Testimony of

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Concerning Hedge Funds

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of the U.S. Senate Committee on Banking, Housing, and Urban Affairs

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Chairman Hagel, Ranking Member Dodd, and Members of the Subcommittee:

I. Introduction

Thank you for inviting me to testify today about hedge funds, the role they play in our securities markets, and the Commission's role in their oversight. The Commission has a substantial interest in the activities of hedge funds and their advisers, which only recently have become major participants in our securities markets.

The Commission recognized the growing importance of hedge funds almost four years ago when it directed the staff of the Division of Investment Management to undertake a fact-finding mission aimed at reviewing the operation and practices of hedge funds and their advisers. That review led to the publication by the Commission of a staff report entitled "Implications of the Growth of Hedge Funds," in which the staff described in detail the organization of the hedge fund industry, its growth, and regulation.[1]

While identifying a number of concerns and making several policy recommendations, the report also described the many benefits hedge funds provide investors and our national securities markets. They contribute substantially to market efficiency, price discovery and liquidity. By actively participating, for example, in markets for derivative instruments, hedge funds can help counterparties reduce or manage their own risks, thus reducing risk assumed by other market participants. Moreover, many hedge funds provide an important risk management tool for institutional investors wishing to allocate a portion of their portfolio to an investment with low correlation to overall market activity.[2]

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1 *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (Sept. 2003), available at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

2 A recent study reported that 78% of institutional investors surveyed said that hedge funds reduced the volatility of their portfolio. State Street Corporation, *Hedge Fund Research Study* (Mar. 2006) at 4.

II. Background

Hedge funds are pools of investment capital that are managed by professional investment advisers and that are not offered generally to the public. They are operated so that they are not subject to the same regulatory requirements of mutual funds, which are governed by the Investment Company Act of 1940 which contains many safeguards for retail investors. Hedge funds are not characterized by a single dominant investment strategy, although many seek to obtain returns that are not correlated to market returns and instead seek to obtain an "absolute return" in a variety of market environments. Some adopt a "multi-strategy" approach that permits the adviser to determine, at any given time, what investment strategy to follow to pursue returns for the investors. Hedge funds also do not have a single risk profile. Some utilize leveraging techniques that expose investors to substantial risks, while others adopt investment strategies more similar to mutual funds.

Hedge funds do, however, share some organizational characteristics that distinguish them from most mutual funds. Most are organized by advisers that retain a substantial equity participation in the fund, and who receive compensation based, in large part, upon gains achieved by the fund (a "performance fee"). A typical fee arrangement will pay the adviser two percent of the total amount of assets under management and 20% of both realized and unrealized gains. Hedge fund managers view these fee structures as better aligning their interests with the interests of their investors and providing substantial incentives for good performance.

Hedge fund managers usually have a great deal of flexibility in managing the fund, which permits them to take advantage of market opportunities that may not be available to other types of institutional investors. They can change investment strategies, trade rapidly, and utilize leveraging techniques not permitted to mutual funds. And, in contrast to mutual funds, which must disclose publicly their portfolio holdings quarterly, many hedge funds do not even disclose portfolio holdings to all of their investors. Hedge fund advisers do, however, often offer disclosure to their investors about the extent and flexibility of their investment strategies.

1. Growth and Significance of Hedge Funds

The ability of some hedge fund managers to generate significant returns has attracted a great deal of investor interest. It is estimated that hedge funds today have more than $1.2 trillion dollars of assets, a remarkable growth of almost 3,000% in the last 16 years.[3] In 2005, an estimated 2,073 new hedge funds opened for business.[4] One report recently projected that assets of hedge funds may grow to $6 trillion by 2015.[5]

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3 *See* Hedge Fund Research, *HFR Q1 2006 Industry Report*.

4 *See* Hedge Fund Research, *HFR Q1 2006 Industry Report*. During 2005, 848 funds were liquidated. *Id*.

5 Van Hedge Fund Advisers, International, LLC, *Hedge Fund Demand and Capacity 2005-2015* (Aug. 2005).

Much of the growth of hedge funds is attributable to increased investment by institutions, such as private and public pension plans, endowments and foundations.[6] Many of these investors sought out hedge funds during the recent bear markets in order to address losses from traditional investments.

