

Statement of Christopher Cox
Chairman, U.S. Securities & Exchange Commission
Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs
on the Regulation of Hedge Funds

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Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

Thank you for inviting me to testify today about the regulation of hedge funds. It is an especially welcome opportunity to appear on this panel with other members of the President's Working Group on Financial Markets, including the Department of the Treasury and the Commodity Futures Trading Commission.

As you have recognized, each of us has responsibility for different, but crucial aspects of the world in which hedge funds operate. That's why the Securities and Exchange Commission is working closely and cooperatively with the other members of the President's Working Group on the questions of the systemic market risks posed by hedge fund activity, and the investor protection issues that stem from the increasing exposure of retail investors to hedge fund investment opportunities.

I should emphasize at the outset, Mr. Chairman, that my testimony today reflects my views as Chairman of the SEC, and does not represent the position of the five-member Commission. The views I am expressing this morning are solely my own.

It has been eight years since Long Term Capital Management collapsed, after losing \$4 billion in just five weeks. Then-Fed Chairman Alan Greenspan said at the time that, had the Federal Reserve Bank of New York not intervened to organize a \$3.6 billion bailout by the fund's creditor banks, the bankruptcy of LTCM "could have potentially impaired the economies of many nations, including our own." LTCM was effectively liquidated by early 2000.

This spectacular hedge fund collapse left in its wake not only ruined investors, but also serious questions about the threat to our capital markets as a whole from such significant funds pursuing high risk strategies with excessive leverage. In the months that followed, President Clinton established the President's Working Group on Financial Markets, with the SEC as a member, to coordinate regulatory oversight of these issues as well as other questions that broadly impact the national securities markets.

Since then, the President's Working Group has focused intently on the concern that the failure of one or more significant and highly leveraged investment pools, such as the Long Term Capital Management hedge fund, could threaten the stability of financial markets. We are more certain now than ever before that preventing future market instabilities will require a coordinated effort by all financial securities regulators.

But given the recent invalidation of the SEC's hedge fund rule by the United States Court of Appeals, we have been forced back to the drawing board to devise a workable means of acquiring even basic census data that would be necessary to monitor hedge fund activity in a way that could mitigate systemic risk.

The current lack of such basic data requires me to hedge when I say that the SEC's best estimate is that there are now approximately 8,800 hedge funds, with approximately \$1.2 trillion of assets. If this estimate is accurate, it implies a remarkable growth in hedge fund assets of almost 3,000% in the last 16 years. Much of this growth is attributable to increased investment by institutions. This includes not only investment companies and investment banks, but also private and public pension plans, endowments, and foundations.

Last year, we believe an estimated 2,000 new hedge funds opened for business. There were just over 2,500 hedge fund advisers registered with the Commission at the end of June 2006. Half of those registered following the Commission's hedge fund rule. The vast majority of the registered hedge fund advisers, 88% of them, are domiciled in the United States.

Although hedge funds represent just 5% of all U.S. assets under management, they account for about 30% of all U.S. equity trading volume. They are particularly active in the convertible bond market and the credit derivatives market. We are also seeing hedge funds becoming more active in such varied activities as the market for corporate control, private lending, and the trading of crude petroleum.

It is undeniable that in addition to raising questions such as systemic risk and investor protection, hedge funds also provide investors and our national securities markets with tangible benefits. They contribute substantially to capital formation, market efficiency, price discovery, and liquidity. By actively participating in derivatives markets, hedge funds can help counterparties reduce or manage their own risks. Some hedge funds provide a way for institutional investors to reduce their exposure to downside risk by allocating a portion of their portfolio to an investment with a low correlation to overall market activity.

But given the general lack of public disclosure about the way hedge funds operate, the lack of standards for measuring a fund's valuation and its performance, the possibilities for undisclosed conflicts of interest, the unusually high fees, and the higher risk that accompanies a hedge fund's expected higher returns, these are not investments for Mom and Pop. They are generally risky ventures that simply don't make sense for most retail investors.

While some refer to an alleged growing trend toward the "retailization" of hedge funds, the Commission's staff are not aware of significant numbers of truly retail investors investing directly in hedge funds. In my view, such a development, were it to occur, should be viewed with alarm. Indeed, in the wake of the Court of Appeals decision in the *Goldstein* case, I intend to recommend to the full Commission that the

SEC take formal steps to further limit the marketing and availability of hedge funds to unsophisticated retail investors.

