

COALITION OF PRIVATE INVESTMENT COMPANIES

TESTIMONY OF JAMES CHANOS

CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES**

HEARING ON “PERSPECTIVES ON HEDGE FUND REGULATION”

MAY 7, 2009

Chairman Kanjorski, Ranking Member Garrett, and Members of the Committee. My name is James Chanos, and I am President of Kynikos Associates LP, a New York private investment management company that I founded in 1985.¹ I am appearing today on behalf of the Coalition of Private Investment Companies (CPIC), a group of about twenty private investment companies with a wide range of clients that include pension funds, asset managers, foundations, other institutional investors, and qualified wealthy individuals.

I want to thank the Committee for inviting me to testify on the subject of hedge fund regulation and Congressman Capuano's bill, H.R. 711, the "Hedge Fund Adviser Registration Act of 2009," to require hedge fund managers and managers of other private investment vehicles to register with the Securities and Exchange Commission ("SEC") as investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"). I am honored to have this opportunity to testify on behalf of CPIC and look forward to working with you and your staff in the months ahead.

I. Overview and Summary of Recommendations

This is a difficult time for our nation. A sustainable economic recovery depends upon investors gaining confidence that their interests come first with the companies, asset managers, and others with whom they invest their money, and having confidence that regulators are safeguarding them against fraud.

I am a strong supporter of the SEC, its dedicated staff and its mission. But I am also aware that increased regulation and government supervision does not always bring increased

¹ Prior to founding Kynikos Associates LP, I was a securities analyst at Deutsche Bank Capital and Gilford Securities. My first job on Wall Street was as an analyst at the investment banking firm of Blyth Eastman Paine Webber, a position I took in 1980 upon graduating from Yale University with a B.A. in Economics and Political Science.

protection for investors or support economic growth. After all, before the current 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. As we have all learned, 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 made and securitized unsound loans beyond all reason, creating a massive credit bubble that finally burst. Similarly, Bernard Madoff used his firm, Bernard L. Madoff Investment Securities, LLC — which was registered with the SEC as a broker-dealer and investment adviser and subject to examination and regulation — to perpetrate his Ponzi scheme under the noses of the SEC and FINRA.

Simply imposing new regulation without properly tailoring it to address the relevant risks would add to the burdens of hard working, but already overstretched agency staffs. Investors would 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, and I believe our entire industry, 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. While there will be much discussion about what the components of new regulation should be, CPIC would like to offer these principles for the Subcommittee’s consideration:

- 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. The Subcommittee 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; and
- 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.

II. The State of the Hedge Fund Industry and Financial Markets

As the Subcommittee is aware, in the summer of 2007 and throughout 2008, financial markets began to unravel. Major regulated financial institutions collapsed or went bankrupt as the U.S. Treasury provided capital infusions and U.S.-backed guarantees in order to prevent the demise of banks, insurance companies, and others who were deemed “too big to fail,” and stave off a global economic collapse. A chain of interlinked securities – including derivatives and off-balance sheet vehicles – sensitive to housing prices triggered a downward spiral in financial markets worldwide, demonstrating the scale of interdependence in today’s global economy and the vulnerability it causes.² As the problems became more severe, the crisis mushroomed beyond subprime debt to threaten less risky assets. Credit markets dried up, and equity markets

² There are many research papers and studies that examine the source of the financial crisis. One example: Gary B. Gorton, *The Panic of 2007* (Yale Int’l Ctr. for Fin., Working Paper No. 08-24, 2008) (*available at* <http://ssrn.com/abstract=1255362>). I would encourage you to read the analysis by Lord Adair Turner, Chairman of the U.K. Financial Services Authority (“FSA”), in which he recounts how developments in the banking and the near-bank system caused serious harm to the real economy: Speech at the Economist’s Inaugural City Lecture: The Financial Crisis and the Future of Financial Regulation (Jan. 21, 2009) (*available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml). A more extensive discussion is provided in *The Turner Review: A Regulatory Response to the Global Banking Crisis*, (Mar. 18, 2009) (*available at* <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/037.shtml>).

in 2008 posted one of their worst years since the 1930s. As a result, the value of financial assets held at banks, investment firms, and others collapsed, jeopardizing their survival as they sharply curtailed activities. The downturn spread throughout our economy and worldwide, fueling job losses, prompting bankruptcies, and causing household wealth to erode.

As might be expected with those events, the hedge fund industry also experienced a sharp reversal. The amount of money managed by hedge funds plummeted, reflecting sharp declines in asset values, a rise in client redemptions, and regulatory closures of margin accounts. Last year was among the worst in the industry's history, with total assets under management falling to \$1.41 trillion. This represented a decline of \$525 billion from the all-time peak of \$1.93 trillion reached mid-year 2008, with more than 1,471 funds (a record in one year) liquidating.³

Hedge funds on average in 2008 posted their worst performance since 1990. The Hedge Fund Research, Inc. Fund Weighted Composite Index dropped 18.3 percent for all of last year, which was only the second calendar year decline since 1990.⁴ That said, hedge fund losses on average were less than those of the S&P 500, with 24 different hedge fund strategies performing better than the S&P 500 benchmark.⁵

As the first quarter came to a close this year, hedge fund performance, as measured by the HFRI Fund Weighted Composite Index, began to improve. This index posted a gain of 0.53 percent for the quarter, resulting in a performance-based gain of approximately \$28 billion, a

³ See Hedge Fund Research, Inc., *2008 Worst Year Ever for Hedge Funds*, HEDGE FUNDS REVIEW (Jan. 21, 2009) (available at <http://www.hedgefundsreview.com/public/showPage.html?page=835942>). "During 2008[,] the industry experienced [] six consecutive months of declines between June and November, interrupted only by December's 0.41 percent gain, including a concentrated, volatile two-month period in September and October in which the cumulative decline approached 13 percent."

