Coalition of Private Investment Companies

Hedge Funds

How They Serve Investors in U.S. and Global Markets

HedgeFundFacts.org

The Coalition of Private Investment Companies (CPIC) is a group of private investment companies that are diverse in size and the investment strategies they pursue. Their clients include pension funds, asset managers, foundations, other institutional investors, and qualified wealthy individuals.

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Introduction

The year 2009 is proving to be a turning point for the hedge fund industry, with performance rebounding from record losses last year (2008). The pace of redemptions is slowing with many forecasting a net inflow to hedge funds for 2009, as investors reassess their allocations to alternative investment strategies.[1]

Institutional investors continue to see the value of diversifying their portfolios by including hedging strategies to manage risks and improve returns. Several surveys in early 2009 found that investors seek out hedge funds largely for their "diversified/uncorrelated returns," and most (81 percent) say their original premise for investing in hedge funds is still valid.[2]

Our responsibilities as managers of private investment pools have become greater in light of the global financial crisis and its aftermath. Investors are spending more time conducting due diligence and, hence, are demanding greater transparency and more clarity about valuation approaches. To maintain

"Hedge funds . . . are extremely important to the success of our investment program."

Joseph A. Dear
Chief Investment Officer, CalPERS
July 15, 2009[3]

The Way Forward: CPIC's Proposal

Principles to Guide a New Regime to Monitor Systemic Risk

- Financial regulation must be based upon activities, not actors, and it should be scaled to size and complexity.
- All companies that perform systemically significant financial functions should be regulated.
- Regulators should have the authority to follow the activities of systemically important entities, regardless of where in the entity a financial activity takes place.
- As the complexity of corporate structures and financial products intensifies, so, too, should regulatory scrutiny.
- There should be greater scrutiny based upon the "Triple Play" — an entity that is an originator, underwriter/securitizer, and investor in the same asset.
- Above all, the systemic risk regulator must enforce transparency and practice it.

Principles to Guide Functional Regulation of Hedge Funds

- Simply removing exemptions from the *Investment Company Act of 1940* and the *Investment Advisers Act of 1940* upon which private investment funds rely will prove unsatisfactory.
- Any new regulation should provide for targeted controls and safeguards for appropriate oversight of private investment companies, but should also preserve operational flexibility.
- More detailed requirements for large private investment companies would address the greater potential for systemic risk posed by such funds, depending on their use of leverage and trading strategies.
- Regulation should address basic common-sense protections for investors in private investment companies, particularly with respect to disclosure, custody of fund assets, valuation, and periodic audits.
- Areas such as counterparty, lender, and systemic risks should be addressed through disclosures to regulators and counterparties.

investors' trust and confidence in how we manage their funds, it remains imperative that we continue to put our clients' interests first and foremost.

The Obama Administration and Congress confront a very challenging job. They must work to shore up confidence in financial markets and improve liquidity while re-engineering the regulatory structure to meet investor protection needs—without compromising financial innovation. A comprehensive overhaul of banking and securities regulation is under consideration, including new statutory requirements for private investment companies. From greater supervision of banks and broker-dealers, to more vigorous oversight of previously unregulated markets, all aspects of the U.S. regulatory system are on the table for review. The proposal by the White House in mid-July 2009 is an important step forward in strengthening oversight and regulation of our financial markets to rebuild investor trust and confidence, a foundation of our economic recovery.

Simply imposing new regulation, though, without properly tailoring it to address the relevant risks would add to the burdens of hard-working, but already overstretched government regulators. Investors could be lulled into the false belief that a problem has been resolved. Therefore, any new regulation must be "smart" regulation, with mechanisms carefully targeted to reduce risks to investors and the economy, without imposing unnecessary burdens on market participants.

The Coalition of Private Investment Companies recognizes that a modernized financial regulatory system—one that addresses overall risk to the financial system and regulates in a consistent manner market participants performing the same functions—will include regulation of hedge funds and other private pools of capital. In testimony before Congress, CPIC outlined the principles its members believe should guide lawmakers in overhauling the regulatory system.[6] We also proposed a statute specifically tailored to private investment companies. (See pages 29–30 for more information.)

This "primer" supports efforts by Members of Congress, their staffs, the Administration, the media, investors, and others to learn about hedge funds, their role in the U.S. and global economies, and the relevant regulations. It will be incumbent upon our industry to answer questions, for example, about how a new regulatory regime should address systemic risks and operational issues.

By working together, we can shape an approach that strengthens the integrity of our financial markets in order to attract capital essential for financing innovation and fueling our economy's recovery. Over the past few years, CPIC has been testifying before Congress, submitting comment letters on regulatory proposals to the Securities and Exchange Commission, and briefing policymakers at the White House and Treasury. As CPIC's chairman, I commit that we will work closely with the Administration and Congress to develop proper solutions that meet public policy goals, while boosting investor confidence, increasing investment opportunities, and supporting economic growth.

Sincerely,

James S. Chanos
Chairman
Coalition of Private Investment Companies

"Hedge funds provide liquidity, price efficiency, and risk distribution, and contribute to the further global integration of markets."

Technical Committee
International Organization of Securities Commissions
March 2009[4]

"These funds play an important role in enhancing liquidity and efficiency in the market, and subjecting them to fewer limitations on their activities has been, and continues to be, a reasonable policy choice."

Sen. Jack Reed
July 15, 2009[5]

'A Positive Force in the American Financial System'*

More than 8,900 hedge funds, or private investment companies, managed more than $1.43 trillion in assets as of June 2009.[7] These funds serve an important role in U.S. and global markets, providing qualified investors with opportunities to manage risks and achieve above-average gains. By operating with tremendous flexibility, hedge funds provide liquidity, making financial markets more efficient. Over the past decade, the industry has become more diverse, less leveraged, and more flexible. The innovative investment strategies of private investment companies have strengthened the global competitiveness of the U.S. financial services sector, attracting intellectual and financial capital. As their responsibilities have grown, private investment companies have improved their governance practices, risk-management tools, investor disclosures, and operational infrastructures.

What is a Hedge Fund, or Private Investment Company?

The term "hedge fund" was coined by a *Fortune* magazine writer in an article about the founder of these investments, Alfred Winslow Jones. (See box below.) It is a term without legal meaning but it generally refers to privately offered, professionally managed pooled investment vehicles.[8] "Hedge" (from hedging, or protecting, your investment) derives from the aim of making money, whether a market rises or falls, while managing risk exposure.

Origin of Hedge Funds

The year was 1949 and World War II had just ended. Alfred Winslow Jones, a sociologist, was working on assignment for *Fortune* magazine, investigating research on stock-market forecasting. Intrigued by the unorthodox investing methods, Jones developed his own approach, a "market neutral" fund. He would buy undervalued securities and short sell other stocks, which provided a hedge against market risk.

Jones was the first to use short selling, leverage, and incentive fees in combination. In 1952, he created the first multi-manager hedge fund. A *Fortune* magazine article ("The Jones Nobody Keeps Up With") in 1966 about Jones's "hedge fund" astonished the investment community with its outperformance. That set off a rush, and, within a few years, the number of hedge funds increased from a handful to more than 100.

SOURCE: Philipp Cottier, *Hedge Funds and Managed Futures: Performance, Risks, Strategies, and Use in Investment Portfolios*. Bern, Switzerland: Verlag Paul Haupt, 1997. Michael Litt, "Paradigm Shift in Pension & Wealth Management." American Enterprise Institute, May 12, 2006. Available at: http://www.aei.org/paper/24369.

Over the past decade, the industry has become more diverse, innovative, and flexible. Its responsibilities have grown in step with its expansion.

* ***Federal Reserve Board Chairman Ben Bernanke, November 15, 2005***[9]

Dispersing risk through hedging strategies creates a more resilient financial system.

Hedge Funds as Pioneers

Hedge funds pioneered many money-management techniques, including:

- ☐ Simultaneous trading in a broad range of markets and financial products
- ☐ Long/short strategies
- ☐ Employing/developing traders’ skills in specific markets
- ☐ Incentive-based fee structures along with owner/manager participation in fund performance

SOURCE: John H. Makin, “Hedge Funds: Origins and Evolution.” American Enterprise Institute. May 15, 2006. Available at: http://www.aei.org/paper/24395.

Although the term “hedge fund” is widely used, the more accurate phrase is “private investment company” or “pooled investment vehicle.”

Interests in these funds are sold in private offerings primarily to “accredited” investors, specifically institutional investors and “high net worth” individuals.[10] A fund pools the monies it receives to invest and then buys a variety of securities and financial instruments. Private placement memoranda may describe investment parameters, terms, and redemption rules, among other things. Institutional investors and/or their advisers typically perform rigorous, ongoing qualitative and quantitative analysis, called “due diligence,” of the fund and its management company. Institutions typically devote an average of seven months to this process and twelve additional weeks to approval, according to a 2008 white paper by the investment consultant SEI.[11] (See “Investors’ Rigorous ‘Due Diligence’” on page 20.)

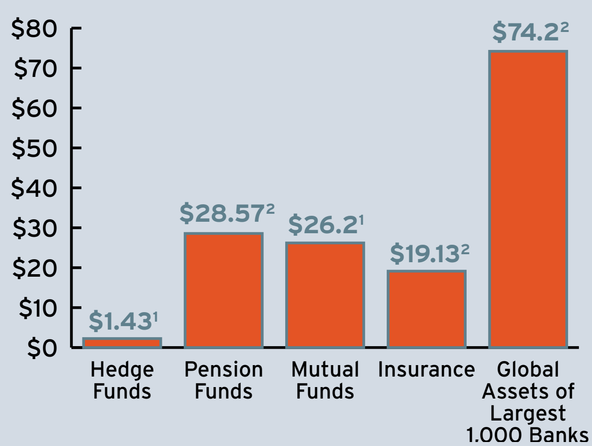
Hedge funds are as diverse as the managers who run them.[12] They may invest in or trade a variety of financial instruments, including stocks, bonds, currencies, futures, options, other derivatives, and physical commodities. Funds that invest primarily in illiquid assets—for example, real estate, venture capital, and private equity—generally are not considered “hedge funds,” although some hedge funds do hold these investments.

Portfolio strategies vary widely and include leverage, short selling, active trading, and arbitrage. (See the box “Investing Strategies” on page 5.) Some funds own securities for the long term, using different qualitative and quantitative methods to guide their decisions. Others sell short, meaning they sell shares they do not own and then borrow those shares to complete the transaction. They do so to hedge risks and lock in transaction costs, namely the spread, or the difference between the “bid” and “ask.” (To learn more, visit www.financialdetectives.org.) Some hedge funds are strictly traders, buying and selling securities to capture market inefficiencies and make profits. Still others are “activists,” using an equity position in a company to encourage management to make changes that will increase shareholder value over the long term.[13]

Even though the assets managed by hedge funds have increased six-fold over the past decade to $1.43 trillion by June 2009, this amount is relatively small in comparison to other major global investment pools. The chart on page four shows that hedge funds

Relative Size of Hedge Funds

(Trillions of dollars)



Hedge funds as a percent of total: 1.1%

[1]Global funds under management second quarter 2009. [2]Pension fund and insurance assets under management are estimates based on 10 percent growth in 2006. SOURCE: Michael R. King and Philipp Maier, “Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks.” October 30, 2008. Available at: http://ssrn.com/abstract=1297188. McKinsey Global Institute, *Mapping Global Capital Markets: Fifth Annual Report*. October 2009. Available by registration at: http://www.mckinsey.com.

Investing Strategies

Arbitrage: Simultaneous buying and selling of securities or other financial instruments to profit from often minute variances in prices. Some examples:

Convertible Arbitrage: Long on convertible securities (usually preferred shares or bonds) that are exchangeable for a set number of another security (usually common shares) at a pre-stated price, and short the underlying equities.

Merger/Risk Arbitrage: Trade securities of companies involved in announced corporate takeovers/ mergers.

Special Situations: Undervalued securities are purchased in anticipation that they will rise in value because of an expected favorable turn of events.

Distressed Securities: Investing in securities (equity and/or debt) of a company either already in distress or facing bankruptcy, with the expectation that the company's securities will appreciate.

Hedging: Buying/selling a security to offset a potential loss on another investment.

Leverage: Using borrowed money for investment purposes.

Macro: Trading and investing based on broad directional movements in stocks, bonds, foreign exchange rates, and commodity prices, often expressed through indices or other broad measurements of economic activity.

Managed Futures: Funds or accounts that seek to profit by taking positions in a portfolio of futures contracts. Employ trend-following strategies in futures (exchange-traded contracts to deliver a commodity at a set place, time, and price).

Market Neutral: Typically a strategy in which equal amounts of capital are invested long and short to "neutralize" market risk by purchasing undervalued securities and shorting the overvalued ones. Also called a "long/short" strategy.

Market Timing: Anticipating when to be in and out of markets. The allocation of assets among investments, primarily switching between stocks, bonds, and cash depending on market and/or economic outlook. Seeking to sell at or near the market's top and buy at or near a market trough in particular categories of investments.