The ability of hedge fund managers to sustain above-market returns is a matter of some debate, as is the likelihood that hedge funds as an asset class will continue to grow.[7] Nonetheless, hedge funds play and will likely continue to play an important role in the securities markets, the significance of which exceeds the amount of their assets. Although hedge funds represent just 5% of all U.S. assets under management, they account for about 30% of all U.S. equity trading volume.[8] They are highly active in the convertible bond and credit derivatives markets. Moreover, hedge funds are becoming more active in the markets for corporate control,[9] private lending, and crude petroleum. Their activities affect all Americans directly or indirectly.

2. Application of the Federal Securities Laws

Press articles typically refer to hedge funds as "lightly regulated" investment pools. In a sense, they are correct. As noted above, hedge funds are organized and operated so that they are not subject to the Investment Company Act of 1940. In addition, hedge funds issue securities in "private offerings" that are not registered with the Commission under the Securities Act of 1933, and hedge funds are not required to make periodic reports under the Securities Exchange Act of 1934. However, hedge funds are subject to the same prohibitions against fraud as are other market participants, and their managers have the same fiduciary obligations as other investment advisers.

III. The Commission's Oversight of Hedge Fund Activities

The Commission's oversight responsibilities with respect to hedge fund activities generally fall into three principal areas: fiduciary obligations; market abuse; and risks to broker-dealers. Each is described below.

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6 *See* Hennessee Group, *2004 Hennessee Hedge Fund Survey of Foundations and Endowments* (reporting that the investors surveyed had an average commitment of 17% of assets, and a projected commitment of 19% by 2005).

7 *See* Nicholas Chan, Mila Getmansky, Shane M. Haas, and Andrew W. Lo, "Systemic Risk and Hedge Funds," (Aug. 1, 2005) (unpublished manuscript, to appear in M. Carey and R. Stulz, eds., *The Risks of Financial Institutions and the Financial Sector*, Chicago, IL: University of Chicago Press).

8 *See* Pam Abramowitz, "Trade Secrets," Institutional Investor's Alpha, January/February 2006.

9 Mara Der Hovanesian, "Attack of the Hungry Hedge Funds," Business Week (Feb. 2006); Henry Sender, "Hedge Funds: The New Corporate Activists--Investment Vehicles Amass Clout In Public Firms, Then Demand Management Boost Share Price," The Wall Street Journal (May 13, 2005).

1. Fiduciary Obligations

Hedge fund managers are "investment advisers" under the Investment Advisers Act of 1940. As a result, a hedge fund manager owes the fund and its investors a fiduciary duty that requires the manager to place the interests of the hedge fund and its investors first, or at least fully disclose any material conflict of interest the manager may have with the fund and its investors. Hedge fund advisers have this fiduciary obligation as a matter of law regardless of whether they are registered with the Commission.

The Advisers Act provides the Commission with authority to enforce these obligations, which the Commission has exercised vigorously in order to protect investors. Over the past several years the Commission has brought a number of enforcement cases against hedge fund advisers who have violated their fiduciary obligations to their hedge funds and investors. These cases involve advisers who have engaged in misappropriation of fund assets; portfolio pumping; misrepresenting portfolio performance; falsification of experience, credentials and past returns; misleading disclosure regarding claimed trading strategies; and improper valuation of assets. In some cases we have worked with criminal authorities.

Recent examples of significant cases brought by the Commission include:

- *SEC v. Samuel Israel III; Daniel E. Marino; Bayou Management, LLC et al*. The Commission alleged that the advisers of a Connecticut-based group of hedge funds defrauded investors in the funds and misappropriated millions of dollars in investor assets for their personal use. Over $450 million was raised from investors. The advisers issued fictitious account statements to investors and used a sham accounting firm to forge audited financial statements in order to hide substantial losses. These losses resulted from, among other things, the theft of funds by the advisers who withdrew "incentive fees" to which they were not entitled. On September 29, 2005, the Commission filed an action in U.S. District Court seeking injunctions, disgorgement of ill-gotten gains, prejudgment interest, and civil money penalties.[10] Also on that date, Israel and Marino pleaded guilty in a companion criminal case. They have not yet been sentenced. On April 19, 2006, the defendants in the civil case consented to an order permanently enjoining them from future violations of the antifraud statutes of the federal securities laws.[11]

- *SEC v. Sharon E. Vaughn and Directors Financial Group, Ltd*. The Commission alleged that an Illinois hedge fund adviser registered with the Commission defrauded fund investors by improperly investing fund assets in a fraudulent "prime bank" trading scheme contrary to the fund's disclosed trading strategy. According to the Commission's complaint, the adviser and its principal had an undisclosed profit sharing agreement with one of the trading program promoters. The adviser and principal consented to

[10] Litigation Release No. 19406 (Sept. 29, 2005).

