STENOGRAPHIC MINUTES
Unrevised and Unedited
Not for Quotation or
Duplication

****Preliminary Transcript****

HEDGE FUNDS AND THE FINANCIAL MARKET

Thursday, November 13, 2008

House of Representatives,

Committee on Oversight and

Government Reform,

Washington, D.C.

"This is a preliminary transcript of a Committee Hearing. It has not yet been subject to a review process to ensure that the statements within are appropriately attributed to the witness or member of Congress who made them, to determine whether there are any inconsistencies between the statements within and what was actually said at the proceeding, or to make any other corrections to ensure the accuracy of the record."

Committee Hearings

of the

U.S. HOUSE OF REPRESENTATIVES

OFFICE OF THE CLERK
Office of Official Reporters

RPTS JOHNSON

DCMN ROSEN

HEDGE FUNDS AND THE FINANCIAL MARKET

Thursday, November 13, 2008

House of Representatives,

Committee on Oversight and

Government Reform,

Washington, D.C.

The committee met, pursuant to call, at 10:06 a.m., in Room 2154, Rayburn House Office Building, Hon. Henry A. Waxman [chairman of the committee] presiding.

Present: Representatives Waxman, Towns, Maloney, Cummings, Tierney, Lynch, Yarmuth, Norton, Cooper, Van Hollen, Sarbanes, Davis of Virginia, Souder, and Issa.

Staff Present: Phil Barnett, Staff Director and Chief Counsel; Kristin Amerling, General Counsel; Stacia Cardille, Counsel; Erik Jones, Counsel; Theo Chuang, Deputy Chief Investigative Counsel; John Williams, Deputy Chief Investigative Counsel; Roger Sherman, Deputy Chief Counsel; Michael Gordon, Senior Investigative Counsel; Karen

Lightfoot, Communications Director and Senior Policy Advisor; Caren Auchman, Communications Associate; Zhongrui Deng, Chief Information Officer; Mitch Smiley, Staff Assistant; Jennifer Owens, Special Assistant; Brian Cohen, Senior Investigator and Policy Advisor; Earley Green, Chief Clerk; Jennifer Berenholz, Assistant Clerk; Leneal Scott, Information Systems Manager; Alvin Banks, Staff Assistant; Lawrence Halloran, Minority Staff Director; Jennifer Safavian, Minority Chief Counsel for Oversight and Investigations; Ellen Brown, Minority Senior Policy Counsel; Jim Moore, Minority Counsel; Christopher Bright, Minority Senior Professional Staff Member; Brien Beattie, Minority Professional Staff Member; Molly Boyl, Minority Professional Staff Member; John Cuaderes, Minority Senior Investigator and Policy Advisor; Adam Fromm, Minority Professional Staff Member; Patrick Lyden, Parliamentarian and Member Services Coordinator; Larry Brady, Minority Senior Investigator and Policy Advisor; Brian McNicoll, Minority Communications Director; and John Ohly, Minority Staff Assistant.

Chairman WAXMAN. The committee will come to order. The focus of our Committee today is the hedge fund industry. Our four previous hearings have looked at failure. Our first two hearings examined the collapse of Lehman Brothers and AIG. We learned that these companies took on massive risk. When the bottom fell out, senior management walked away with millions of dollars, while shareholders and taxpayers lost billions. Our third hearing focused on the role of the credit rating agencies. At that hearing, we learned about the colossal failures of these gatekeepers of the financial markets. As one internal document said, "We sold our soul to the devil for revenue."

At our fourth hearing, we examined the role of financial regulators. Former Federal Reserve Chairman Alan Greenspan told us that he had identified a flaw in the deregulatory ideology he had championed. Today's hearing has a different focus. The five hedge fund managers who will testify today have had unimaginable success in the financial markets. Although there is a variation on how much they made individually, on average our witnesses made over $1 billion a year. That is on average $1 billion a year.

There are two reasons we have invited these hedge fund managers to testify. First, these are some of the most successful and knowledgeable investors in our financial markets. They each have valuable perspectives to share about what has gone wrong and what steps we need to restore our financial system. Second, their testimony and the testimony of the independent experts on our first panel will help the committee to examine three important issues. What role have hedge funds played in our current financial crisis? Do hedge funds pose a systemic risk to our financial system? And what level of government oversight and regulation is appropriate?

Currently, hedge funds are virtually unregulated. They are not required to report information on their holdings, their leverage, or their strategies. Regulators aren't even certain how many hedge funds exist and how much money they control. We do know, however, that hedge funds are growing rapidly and becoming increasingly important players in the financial markets. Over the last decade, their holdings reportedly have increased over five-fold, to more than $2 trillion. We also know that some hedge funds are highly leveraged. They invest in assets that are illiquid and difficult to price, and sell rapidly.