⁴ See *id.*

⁵ See Hedge Fund Research, Inc., *HFR Global Hedge Fund Industry Report: Year End 2008* (2009), at 46, 59, 89.

sharp contrast to the \$162 billion in performance-based losses in the previous quarter.

Withdrawals, however, continued, totaling \$85 billion for the first quarter this year. Total industry capital declined to \$1.33 trillion as of March 30 this year.⁶ Despite those redemptions, several surveys suggest that institutional investors remain committed to hedge funds. According to the State Street Hedge Fund survey recently published, “three-quarters of institutional investors said they do not plan to modify their portfolio allocations.”⁷ Further, while the study results indicate a moderate decline in overall allocations to hedge funds, the majority of institutions report an intention to increase or maintain current hedge fund allocations over the next 12 months.

III. Legislative Reform

While it often is said that private investment companies are “unregulated,” they are, in fact, subject to a range of securities anti-fraud, anti-manipulation,⁸ margin,⁹ and other trading laws and regulations that apply to other securities market participants.¹⁰ They also are subject to SEC enforcement investigations and subpoenas, as well as civil enforcement action and criminal prosecution if they violate the federal securities laws. However, private investment companies and their advisers are not required to register with the SEC if they comply with the conditions of

⁶ Press Release, Hedge Fund Research, Inc., *Positive Hedge Fund Performance Fails to Offset Record Fund of Funds Withdrawals in Q109*, (Apr. 21, 2009) (available at https://www.hedgefundresearch.com/pdf/pr_20090421.pdf).

⁷ Press Release, State Street Corporation, *State Street Hedge Fund Study Shows Institutional Investors Remain Committed to Hedge Funds Despite Moderate Decline in Allocations*, (Mar. 26, 2009) (available at http://pr.statestreet.com/us/en/20090326_1.html).

⁸ See Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. § 78j) and Rule 10b-5 thereunder (17 C.F.R. § 240.10b-5).

⁹ 12 C.F.R. §§ 220, 221, 224.

¹⁰ See e.g., Exchange Act §§ 13(d), 13(e), 14(d), 14(e) and 14(f) (15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e) and 78n(f)) and related rules (which regulate and require public reporting on the acquisition of blocks of securities and other activities in connection with takeovers and proxy contests).

certain exemptions from registration under the securities laws. In brief, Section 203(b)(3) of the Advisers Act provides an exemption from registration for investment advisers who do not advise mutual funds, do not hold themselves out to the public as investment advisers, and have fewer than 15 clients.¹¹ Advisers to hedge funds and other private investment companies rely on this “private adviser” exemption, because a fund counts as one client.

The “Hedge Fund Adviser Registration Act of 2009,” H.R. 711, would strike Section 203(b)(3) of the Advisers Act, removing the “private adviser” exemption entirely. By requiring hedge fund managers to register as investment advisers, the bill seeks to provide a number of important protections for investors. However, we believe that using the Advisers Act as the basic template for regulation will ultimately prove ineffective to mitigate systemic risk. Moreover, simply requiring registration under the Advisers Act could degrade investor due diligence, by causing undue reliance upon SEC regulation under a statute that is insufficiently robust to address the unique characteristics of private funds.¹² We believe that the twin goals of improved investor protection and enhanced systemic oversight could be better achieved with a standalone statute tailored for private investment funds.

The Advisers Act, as well as the Investment Company Act of 1940 (which applies primarily to the retail mutual fund sector), is designed primarily for retail investor protection and has no provisions designed to protect funds from counterparties or to control systemic risk.

¹¹ 15 U.S.C § 80b-3. In general, the Adviser’s Act defines a person engaged in the business of advising others as to investments in securities as an “investment adviser.” Advisers Act Section 202(a)(11); 15 U.S.C. § 80b-2.

¹² At present, investors rely upon their own due diligence before making a decision as to whether to invest in a hedge fund. “The due diligence process is the set of procedures used to gather information about a particular investment for the purpose of deciding whether the investment opportunity is appropriate. The same information collected in this process is also necessary for the ongoing monitoring of an investment.” *Principles and Best Practices for Hedge Fund Investors: Report of the Investors’ Committee to the President’s Working Group on Financial Markets* at 14 (Jan. 15, 2009), (available at <http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf>).