Short Selling: Selling a borrowed security with the anticipation that it can be purchased later at a reduced cost, generating a profit.

represent 1.1 percent of the total funds and assets of financial institutions. Nevertheless, studies show they account for a significant amount of the trading volume in U.S. equities and an even higher share in more complex financial instruments.[14]

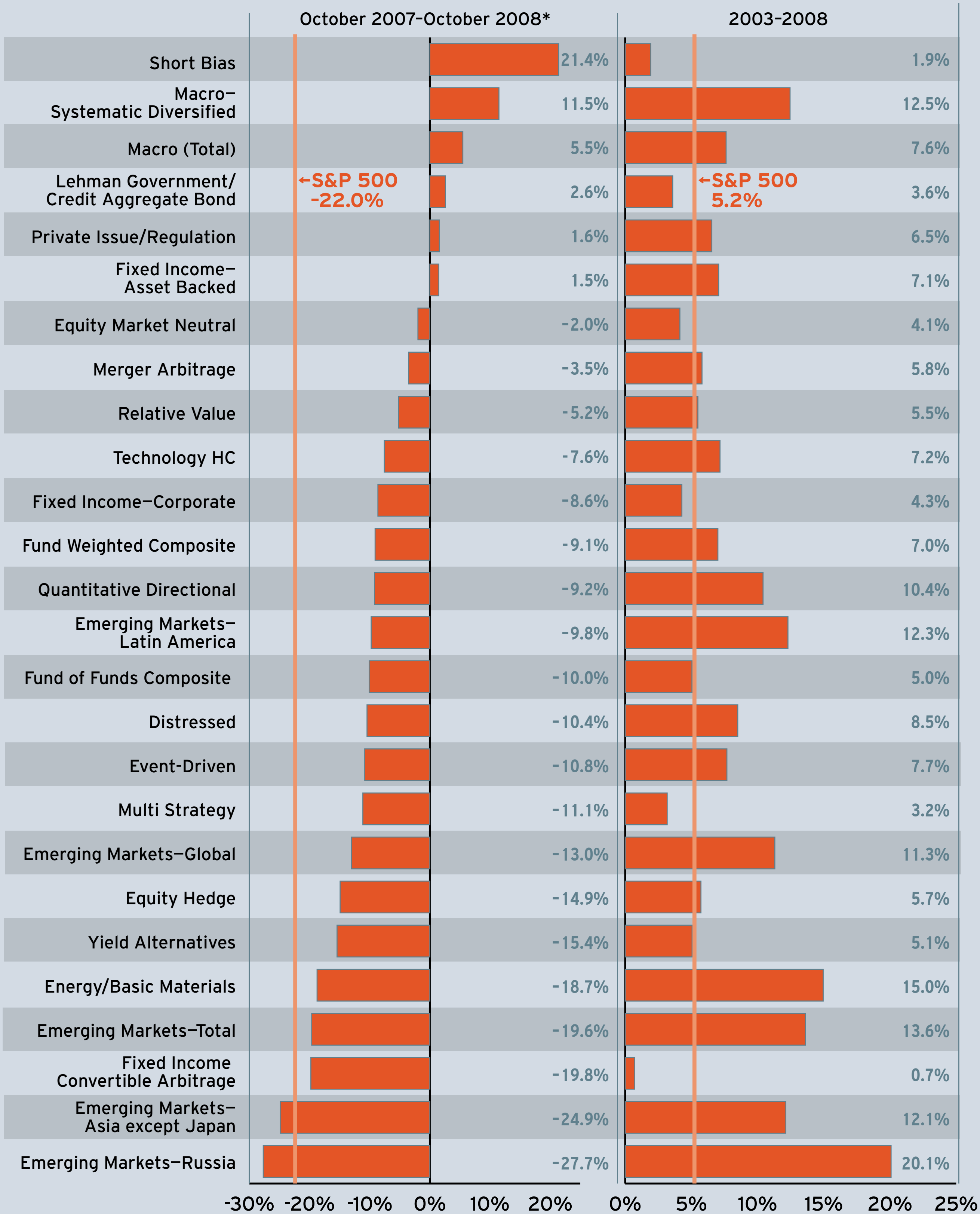
For the eleven-year period from January 1, 1998 through December 31, 2008, the average hedge fund returned 7.45 percent a year (annualized return), compared to a 1.38-percent loss for the Standard & Poor's 500 Index (with dividends) and a 2.79-percent loss for the FTSE 100 Index, according to Hedge Fund Research, Inc.[15] In 2009, the HFR index was up 9.46 percent through June while the S&P 500 rose 3.19 percent.

Hedge funds can protect investments during market downturns. From January 1990 through June 2009, the S&P 500 experienced 36.75 percent negative months, dropping 3.71 percent during these downturns, while hedge funds lost only 0.67 percent during those general market downturns. Over the same time period, hedge funds experienced positive gains in 72.22 percent of the months, compared to 63.25 percent positive months for the S&P 500. Even in one of the worst years for hedge funds, 2008, the broad-based HFRI Fund-Weighted Composite Index fell 18.36 percent, compared to a 38.5-percent drop in the S&P 500, according to Hedge Fund Research, Inc. In 2008, though, approximately 70 percent of hedge funds had lost money. Never before had so many funds lost money. Hedge funds also experienced their widest performance spread in their history in 2008, with the bottom 10 percent losing more than 62 percent and the top 10 percent soaring more than 41 percent.[16] (See the chart "Performance of Hedge Fund Strategies vs. S&P 500" on page 6.)

Nevertheless, hedge funds can consistently outperform their benchmarks, such as the S&P 500 Index, and are persistent in their outperformance, according to a study issued by the National Bureau of Economic Research in 2006.[17] "For every

Hedge funds serve many key functions: risk management, arbitrage, liquidity providers, and financial innovation.

Performance of Hedge Fund Strategies vs. S&P 500



SOURCE: Hedge Fund Research, Inc. November 17, 2008 *During this period, the markets were particularly volatile as security regulators worldwide imposed constraints on short selling activity. Available by subscription at: http://www.hedgefundresearch.com.

100 basis points [a basis point is one-hundredth of a percentage point] by which a hedge fund beat its benchmark over a given three-year period, the researchers found, it outperformed that benchmark by 57 basis points, on average over the next three years."[18] This performance advantage "lasts far longer for a hedge fund than it does for a mutual fund," the researcher told *The New York Times*. On average, a mutual fund tends to stay a top performer for 12 months or less; often, it then becomes a market laggard.[19]

As the industry evolved over the past decade, U.S. institutional investors' demand for alternative investments, including hedge funds, rose steadily.[20] This led to rapid growth in both the number of funds and the amount of assets under management, as well as to many changes in the investing styles and strategies employed. With this expansion, the industry became more diverse, innovative, and flexible, while reducing leverage.

Investor nervousness and disappointing hedge fund returns during the 2007–2008 credit crisis led to a sharp decline in new capital inflows, as the industry experienced its largest net capital redemption ever during 2008. Ahead, McKinsey's Global Institute forecasts a nine-percent yearly increase in hedge fund assets under management through 2013, to $3 trillion, or one-quarter the growth rate that occurred between 2000 and 2007. "The long-term fundamental trends that have driven the industry's growth so far will likely continue. New money will come from large institutional investors, such as pensions and endowments, increasing their allocations to alternative asset classes; from petrodollar investors seeking higher returns; and, from a growing number of funds of hedge funds, which open up the asset class to less wealthy investors."[21] Surveys of institutional investors in early 2009 forecast similar rates of growth (see page 12).

"Amid the global financial crisis, hedge fund investors still feel their original rationale—diversified/uncorrelated returns—is largely intact."

Casey Quirk/ The Bank of New York Mellon April 2009[22]

Managers Strengthened Operational Risk Frameworks

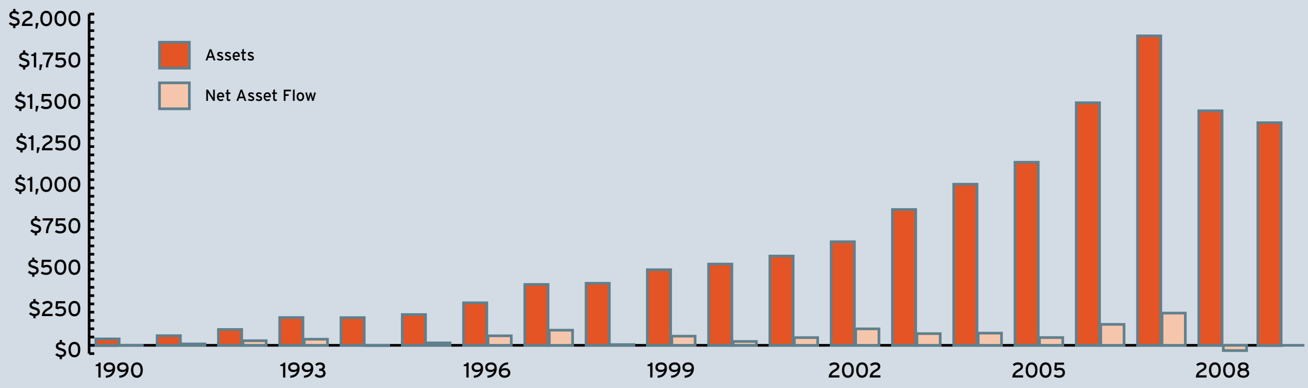
What changes has your firm made to its operational risk framework over the past two years (2007–2008) as a result of adopting complex/alternative products and strategies? And what changes do you expect to make in the next two years (2009–2010)?

	HAVE MADE THIS CHANGE	WILL MAKE THIS CHANGE WITHIN THE NEXT TWO YEARS	NO PLANS TO MAKE THIS CHANGE	DON'T KNOW/ NOT APPLICABLE
Formalization of operational risk frameworks	38%	27%	14%	21%
Review and formalization of governance arrangements	38	25	19	18
Expansion of operational risk and compliance team	35	27	23	16
Updated risk-management systems	38	32	14	15
Review and enhancement of control systems	38	27	17	17
Review and evaluation of valuation methodologies	34	33	17	17
Creating a more risk-aware culture	37	31	16	16

SOURCE: KPMG, *Beyond the Credit Crisis: The Impact and Lessons Learnt for Investment Managers*. June 2008. Available at: http://www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Beyondthecreditcrisis.aspx.

Growth of Hedge Funds, 1990–2009

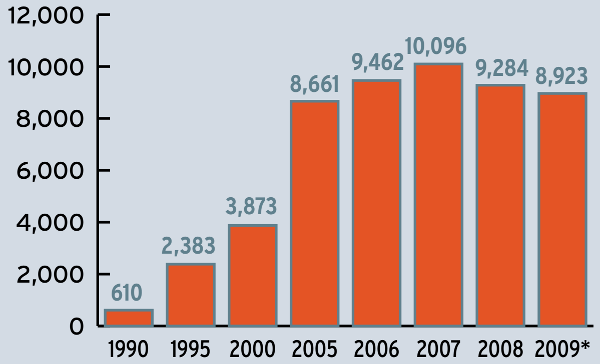
Assets under Management and Net Asset Flow, 1990–2009* (billions of dollars)



*Second quarter 2009. Estimates vary over the amount of assets and the number of funds. Research companies use different definitions and models to value hedge fund assets. SOURCE: Hedge Fund Research, Inc. Available by subscription at: www.hedgefundresearch.com.

Number of Funds

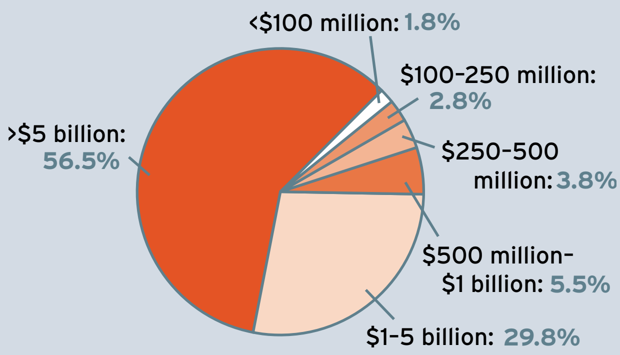
1990-2009*



*Second quarter 2009. SOURCE: Hedge Fund Research, Inc. Available by subscription at: www.hedgefundresearch.com.

Size

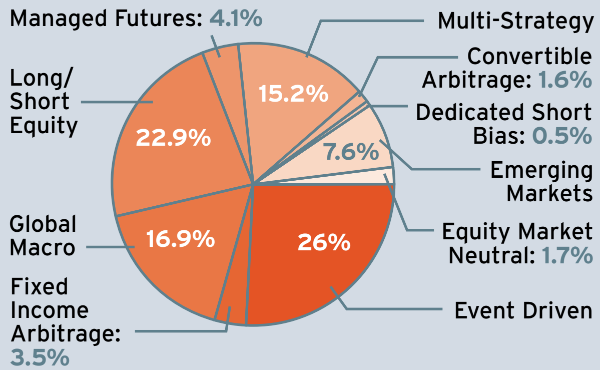
Assets under Management, 2009*



*Percent of total number of hedge funds in each size category. Second quarter 2009. SOURCE: Hedge Fund Research, Inc. Available by subscription at: www.hedgefundresearch.com.