[11] Litigation Release No. 19692 (May 9, 2006).

injunctions and agreed to disgorgement of over $800,000.[12] As a result of the SEC's action and a subsequent criminal action brought by the U.S. Attorney's office involving individuals associated with the trading program, hedge fund investors were returned most of their principal investment and profits prior to investment in the trading program.

a. *New Registration Requirement*

Until recently, registration with the Commission was optional for many hedge fund advisers. In February of this year, new rules became effective that require that most hedge fund advisers register with the Commission under the Advisers Act.[13] The new rules do not regulate hedge fund strategies, risks or investments. The new rules have given the Commission basic census data about hedge fund advisers. In addition, registration has required hedge fund advisers to implement compliance programs to prevent, detect and correct compliance violations and to designate a chief compliance officer to administer each adviser's compliance program. Registration also has provided the Commission authority to conduct compliance examinations of registered hedge fund advisers. Based upon registration data we now know that 24% of the 10,000 investment advisers currently registered with the Commission advise at least one hedge fund. Of the 2,456 hedge fund advisers registered with us as of the end of April, 1,179 (45%) registered in response to the new rule.[14] The vast majority of the hedge fund advisers (88%) registered with the Commission are domiciled in the United States.

b. *Examinations*

As mentioned above, registered hedge fund advisers may be subject to on-site compliance examinations by SEC examiners in the Office of Compliance Inspections and Examinations (OCIE). The SEC maintains a risk-based examination program, and determines which firms to examine based on their risk characteristics. Hedge fund

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[12] Litigation Release No. 19589 (Mar. 3, 2006).

[13] The Commission's recent rulemaking required certain hedge fund advisers to register as investment advisers with the Commission under the Investment Advisers Act of 1940, under which registration previously had been optional for many hedge fund advisers. Commissioners Glassman and Atkins dissented from the rulemaking. Registration Rule at 72089. With respect to the management of hedge funds whose advisers are registered with the Commission, the Commission in adopting the adviser registration requirement observed that, "The [Advisers] Act does not require an adviser to follow or avoid any particular investment strategies, nor does it require or prohibit specific investments." Registration Rule at section II.A. [*Registration Under the Advisers Act of Certain Hedge Fund Advisers,* Investment Advisers Act Release No. 2333 (Dec. 2, 2004), 69 FR at 72060, *petition for review filed* (D.C. Cir. No. 04-1434 (argued Dec. 9, 2005). ("Registration Rule").]

[14] Registration forms indicate that these advisers report just over 13,000 hedge funds with aggregate assets of about $2 trillion. Because reported assets include assets of "feeder" funds as well as "master" funds in which they invest, total reported assets likely are higher than if assets of "feeder" funds were excluded.

advisers have been included in the same pool as other registered advisers, and thus, like other advisers, the staff determines which firms to examine based on the compliance risks the firm presents to investors. Examination staff are working with the Division of Investment Management and Office of Risk Assessment to develop improved metrics to assess the compliance risks of registered advisers in order to continue to focus our exam resources. In addition, OCIE has developed a specialized training program to better familiarize examiners with the operation of hedge funds and thus improve the effectiveness of our examination of hedge fund advisers.

During a routine compliance examination, the staff reviews the effectiveness of the compliance controls that every registered investment adviser must have in place to prevent or detect violations of the federal securities laws. In those areas where controls appear to be weak, our examiners will obtain additional information to determine if the weak control environment has resulted in a violation of the securities laws. The staff also reviews disclosure documents, including any private placement memoranda provided to hedge fund investors, to determine whether the disclosure appears to accurately reflect the hedge fund adviser's management of the fund. In addition, the staff identifies areas of potential conflicts of interest with respect to the hedge fund adviser and the fund that it advises to determine whether appropriate disclosure has been made.