Many requirements of the Advisers Act are irrelevant, or would be counterproductive, if applied to private investment companies. For example, compensation restrictions imposed by the Advisers Act are not particularly well suited to the regulation of managers of investment pools with high net worth and institutional investors. Such investors are fully capable of understanding the implications of performance-based fees. Likewise, client-trading restrictions under the Advisers Act that require client consent on a transaction-by-transaction basis are unduly burdensome for private fund management. In addition, the Advisers Act custody provisions exclude certain types of instruments that are commonly owned by private investment funds, an exclusion that would deprive investors in those funds of the protection that a custody requirement provides.¹³ Moreover, the Advisers Act is generally silent on methods for winding down an investment fund or client account, an area which the law should address in some detail for large private investment companies. In sum, the Advisers Act, which was adopted in largely its current form in 1940, is not well suited to investment structures and strategies developed primarily in the last twenty years.¹⁴

¹³ These instruments are privately-issued securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, which, under current law, can simply be titled in the name of the private investment fund and the evidence of ownership held in a file drawer at the manager of the private investment fund. The issuers of those assets are permitted to accept instructions from the manager to transfer cash or other value to the manager. This gaping hole in current Advisers Act custody requirements can allow SEC-registered advisers easily to abscond with money or other assets and falsify documentation of ownership of certain categories of assets, and makes it difficult for auditors, investors and counterparties to verify the financial condition of advisory accounts and private investment funds. Requiring independence between the function of managing a private investment fund and controlling its assets, by requiring that *all assets* be titled in the name of a custodian bank or broker-dealer and requiring *all cash flows* to move through the independent custodian, would be an important control. Similarly, requiring an independent check on the records of ownership of the interests in the private investment fund, as well as imposing standards for the qualification of private investment fund auditors— neither of which currently is required by the Advisers Act— would also greatly reduce opportunities for mischief.

¹⁴ While H.R. 711 would not impose Investment Company Act requirements on private funds, it should be noted that doing so would subject private funds to a law that does not fit their purpose or design. For example, current restrictions on mutual funds from engaging in certain types of transactions, such as trading on margin and short selling, would severely inhibit or foreclose a number of hedge fund trading strategies that are fundamental to their businesses and the markets. Convertible bond arbitrage relies on selling short the underlying equity while buying the bond. This strategy provides essential support for the convertible bond market, upon which many corporations

We believe legislation should be developed that would contain targeted controls and safeguards needed for oversight of private funds, while preserving their operational flexibility. Congress may wish to consider more detailed requirements on large private investment companies (or families of private investment companies) in order to address the greater potential for systemic risk posed by such funds, depending upon their use of leverage and their trading strategies.

Congress also may wish to consider giving legal effect to certain measures that were identified as “best practices” for fund managers in a report issued earlier this year by the Asset Managers’ Committee (“AMC Best Practices”) — a group on which I served at the request of the President’s Working Group on Financial Markets.¹⁵ For example, one of the most important of these recommendations is that managers should disclose more details — going beyond Generally Accepted Accounting Standards — regarding how their funds derive income and losses from Financial Accounting Standard (FAS) 157 Level 1, 2 and 3 assets.¹⁶ Another recommendation is that a fund’s annual financial statements should be audited by an independent public accounting firm that is subject to PCAOB oversight. Still another recommendation would assure that potential investors are provided with specified disclosures relating to the fund and its management before any investment is accepted. This information should include any disciplinary history and pending or concluded litigation or enforcement actions, fees and expense

rely for capital. As another example, requirements for boards of directors set by the Investment Company Act are designed to protect the large numbers of retail investors in mutual funds, and are a poor fit for vehicles that are offered only to high net worth and institutional investors.

¹⁵ *Best Practices for the Hedge Fund Industry: Report of the Asset Managers’ Committee to the President’s Working Group on Financial Markets* (Jan. 15, 2009) (available at <http://www.amaicmte.org/Asset.aspx>).

¹⁶ In brief, under FAS 157, Level 1 assets are those that have independently derived and observable market prices. Level 2 assets have prices that are *derived from* those of Level 1 assets. Level 3 assets are the most difficult to price — prices are derived in part by reference to other sources and rely on management estimates. Disclosure of profits and losses from these categories will allow investors to better assess the diversification and risk profile of a given investment, and to determine the extent to which fund valuations are based on the “best guess” of fund management.

structure, the use of commissions to pay broker-dealers for research (“soft dollars”), the fund’s methodology for valuation of assets and liabilities, any side-letters and side-arrangements, conflicts of interest and material financial arrangements with interested parties (including investment managers, custodians, portfolio brokers, and placement agents), and policies as to investment and trade allocations.

Congress also should require safeguards that I have advocated for many years — simple, common-sense protections relating to custody of fund assets and periodic audits.¹⁷ And, Congress should address areas of importance to the financial system that neither the Advisers Act nor the Investment Company Act addresses, including counterparty risk, lender risk, and systemic risk. These types of issues can be addressed through required disclosures to regulators and counterparties.