Strategy Focus

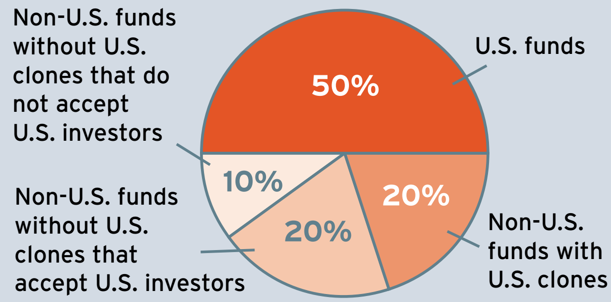
2009*



*Second quarter 2009. SOURCE: Investment strategy components of Credit Suisse/Tremont Hedge Fund Index. June 2009. Available at: http://www.hedgeindex.com/hedgeindex/en/weights.aspx?ChartType=PieChart&cy=USD&indexname=HEDG.

U.S. Leadership

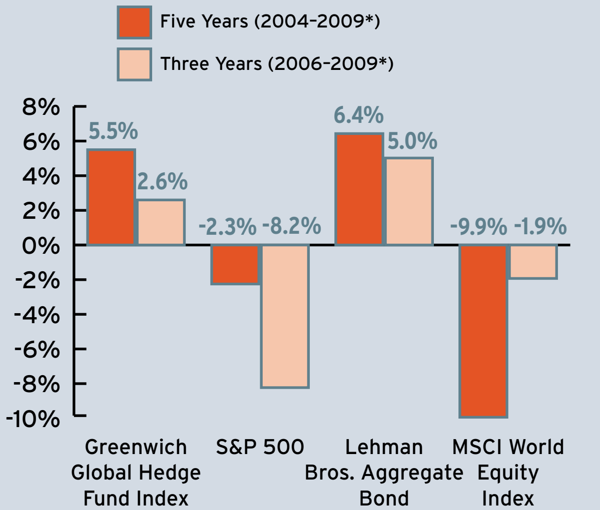
U.S. Leads in Management of Hedge Fund Assets



SOURCE: Greenwich Alternative Investments, LLC, 2006. Used by permission. Available at: www.greenwichai.com.

Global Hedge Fund Returns

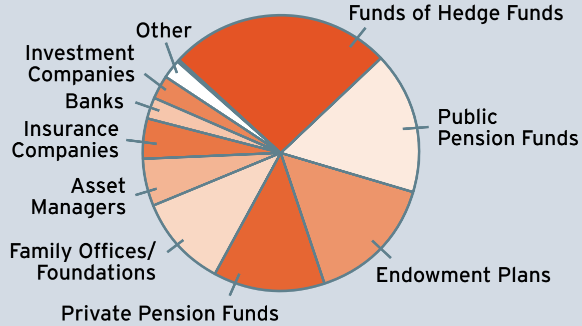
Compound annual growth rate (percent)



*As of June 30, 2009. SOURCE: Greenwich Alternative Investments, LLC. Used by permission. Available at: http://www.greenwichai.com/GenPages/gvperformance.aspx?vNode=4&vChild=0 .

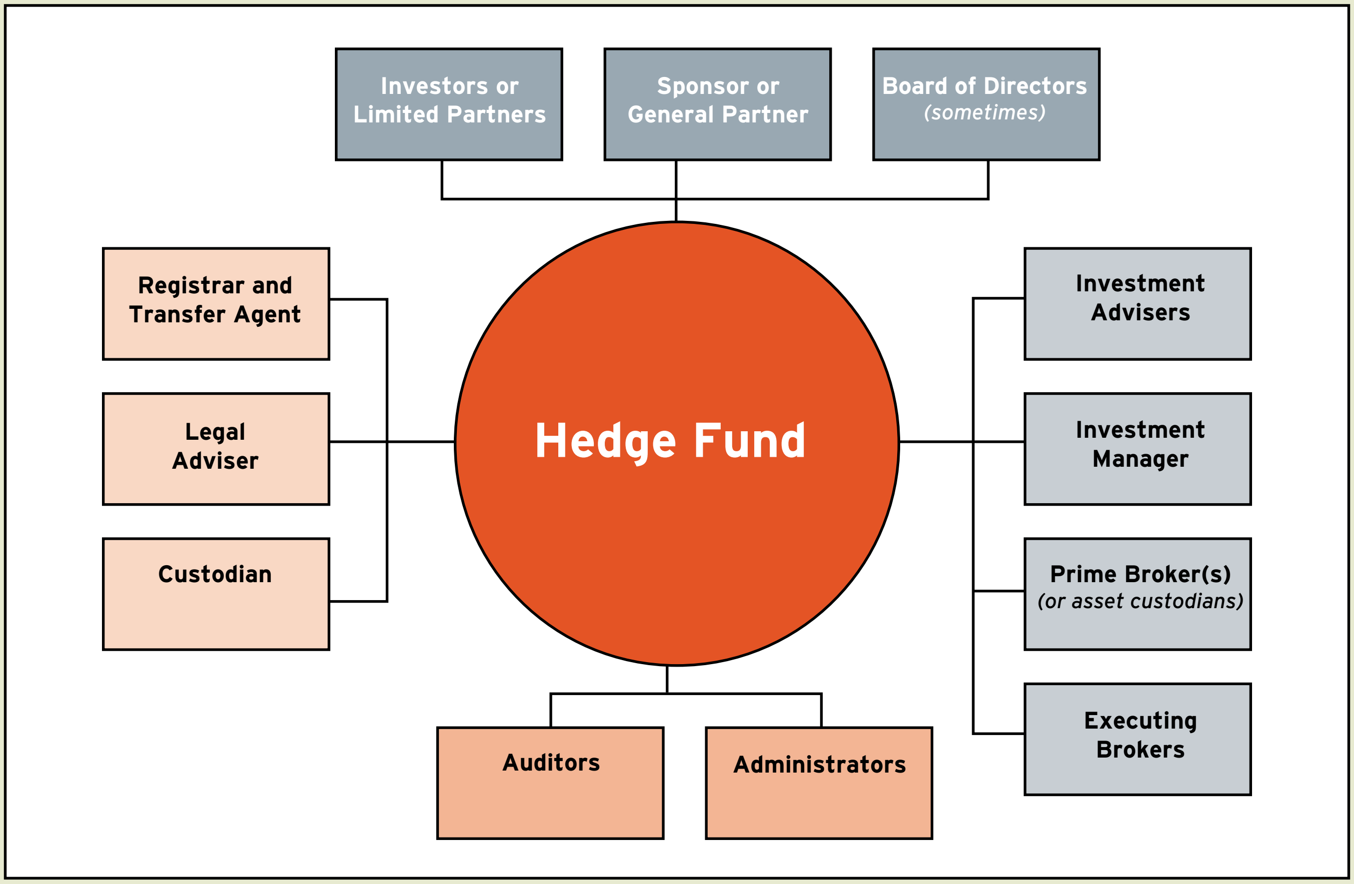
Institutional Investors in Hedge Funds

2008



SOURCE: Preqin Ltd., *Overview of the Global Hedge Fund Institutional Investor Universe: Special Report*. November 2008. Available at: http://www.preqin.com/docs/reports/Preqin_Hedge_Research_November08.pdf.

Operational Structure



Sponsor: typically holds founder voting shares, which control management of the fund but are usually not entitled to any distribution or share in the equity.

Manager, Management Company/Investment Adviser: responsibilities include determining investment strategy, making choices in portfolio holdings, and making operational decisions.

Board of Directors: responsible for monitoring the fund's overall operations (for funds with a board).

Fund Administrator: ensures calculation of the net asset value and performs administrative services such as accounting and bookkeeping.

Custodian: safekeeping of fund's assets, clearing and settling all trades, and monitoring corporate actions such as dividend payments.

Legal Adviser: assists the fund with legal matters.

Auditors: audit the fund for compliance with accounting practices and verify the annual financial statement, if any.

Registrar, Transfer Agent: keeps and updates a register of shareholders, which typically are limited partners.

Distributors/Placement Agents: handles marketing and distribution of fund shares to accredited investors.

Brokers: unless a hedge fund has direct access to the market, it needs to place its orders with a broker, typically using the services of several executing brokers.

Prime Brokers: provide execution and operational services, including clearing trades, acting as global custodian, and providing both margin financing and securities lending.

SOURCE: François-Serge Lhabitant, *Hedge Funds: Myths and Limits*. 2002. Copyright John Wiley & Sons Limited. Reproduced with permission.

An Essential Part of Competitiveness for U.S. Markets

Capital markets in the United States and elsewhere have been successful in providing capital and financing for economic growth and development worldwide. The fundamental integrity of U.S. markets—and the knowledge that money can be invested in a staggering array of products, free from fraud and overly burdensome government controls—creates a powerful incentive for businesses and individuals to invest.

Hedge funds play a critical role in the financial markets, broadening the use of investment strategies, increasing the number of participating investors, and enlarging the pools of capital available. For investors, hedge funds can serve a risk-management purpose since their returns are often uncorrelated to those in the equity and fixed-income markets (see page 12). Their importance has been acknowledged by the President's Working Group on Financial Markets, the Commodities Futures Trading Commission, the Securities and Exchange Commission, two chairs of the Federal Reserve Board, and Members of Congress.[23]

Provide Liquidity, Help Investors Manage Risks

Markets work best when investors draw on diverse sources of information and utilize different strategies and securities to manage, or hedge against, risks. Private investment companies provide valuable liquidity to financial markets in normal market conditions and especially during periods of stress. "By buying irrationally cheap assets and selling irrationally expensive ones, they shift market prices until the irrationalities disappear, thus ultimately facilitating the efficient allocation of the world's capital," observes Sebastian Mallaby, a Fellow with the Council on Foreign Relations.[24] As a consequence, hedge funds can be less volatile than individual stocks or mutual funds.

The sheer variety of investing strategies that hedge funds employ also strengthens capital markets, particularly by improving opportunities for price discovery. Short selling, for example, "contributes to the market's process of finding correct prices, and it's valuable to have hedge funds doing this," said Jeremy Seigel, Professor of Finance at the Wharton School of the University of Pennsylvania.[25]

How have hedge funds improved liquidity?

"When the options and other fixed-income markets were under stress in the summer of 2003," said Patrick M. Parkinson, then Deputy Director, Division of Research and Statistics, Federal Reserve, "the willingness of hedge funds to sell options following a spike in options prices helped restore market liquidity and limit losses to derivatives dealers and investors in fixed-rate mortgages and mortgage-backed securities."[26]

A study by the Federal Reserve Bank of Cleveland shows that hedge funds tend "to reduce, not increase, the volatility of price" by going against prevailing wisdom and taking positions, for example, against unsustainable movements in securities prices. Hedge funds do not reinforce asset bubbles, according to the researchers; instead, they may prevent them in the first place.[27]

"The increased risk-sharing capacity and liquidity provided by hedge funds over the last decade has contributed significantly to the growth and prosperity that the global economy has enjoyed."

Professor Andrew W. Lo
MIT Sloan School of Management
November 2008[28]

Between 2005 and 2008, 55 percent of hedge fund managers had experienced a rise in the proportion of their capital coming from the institutional sector, with 14 percent experiencing a decrease, according to a November 2008 survey by research firm Preqin Ltd.[29]

Three-quarters of the institutional investors surveyed by Preqin reported that their hedge fund investments have not met their expectations within the 12 months prior to the survey (published in November 2008). Yet, 46.6 percent of surveyed investors said their long-term outlook on the hedge fund industry remains positive.