In addition to the threat of retailization, the increased investment in hedge funds by institutional investors with retail constituencies, such as public and private pension plans, fund of funds investments, universities, endowments, foundations and other charitable organizations, carries with it the potential for retail exposure to hedge fund risk. This trend, however, is still in its infancy. A recent industry report by Greenwich Associates indicates that 80% of public pension funds, and 82% of corporate funds, have little or no investment in hedge funds. Those corporate pensions that actively invest in hedge funds allocate on average only 5.3% of their assets to this entire investment class. Public pensions that actively invest in hedge funds allocate 5.1%.

The trend among endowments toward hedge fund investments is more pronounced. Nearly two-thirds of endowments invest in hedge funds, and those that do allocate an average of 18% to them. Whether or not this sort of institutional investment directly impacts retail investors, it surely is increasing the potential impact that hedge funds might have on our capital markets.

The concerns about hedge funds that the SEC enunciated when we adopted our hedge fund rule in December 2004 remain the same today. The remarkable pace of hedge fund growth, which we noted at the time, has continued unabated. The potential for retail investors to be harmed by hedge fund risk remains as serious a concern now as then. And the growth in hedge fund fraud that we have seen accompany the growth in hedge funds implicates the very basic responsibility of the SEC to protect investors from fraud, unfair dealing and market manipulation.

And on that point, let me make very clear that notwithstanding the *Goldstein* decision, hedge funds today remain subject to SEC regulations and enforcement under the antifraud, civil liability, and other provisions of the federal securities laws. We will continue to vigorously enforce the federal securities laws against hedge funds and hedge fund advisers who violate those laws. Hedge funds are not, should not be, and will not be unregulated. The challenge for the SEC and the President's Working Group going forward is, rather, to what extent to add new regulations, particularly in light of the recent Court of Appeals ruling.

The fact that hedge funds remain subject to the same prohibitions against fraud as other market participants, and their managers have the same fiduciary obligations as other investment advisers, directly addresses the Commission's concern with the growth in hedge fund fraud. The Securities Act, the Exchange Act, and the Advisers Act each provides the Commission with separate authorities to regulate fraud and unfair dealing by hedge funds. Using this still valid authority over the past several years, the Commission has brought dozens of enforcement cases against hedge fund managers who have engaged in fraud or have violated their fiduciary obligations.

The number of enforcement cases against hedge fund advisers has grown from just four in 2001 to more than 90 since then. These cases involve hedge fund managers who have misappropriated fund assets; engaged in insider trading; misrepresented portfolio performance; falsified their experience and credentials; and lied about past returns. We have brought cases for inaccurate disclosure of trading strategies; undisclosed preferential treatment of hedge fund clients at the expense of other clients; market manipulation; illegal short selling; and improper valuation of assets. In some cases we have worked side-by-side with criminal authorities who have brought criminal actions as well.

Recent examples of significant hedge fund cases brought by the Commission include:

- **SEC v. CMG-Capital Management Group Holding Company, LLC and Keith G. Gilabert**, *Litigation Release No. 19680 (May 1, 2006)* – In April 2006, the SEC filed an action in federal court charging a California hedge fund manager and his advisory firm with misappropriating more than \$1.7 million in funds and misleading investors about the hedge fund’s returns. The Commission is seeking permanent injunctions, disgorgement, and civil penalties against the defendants.
- **SEC v. Nelson J. Obus, Peter F. Black, Thomas Bradley Strickland, Wynnefield Partners Small Cap Value L.P., Wynnefield Partners Small Cap Value L.P. I, Wynnefield Partners Small Cap Value Offshore Fund, Ltd.**, *Litigation Release No. 19667 (Apr. 25, 2006)* – In April 2006, the SEC filed an insider trading case in federal court against a hedge fund manager and two others in connection with trading for three hedge funds in advance of the public announcement of a merger agreement, resulting in illicit gains of over \$1.3 million. The Commission is seeking injunctions against the defendants, as well as disgorgement, civil penalties, and orders barring the hedge fund manager from acting as an officer or director of a public company.
- **SEC v. Kirk S. Wright, et al.**, *Litigation Release No. 19581 (Feb. 28, 2006)* – In February 2006, the Commission obtained a temporary restraining order and other emergency relief in federal court to halt an ongoing offering fraud involving the sale of investments in seven hedge funds by an Atlanta-based promoter and investment advisers controlled by him. The Commission alleged that the defendants raised as much as \$185 million from up to 500 investors through the fraudulent investment scheme, and that the advisers provided investors with statements that misrepresented the amount of assets in the hedge funds and the returns earned by the funds. The Commission is seeking permanent injunctions against the defendants, an accounting and disgorgement of ill-gotten gains, and civil penalties.
- **SEC v. Deehaven Capital Management, LLC and Bruce Lieberman**, *Litigation Release 19683 (May 2, 2006) (also see Investment Advisers Act Release No. 2517 (May 26, 2006))* – In May 2006, the SEC charged hedge fund adviser Deehaven Capital Management, LLC and its former portfolio manager with insider trading based on information that 19 PIPE offerings were about to be publicly announced. Deehaven has