IV. Hedge Fund Transparency.

The Subcommittee has asked us to address the issue of disclosure to hedge fund investors and how it might improve transparency and bolster confidence. As noted above, hedge funds and other private investment funds may solicit and accept investments only from sophisticated high net worth and institutional investors — so-called “accredited investors” and “qualified purchasers,” and institutions such as pension funds, banks, insurance companies and others that own more than \$25 million in investments. Such investors are wealthy and sophisticated; their investments, in general, are managed by investment professionals. They understand the

¹⁷ See Statement of James Chanos, President, Kynikos Associates, SEC Roundtable on Hedge Funds (May 15, 2003) (available at <http://sec.gov/spotlight/hedgefunds/hedge-chanos.htm>). See also Testimony of James Chanos before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on Regulation of the Hedge Fund Industry (Jul. 15, 2004) (available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=79b80b77-9855-47d4-a514-840725ad912c); Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) (available at <http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf>).

importance of due diligence and are capable of demanding information from hedge fund managers before making any investment. In 2007, the President’s Working Group on Financial Markets found that pension plans (and their beneficiaries) are protected by professional asset managers that are held to fiduciary standards, and that concerns with respect to such indirect exposures are “best ... addressed through sound practices on the part of the fiduciaries that manage such vehicles.”¹⁸ In our experience, many institutional investors engage in extensive due diligence and ongoing monitoring activities that far exceed the standard disclosures provided by other investment vehicles.¹⁹ Such investors have a simple approach: if you do not provide the information we want, you will not get our business.

Yet, while we do not believe the due diligence practices employed by sophisticated investors are deficient or warrant government intervention into the private contractual relationships among investors, funds, and their advisers, it does seem to us that some simple, common-sense disclosures could be required of private investment funds before they accept an investment. For example, funds could be required to provide potential investors with certain information, and to provide existing investors with ongoing disclosures.²⁰ Specifically, legislation could require 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”);

¹⁸ *Agreement Among PWG And U.S. Agency Principals On Principles And Guidelines Regarding Private Pools Of Capital*, at 2 (Feb. 22, 2007) (available at http://www.treasury.gov/press/releases/reports/hp272_principles.pdf).

¹⁹ See, for example, the due diligence and monitoring regime employed by the California Public Employees Retirement System at <http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/aim/home.xml>, and at <http://www.calpers.ca.gov/index.jsp?bc=/investments/policies/inv-asset-classes/aim/home.xml>.

²⁰ This requirement is also consistent with the AMC Best Practices.

- 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.

As noted earlier, the Asset Managers' Committee specifically recommended many of these disclosures. Congress could give the recommendations legal effect.

On the other hand, we believe that requiring hedge funds to make public disclosure of such matters as investments and trading positions would have severely negative consequences. CPIC previously commented on this issue last year 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.²¹ We 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.

If investments and trading positions were subject to 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

²¹ *Disclosure of Short Sales and Short Positions by Institutional Investment Managers*, Rel. No. 34-58785 (Oct. 15, 2008), 73 Fed. Reg. 61678 (Oct. 17, 2008).

would result from public disclosure of such information.²² To illustrate, 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 investment positions may also confuse investors. For example, 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 and their clients and, more broadly, the process of price discovery.

²² For example, the Federal Trade Secrets Act sets criminal penalties for the unauthorized revelation of trade secrets. The Freedom of Information Act (FOIA) and SEC's Rules under FOIA provide that the SEC generally will not publish matters that would "[d]isclose trade secrets and commercial or financial information obtained from a person and privileged and confidential [information]." Also, in connection with long position reporting under Section 13(f) of the Exchange Act, Congress specified that the SEC, upon request, should exempt from public disclosure information that would reveal an investment manager's ongoing trading programs. The legislative history of Section 13(f) in the Senate Banking Committee report emphasized that it "believe[d] that generally it is in the public interest to grant confidential treatment to an ongoing investment strategy of an investment manager. Disclosure of such strategy would impede competition and could cause increased volatility in the market place." Report of Senate Committee on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 87 (1975).

These issues, of course, relate to investment positions. We are of the opinion, though, that the hedge fund industry could benefit from public transparency in other areas. To this end, hedge funds and other privately offered pooled investment vehicles could be required to file with the SEC, and keep current, an on-line publicly-available registration statement. Disclosures could include: the fund's name and principal place of business, the year of formation and the year in which operations commenced; the investment manager of the fund, its principal place of business, and its contact information; 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 auditor of the fund; yearly gross and net asset values of the fund since inception; the number of investors as of the most recent calendar year-end; and a brief description of its investment strategy.

V. Don't Shoot the Messenger

In crafting new legislation to regulate hedge funds and other private investment companies, care should be taken not to demonize the funds or impose punitive or restrictive measures that could cause long-term harm to our markets and our economy. Hedge funds and other private investment companies perform many beneficial functions in our markets, without the government backstop. In a recent column, Michael Hirsch in *Newsweek* noted the fundamental misunderstanding of the beneficial role that hedge funds are performing in our economy:

[A]s the bubble began to overheat in the last few years, our government authorities were most worried about the damage that those unregulated, mysterious hedge funds might do to the financial system.... And after the crash last year, hedge funds came under attack for short-selling A lot of people were waiting for the hedge-fund industry—which would get no bailouts à la AIG and Citigroup—to collapse into the dustbin of history.

It never happened. Sure, plenty of hedge funds went under: a record 1,471 were liquidated in 2008, out of a total of 6,845, according to Hedge Fund Research, a Chicago-based tracking firm. The industry's total capital plunged by \$600 billion to \$1.33 trillion as of the end of the first quarter of 2009....