A bfinance (an independent financial services consultancy) survey of pension funds conducted in October 2008 suggests that the "broad meltdown seems to have further cemented pension funds' desire to increase exposure to alternative assets and strategies and decrease reliance on equities." Thirty-seven percent of respondents said they planned to decrease exposure to equities in the next three years compared to 26 percent for fixed-income and four percent for hedge funds.[30]

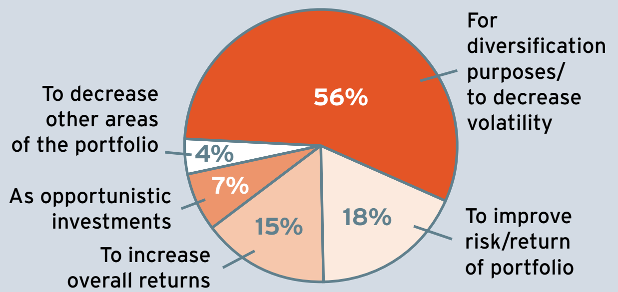
Casey Quirk and The Bank of New York Mellon forecast that hedge fund assets will reach nearly $2.6 trillion by year-end 2013, based on their interviews with senior industry professionals, including institutional investors, between December 2008 and March 2009. Nearly half of the future flows will come from North America. "Public and corporate pensions will continue to gradually build their hedge fund portfolios, holding more than 5.5 percent of assets in hedge fund strategies by 2013."[31]

The two key drivers of recovery for hedge funds are "the fact that investors and advisors broadly still believe in the premise behind hedge fund investing, and the way in which investors are rethinking hedge fund strategies' role within their broader portfolios," the survey concluded.[32]

The greatest threat to hedge fund investment is concern over investment loss, according to a 2009 survey of institutional investors by State Street Corporation in conjunction with the Global Absolute Return Congress. One-quarter (26 percent) of the asset owners surveyed said "investment loss is the single greatest threat to the hedge fund industry."[33]

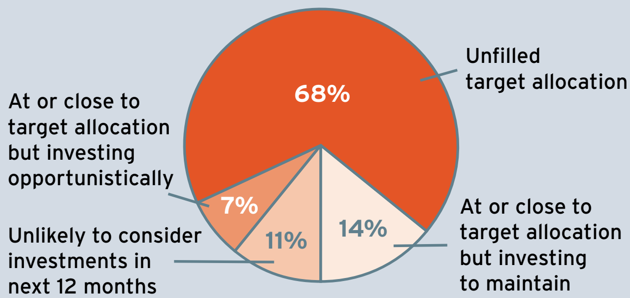
In testimony before the Senate Banking Subcommittee in July 2009, Joseph A. Dear, Chief Investment Officer for CalPERS, stressed that hedge funds make "realization of our target rate of return feasible." He noted that the pension fund's return in hedge fund investments over the past five years has been 3.89 percent, "considerably above what we earn in public markets."[34]

Primary Reasons for Investing in Hedge Funds



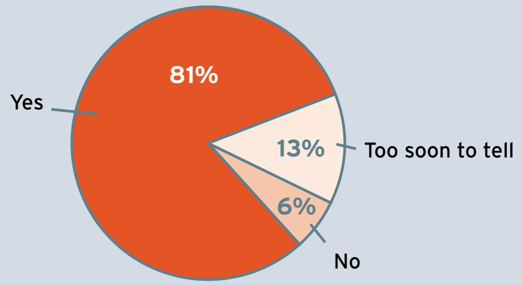
SOURCE: Preqin Ltd., *Overview of the Global Hedge Fund Institutional Investor Universe: Special Report*. November 2008. Available at: http://www.preqin.com/docs/reports/Preqin_Hedge_Research_November08.pdf.

Institutional Investors' Hedge Fund Allocations



SOURCE: Preqin Ltd., *Overview of the Global Hedge Fund Institutional Investor Universe: Special Report*. November 2008. Available at: http://www.preqin.com/docs/reports/Preqin_Hedge_Research_November08.pdf.

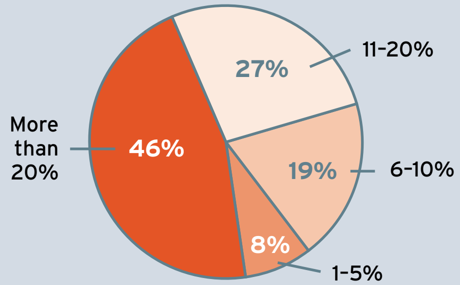
Original Premise for Investing Remains Valid



SOURCE: Casey Quirk and The Bank of New York Mellon, *The Hedge Fund of Tomorrow: Building an Enduring Firm*. April 2009. Available at: http://www.caseyquirk.com/knowledge_center/hedge_funds.php.

Boards, Trustees Discuss Alternative Investments

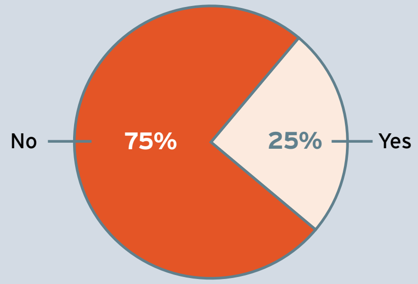
Time spent discussing alternative investments



SOURCE: State Street Corporation, *2009 State Street Hedge Fund Research Study*. February 2009. Available at: http://pr.statestreet.com/us/en/20090326_1.html.

Institutional Investors Plan to Stay the Course

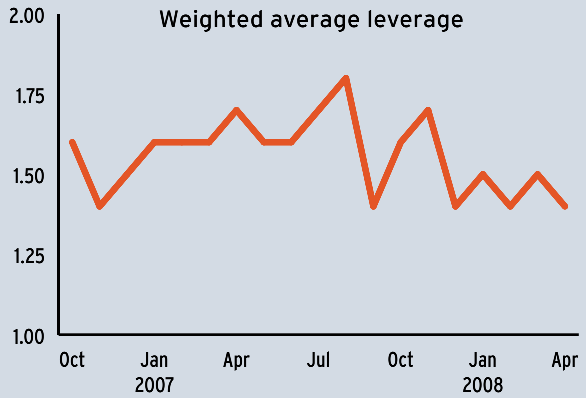
Plan to modify asset allocation due to recent financial turmoil



SOURCE: State Street Corporation, *2009 State Street Hedge Fund Research Study*. February 2009. Available at: http://pr.statestreet.com/us/en/20090326_1.html.

Hedge Funds Utilize Conservative Leverage

Many hedge funds do not have any leverage. Most of the rest have very controlled, conservative levels. Recent studies indicate that while around 72 percent of hedge funds embody leverage, only 20 percent have balance sheet leverage ratios of more than 2:1.



SOURCE: Merrill Lynch, *Global Fund Manager Survey*, 2008. Available at: http://seekingalpha.com/article/124783-a-graphical-look-at-hedge-fund-leverage.

"Hedge funds can help mitigate market-wide concentrations of risk by transferring and distributing market risk through their willingness to be counterparties in derivatives trades."

Technical Committee
International Organization of Securities Commissions
March 2009[35]

Private investment companies absorb risks by pursuing different investment strategies that use different products and securities, according to Mallaby. "For example, banks [may] have to limit their lending for fear that borrowers might default. But hedge funds are willing to buy credit derivatives that transfer the default risk from the banks to themselves—freeing the banks to finance more economic activity. . . . If a currency or stock market starts to plummet, the best hope for stability lies in self-confident, deep-pocketed investors willing to bet that the fall has gone too far, and hedge funds are well designed to perform this function."[36]

A 2004 study by the New York Mercantile Exchange on the role of hedge funds in its natural gas and crude oil futures markets found that the funds' "modest" role [accounting for 2.69 percent of trading in crude oil and 9.05 percent in natural gas] was a positive one. Hedge funds held positions significantly longer than the rest of the market, providing a "non-disruptive source" of liquidity. Their participation in natural gas futures resulted in "decreases in price volatility."[37]

As the global credit crisis took hold in 2007 and worsened in 2008, hedge funds experienced a sharp rise in redemptions to a record $31 billion by year-end 2008. In performance terms, hedge funds lost 18.36 percent in 2008, according to Hedge Fund Research, Inc., their worse year since 1998. That aggregate statistic, though, hides the wide range in performance; the top 10 percent of funds by performance were up 41 percent in 2008, offset by the bottom 10 percent, which declined by 62 percent. As the chart on page 6 shows, some strategies outperformed the S&P 500, while others experienced smaller losses than equity markets generally did. By the end of April 2009, hedge funds had begun to perform better, with the sector having its best month then in terms of performance since 2000.[38]

Flexibility: Creates Opportunities, Spurs Innovation

The ability to trade different securities simultaneously in several markets maximizes opportunities for returns, improves risk management, and spurs innovation in financial products, services, and strategies.

Why Does Liquidity Matter?

Liquidity refers to the market's ability to handle a large volume of trading without significant price swings. If a security is priced at $10 and the market is liquid, your sale of one share, or perhaps several thousand, should not cause that security's price to fall much, if at all. In illiquid markets, your offer to sell may cause the share price to drop, sometimes sharply, and conversely, your offer to buy may fuel a steep price increase.

Why? Supply and demand. More supply, less demand leads to lower prices. Greater demand, less supply causes prices to rise. Securities are considered to be more liquid than real estate and collectibles. Liquidity attracts investors to the market because it assures them that they have flexibility in exchanging their securities for cash and vice versa, enabling them to take swift advantage of market shifts.

Liquidity has two dimensions: breadth—the range of securities that are liquid; and, depth—the amount of securities that can be bought or sold before the transaction itself influences the security's value.

The 2007–08 Global Credit Crisis and Hedge Funds

The global credit crisis had its origins in a bubble of rising real estate prices, followed by a sharp fall in housing prices that began in 2007 and dropped roughly 20 percent on average nationwide by fall 2008. That led to an escalation of mortgage delinquency and default rates, which may ultimately result in losses exceeding $4 trillion.[39] Financial institutions pulled back on credit availability, "deleveraged" by selling off bad debts at heavy losses, and pursued quick foreclosures of delinquent mortgages.

A liquidity crisis ensued in the credit markets, spilling over into other markets, as some financial institutions became insolvent and others neared bankruptcy. Banks grew increasingly reluctant to lend to one another, as demonstrated by the wide gap that emerged between the London Interbank Offered Rate (LIBOR) and Treasury securities interest rates. Risk premiums for debt soared, making credit more scarce and costly. Markets froze worldwide in a vicious downward cycle of worsening liquidity. By fall 2008, losses on loans and securities from the financial turmoil and weakening economies had exceeded $1 trillion, according to International Monetary Fund estimates.[40] Lack of investor confidence and trust compounded the problem.

What role did hedge funds play?

Funds that owned subprime debt and related securities lost value amid the financial turmoil. As the former SEC Chairman David Ruder explained in testimony before a House panel in November 2008, "Although some hedge funds hedged CDO [collateralized debt obligation] risk and made substantial profits, many hedge funds suffered major losses when the CDOs lost value."[41]

Maria Strömqvist with the Swedish Riksbank observed: "To simplify somewhat, we can say that the hedge funds have been affected more by the present financial crisis than they have affected it."[42]

SEC Commissioner Kathleen Casey, who chairs the IOSCO Technical Committee, made a similar point in releasing the IOSCO report *Hedge Funds Oversight: Final Report* in June 2009: "Securities regulators recognize that the current crisis in financial markets is not a hedge fund driven event. Hedge funds contribute to market liquidity, price efficiency, risk distribution and global market integration."[43]

The observation in April 2008 by Sebastian Mallaby of the Council on Foreign Relations remains valid today: Hedge fund "failures have stemmed mainly from errors that were not of their own making. Because banks have mismanaged themselves so thoroughly, they have had to mobilize capital by calling in loans to hedge funds, forcing the funds to sell off positions precipitously. Forced sales have driven down the value of the hedge funds' remaining holdings, undermining their creditworthiness and triggering a further calling in of loans, further forced sales, and further losses. This vicious circle has caused a few funds to go bust. But the trigger was . . . subprime losses in the regulated banking system."[44]

A similar conclusion was reached by researchers at the Bank of International Settlements and the Bank of Canada: "[U]nregulated hedge funds have not been the main protagonists during the current crisis. Instead, the greatest systemic risk has come from large complex financial institutions that are subject to varying degrees of regulation."[45]

Another report on the global banking crisis by Lord Adair Turner, Chairman of the UK Financial Services Authority, found that "hedge funds did not play a significant role in the crisis."[46] The de Larosière Group reached a similar conclusion in its study for the European Union.[47]

"Despite endless hand-wringing about hedge funds as a threat to the financial system, hedge funds were not the main cause of the credit crisis."

Robert A Jaeger
BNY Mellon Asset Management
March 2008[48]

Group of 20 Perspective

"During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions."

Group of 20
November 15, 2008[49]

'An Important Source of Capital'

"Even in light of all of the change and turmoil that is affecting all market participants, hedge funds will continue to play an important role and be an important source of capital and liquidity in world markets, by providing financing to new companies, industries and markets, as well as by committing capital in times of both market stress and market stability. Hedge funds' role in helping to provide efficiencies in pricing of securities and other financial assets throughout the markets as a result of their extensive research and willingness to make investments in all market conditions will continue to be significant."

Asset Managers' Committee
January 15, 2009[50]

Hedge funds have tremendous freedom to invest in just about any area where their managers believe they can outperform the market. They are able to scour global markets looking for opportunities, in contrast to mutual funds, which are primarily restricted to equities, bonds, and cash. "In particular, they can combine both long and short positions, concentrate investments rather than diversify, sometimes with risk, borrow and leverage their portfolios, invest in illiquid assets, trade derivatives, and hold unlisted securities," author Francois-Serge Lhabitant observed. [51]

Unlocks Shareholder Value

Activist hedge funds work to increase shareholder value through their ownership of a company and demands for improvements in management and business strategy. To unlock shareholder value, these funds' managers may work to change a company's leadership, encourage a merger or acquisition, overhaul the capital structure, reduce expenses, cut executive compensation, or disburse cash reserves to shareholders through dividends and buybacks.

One study of nearly 900 instances of hedge fund activism from 2001 through 2005 found that the stock of the average company singled out by a hedge fund outperformed the overall market by five to seven percentage points over a four-week period (the two weeks before and the two weeks after the hedge fund publicly acknowledged its interest in the company).[52] In the year after that initial month of market-beating performance, the average target company's stock kept pace with the overall market. Over the subsequent two years, according to the researchers, the operating performance of the target companies improved markedly.