It is the staff's experience that many of the compliance issues raised by an adviser's management of a hedge fund are similar to those raised by other advisers' asset management activities. For example, these compliance issues include: the use of soft dollar arrangements, the allocation of investment opportunities among clients, the valuation of securities, the calculation of performance, and the safeguards over customers' assets and non-public information. In this regard, let me identify a few areas in which we plan to focus our examinations of hedge fund advisers:

- Side-by-Side Management. Some hedge fund managers also advise other types of advisory accounts, including mutual funds.[15] Because the adviser's fee from the hedge fund is based in large measure on the fund's performance—and because the adviser typically invests heavily in the hedge fund itself, this "side-by-side" management presents significant conflicts of interest that could lead the adviser to favor the hedge fund over other clients. The staff will focus on whether the hedge fund manager appears to have sufficient controls in place to prevent such bias and whether, in fact, the adviser has favored its hedge funds over other clients.

- Side Letter Agreements. Side letters are agreements that hedge fund advisers enter into with certain investors that give the investors more favorable rights and privileges than other investors receive. Some side letters address matters that raise few concerns, such as the ability to make additional investments, receive treatment as favorable as other investors, or limit management fees and incentives. Others, however, are more troubling because they may

15 Almost 15% (379) of the hedge fund advisers registered with the Commission report that they also advise at least one mutual fund.

involve material conflicts of interest that can harm the interests of other investors. Chief among these types of side letter agreements are those that give certain investors liquidity preferences or provide them with more access to portfolio information. Our examination staff will review side letter agreements and evaluate whether appropriate disclosure of the side letters and relevant conflicts has been made to other investors.

- Valuation of Fund Assets. A hedge fund manager typically values the assets of the hedge fund using the market value of those securities. When the fund holds publicly traded securities, that process is fairly simple. Many hedge funds, however, own thinly traded securities and derivative instruments whose valuation can be very complicated and, in some cases, highly subjective. Unlike a mutual fund, hedge fund valuation practices are not overseen by an independent board of directors. A number of the Commission's enforcement cases against hedge fund advisers involve the adviser's valuation of fund assets in order to hide losses or to artificially boost performance. Thus, a review of valuation policies and practices is a key element of hedge fund adviser examinations.

- Custody of Fund Assets. A hedge fund manager typically has access to and directs the use of fund assets. Such access presents a significant risk to fund investors -- as demonstrated in a number of the Commission's enforcement actions involving theft or misuse of fund assets by a hedge fund manager. Therefore, Commission examiners focus attention on the controls used to protect fund assets.

2. Market Abuse

Hedge fund advisers' active trading plays an important role in our capital markets. The federal securities laws and Commission regulations establish rules designed to prevent market abuses. When market activity by hedge fund advisers—like any other participant in the securities markets—crosses the line and violates the law, the Commission has taken appropriate remedial action. In the past year, the Commission has brought enforcement actions against hedge fund advisers for a variety of market abuses, including insider trading, improper activities in connection with short sales, market manipulation, scalping, and fraudulent market timing and late trading of mutual funds.

Recent significant cases have included:

- *In the Matter of Millennium Partners, L.P., Millennium Management, L.L.C., Millennium International Management, L.L.C., Israel Englander, Terence Feeney, Fred Stone, and Kovan Pillai***.** The Commission brought an action against hedge fund managers alleging that the managers generated tens of millions of dollars in profits for their hedge funds through deceptive and fraudulent market timing of mutual funds at the expense of the mutual funds and their shareholders. The adviser and its principals agreed to disgorgement and civil monetary penalties, and have undertaken to implement particular compliance, legal, and ethics oversight measures.[16]

- *SEC v. Hilary Shane*. The Commission alleged a particular type of insider trading involving a PIPE transaction, where the hedge fund adviser agreed to buy shares of a public company in a private offering – a transaction that the Commission alleged was likely to have a significant dilutive effect on the value of the company's shares – and then misused information she had been given (and which she had agreed to keep confidential) about the private offering by short-selling the company's shares. The adviser agreed to disgorge the trading profits, paid a civil penalty, and has consented to be barred from the broker-dealer industry and suspended from the investment advisory industry.[17]
- *SEC v. Scott R. Sacane, et al*. The Commission alleged that hedge fund advisers manipulated the market by creating the appearance of greater demand for two stocks than actually existed. The individual defendants in this case have both pled guilty to related criminal charges and have been barred by the Commission from associating with an investment adviser. In addition, one of the defendants has agreed to pay disgorgement and a civil penalty in the Commission's civil action, which remains pending against the other defendants.[18]