agreed to disgorge \$2.7 million in unlawful profits and to pay \$343,000 in prejudgment interest and a \$2.7 million civil penalty. The portfolio manager agreed to pay a \$110,000 civil penalty and agreed to be barred from associating with an investment adviser for three years.

But while our ability to bring enforcement actions against hedge funds and their managers remains intact following the *Goldstein* decision, the same cannot be said for the Commission's ability to require hedge fund advisers to register and submit to inspections. The Commission stated, when we adopted the hedge fund rule in 2004, that its then-current program of hedge fund regulation was inadequate. With the rejection of the hedge fund rule by the Court of Appeals, I believe that is once again the case. We must move quickly to address the gaping hole that the *Goldstein* decision has left. Some improvements will be possible through administrative action. Others, however, may well require legislation.

As you consider the possibility of legislation, which is of course the prerogative of the Congress, the SEC stands ready to assist you with technical advice and assistance should you request it. As a general principle, which I would apply both to the Commission's future regulatory actions in this area as well as to any potential legislation, I would counsel that to the maximum extent possible our actions should be non-intrusive. There should be no interference with the investment strategies or operations of hedge funds, including their use of derivatives trading, leverage, and short selling. Nor should the federal government trammel upon their creativity, their liquidity, or their flexibility. The costs of any regulation should be kept firmly in mind. Similarly, there should be no portfolio disclosure provisions. A hedge fund's ability to keep confidential its trading strategies and portfolio composition should be protected. And hedge funds should be able to continue to charge their clients performance fees, just as they do now.

Immediately following the *Goldstein* ruling, I instructed the SEC's professional staff to promptly evaluate the court's decision, and to provide me with a set of alternatives that the SEC could pursue without legislation. That evaluation is still underway, but I have already decided upon several urgent courses of action which I can report to this Committee today. Specifically, I intend to recommend to the full Commission the following emergency rulemakings and Commission actions:

First, I will recommend that the SEC promulgate a new anti-fraud rule under the Investment Advisers Act that would have the effect of "looking through" a hedge fund to its investors. This would reverse the side-effect of the *Goldstein* decision that the anti-fraud provisions of Sections 206(1) and 206(2) of the Act apply only to "clients" as the court interpreted that term, and not to investors in the hedge fund. I believe that such a rule is possible because the court itself noted that another anti-fraud provision, Section 206(4), is not limited to fraud against "clients." The result would be a rule that could withstand judicial scrutiny, and which would clearly state that hedge fund advisers owe serious obligations to investors in the hedge funds. The staff is currently analyzing what the contours of such a rule might be, given the Commission's authority to adopt such a rule under Section 206(4).

Second, I am directing the SEC staff to take emergency action to insure that the transitional and exemptive rules contained in the 2004 hedge fund rule are restored to their full legal effect. This is necessary to insure that hedge fund advisers who were relying on the now-invalidated rule are not suddenly in violation of our regulatory requirements when the court issues its final mandate in mid-August.

For example, among the provisions of the hedge fund rule that the court invalidated was a section governing the Advisers Act's restrictions on performance fees for hedge fund adviser contracts that were entered into before the hedge fund rule went into effect. This section of the hedge fund rule was designed to prevent a hedge fund adviser from having to renegotiate the terms of its existing advisory contracts, or from having to expel from the fund (including venture capital and private equity funds as well as hedge funds) pre-existing investors who are not "qualified clients."

Likewise, I am directing emergency action to restore to newly registered hedge fund advisers their qualified exemption from the recordkeeping requirement for performance data prior to their registration. (They would still be required to maintain all records they have to substantiate their prior performance.) Without this emergency action prior to mid-August, newly registered hedge fund advisers that remain registered, but that did not create records for the periods prior to their registration, will lose the ability to use their performance track record. Rather perversely, that would discourage hedge fund advisers from voluntarily remaining registered.