"Hedge funds provide an example of effective shareholder activism," said one of that study's researchers, Alon Brav, a Finance Professor at Duke University. "When other institutional investors engage in activism—such as pension funds or mutual funds—they typically have not been effective in improving firm performance."[53]

Enhances U.S. Competitiveness in Global Markets

Global equity market capitalization totaled more than $32.57 trillion in December 2008, according to the World Federation of Exchanges.[54] The United States is seeing financial services move not only to such traditional competitors as London and Hong Kong, but also to Mumbai, Dubai, and Bahrain, where rapidly accumulating wealth is being invested with local firms and markets.

U.S. capital markets, however, remain the largest by far, attracting 85 percent of the savings invested outside home markets, according to McKinsey & Co.[55] That position could erode if the United States loses its edge in innovation, its pools of capital shrink, and its financial markets become less efficient.

A vital hedge fund industry is key to maintaining America's competitive edge by attracting human and financial capital, which in turn fuels a strong, growing economy. The flexibility afforded by statutes and regulations enables hedge funds to develop the best ideas in their strategies in many different markets.

Globalization, the proliferation of new financial risks, and the complexities of managing different investments worldwide necessitate unique, state-of-the-art instruments and strategies that U.S. financial institutions are pioneering. As a result of their leadership, U.S.-based hedge funds account for 50 percent of total hedge fund assets under management.

Almost two-thirds of institutional investors surveyed by Morningstar and *Barron's* said in November 2008 that alternatives led by hedge funds will become as important as stocks, bonds, or mutual funds—or more so—in the next five years. Almost half of the institutions surveyed allocate more than 10 percent of their portfolios to alternative investments, and nearly 20 percent allocate more than 25 percent of their portfolios to alternatives. Hedge funds were responsible for driving growth, according to 38 percent of the institutional investors surveyed. Investments in hedge funds may increase for one-quarter of the institutions surveyed over the next five years. The majority (76 percent) of institutions said portfolio diversification was driving the growth of alternative investment.[56]

Hedge funds also contribute to the efficiency of U.S. capital markets by helping to price securities close to their fundamental values. "By trading on the basis of sophisticated and extensive market research, hedge funds provide markets with price information that translates into pricing efficiency," said George E. Hall, Chief Investment Officer of Clinton Group. "In targeting temporary price inefficiencies and market dislocations, hedge funds effectively help to minimize market distortions and eliminate these dislocations."[57] That, in turn, leads to superior capital allocation,[58] which finances growth, innovation, and job creation.

"The greatest proportion of investors said that they view hedge funds as a necessary source of diversification, primarily away from equity market volatility, that provides superior returns to traditional fixed-income investments."

Casey Quirk/
The Bank of New York Mellon
April 2009[59]

CalPERS Perspective on Hedge Funds' Value

Joseph A. Dear, Chief Investment Officer of the world's fourth largest pension fund, CalPERS, outlined the benefits that hedge funds and other pools of private investment capital provide:

- Useful components of a diversified investment portfolio to enhance returns and add effective risk management tools.
- The ability to bring together like-minded investors that have been committing long-term capital to a number of investment areas.
- More flexibility to invest in accordance with opportunities in contrast to being limited to a particular category or "style."
- Benefits to the larger financial system including innovation, gains in both growth and employment, and the provision of capital for economic and technological advancement.

SOURCE: Joseph A. Dear, *Written Statement Prepared For: U.S. Senate Banking Subcommittee on Securities, Insurance and Investment Re: Regulating Hedge Funds and Other Private Investment Pools*. July 15, 2009. Available at: http://www.calpers.ca.gov/eip-docs/about/press/news/invest-corp/dear-senate-testimony-regulating-hedge-funds.pdf.

Protecting Investors, Promoting Innovation

Hedge funds are subject to many of the same restrictions on their investment and portfolio trading activities as most other securities investors, including the following requirements:

- Anti-fraud and anti-manipulation requirements, such as Section 10(b) of the *Securities Exchange Act of 1934* and Rule 10b-5, as well as insider-trading prohibitions, both in the funds' investment and portfolio-trading activities, and in the funds' offers and sales of units to their own investors;[60]
- Margin rules,[61] which limit use of leverage to purchase and carry publicly traded securities and options;
- SEC Regulation SHO,[62] which regulates short selling;
- *Williams Act* amendments[63] to the *Securities and Exchange Act of 1934* and related SEC rules, which regulate and require public reporting on the acquisition of blocks of securities and other activities in connection with takeovers and proxy contests;
- SEC, CFTC, and Treasury portfolio and other reporting requirements for large positions; and,
- FINRA "new issues" rule 2790 (which governs initial public offering allocations).[64]

Hedge funds must also abide by the rules and regulations of markets in which they seek to buy or sell financial products. For example, when sold through a broker-dealer as the placement agent, hedge funds are subject to suitability requirements under FINRA rules. Hedge funds are also regulated by the terms of certain exemptions from registration under the *Securities Act of 1933*, the *Investment Company Act of 1940*, the *Investment Advisers Act of 1940*, and, in some cases, the *Commodity Exchange Act*.[65] To meet these exemptions, they must limit their offerings to private placements with sophisticated investors, who are able to understand and bear investment risks. The hedge fund must either restrict its beneficial owners to no more than 100 persons and entities (typically all or most of whom are "accredited investors"), or to super-accredited "qualified purchasers" (a category of investor that includes, in brief, individuals with more than $5 million in investments and institutions with more than $25 million in investments).[66]

"Congress originally was wise to limit the investor pool to those wealthy enough to be able to make judgments on their own, without the help of SEC regulations," said Wharton Finance Professor Richard Marston, Director of the George Weiss Center for International Financial Research.[67] The reasoning, Marston said, is that these individuals and institutions can perform the necessary due diligence themselves and can take on large risks.

Hedge funds are not regulated in the same manner as publicly traded mutual funds. They are not subject to the additional restrictions imposed by the *Investment Company Act of 1940*—restrictions intended to protect less sophisticated investors when investing in traditional retail funds.

Hedge funds are designed by law to operate with optimum flexibility.

Hedge Fund Attributes

- They may generate positive returns in rising and falling equity and bond markets.
- Including hedge funds in a balanced portfolio may reduce overall portfolio risk and volatility and may increase returns.
- The variety of hedge fund investment styles—many uncorrelated with each other—provides investors with a wide choice of hedge fund strategies to meet their investment objectives.
- Hedge funds provide an ideal long-term investment solution, eliminating the need to correctly time entry and exit from markets.
- Adding hedge funds to an investment portfolio may provide diversification not otherwise available in traditional investing.

SOURCE: Magnum Funds. Available at: http://www.magnum.com/hedgefunds/abouthedgefunds.asp.

Hedge Fund Risks

- ☐ **Investment/portfolio** (assets, strategies)
- ☐ **Liquidity** (ability to access capital)
- ☐ **Counterparty** (default)
- ☐ **Operations** (independence, competence, compliance)
- ☐ **Financing** (repayment)
- ☐ **Co-investor** (capital stability)
- ☐ **Key persons and talent** (business stability)

SOURCE: Casey Quirk and The Bank of New York Mellon, *The Hedge Fund of Tomorrow: Building an Enduring Firm.* April 2009. Available at: http://www.caseyquirk.com/docs/research_insight/2009-04_The_Hedge_Fund_of_Tomorrow.pdf.

In December 2004, the SEC issued a rule change that required most hedge fund advisers to register with the SEC by February 1, 2006 as investment advisers under the *Investment Advisers Act of 1940*. The requirement, with minor exceptions, applied to firms managing in excess of $25 million with more than 15 investors. The SEC said it was adopting a "risk-based approach" to monitoring hedge funds as part of an evolving regulatory regime for the industry.[68]

This rule change was challenged in court (*Goldstein v. SEC, 451F.3d873 [D.C.Cir.2006]*). In June 2006, the U.S. Court of Appeals for the District of Columbia ruled that the SEC had erred in changing its long-standing interpretations of provisions of the *Investment Advisers Act of 1940* and, therefore, hedge fund advisers managing less than 15 funds would no longer be required to register.[69]

In light of this decision, the SEC adopted a new anti-fraud rule prohibiting investment advisers to pooled investment vehicles, including hedge funds, from defrauding current and prospective investors. The rule clarifies that an adviser's duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with the ultimate investors and that the commission may bring enforcement actions under the *Investment Advisers Act of 1940* (15 U.S.C. §80b) against investment advisers who defraud investors or prospective investors in those pooled investment vehicles.[70]

During Senate confirmation hearings in early 2009, Treasury Secretary Timothy Geithner[71] and SEC Chairman Mary Schapiro[72] both endorsed registration of hedge funds as a means of achieving greater transparency and oversight. Secretary Geithner elaborated on his approach in March 2009, stating that registration and other regulatory requirements, including new disclosure obligations, should be adopted for managers of private pools of capital, not just hedge funds.[73] Chairman Schapiro has called for more authority over hedge funds, including the "ability to inspect and examine." She said, "We need the ability to require the maintenance of books and records and some further rulemaking authority."[74] Their recommendations were incorporated into regulatory reform legislation the White House unveiled in July 2009.[75]

In 2007, the SEC announced the creation of a new hedge fund task force within the Enforcement Division as part of the commission's latest initiative to "enhance its efforts to combat hedge fund insider trading."[76]

Over the last five years (2004 to 2009), the SEC brought more than 100 cases involving hedge funds, according to Commissioner Elisse B. Walter in testimony before the House Financial Services Committee in March 2009.[77] "The SEC is focusing on several issues involving hedge funds and other institutional traders,

> "The hedge fund legal regime includes not only federal securities law but also the entity and contract law provisions governing the fund, its manager, and investors."
>
> ***Houman B. Shadab, Senior Research Fellow, George Mason University, September 25, 2008[78]***

including (i) possible manipulation, abusive short selling and collusion; (ii) valuation concerns with respect to illiquid assets; and (iii) potential insider trading in a host of circumstances, including prior to mergers and acquisitions and in the credit derivatives market," she said.

The Commodities Futures Trading Commission (CFTC) regulates those hedge fund advisers registered as commodity pool operators (CPO) or commodity trading advisers (CTA). The CFTC has authorized the National Futures Association (NFA), a self-regulatory organization for the U.S. futures industry, to conduct day-to-day monitoring of registered CPOs and CTAs. The CFTC, like the SEC and bank regulators, "can use their existing authorities—to establish capital standards and reporting requirements, conduct risk-based examinations, and take enforcement actions—to oversee activities, including those involving hedge funds, of broker dealers, of futures commission merchants, and of banks, respectively."[80]

In January 2009, two blue-ribbon, private-sector committees established by the President's Working Group on Financial Markets issued separate yet complementary sets of policies for hedge fund investors and asset managers.[81] The best practices for the asset managers called on hedge funds to adopt comprehensive best practices in all aspects of their business, including the critical areas of disclosure, valuation of assets, risk management, business operations, compliance, and conflicts of interest.[82] The best practices for investors include a *Fiduciary's Guide* and an *Investor's Guide*. The *Fiduciary's Guide* provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The *Investor's Guide* provides recommendations to those charged with executing and administering a hedge fund program once a hedge fund has been added to the investment portfolio.[83]

> "Hedge fund advisers have improved disclosure and become more transparent about their operations, including risk management practices, probably as a result of recent increases in investments by institutional investors . . . and guidance provided by regulators and industry groups."
>
> ***Government Accountability Office May 7, 2009***[79]

Investors' Rigorous 'Due Diligence'

Through "due diligence," investors identify managers with whom to invest and then monitor those managers to ensure that investing with them is appropriate for the investor. The level of quantitative and qualitative analysis is considerable to understand fully the operational and financial risks of a hedge fund.

Institutional investors or their financial managers generally require a private investment company to provide answers to detailed questions regarding its background, strategies, research, personnel, returns, compliance programs, risk profile, and accounting and valuation practices. Prospective investors also review liquidity restrictions, management and performance fees, and any applicable lock-up periods. (See the "Model Due Diligence Questionnaire" on page 21.)

As part of the due diligence process, investors successfully demand from hedge fund managers effective internal controls to discourage fraud, according to research published in June 2009 by professors from the University of Pennsylvania's Wharton School of Business and the University of Chicago. Investors also use the fees they pay as part of their incentives to ensure strong internal controls. "[W]e find a positive association between the quality of internal controls and the performance fees rewarded to managers, which is consistent with investors protecting against potential financial misstatements by placing less emphasis on the reported performance when internal controls are less likely to detect or prevent managers from manipulating reported performance."[84] Other research shows that due diligence can be an important source of the "alpha" (meaning performance above a benchmark) in a well-designed hedge fund portfolio strategy.[85]

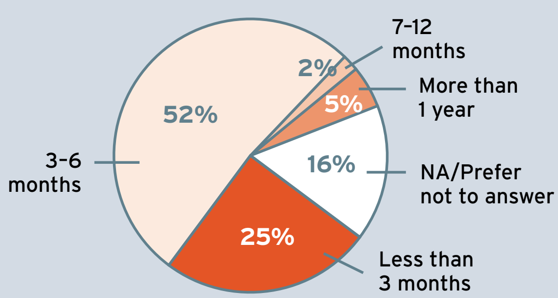
Pension funds typically have in place extensive due diligence review processes to protect the interests of their beneficiaries and safeguard their funds' health. Under the *Employee Retirement and Income Security Act* (ERISA), plan fiduciaries are expected to meet general standards of prudent investing.[86]

At the California Public Employees' Retirement System (CalPERS), three layers of supervision monitor the decisions about hedge fund investments. These are the fund's internal staff and two outside advisors (Pacific Alternative Asset Management Co. and UBS). "Within CalPERS, a committee of highly skilled investment professionals reviews every hedge fund investment before it is added to the CalPERS portfolio. The committee also oversees manager due diligence, selection, contract negotiation, portfolio construction, risk analytics, and manager monitoring. Investment staff and program advisers spend hundreds of hours researching individual hedge funds, auditing their investment processes, interviewing the hedge fund managers, checking references, reviewing broker statements, talking to their auditors, examining their compliance systems, and plotting performance before an investment is made."[87]

CalPERS monitors monthly returns and risk profiles to ensure managers deliver as promised—with the same questions, scrutiny, examination, and thoughtfulness that went into selecting the manager in the first place. CalPERS staff speak with every hedge fund manager monthly and visit them semi-annually.

