealers learned from this experience and generally no longer provide such favorable transaction terms to hedge funds. However, the business opportunities associated with a large hedge fund could put pressure on a financial institution's credit risk procedures.

Also in the period just prior to its near collapse, the LTCM sold to other market participants large volumes of financial products that provided protection against adverse movements in various equity indices. To create these positions, the LTCM sold options to counterparties such as broker-dealers and banks, which used the options to hedge their own securities positions. At the time of its troubles, the LTCM essentially was the sole provider of these hedging tools. Accordingly, the LTCM experience demonstrates the danger of multiple major market participants establishing identical credit exposures with a single counterparty that is not subject to an effective disclosure regime.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SUNUNU FROM WILLIAM H. DONALDSON

Q.1. For hedge funds that register as investment companies with the Securities and Exchange Commission, what disclosures regarding assets and liabilities are required? What other disclosure or audit requirements are these funds subject to?

A.1. All of the hedge funds currently registered as investment companies with the Commission have registered as closed-end funds. Like all other closed-end funds, these hedge funds are subject to numerous requirements designed to protect investors. A registered closed-end hedge fund must follow the reporting requirements of the Investment Company Act similar to those followed by other registered investment companies. For instance, the hedge fund must register on the form applicable to all other closed-end funds. That form does not distinguish between the disclosures—financial disclosures or otherwise—required for a closed-end fund operating as a hedge fund, and for any other kind of closed-end fund.

A closed-end fund's prospectus contains important information about: Its fees and expenses, investment objectives and strategies, risks, performance, valuation policies, and more. The fund's statement of additional information (SAI) includes information that is not necessarily needed by investors to make an informed decision, but that some investors find useful. The SAI generally includes information, or additional information, about: The fund's history and its policies; officers, directors, and persons controlling the fund;

advisory and other services; brokerage commissions; and tax and other matters.

The SAI also generally includes the fund's financial statements. In the initial registration statement, the fund's statement of assets and liabilities is commonly referred to as the "seed balance sheet." Like any closed-end fund, the seed balance sheet for a registered hedge fund reflects the initial minimum of $100,000 contributed by the adviser to make the fund operational. It also reflects the hedge fund's assets and liabilities, and those are presented in the same manner as those for any other closed-end fund.

After a registered hedge fund commences operations, it must file and provide to shareholders financial statements semi-annually, just like other registered investment companies. The form and content of the financial statements of a registered hedge fund is the same as that of any registered closed-end fund. Financial reporting for publicly registered investment companies is governed by the rules of Regulation S–X.[1]

In the statement of assets and liabilities, a registered investment company typically reports investments in securities as the first asset because of their relative importance to total assets. Other assets reported include, among other things, receivables for securities sold, and dividends and subscriptions receivable from shareholders. Liabilities reported include, among other things, payables for various operational expenses, accrued liabilities for securities sold short, open option contracts written, and distributions payable to shareholders.

Other financial statements and schedules that must be disclosed in a registered investment company's (registered hedge fund or otherwise) shareholder reports include:

- a schedule of investments—a detailed list of the portfolio securities as of the latest period;[2]
- a statement of operations—shows increase or decrease in net assets resulting from investment activities by reporting investment income from dividends, interest, and other income less expenses, and the amount of gain or loss from investment and foreign currency transactions;
- a statement of changes in net assets—summarizes results from operations, dividends, and distributions to shareholders, capital share transactions, and capital contributions;
- financial highlights—contains per share operating performance data for a typical share outstanding (for those investment companies that are unitized), as well as total investment return, analytical ratios, and other supplemental data for a period of at least 5 years; and
- a statement of cash flow—explains changes in cash and cash equivalents. The statement classifies cash receipts and cash payments as resulting from operating, investing, and financing activities and includes a reconciliation of net cash provided by and

[1] The initial balance sheet must be audited. The fund also must undergo an annual audit after each fiscal year end.

[2] Those "funds of hedge funds" that invest solely in other hedge funds only would report the underlying hedge funds in which they invested, not the underlying investments made by those underlying hedge funds.

used for operating activities to net increase or decrease in net assets from operating activities.[3]

In addition to filing semi-annual reports, registered investment companies must file Form N–SAR semi-annually. The N–SAR is a regulatory report used by the Commission to review whether the registered investment companies are in compliance with the Investment Company Act. It is not provided to shareholders but is publicly available.

N–SAR includes similar information reported in the financial statements. A closed-end fund must provide the aggregate number of shares and net consideration paid for all repurchases of the fund's stock during the reporting period, and also must disclose rate schedules for fees paid to investment advisers. The fund also must provide, among other things, the top ten brokers with whom it executed commission and non-commission trades. In addition, the annual N–SAR includes an auditor's report on the fund's internal controls. In that report, the auditor must identify any material weaknesses in the fund's accounting system or in the fund's internal controls.

Q.2. Following the LTCM's collapse, the President's Working Group on Financial Markets issued a report addressing the excessive leveraging by hedge funds and banks lending to hedge funds. As part of this report, the Fed and the OCC issued new guidelines with instructions to banks lending to hedge funds. Please detail these guidelines, as well as the degree to which they have been implemented, and their effectiveness in limiting inappropriate leverage in financial institutions.

A.2. We must defer to the Fed and the OCC to provide a detailed response to this question. We can report that Commission staff members have worked alongside U.S. banking regulators in a number of groups that have examined issues related to highly leveraged institutions. For example, staff members participated in a Working Group on Highly Leveraged Institutions for the Financial Stability Forum. In the course of this work, U.S. banking regulators reported that a 2000 review found a decline in the aggregate level of U.S. national bank exposure to highly leveraged institutions and a decline in the number of institutions providing credit to that sector. The banking supervisors also report that the banks are doing a better job of due diligence and ongoing monitoring of hedge fund counterparties. Finally, they report that U.S. banks continue to work on improving the measurement of potential future exposure as part of their efforts to improve counterparty credit risk management.

[3] A registered investment company need *not* include a statement of cash flows in its shareholder report if it meets certain criteria, including that the fund's net assets be made up of highly liquid investments throughout the period. Funds of hedge funds invariably have to supply a statement of cash flows because they do not meet this criterion.