But here's the key point: the fallout happened very quietly—with no systemic risk discernible. Compared to the overlong horror movie we've been watching—Night of the Living Dead Banks—what happened in the hedge-fund world sounds almost healthy and clean. After all, that's the way capitalism is supposed to work: incompetents go out of business, smart guys clean up. And overall, the hedge-fund industry has shown remarkable resiliency in the face of the catastrophe....²³

One of the investment methods used by hedge funds and other private investment companies — as well as by broker-dealers, banks, and other institutional traders — is short selling. Private investment funds use short selling to hedge risk, to bring efficiencies to securities markets by arbitraging away price discrepancies, and in connection with ferreting out overpriced (and fraudulent) securities.

When equity prices collapsed last fall, one of the few regulatory actions taken by the SEC was to impose an emergency ban on short selling — an action then-Chairman Cox and current Commissioner Paredes later recognized as a mistake, in view of the adverse impact it had on investors and the markets.²⁴ Virtually every study conducted on the ban's impact on the market — including studies on the very stocks it was designed to “protect” — reached the same conclusion: the ban had adverse effects on investors, issuers, and the markets by increasing

²³ Michael Hirsch, *Power to the Hedge Funds! Long Demonized, They May be the Model Firms of the Future*, NEWSWEEK (Apr. 23, 2009) (available at <http://www.newsweek.com/id/194893>).

²⁴ See Amit R. Paley and David S. Hilzenrath, *SEC Chief Defends His Restraint*, p. A01, THE WASHINGTON POST (Dec. 24, 2008) (available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/23/AR2008122302765.html>); Troy A. Paredes, Commissioner, U.S. SEC, Remarks at “The SEC Speaks in 2009,” (Feb. 6, 2009) (available at <http://www.sec.gov/news/speech/2009/spch020609tap.htm>).

volatility, reducing liquidity, clouding price discovery, preventing effective hedging in rapidly declining markets, and severely impeding the convertible bond market.²⁵

Currently, the SEC is under tremendous pressure to implement new price restrictions on short selling. Yet, there is no credible data showing that short selling was the cause of the market's decline or that it caused the downfall of individual issuers such as Lehman, Bear Stearns, Fannie Mae, Freddie Mac or AIG. Short sales of financial stocks also constituted a small percentage of trading volume and total shares outstanding. The U.S. experience shows that financial institutions' share prices were reacting largely to problems specific to those institutions' financial health and long-term viability — not to the short-interest positions. In fact, the SEC's Office of Economic Analysis, in a memorandum analyzing the SEC's July 2008 Emergency Order requiring pre-borrowings for short sales, concluded that a control sample of non-financial issuers “experienced no substantive change in short interest since October 2007,” a fact that “suggests that the increase in overall short interest reported by the media is driven by financial stocks and most likely the result of negative sentiment induced by the credit crisis.”²⁶

²⁵ See Ekkehart Boehmer, Charles M. Jones, and Xiaoyan Zhang, *Shackling Short Sellers: The 2008 Shorting Ban*, (2008) (working paper) (available at <http://www2.gsb.columbia.edu/faculty/cjones/ShortingBan.pdf>); Ian W. Marsh and Norman Niemer, *The Impact of Short Sales Restrictions* (Nov. 30, 2008) (working paper) (available at <http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf>); Abraham Lioui, *The Undesirable Effects of Banning Short Sales* (Apr. 16, 2009) (available at http://faculty-research.edhec.com/jsp/fiche_document.jsp?CODE=1239890717080&LANGUE=1); Arturo Bris, *Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order*, *IMD Working Paper* (Aug. 12 2008) (available at: <http://www.imd.ch/news>); Ana Avramovic, *What Happened When Traders' Shorts Were Pulled Down?*, *Credit Suisse Market Commentary* (Sept. 30, 2008) (available at <https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=11181&m=-1730413896>); Ana Avramovic, *Examining the Wake of the Short Sale Restriction*, *Credit Suisse Market Commentary* (Oct. 13, 2008); Ana Avramovic and Phil Mackintosh, *The Blame Game: What Caused Spreads to Widen?*, (Nov. 12, 2008) (available at <https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=11354&m=1083827502>); Jeff Benjamin, *Academics Slam Short-Selling Ban*, *INVESTMENT NEWS* (Dec. 22, 2008) (available at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20081222/REG/812229981>).

²⁶ Memorandum of the SEC Office of Economic Analysis (Jan. 14, 2009) (available at <http://www.sec.gov/spotlight/shortsales/oeamemo011409.pdf>).

The SEC itself, even as it proposes new rules to curb short selling, admits that the price declines in the equity markets were due to long sales (noting that a study by its own Office of Economic Analysis “found that long sellers were primarily responsible for price declines” in September 2008).²⁷ Thus, the collapse in share prices of these institutions was not due to “bear raids,” but due to long selling — investors selling their holdings — motivated by massive losses and the presence of bad assets on these institutions’ books.²⁸

This should have come as no surprise. According to *Fortune* magazine, corporate profits — in the form of the aggregate earnings of the Fortune 500 — dropped 87 percent in 2008 from their peak in 2006.²⁹ In the financial services sector, which makes up roughly one-third of the Fortune 500, earnings went from a positive \$257 billion in 2006 to a loss of \$213 billion in 2008.³⁰ Earnings collapsed. Balance sheets were in disarray. Share prices in this sector declined because investors sold stocks in response to very weak issuer fundamentals.