The Teacher Retirement System of Texas (TRS) conducts a similarly rigorous process, which begins with a review of the fund's overall investment strategy. That leads to the selection of a "premier list" of investment firms based on various parameters and counsel from experts employed by the fund, according to Britt Harris, the TRS chief investment officer.[88] These firms are then subjected to a "certification process," which includes more than 100 questions across eight categories (organization, investment process, portfolio exposure, risk management, operations, policies and procedures, transparency, and fund terms). An extensive risk management evaluation follows for those firms that become certified. "The final portion of the selection process involves a detailed evaluation of the specific portfolio that the potential manager is likely to purchase, making sure that incentive structures are carefully established, and a thorough negotiation of legal terms."[89]

Time Involved in Due Diligence



SOURCE: *2009 Deutsche Bank Alternative Investment Survey*. March 2009. Available at: http://www.deutsche-bank.de/presse/en/content/press_releases_2009_4406.htm?month=5.

Model Due Diligence Questionnaire

The Managed Funds Association prepared a questionnaire to help investors identify the questions they should consider before making a hedge fund investment. The questionnaire covers the following categories:

Investment manager overview

- ☐ Firm description
- ☐ Personnel
- ☐ Service providers
- ☐ Compliance system and registration with regulatory authorities
- ☐ Infrastructure and controls
- ☐ Business continuity

Overview of activities of investment manager

- ☐ Vehicles managed
- ☐ Other businesses
- ☐ Conflicts of interest
- ☐ Fund information
- ☐ Fund overview and investment approach
- ☐ Fund capital and investor base
- ☐ Fund terms
- ☐ Performance history
- ☐ Risk management
- ☐ Valuation
- ☐ Fund service providers
- ☐ Investor communications

SOURCE: Managed Funds Association, *Model Due Diligence Questionnaire for Hedge Fund Investors*. Available at: http://www.managedfunds.org/downloads/Due%20Dilligence%20Questionnaire.pdf.

Key Issues for Policymakers

As hedge funds grow in size and importance, regulators and legislators are examining: the funds' impact on systemic risks; transparency; the quality of measurement used to determine performance and value the funds' holdings; and, the funds' governance structure. A new regulatory approach for hedge funds is part of a larger effort by the Obama Administration and Congress to develop a comprehensive reform of financial regulation, including the establishment of a systemic risk regulator to monitor and mitigate risks to capital markets and their participants.

> "In my current view, hedge funds deserve a narrowly tailored regulatory treatment."
>
> ***Rep. Paul Kanjorski***
> ***May 7, 2009***[90]

Hedge Funds, the Global Financial Crisis, and Systemic Risk

The worldwide financial crisis called into question the role that various market participants played in creating systemic risks in the U.S. and global financial systems. "Systemic risk" describes "the risk that an economic shock, such as market or institutional failure, triggers (through a panic or otherwise) either the failure of a chain of markets or institutions or a chain of significant losses to financial institutions, resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility."[91] Such events could arise from a loss of liquidity (inability to convert securities into cash), credit (loan defaults), leverage (over-extended in debt), concentration of risk (due to adoption of similar trading strategies), or technology and operational failures.

Several reports published in 2009 examined the causes for the financial crisis, including one led by Lord Adair Turner, chairman of the U.K. Financial Services Authority, and another by the de Larosière Group. These reports emphasized the roles played by macro-economic imbalances, the pace of financial innovation exceeding regulatory capabilities in facilitating excessive leverage, and an irrational exuberance perpetuated by an unsustainable rise in securities and real estate values.[92] In this context, as Treasury Secretary Tim Geithner outlined in testimony in March 2009 before the House Financial Services Committee, "Regulated institutions held too little capital relative to the risks to which they were exposed. And the combined effects of the requirements for capital, reserves and liquidity amplified rather than dampened financial cycles. This worked to intensify the boom and magnify the bust. Supervision and regulation failed to prevent these problems. There were failures where regulation was extensive and failures where it was absent."[93]

What role did hedge funds play? The emerging consensus is that the "recent financial crisis is not actually a 'hedge fund crisis,'" as summarized by the Technical Committee of the International Organization of Securities Commissions.[94] They note, too, that "many of the financial firms that failed or required governmental intervention were already subject to a high degree of regulatory oversight." (See page 15.)

The total amount of assets managed by the hedge fund industry, even at an estimate of $1.43 trillion under management as of June 2009, is dwarfed by almost any other class of asset manager, from mutual funds to investment banks to life insurance companies. The largest hedge fund is a fraction of the size of leading financial institutions.[95] (See "Relative Size of Hedge Funds" on page 4.)

Regulators and policy makers have expressed concerns about the potential impact of the failure of one or more large funds as a triggering event in which counterparties would be at risk.

An approach that addresses this concern should be coupled with a modernized financial regulatory system—one that addresses overall risk to the financial system and regulates market participants performing the same functions in a consistent manner. This approach does not prevent losses from occurring, but rather works to diminish the risk that such losses by individual market participants would adversely impact the broader financial system. Further, regulators and market participants should continue monitoring the extent to which hedge fund risks are concentrated in too few positions. (See the adjacent box.)

Greater Transparency, Better Reporting

Hedge funds, like other market participants, must comply with a variety of reporting requirements, such as: SEC portfolio reporting (requiring investment managers with investment discretion with respect to more than $100 million in equity securities to periodically report position information); SEC reports of ownership of five percent of a class of equity securities (which must be reported within 10 days of acquiring five percent); reporting to the Treasury large positions in to-be-issued or recently issued Treasury securities and positions in foreign exchange; and large position reporting (for hedge funds that trade in U.S. futures markets) to the CFTC.

There has been a steady improvement in the amount of data available to investors about hedge funds. "Hedge fund advisers have responded to the requirements of these clients by providing disclosure that allows them to meet fiduciary responsibilities," according to the GAO.[96] That said, though, a July 2008 survey of senior executives in the global fund and investment management business showed that the vast majority of respondents want investment banks to improve the risk transparency of their hedge fund products.[97]

In addition, there are some simple, common-sense disclosures that private investment funds could be required to make before they accept an investment. Legislation could reinforce those disclosure obligations by requiring private investment funds to:

- ☐ Create, update, and provide investors with a private placement memorandum disclosing all material information regarding the fund, including any disciplinary history or litigation;
- ☐ Disclose their fees and expense structures, as well their use of commissions to pay broker-dealers for research (i.e., "soft dollars");
- ☐ Disclose their methodologies for valuation of assets and liabilities;
- ☐ Disclose side-letters and side-arrangements;
- ☐ Disclose conflicts of interest and material financial arrangements with interested parties, including investment managers, custodians, portfolio brokers, and placement agents;
- ☐ Disclose policies as to investment and trade allocations;
- ☐ Provide investors with audited annual financial statements and quarterly unaudited financial statements; and,
- ☐ Disclose the portion of income and losses that the fund derives from Financial Accounting Standard (FAS) 157 Level 1, 2, and 3 assets.[98]

The Asset Managers' Committee has specifically recommended many of these disclosures, but Congress could give the recommendations legal effect through a

Principles for a New Regime to Monitor Systemic Risk

CPIC proposed the following principles to guide legislative and regulatory action to create a new regime to surveil systemic risks:

- ☐ Regulation must be based upon activities, not actors, and it should be scaled to size and complexity.
- ☐ All companies that perform systemically significant functions should be regulated.
- ☐ Regulators should have the authority to follow the activities of systemically important entities regardless of where in the entity that activity takes place.
- ☐ As complexity of corporate structures and financial products intensifies, so, too, should regulatory scrutiny.
- ☐ There should be greater scrutiny based upon the "Triple Play"—being an originator, underwriter/securitizer and investor in the same asset.
- ☐ The systemic risk regulator must enforce transparency and practice it.

new statute tailored for private investment companies, or through amendments to the *Investment Advisers Act of 1940*.[100]

However, requiring hedge funds to make public disclosure of certain positions and trading strategies would have severely negative consequences. CPIC previously commented on this issue in 2008 in the context of a proposal by the SEC to require public reporting of short sale positions—a proposal the SEC later pared back to a requirement that disclosure be made only to the SEC for staff use in monitoring short sale activity.[101] CPIC strongly supported the SEC's right to obtain this information for regulatory and enforcement purposes, but argued that public disclosure of information relating to investment managers' positions in securities would unfairly penalize investment managers and their investors and potentially expose them to retaliation. In April 2009, CPIC made similar arguments to the UK Financial Services Authority in response to their proposal requiring short sellers to publicly report their individual positions in specific securities when certain thresholds are met.

If certain positions and strategies were subject to such disclosure, trade secrets and proprietary information would be divulged, which is contrary to long-standing market practices, federal law, and the rules of numerous other federal agencies. These practices, laws, and rules recognize the need to protect businesses from the economic and competitive disadvantages that would result from public disclosure of such information.[102]

"Placing the onus on market participants to provide discipline makes good economic sense. . . . [But] [d]irect regulation may be justified when market discipline is ineffective at constraining excessive leverage and risk-taking."

Federal Reserve Board Chairman Ben Bernanke, May 16, 2006[99]

Fund managers often conduct rigorous, costly financial analyses that focus on an issuer's business plan, and the quality, integrity, and potential growth of their earnings. They gather information from a wide array of sources and review the businesses of competitors, affiliates, and counterparties to significant transactions. Some managers employ accountants, researchers, and financial analysts. Their analytical techniques may have been developed over years of experience and at great expense. Disclosure of investment positions allows other traders to be "free riders," benefiting themselves while reducing the gains that should accrue to those that actually did the research. Public disclosure of short positions may also confuse investors. Short selling in a company's stock can occur for many reasons and not necessarily because the short seller has a negative view of a company's outlook; for example, a financial institution may take a short position to lock in a spread or hedge an investment in convertible bonds. In these cases, public disclosure of a short position, especially by a prominent investor, may mislead investors and trigger panicky selling. Finally, public disclosure of trading positions and investment strategies could expose investment managers to retaliation, such as a "short squeeze" campaign. Likewise, issuers may cut off communications with funds who report short positions in the issuers' securities. This type of retaliation prejudices institutional investment managers, their clients, and, more broadly, the process of price discovery.

CPIC supports public transparency in other areas that will benefit investors, as outlined in legislation CPIC proposed to Congress (see page 23). CPIC believes hedge funds and other privately offered pooled investment vehicles should be required to file with the SEC, and keep current, an online publicly-available registration statement. Disclosures should include: the fund's name, principal place of business, and its contact information; the year of formation and the year in which operations commenced; the investment manager of the fund; the names and descriptions of the officers and portfolio managers of the fund, as well as its trustees or directors; the name and address of the public accounting firm that serves as the fund's auditor; the fund's yearly gross and net asset values since inception; the number of investors as of the most recent calendar year-end; and, a brief description of its investment strategy.

Valuation, Performance Reporting

Proper valuation of fund assets is an extremely important component of investor protection. These valuations are used to determine the value of a fund's units so that an investor knows what his or her investment is worth at a given point in time. These measurements also determine the price at which new units are issued and existing ones are redeemed. To avoid dilution and unfairness, these calculations must be accurate, using an unbiased, consistent, and transparent method.

The consistency and uniformity of performance reporting goes to the heart of an investor's ability to choose wisely among a myriad of financial and investment products, giving the investor an "apples vs. apples" choice—a true comparison. A February 2009 survey of institutional investors by State Street Corporation shows that "concern over accurate hedge fund valuation has increased, most likely due to growing complexity in investment strategies." This concern rose, survey participants said, because, among the challenges arising from the recent market volatility has been the difficulty in "accurately valuating derivatives and other complex financial instruments [held by hedge funds]." [103]

U.S.-based hedge funds are subject both to GAAP (Generally Accepted Accounting Principles) accounting standards and to federal and state anti-fraud restrictions in their performance reporting.