Not only has the Commission brought enforcement actions against the hedge funds and hedge fund advisers that engage in these transactions, it has brought actions against fund service providers who facilitated these unlawful securities trading activities. Recently, for example, we settled an enforcement action against a large broker-dealer that helped hedge funds foil the efforts of mutual funds to detect the hedge funds' market timing, and made it possible for certain favored hedge fund clients to "late trade" mutual fund shares.[19]

[16] Investment Advisers Act Release No. 2453 (Dec. 1, 2005).

[17] Litigation Release No. 19227 (May 18, 2005). Because she entered into the short sales prior to the effective date of the registration statement for the PIPE and then covered her short sales with those she obtained in the PIPE offering, the Commission also alleged that Ms. Shane violated section 5 of the Securities Act.

[18] Litigation Release No. 19424 (Oct. 12, 2005). *See also In the Matter of Scott R. Sacane*, Investment Advisers Act Release No. 2483 (Feb. 8, 2006); *In the Matter of J. Douglas Schmidt*, Investment Advisers Act Release No. 2491 (Feb. 28, 2006); *SEC v. Scott R. Sacane, et al.*, Litigation Release No. 19515 (Dec. 22, 2005); *SEC v. Scott R. Sacane, et al.*, Litigation Release No. 19605 (Mar. 9, 2006).

[19] *In the Matter of Bear, Stearns & Co., Inc., and Bear, Stearns Securities Corp.*, Securities Act Release No. 8668 (Mar. 16, 2006) (defendants agreed to censure, payment of disgorgement and civil monetary penalties, and have undertaken to implement particular compliance oversight measures).

3. Risks to Broker-Dealers

Hedge funds can (although we understand many do not) make significant use of leverage. Most hedge funds use one or more "prime brokers," which provide clearing and related services to the fund and its adviser. One core service prime brokers offer their hedge fund customers is secured financing, notably margin lending, where the hedge fund borrows from the prime broker in order to buy securities, which then serve as collateral for the loan.[20]

The Commission continues to focus attention on broker-dealers' exposure to hedge fund risks and the broader implications this aspect of the financial system may have. The Commission staff meets regularly with other members of the President's Working Group on Financial Markets, and works with the industry members that comprise the Counterparty Risk Management Policy Group. In addition, the Commission's consolidated supervision program for certain investment banks now allows the staff to examine not only the broker-dealer entities within a group, but also the unregulated affiliates and holding company where certain financing transactions with hedge funds are generally booked. Commission staff meets at least monthly with senior risk managers at these broker-dealer holding companies to review material risk exposures, including those resulting from hedge fund financing and those related to sectors in which hedge funds are highly active.

IV. Looking Forward

As a result of our recently-implemented hedge fund adviser registration rulemaking, the Commission now has more data about hedge funds and their advisers. The staff is in the process of evaluating those data and considering methods to refine its ability to target our examination resources by more precisely identifying those advisers, including hedge fund advisers, that pose greater compliance risks.

In addition, the Commission staff is working with the United Kingdom's Financial Services Authority, to coordinate policy and oversight of the 165 hedge fund advisers registered with the Commission that are located in the United Kingdom. The staff also expects to coordinate examinations with the Commodity Futures Trading Commission (CFTC). To that end, we recently provided information to the CFTC indicating the identities of hedge fund advisers registered with the Commission who report on their registration forms that they are also actively engaged in commodities business (approximately 350 firms).

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[20] Prime brokers may also structure these financing transactions as repurchase agreements, where they buy the securities from the hedge fund subject to the fund's obligation to repurchase the securities from the broker in the future at a specified price. Prime brokers may also produce similar economics through the use of over-the-counter derivative contracts with hedge funds.

V. Conclusion

In conclusion, I would like to thank the Subcommittee for holding this hearing on a subject of growing importance to us and to all American investors. Hedge funds play an important role in our financial markets. With respect to hedge funds, their advisers and all market participants, the Commission will continue to enforce vigorously the federal securities laws.