The focus on restricting short sales is all the more disheartening because short sellers provide substantial benefits to the marketplace. The vast majority of short sales are *market neutral*. A short sale of one security is made in conjunction with the purchase of a different security, and the paired transaction cannot drive down prices of the market as a whole.³¹ The

²⁷ *Amendments to Regulation SHO*, SEC Rel. No. 34-59748, 74 Fed. Reg. 18042, at 18049 (Apr. 20, 2009).

²⁸ A report by Credit Suisse makes the point that increased volatility since repeal of the uptick rule coincides with the demise of Bear Stern’s hedge funds, an event that clearly signaled the weakness in holdings of credit backed securities and the portfolios of large financial firms. See Ana Avramovic, *Ticking Off the Shorts*, (Apr. 23, 2009) (available at <https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=12012&m=-409136585>).

²⁹ Shawn Tully, *Pop! Went the Profit Bubble*, FORTUNE (Apr. 21, 2009) (available at http://money.cnn.com/2009/04/16/news/companies/tully_profitbubble.fortune/index.htm).

³⁰ *Id.*

³¹ An investor who thinks Microsoft will outperform Apple, for example, may buy shares of Microsoft and sell shares of Apple short. This also occurs, for example, in arbitrage transactions when buyers of convertible bonds short the underlying equity security as a hedge, where the seller has no view of the fundamentals of the company but simply is locking in a spread. An investor also might go long options and/or futures and then short the individual equities that make up the corresponding index. In this case, the investor has no fundamental view of the 2,000

U.S. markets' depth and liquidity depend upon the ability of these various investors to employ short sale techniques.

To the extent that short selling is directional, on the other hand, short sellers play an extremely important role as skeptics in the marketplace. A functioning free market requires buyers *and* sellers. In the U.S. markets, differing points of view meet about the worth of a particular company's business plans, inventions, products, services, and management team. The resulting price for a stock is the sum total of all that information and ideas mixing together in the marketplace. This price discovery function is one of the most important features of our free market system of raising capital. To quote Bernard Baruch's testimony before the House Committee on Rules in 1917:

To enjoy the advantages of a free market, one must have both buyers and sellers, both bulls and bears. A market without bears would be like a nation without a free press. There would be no one to criticize and restrain the false optimism that always leads to disaster.³²

The 2003 SEC Staff Report on Implications of the Growth of Hedge Funds describes how, in addition to providing liquidity:

[s]hort selling also can contribute to the pricing efficiency of the markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on or hedges against a downward movement in a security, the transaction is a mirror image of the person's who purchases the security based upon speculation that the security's price will rise or in order to hedge against such an increase. The strategies primarily differ in the sequence of transactions. 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

stocks being shorted; he simply is locking in a spread. Risk arbitrage is another area where investors, in connection with an announced acquisition, may short the acquirer and go long the target, since an acquirer often uses its own shares to make an acquisition, thereby diluting and lowering share value.

³² Testimony of Bernard Baruch, House Committee on Rules, U.S. House of Representatives, 64th Congress, January, 1917.

performance. This evaluation is reflected in the resulting market price of the security.³³

In the heady years leading up to the 2007-2008 decline in market prices for equity securities, an unfortunate side effect of the tremendous hype of the U.S. marketplace was a tendency to overlook, or at least not seek out, negative information regarding investments. It is natural for a company's management — and often those outside agents who are employed by the company — to want to put the best possible face on the company's operations, plans, and strategies. The role of the fundamental short seller is to test those ideas, to ask the hard questions, and to try to understand if the management team has properly thought through all the things that could go wrong — or whether management is telling the truth.

Short sellers in recent years often have been the watchdogs when others have failed to bark.³⁴ As I testified in hearings before the Energy and Commerce Committee in 2002, my firm, Kynikos, saw the potential for Enron's collapse nearly a year before it occurred.³⁵ After reading news reports of Enron's aggressive accounting practices and reviewing the company's SEC filings, we grew suspicious. While Wall Street bulls were content to hype the stock of the "black box" that was Enron, Kynikos went in the other direction, concerned by the issues that proved to be Enron's undoing: aggressive accounting, poor return on capital, numerous one-time gains, poorly explained special purpose entities, high volumes of insider stock sales, and statements

³³ *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, at 40 (Sept. 2003) (*available at* <http://www.sec.gov/news/studies/hedgefunds0903.pdf>).

³⁴ There is little question of the need for a market watchdog. The SEC, pursuant to a requirement of the Sarbanes Oxley Act of 2002, issued a report reviewing 515 enforcement actions arising out of 227 investigations of alleged financial reporting and disclosure violations in the five years leading up to enactment of the Sarbanes Oxley Act. U.S. Securities and Exchange Commission, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (2003) (*available at* <http://www.sec.gov/news/studies/sox704report.pdf>). The Commission reported that it brought enforcement actions against 164 entities and 705 individuals who had been involved in improper accounting and reporting practices.

³⁵ *See Developments Relating to Enron Corp.: Hearing Before the H. Comm. On Energy and Commerce* (Feb. 6, 2002) (testimony of James S. Chanos).

about product lines that simply could not be reconciled with obvious market realities. Had the market responded to what the short sellers were finding, the fiasco that was the collapse of Enron may have been less severe.