The Asset Managers and Investors Committees of the President's Working Group on Financial Markets outlined best practices to govern the valuation processes funds should use to assess investment positions and the valuation policy and procedures investors should adopt.[104]

In their view, fund managers "should establish a comprehensive and integrated valuation framework to provide for clear, consistent valuations of all the investment positions in the fund's portfolio, while minimizing potential conflicts that may arise in the valuation process." Specific components of this framework should include a governance structure, well-documented valuation policies, and independent personnel who are extremely knowledgeable about valuation methodologies. The valuation policy's elements should cover methodologies (including sources of prices for different types of investment positions), internal documentation procedures to support valuations, and a delineation of the circumstances that permit a manager to rely upon models.[105]

Investors must "understand the processes and controls related to deriving valuation, and that [they] evaluat[e] and monito[r] these on an ongoing basis," the Investors Committee of the President's Working Group advised in its best practices in January 2009. Investors should verify that a fund's manager has a written statement of valuation policies and procedures, a governance process to ensure consistent and appropriate application of valuation methodologies, rigorous data collection that includes secondary sources whenever possible, and the use of third party, independent administrators.[106]

The SEC provides guidance on the valuation of securities, derivatives, and other assets lacking readily available market quotations, which requires the use of good faith estimates but does not provide a clear, uniform methodology. This guidance, though, warrants updating.

Short Selling

Professional investors rely on short selling strategies to accomplish their investment goals. A short sale is any sale of a security the seller does not own or a sale that is completed by delivery of a borrowed security. As financial detectives, short sellers look for securities that are overpriced. Through their prime broker, the short seller promises the lender to replace the borrowed shares in the future, and pays certain costs until the borrowed shares are returned. Short sellers receive a credit

Hedge funds are subject to many of the same statutory and regulatory requirements as all other institutional market participants engaged in the same trading and investing activities.

Short Selling Adds Liquidity

"Short selling . . . can contribute to the pricing efficiency of the markets. . . . When a short seller speculates on . . . a downward movement in a security, the transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise. . . . Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security."

SEC Staff Report September 2003[107]

Hedge Fund Valuation: Counsel from the CFA Institute Centre for Financial Integrity

VALUATION OF LIABILITIES

Position: Investment funds should value the instruments on their balance sheets that create leverage.

Rationale: The valuation of traditional investment fund holdings essentially relies solely upon a valuation of the asset side of the balance sheet because such funds do not carry debt. Hedge funds, however, use a variety of leverage instruments to boost their returns. Unless these liabilities are valued, it would create a mismatch for the net asset value of the fund by marking the asset side of the balance sheet to market but leaving the liabilities at cost.

HIERARCHY OF VALUATION METHODS

Position: Valuation of hedge fund portfolios should use a hierarchy of valuation techniques, with the use of public price quotes as the preferred method. For instruments which have no publicly available quotes, valuations should first rely upon widely accepted valuation techniques and models, and only in rare circumstances rely upon proprietary valuation models.

Rationale: Reliance on quoted prices for transactions involving liquid securities provides the most reliable proxy for the valuation of instruments where such prices are available. Widely accepted valuation models are the next preferred technique due to their acceptance and the general understanding by investors. Only in rare circumstances involving one-of-a-kind, complex, and structured instruments should the valuation look to the use of proprietary valuation models because of the potential for manipulation.

DISCLOSURE OF VALUATION MODELS

Position: Valuation of hedge fund holdings whose prices are not publicly available should fully disclose to hedge fund investors information about the models used to value such instruments and the assumptions used in the valuation process, and should describe both the instrument being valued and the structure underlying the instrument.

Rationale: Investors need to know what valuation models and assumptions are used to determine whether they are realistic. They also need to understand the instrument being valued and the structure underlying the instrument to determine whether the valuation method is appropriate.

SOURCE: CFA Institute Centre for Financial Market Integrity. Available at: http://www.cfainstitute.org/centre/topics/hedge/official/hedgefunds_valuations.html.

"More institutions are looking for better ways to measure and manage risk, and many place equal emphasis on qualitative and quantitative analysis when monitoring hedge fund performance."

State Street Corporation February 2009[108]

rebate on sales proceeds that come into the prime broker's account. (Visit www.financialdetectives.org to learn more and download a primer on short selling.)

Short selling is an integral part of the workings of capital markets, providing liquidity, driving down overpriced securities, and increasing efficiency. In equity markets, there are many types of short sellers. The vast majority are market neutral, where the seller has no view of a particular company's outlook. As the SEC noted, "short selling provides the market with two important benefits: market liquidity and pricing efficiency."[109]

The short sellers' detective work helps to align securities' prices with fundamental values. "Virtually every piece of empirical evidence in every journal article ever published in finance concludes that without short sellers, prices are wrong."[110]

Researchers have shown that short selling:

- Identifies overvalued stocks and acts as a safety value in bringing the prices of overvalued companies' shares back to alignment with prices those companies' fundamentals would justify[111]
- Increases the information flowing to investors, improving efficiency in securities pricing and lowering investors' transaction costs[112]
- Focuses investors' attention on companies' fundamentals by focusing investors' attention on misperceptions about those fundamentals[113]
- Improves market quality by deepening liquidity[114]

President's Working Group Private-Sector Committee Provides Recommendations to Hedge Fund Managers

A blue-ribbon private-sector committee established by the President's Working Group on Financial Markets provided the following best practices in January 2009 for asset managers to guard against systemic risk and ensure the United States remains the world's most competitive financial marketplace:

Comprehensive Approach to Strengthening Business Practices: The committee's report asks hedge funds to accept that they play an important role in the financial marketplace and, therefore, must take a comprehensive approach to best practices in all phases of their business:

- **Disclosure:** Strong disclosure practices that provide investors with the information they need to determine whether to invest in a fund, monitor an investment, and make a decision to redeem their investment.
- **Valuation:** Robust valuation procedures that call for a segregation of responsibilities, thorough written policies, oversight and other measures for the valuation of assets, including a specific emphasis on hard-to-value assets.
- **Risk management:** Comprehensive risk management that emphasizes measuring, monitoring, and managing risk, including stress testing of portfolios for market and liquidity risk management.
- **Trading and business operations:** Sound and controlled operations and infrastructure, supported by adequate resources and checks and balances in operations and systems to enable a manager to achieve best industry practice in all of the other areas.
- **Compliance, conflicts, and business practices:** Specific practices, such as a written code of ethics and compliance manual, to address conflicts of interest and promote the highest standards of professionalism and a culture of compliance.

Innovative, Far-Reaching Protections That Exceed Current Industry Practices

Disclosing Hard-to-Value Assets: Some of the challenges financial institutions have faced relate to the valuation of hard-to-value financial products, such as complex derivatives. New accounting standards will be in place that require financial institutions to categorize assets in three levels based on how difficult they are to value. Hedge funds should implement these new standards and then go beyond them by disclosing quarterly the portion of their assets and profit (or loss) attributable to assets in each of the three levels.

Comprehensive Investor Disclosure Based on Public Company Model: Each year, public companies provide investors with an annual summary of their performance; qualitative and quantitative quarterly reports; and timely updates of significant events. The committee's report, for the first time, draws from the key principles of the public company disclosure regime and calls for hedge funds to:

- Provide investors with a comprehensive summary of their performance, including a qualitative discussion of hedge fund performance and annual and quarterly reports;
- Make timely disclosures of material events; and,
- Produce independently audited, GAAP-compliant financial statements so investors get accurate, independently verified financial information.

Segregating Duties to Minimize Conflicts of Interest: Having a system of checks and balances where key functions are segregated to minimize conflicts of interests is critical to all complex financial institutions. As such, these new practices should:

- **Address conflicts:** Because it is impossible to anticipate every potential conflict of interest relevant to the hedge fund industry, managers should establish a Conflicts Committee to review potential conflicts and address them as they arise.
- **Segregate functions:** Functions should be separated between portfolio managers and non-trading personnel who are responsible for implementing the valuation process.
- **Assessing Counterparty Risk:** Recognizing the extent to which hedge funds deal with many counterparties, managers should assess the creditworthiness of counterparties and understand the complex legal relationships they may have with these counterparties.

Increased Accountability for Hedge Fund Managers: Both the investor and the hedge fund manager are accountable and must implement appropriate practices to maintain strong controls and infrastructure.

The *Best Practices* are available at: Asset Managers' Committee, *Best Practices for the Hedge Fund Industry. Report of the Asset Managers' Committee to the President's Working Group on Financial Markets*. January 15, 2009. Available at: http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf. See also: Asset Managers' Committee, *Best Practices for the Hedge Fund Industry. Report of the Asset Managers' Committee to the President's Working Group on Financial Markets*. April 15, 2008. Available at: http://www.amaicmte.org/Public/AMC_Report.pdf.

"There's a valuable role that's played by short-selling. It brings information into the marketplace that's incredibly useful and valuable."

SEC Chairman Mary Schapiro
May 14, 2009[115]

"Alternative investments . . . play an important role in the European economy. They are an alternative source of capital for European companies. This is particularly significant at the present time when banks are restricting lending."

EU Internal Market Commissioner
Charlie McCreevy
April 29, 2009[116]

Researchers have called short sellers "canaries in the mine," "investors' heroes," "an antidote to overly optimist CEOs," and investors' "first line of defense."[117]

Constraints on short selling have been found to undermine market quality, thereby harming investors' interests. "Markets which prevent or do not practice short sales are characterized by poor information diffusion and price discovery. . . . Market efficiency and the ability to hedge investments are attractive factors to sophisticated global investors," according to the *Financial Times*.[118]

Engaging in short selling entails risks and costs. One danger is the theoretical possibility of an unlimited loss. In comparison to a "long" purchase of shares, where the investor can only lose the amount of money he or she originally invested (plus fees), there is no maximum to the loss that a short seller could incur. In other words, there is no cap on how high a share price could go; the higher the share price, the greater the loss.

Governance

The governance of hedge funds needs to be viewed from a different perspective than that for mutual funds and other types of asset managers. The exemptions from regulation under the *Investment Advisers Act of 1940* and the *Investment Company Act of 1940* for hedge funds and their advisers are designed to encourage tremendous flexibility in the range of investment strategies and products these funds can use. That capability has enabled them, as the Federal Reserve, the SEC, and academics have shown, to play a key role in stabilizing markets by providing liquidity. (See pages 3–7.)

Finance Professor Bruce N. Lehmann observes that "governance issues associated with hedge funds are best understood by looking at other limited partnerships or public firms that are similar in terms of assets or liabilities."[119]

In his view, if the regulatory structure for hedge funds changes dramatically, hedge funds will not be able to operate as efficiently as they do now.

Lehmann observes that "the governance structure of hedge funds improves on that of public companies with regard to moral hazard in three ways. First, hedge-fund managers receive a more refined performance-based fee. . . . Second, managerial wealth is managed inside the fund. Third, managers are bound to the fund to some extent via exit restrictions." As a result, the incentives in a typical hedge fund governance structure are "far stronger" than those at public corporations.

The Way Forward

CPIC is a strong supporter of the SEC, its dedicated staff, and its mission. But increased regulation and government supervision does not always bring increased protection for investors or support economic growth. Before the 2007–2009 economic downturn, some observers predicted that hedge funds and other private pools of capital would be the source of the next financial crisis, because these investment vehicles are not as heavily regulated as other financial firms. However, the greatest harm to investors and the global economy actually came from comprehensively regulated institutions like banks, insurance companies, broker-dealers, and government-sponsored enterprises. While under direct regulatory supervision, examination, and enforcement, these heavily regulated organizations piled on debt and both made and securitized unsound loans beyond all reason, creating a massive credit bubble that finally burst.

Simply imposing new regulation without properly tailoring it to address the relevant risks would add to the burdens of hard-working, but already overstretched government agency staffs. Investors could be lulled into the false belief that a problem has been resolved. Therefore, any new regulation must be "smart" regulation, with mechanisms carefully targeted to reduce risks to investors and the economy, without imposing unnecessary burdens.

CPIC recognizes that a modernized financial regulatory system—one that addresses overall risk to the financial system and regulates in a consistent manner market participants performing the same functions—will include regulation of hedge funds and other private pools of capital. These policy discussions should be guided by the following principles:

- Any new regulations should treat all private investment funds similarly, regardless of the fund manager's investment strategy.
- The *Investment Advisers Act* and the *Investment Company Act* are awkward statutes for achieving the policy objectives of increased private investment fund oversight. Congress should consider drafting a new statute that clearly spells out a preferred means of improving oversight without degrading investor due diligence, stifling innovation, reducing market liquidity, or harming global competitiveness.
- New regulation should draw upon the best practices work of the President's Working Group Asset Managers and Institutional Investors Committees; their reports provide many specific improvements carefully crafted for the unique nature of private investment companies.
- Regulation for systemic and market risk should be scaled to the size of the entity, with a greater focus placed on the largest funds or family of funds.

In July 2009 testimony before the Senate Banking Subcommittee on Securities, Insurance, and Investment, CPIC outlined the case for a new statute specifically tailored to private investment companies. Neither the *Investment Company Act* nor the *Advisers Act* in its current form is the ideal tool for the job of regulating hedge funds and other private investment companies. They do not contain the provisions needed to address the potential risks posed by the largest private investment companies, the types of investments they hold, and the contracts into which they enter. At the same time, those laws each contain provisions designed for the types of businesses they are intended to regulate—laws that would either be irrelevant to oversight of private investment companies or would unduly restrict their operation.