Yet another emergency action I am directing will restore the extension of time that was given to advisers for funds of hedge funds to provide their audited financial statements. The underlying hedge funds do not typically supply their audited financials to the fund of funds manager until the 120-day deadline, so the fund of funds managers need extra time to complete their audit work and send out the reports. The hedge fund rule gave it to them, but the *Goldstein* decision invalidated that relief. I intend for the Commission to restore the extension of time from 120 to 180 days.

Similar action is needed to undo yet another effect of the *Goldstein* decision, which is to undo the Commission's 2004 hedge fund rule insofar as it applied to off-shore advisers to off-shore hedge funds. Those advisers had to register under the new rule (assuming their funds had more than 14 U.S. investors), but they would have been subject to different treatment under the Advisers Act because they could treat the off-shore fund as their "client" for all other purposes. The Court's ruling, however, eliminated this aspect of the rulemaking; and by creating doubt whether registered offshore advisers will be subject to all of the provisions of the Act with respect to their offshore hedge funds, the ruling has created a disincentive for offshore advisers to remain voluntarily registered. I have directed the Commission staff to address this disincentive to registration.

Finally, to address my concerns with respect to the retailization of hedge funds, I have asked the staff to analyze and report to the Commission on the possibility of

amending the current definition of "accredited investor" as applied to retail investment in hedge funds without registration. I am concerned that the current definition, which is decades old, is not only out of date, but wholly inadequate to protect unsophisticated investors from the complex risks of investment in most hedge funds. Under the Commission's Regulation D, for example, one definition of an "accredited investor" is "Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000." This does not exclude one's residence. The Commission's hedge fund rule would have had the effect of increasing this suitability threshold to \$1.5 million of net worth, rather than \$1 million, for any hedge fund that charges a performance fee.

This was an important change, and I would like to see it restored. In California, the median home price is well over one-half million dollars. So post-*Goldstein*, with barely more than \$200,000 apiece in other assets, a California couple could qualify to buy a hedge fund in an unregistered offering -- even though that relatively small amount might represent their entire life savings in the form of a teacher's or fire fighter's retirement fund.

Beyond these emergency rulemakings and other actions to restore as much of the pre-*Goldstein* rule as possible, I have directed the SEC staff to continue to conduct compliance examinations of investment advisers who remain registered with us, or register with us in the future. All registered hedge fund advisers are subject to SEC regulation, and the SEC will continue to conduct risk-based examinations of hedge fund advisers that are registered with the SEC. The purpose of these exams will be to evaluate the hedge fund adviser compliance programs, and to detect violations of the securities laws.

Our continuing oversight of hedge fund advisers who remain registered with the SEC post-*Goldstein* will cover the majority of the over 2,500 of the hedge fund advisers of which we are aware. Because fully half of these advisers were registered with the SEC before the hedge fund rule required it, we anticipate that at least this number will voluntarily remain registered. And while some number of hedge fund advisers will certainly de-register as a result of the court's decision, our experience since *Goldstein* is that more hedge fund advisers have become newly registered than have de-registered. In other words, although these are early returns and may not be indicative of the final outcome, we have actually experienced a net increase in hedge fund adviser registrations since the *Goldstein* decision.

We are also working with other regulators, including the CFTC and the other members of the President's Working Group, to coordinate our hedge fund oversight efforts. As I have noted, each member agency of the President's Working Group has a unique responsibility and provides a critical perspective when it comes to the efficient and effective functioning of our capital markets. In addition, we are working in close coordination with the Financial Services Authority in the United Kingdom, since together the U.S. and the U.K. account for the vast majority of the world's hedge fund activity, including prime brokerage.

As we move forward, it will be important that we view the whole picture as we work to evaluate both the systemic market risks and the retail investment issues associated with the growing presence of hedge funds in our capital markets. Hedge funds are a significant and growing part of our financial markets that yield not only risks but also many benefits for our economic system. Each of us at this table, as members of the President's Working Group, has an interest and responsibility to continue working collaboratively to evaluate both the systemic market risks and retail investment issues associated with hedge funds in order to maintain these overall benefits. I and the SEC are committed to doing so.

Thank you for inviting me to testify on this important subject. I am happy to answer any questions you may have.