Enron is not the only example. Short sellers detected accounting irregularities at Tyco International as far back as 1999. In 2005, the SEC obtained a \$200 million disgorgement from the former CEO of AremisSoft, a high tech company that went bankrupt following the exposure of fraudulent statements and accounting practices that were first uncovered by short sellers.³⁶ Other examples of such financial detective work include Sunbeam Corporation, Coleco, Boston Chicken, Baldwin United, and Conseco. These were not companies that short sellers destroyed in “bear raids.” These were companies whose fundamentals were scrutinized by professional investors and found to be inadequate to support their market valuation. In the process of discovering fraud or mismanagement and exposing it, short sellers may have corrected some of the inefficiencies in the market and may have prevented additional investors from losing money in an ongoing fraud. As one columnist correctly observed, “[i]n general, the companies that short sellers target deserve it.”³⁷

Short sellers also warned of the impending crisis in the financial markets as early as 2006. *Newsweek* recently reported that Paul Singer of Elliott Associates, “in an extraordinarily prescient analysis in September 2006 declared that the subprime mortgage securitization market was a historic scam. He correctly identified the ratings agencies as chief culprits.”³⁸ In the spring of 2007, I joined Mr. Singer in outlining to finance ministers and central bankers at a G-7

³⁶ *SEC v. Roys Poyiadjis, Lycourgos Kyprianou et. al.*, SEC Litig. Rel. No. 19,529, 2005 SEC Lexis 1364 (Jun. 9 2005).

³⁷ James Surowiecki, *Get Shorty*, THE NEW YORKER (Dec. 1, 2003) (available at http://www.newyorker.com/printables/talk/031201ta_talk_surowiecki).

³⁸ *See supra* n. 21.

finance ministers meeting the looming crisis in credit structures and overleveraged banks and brokerage firms. Our audience listened politely, but, as events now show, failed to take any meaningful action. The decision by those in charge of regulating our economy to ignore fundamental problems has cost us millions of jobs and lost homes, hundreds of billions in government spending, and trillions of dollars in investment losses.

Over the years, the SEC has periodically reexamined its position on short selling, but the results have consistently been the same: short selling is good for the markets, and critics' complaints are unfounded. A number of in-depth studies have borne out this finding.³⁹ As the highly respected former SEC Commissioner Irving Pollack observed in his 1986 report *Short-Sale Regulation of NASDAQ Securities*, "the early attempts to prohibit short sales did not withstand the test of time, and short sales gradually came to be recognized as essential to the efficient functioning of securities markets."⁴⁰

Congress examined short selling as part of its investigation into the market break of 1987, and again, not only was short selling exonerated, it was identified as a valuable tool for U.S. securities markets. During Congressional hearings in November of 1989, the Director of the SEC's Division of Market Regulation told Congress that short selling "provide[s] the market

³⁹ Studies were conducted in 1935 and 1951 by the Twentieth Century Fund, and in 1937, 1963, and 1976 by the SEC. A report by Irving Pollack summarized the findings of the 1935 study: "The study found that, in general, short selling does not have any appreciable effect in limiting the extremes to which prices may rise. Its tendency is to accelerate the downward trend in prices during the early and middle phases of movements and either check the price trend in the lower phase or heighten its movement after prices have turned upward. However, the study found that considered in terms of long positions and total trading, short sales ... have not been in sufficient volume to warrant the belief that their actual effect is at all material." See Irving M. Pollack, *SHORT-SALE REGULATION OF NASDAQ SECURITIES*, at 30 (1986).

⁴⁰ Pollack, *id.* at 20.

with two vital benefits: market liquidity and pricing efficiency.”⁴¹ The Deputy Director of the SEC’s Enforcement Division also commented on short sale complaints. While confirming that the SEC had taken “appropriate enforcement action” in instances where short sales had been “used as a means to achieve an illegal end,” he observed that short sellers were often the discoverers, and not the perpetrators, of the illegal behavior:

[T]he Commission has found occasions where short sellers have detected corporations which are engaged in violations of the securities and other laws themselves in order to inflate the value of their securities. When we have sustainable evidence of this type of violation, we will bring that case as well.⁴²

He also emphasized that the SEC “frequently find[s] that the complaints of downward manipulations that we receive from issuers or their affiliates do not lead to sustainable evidence of violations of the antifraud provisions of the federal securities laws.”⁴³

In 2003 hearings before this Subcommittee, Congress again reviewed short selling amid allegations by certain groups that short sellers and plaintiffs lawyers were sharing information in order to drive down the stock of companies.⁴⁴ These allegations were effectively rebutted by Professor Owen Lamont of Yale University, who testified that his research showed:

[W]hen you have these fights against short sellers and firms, short sellers are usually vindicated by subsequent events. Firms that take anti-shortening actions tend to have falling prices in the following years, suggesting that they were overpriced to begin with, perhaps due to fraud by management; perhaps just due to excessively optimistic investor expectations.

⁴¹ *Short-Selling Activity in the Stock Market: The Effects on Small Companies and the Need for Regulation: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs, 101st Cong. 387 (1989)* (statement of Richard G. Ketchum, Dir., Div. of Market Regulation, SEC).

⁴² *Id.* at 392 (statement of John H. Sturc, Assoc. Dir., Div. of Enforcement, SEC).

⁴³ *Id.* at 434.