Many of the elements of such a statute should be similar to provisions currently in the *Advisers Act* or *Investment Company Act*, but others would be tailored to private investment funds. Such a new statute could be codified as a new Section 80c of Title 15 of the US Code. (Section 80a is the *Investment Company Act*, while Section 80b is the *Investment Advisers Act*) and should apply to private investment funds of all kinds with assets under management of more than $30 million, no matter whether a fund is called a "hedge," "venture capital," "private equity" or other type of fund. They should also include all foreign investment companies that conduct U.S. private offerings, so that a fund would gain no benefit by organizing or operating as an "offshore" entity. Private funds subject to the new statute would not be subject to registration under the *Investment Company Act* if they continue to meet the standards for exclusion under Sections 3(c)(1) or 3(c)(7)[120] or other relevant exemption, nor would they be subject to registration under the *Advisers Act* if they continue to meet the requirements for exemptions under that act. They would, however, be required to register under the new "Private Investment Company Act" and be subject to its provisions. Registration—whether under the *Advisers Act* or under a new "Private Investment Company Act"—will bring with it the ability of the SEC to conduct examinations and bring administrative proceedings against registered

A new financial regulatory system must be "smart" regulation, with mechanisms carefully targeted to reduce risks to investors and the economy, without imposing unnecessary burdens.

Efforts to strengthen oversight and regulation of our financial markets must be driven by the need to rebuild investor trust and confidence, a foundation in rebuilding the economy.

The Bottom Line

Honest and fair dealing instills investor confidence, which is the foundation of the U.S. financial markets. A sustainable economic recovery depends upon investors' belief that their interests come first and foremost with the companies, asset managers, and others with whom they invest their money, and their belief that regulators are effectively safeguarding them against fraud. A new financial regulatory system must be "smart" in its approach, with mechanisms carefully targeted to reduce risks to investors and the economy, without imposing unnecessary burdens upon market participants and unnecessary costs upon investors.

funds and their personnel. The SEC also will have the ability to bring civil enforcement actions and to levy fines and penalties for violations.

CPIC's proposal includes provisions to:

- ☐ **Reduce the risks of Ponzi schemes and theft.** Money managers would be required to keep client assets at a qualified custodian, and by requiring investment funds to be audited by independent public accounting firms that are overseen by the Public Company Accounting Oversight Board (PCAOB).
- ☐ **Extend custody requirements to all investments held by covered funds.** Fund assets should be held in the custody of a bank, registered securities broker-dealer, or (for futures contracts) a futures commission merchant. A fund's annual financial statements should be audited by an independent public accounting firm that is subject to PCAOB oversight.[121] While the SEC has adopted custody rules for registered advisers pursuant to its anti-fraud authority under the *Advisers Act* (and recently proposed amendments to those rules), we believe Congress should provide specific statutory direction to the SEC to adopt enhanced custody requirements for all advisers.
- ☐ **Require specific disclosures by private investment funds to investors and counterparties.** The proposal would require private investment funds to provide potential investors with specific disclosures before accepting any investment, and provide existing investors with ongoing disclosures.[122] Among other things, a private fund should be required to disclose in detail its methodologies for valuation of assets and liabilities, the portion of income and losses that it derives from Financial Accounting Standard (FAS) 157 Level 1, 2, and 3 assets,[123] and any and all investor side-letters and side-arrangements. Likewise, private funds should have to disclose the policies of the fund and its investment manager as to investment and trade allocations. They should also disclose conflicts of interest and financial arrangements with interested parties, such as their investment managers, custodians, portfolio brokers, and placement agents. Funds should also be transparent with respect to their fees and expense structures, including the use of commissions to pay broker-dealers for research ("soft dollars"). Investors should receive audited annual financial statements and quarterly unaudited financial statements. These recommendations are consistent with those from the Administration.
- ☐ **Establish requirements for large funds, family of funds and/or its manager.** The proposal considers establishing a gross assets threshold (e.g., $500 million). For example, larger funds should be required to adopt a code of ethics and a proxy voting policy, implement written supervisory and compliance procedures, designate a chief compliance officer, and implement disaster recovery, business continuity, and risk management plans to identify and control material operational, counterparty, liquidity, leverage, and portfolio risks.[124] In addition, such a fund should be required to adopt a detailed plan to address liquidity and for conducting an orderly wind-down that assures parity of treatment of investors in the event of a major liquidity event.
- ☐ **Require customer identification and anti-money laundering programs.** Private investment companies would have to file suspicious activity reports and currency transaction reports, just as securities broker-dealers are required to do.[125]

End Notes

1. In 2008, the S&P 500 Index was down 38.5 percent, its worst annual percentage decline since 1937 and its third worst on record; largest quarterly [4th quarter: −298] and daily [September 29: −107] points decline ever; sixth worst daily percentage decline [October 15: −9.0 percent]). Dow Jones Industrial Index: −33.8% (worst annual percentage decline since 1931 and 3rd worst on record; largest quarterly [4th quarter: −2,330] and daily [September 29: −778] points decline ever; sixth worst daily percentage decline [October 15: −7.9 percent]). S&P 500 and Dow Jones: There was no point in 2008 where the indices were up for the year at the close of a trading day. Since 1900, 2008 was only the fourth year (after 1910, 1962 and 1977) where the Dow never had a single day where it closed up for the year. FTSE Eurofirst 300 Index: −44.8 percent (worst yearly percentage fall since its creation in 1986). Nikkei 225 Average: −42.1% (biggest annual percentage decline on record). CBOE Volatility Index (VIX): Historical high in November based on new calculation, but remained below levels seen during the 1987 crash based on a previous calculation. Hedge funds experienced the largest performance spread in their history in 2008, with the bottom 10 percent losing more than 58 percent and the top 10 percent soaring more than 40 percent, according to Hedge Fund Research, Inc. Hedge Fund Research, Inc., “Investors Withdraw Record Capital from Hedge Funds as Industry Concludes Worst Performance Year in History.” Press Release. January 21, 2009. Available at: https://www.hedgefundresearch.com/pdf/pr_01212009.pdf. Hedge Fund Research, Inc. “Positive Hedge Fund Performance Fails to Offset Record Fund of Funds Withdrawals in Q109.” Press Release. April 21, 2009. Available at: https://www.hedgefundresearch.com/pdf/pr_20090421.pdf.
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5. Sen. Jack Reed, *Opening Remarks for the hearing of the U.S. Senate Banking Subcommittee on Securities, Insurance and Investment Concerning Regulating Hedge Funds and Other Private Investment Pools*. July 15, 2009. Available at: http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=90721236-1de4-480a-aea5-d7c7585e355e.
6. James S. Chanos, *Testimony before the U.S. Senate Banking, Housing, and Urban Affairs Committee Hearing on Enhancing Investor Protection and the Regulation of Securities Markets—Part II*. March 26, 2009. Available at: http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=7d3cbeca-241a-4bee-8ff6-a858c6902d69.
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8. There is no statutory or regulatory description of a hedge fund. Securities and Exchange Commission, *Staff Report: Implications of the Growth of Hedge Funds*. September 2003. Available at: http://www. sec.gov/news/studies/hedgefunds0903.pdf.
9. Reuters, “Hedge Funds a Positive Force in Markets—Bernanke.” November 16, 2005. Available at: http://www.hedgeco.net/news/11/2005/hedge-funds-a-positive-force-in-markets-bernanke.html.
10. An individual is considered to be an “accredited investor” if they have a net worth of at least $1 million or have made at least $200,000 each year for the last two years ($300,000 with his or her spouse if married) and have the expectation to make the same amount this year. Qualified purchasers include: (a) Individuals who own $5 million in investments; (b) Institutional investors who own $25 million in investments; (c) A family-owned company that owns $5 million in investments; and, (d) A “qualified institutional buyer” under Rule 144A of the 33 Act.
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12. Chanos, op. cit., footnote 5. James Chanos, *Testimony before the Senate Banking, House, and Urban Affairs Committee*. May 16, 2006. Available at: http://banking.senate.gov/public/_files/ACF82BA.pdf. An overview of hedge fund strategies by the Hedge Fund Center is available at: http://hedgefundcenter.com/hfc/hedge-fund-strategiesstyles/. Information about the CFSB Tremont Index categories of investment strategies is available at: http://www.hedgeindex.com/hedgeindex/en/default.aspx?cy=USD.
13. See: Emmanual Zur, “The Power of Reputation: Hedge Fund Activists.” December 15, 2008. *AAA 2009 Financial Accounting and Reporting Section (FARS) Paper*. Available at: http://ssrn.com/abstract=1267397. See also: Alon Brav, Wei Jiang, Frank Partnoy, and Randall S. Thomas, “Hedge Fund Activism, Corporate Governance and Firm Performance.” Available at: http://www. fdic.gov/bank/analytical/CFR/2006/oct/hedge_fund.pdf.
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19. Ibid.
20. Casey Quirk, op. cit., footnote 4. See also: Prequin, op. cit., footnote 4.
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    "Under ERISA, a fiduciary is a person who (1) exercises discretionary authority or control over plan management or any authority or control over plan assets; (2) renders investment advice regarding plan moneys or property for direct or indirect compensation; or (3) has discretionary authority or responsibility for plan administration. 29 U.S.C. §1002(21)."
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121. This requirement is consistent with the AMC Best Practices, and would close the above-described gaps in the protections provided by the Advisers Act custody rule. Chanos, July 15, 2009 testimony, op. cit., footnote 6.
122. This requirement is consistent with the AMC Best Practices.
123. See n. 15 *supra*.
124. These requirements are consistent with the AMC Best Practices.
125. This requirement is consistent with the AMC Best Practices.

Resources

News Services and Data Providers

Alternative Asset Center
AsiaHedge
Bloomberg
Dow Jones Newswire
Eurekahedge
EuroHedge
Financial Times
HedgeWeek
HedgeWorld
HFR—Hedge Fund Research
InvestHedge
MondoHedge
Reuters
The Wall Street Journal

Exchanges

Australian Stock Exchange Limited
CME Group (a new entity representing the July 2007 merger of the Chicago Mercantile Exchange and the Chicago Board of Trade)
Eurex
FINEX
Intercontinental Exchange
Montreal Exchange
NASDAQ Stock Market
New York Mercantile Exchange
NYSE Euronext, Inc. (runs the New York Stock Exchange, Euronext, and NYSE Arca)
Singapore Exchange Ltd.

Associations

Alternative Investment Management Association
Chartered Alternative Investment Analyst qualification
Bundesverband Alternative Investments e.V.
CFA Institute
Family Office Exchange
Futures Industry Association
Futures & Options Association, UK
International Association of Financial Engineers
International Compliance Association
Japan Commodities Fund Association
Managed Funds Association
The Professional Risk Managers' International Association
Securities Industry and Financial Markets Association (U.S.-based)
Swiss Futures and Options Association

Regulatory Bodies

Australian Prudential Regulation Authority, Australia
Australian Securities & Investments Commission, Australia
Authority for the Financial Markets, Netherlands
Banca D'Italia, Italy
Bank of Japan, Japan
Commodity Futures Trading Commission, USA
Cayman Islands Monetary Authority, Cayman Islands
Commission des Operations de Bourse, France
Commissione Nazionale per le Societa e la Borsa, Italy
Comision Nacional Del Mercado De Valores, Spain
Comision Clasificadora De Riesgo, Chile
China Securities Regulatory Commission, China
Commission De Surveillance Du Secteur Financier, Luxembourg
Dubai International Financial Centre, Dubai
Federal Reserve System, USA
Financial Institutions Commission, Canada
Financial Services Board, South Africa
Financial Supervision Authority, Finland
Finansinspektionen, Sweden
Financial Industry Regulatory Authority, USA
Financial Services Authority, UK
Government of Monaco, Monaco
Guernsey Financial Services Commission, Guernsey
Hong Kong Monetary Authority, Hong Kong
Irish Financial Services Regulatory Authority, Ireland
Inland Revenue, UK
International Organization of Securities Commission
Isle of Man Government, Isle of Man
Japan Commodities Fund Association, Japan
Jersey Financial Services Commission, Jersey
Kredittilsynet, Norway
Ministere De L'Economie Des Finances et de L'Industrie, France
Ministry of Finance, Singapore
Monetary Authority of Singapore, Singapore
National Futures Association—mainly USA-related
New York Federal Reserve Bank
Ontario Securities Commission, Canada

Securities and Exchange Commission, USA
Securities and Futures Commission, Taiwan
Securities Commission, Malaysia
Securities and Futures Commission, Hong Kong
Swiss Federal Banking Commission, Switzerland

Academic Research and Education Centers

London Business School Hedge Fund Centre
www.london.edu/hedgefunds/ hedge_fund_centre/hedge_fund_centre.html

University of Massachusetts: Center for International Securities and Derivative Models
www.umass.edu/som/cisdm/

Chartered Alternative Investments Analysts Program (University of Massachusetts)
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