⁴⁴ *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Entities, 108th Cong. 116 (2003) 28-30* (statement of Paul Kamenar, Senior Executive Counsel, Washington Legal Foundation).

“Short sellers,” he opined, “are good at detecting and publicizing fraud on the part of firms. . . . To protect investors, we need a vibrant short seller community.”⁴⁵

In 2006, the SEC completed an eight-year series of studies and pilot programs on the “tick test” of Rule 10a-1, including extensive data gathering and analysis by the SEC’s Office of Economic Analysis. From these studies, the SEC found little empirical justification for maintaining price test restrictions on short selling. The SEC study determined that price test restrictions on short selling actually amplify volatility in large capitalization companies.⁴⁶ The SEC study did not find “any indication that there is an association between extreme price movements and price test restrictions” on short selling.⁴⁷

However, in the face of blistering criticism from Congress, the press, and shareholders about its perceived failure to effectively regulate the investment banks, broker-dealers, and markets under its jurisdiction, the SEC is attempting to resurrect short sale price tests through a rulemaking proposed last month, even while stating that it is “not aware of specific empirical evidence that the elimination of short sale price tests has contributed to the increased volatility in U.S. markets.”⁴⁸ In other words, the SEC has decided to “round up the usual suspects.”

According to Amity Shlaes, author of *The Forgotten Man: A New History of the Great Depression*, one of the parallels between the recent past and that of 80 years ago is that “they had a witch-hunt against their short sellers in the early 1930s just as we have a lot of pressure on the short sellers now, making short sales illegal, [and complaining about] hedge funds” Ms.

⁴⁵ *Id.* at 34 (statement of Owen Lamont).

⁴⁶ SEC, *Regulation SHO and Rule 10a-1*, 71 Fed. Reg. 75068, 75073 (Dec. 13, 2006) (footnotes omitted) (Release proposing repeal of Rule 10a-1 and amendments to Regulation SHO).

⁴⁷ SEC, *Regulation SHO and Rule 10a-1*, 72 Fed. Reg. 36348, 36351 (Jul. 3, 2007) (release adopting amendments to Regulation SHO and repealing Rule 10a-1) (footnotes omitted).

⁴⁸ *Amendments to Regulation SHO*, SEC Rel. No. 34-59748, 74 Fed. Reg. 18042, at 18046 (Apr. 20, 2009).

Shlaes noted, “Hedge funds did not cause this problem.”⁴⁹ We hope that a second parallel to the 1930s does not develop — one where economic recovery is slowed by refusal to recognize true causes and continued blame on the messengers. As stated by Nobel economics laureate Gary Becker last fall, “[t]he temporary banning of short sales is an example of a perennial approach to difficulties in financial markets and elsewhere; namely, ‘shoot the messenger.’ Short sales did not cause the crisis, but reflect beliefs about how long the slide will continue.”⁵⁰

VI. Perspectives on the EC-AIF Proposal

The Subcommittee has asked for our views on the European Commission’s April 30, 2009 proposal to regulate alternative investment funds (“EC-AIF Proposed Directive”). We would be happy to provide you with our more detailed views on this very recent and lengthy proposal at a later time. In general, at first reading, we agree in principle with the approach of the EC-AIF Proposed Directive to create a special, carefully tailored proposal designed for regulation of private investment funds, rather than to extend the coverage of the existing framework aimed at retail investment funds or investment advisers. The Proposed Directive appears to have a number of positive elements. For example, it includes registration requirements, allows for appropriate access to information by regulators, requires delivery to investors of audited financial statements, and addresses custody practices. It also provides measures relating to the identification and disclosure of, and procedures to address, conflicts of interest. It establishes requirements for risk management policies and procedures and sets independent pricing service and valuation requirements.

⁴⁹ “Morning Joe,” MSNBC (Oct. 13, 2008). Ms. Shlaes is a syndicated columnist for Bloomberg and a senior fellow at the Council on Foreign Relations.

⁵⁰ Gary S. Becker, *We’re Not Headed for A Depression*, Wall St. J. (Oct. 7, 2008), available at <http://online.wsj.com/article/SB122333679431409639.html>.

Other aspects of the EC-AIF Proposed Directive may be problematic. For example, we do not believe regulatory approval should be required before a private fund retains certain service providers, as the Proposed Directive contemplates. Moreover, the EC-AIF Proposed Directive includes a one-size-fits-all maximum 1:1 equity to debt ratio. This is essentially a random number and not an appropriate restriction to be imposed across all private investment funds. Finally, other aspects of the Proposed Directive, such as those imposing restrictions or requirements on portfolios and investment strategies, seem to be aimed less at protecting investors and the E.U. economy than serving certain constituencies, such as management. We hope that the European Commission continues to engage with all constituencies and address these matters before proceeding further.

VII. Conclusion

Honesty and fair dealing are at the foundation of the investor confidence our markets enjoyed for so many years. A sustainable economic recovery will not occur until investors can again feel certain that their interests come first and foremost with the companies, asset managers, and others with whom they invest their money, and until they believe that regulators are effectively safeguarding them against fraud. CPIC has offered the Subcommittee its views on the issues we believe should be addressed in crafting legislation to regulate private investment companies. We are committed to working diligently with this Committee and other policy makers to achieve that difficult but necessary goal.

Thank you for this opportunity to provide this statement.