And we know from our hearing into Lehman and AIG, combining these factors can cause financial institutions to blow up. And we will hear today some experts worry that the failure of large hedge funds could pose a significant systemic risk to our financial system. We also know that hedge funds can receive special tax breaks. The five witnesses we will hear from today earned on average of a billion dollars last year, yet the tax law allows them to treat the vast majority of their earnings as capital gains. That means that at least some portion of their earnings could be taxed at rates as low as 15 percent. That is a lower tax rate than many school teachers, firefighters, or even plumbers pay. In our prior hearings, we have focused on what went wrong in the past. Today's hearing lets us ask what could go wrong in the future so we can prevent damage before it occurs. Both types of hearings are essential. We need to understand both what happened and what could happen in order to solve the immense economic problems we are facing.

I want to thank all of our witnesses for appearing today. Some of the witnesses readjusted their schedules to testify. They all responded to our requests for documents. And I appreciate their cooperation, and look forward to their testimony. I want to now call on ranking member, Tom Davis for an opening statement.

[Prepared statement of Mr. Waxman follows:]

******** INSERT 1X ********

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman. Thank you for calling the hearing today. Hedge fund losses, and in some cases, complete liquidations are an effect of the current financial crisis. It is unlikely they are the cause. The real origin of this market contraction is the continuing collapse of the U.S. housing market, triggered and fueled by preposterously lax lending standards, loose management, aggressive lobbying, and lavish perks, some at the quasi-governmental giants that dominated the market, Fannie Mae and Freddie Mac. They helped to create and enhance the ravenous hunger for mortgage-backed securities, credit default swaps, and other highly sophisticated byproducts of the housing boom that drew hedge funds into the abyss. As a result, hedge fund redemptions of stocks and others assets will continue to put downward pressure on the market.

It wasn't supposed to be this way. Billed as purely private gambles by sophisticated investors, hedge funds now pose very public peril when the bets go bad. Designed as a strategy to reduce investment risk, hedge funds now compound risk when complex deals start to unravel and throw off unintended consequences. Empowered by sophisticated computer models, hedge fund trading was meant to capitalize on, not cause, global market shifts. But now, due to their size and speed, hedge funds often accelerate wild market fluctuations. So when these unregulated private funds become a public problem, many see a need for greater transparency in their operations and tighter regulation on some hedge fund activities. Greater standardization, registration, disclosure, and some regulatory limitations could help the industry mature and survive. Remember the automobile started out as a purely private, wholly unregulated mode of transportation. But when widespread use of the new and powerful machines began to pose public safety issues, it became necessary to decide as a matter of public policy who was qualified to operate a motor vehicle, how fast they could go, where they could go.

We seem to be at the same crossroads for hedge funds. With as many as 8,000 funds managing up to $1.5 trillion, hedge funds are said to account for 20 to 30 percent of trading volume in the United States in U.S. stocks. They may handle even higher levels of transactions involving more specialized instruments, such as convertible bonds and credit derivatives. Their trades can move markets.

So this isn't just about sophisticated high stakes investors any more. Institutional funds and public pensions now have a huge stake in hedge funds' promises of steady above-market returns. That means public employees and middle income senior citizens, not just Tom Wolfe's masters of the universe, lose money when hedge funds decline or collapse altogether. Brittle complexity, huge transactions on computerized autopilot, and other structural inadequacies make hedge funds particularly, sometimes spectacularly vulnerable to financial contagion, the downward spiral of lost value, margin calls, and redemptions in the desperate search for cash. It is clear investors and regulators need to know more about fund investment strategies, leverage levels, and redemption terms to reduce their systematic risk posed by hedge funds. The hedge fund business model may become a casualty of the downturn or it will adopt to new global realities. Going forward, hedge funds will have to take account of a reduced tolerance by investors and governments for an unregulated parallel financial universe of exotic derivatives run by faceless quants that exerts unpredictable gravitational forces on the open marketplace.

But again, we need to remember in the larger implosion of the housing market, hedge funds are collateral damage. We should avoid Congress's natural tendency to overreact and bayonet the wounded. Today's witnesses bring extensive expertise and experience to our discussion of hedge funds in the current financial crisis. We appreciate their testimony.

Chairman WAXMAN. Thank you very much, Mr. Davis. I would like to introduce the four members of our first panel. Professor David Ruder is a professor at Northwestern University School of Law, and served as chairman of the SEC under President Reagan from 1987 to 1989. Professor Andrew

Lo is director of the Laboratory For Financial Engineering at the Massachusetts Institute of Technology's Sloan School of Management. Professor Joseph Bankman is the Ralph M. Parsons professor of law and business at Stanford Law School. And Mr. Houman Shadab is a senior research fellow from the Mercatus Center at George Mason University. I thank each of you for being here.

STATEMENTS OF PROFESSOR DAVID RUDER, NORTHWESTERN UNIVERSITY SCHOOL OF LAW, FORMER CHAIRMAN U.S. SECURITIES AND EXCHANGE COMMISSION; PROFESSOR ANDREW LO, DIRECTOR, LABORATORY FOR FINANCIAL ENGINEERING, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, SLOAN SCHOOL OF MANAGEMENT; PROFESSOR JOSEPH BANKMAN, STANFORD UNIVERSITY LAW SCHOOL; HOUMAN SHADAB, SENIOR RESEARCH FELLOW, MERCATUS CENTER, GEORGE MASON UNIVERSITY

Chairman WAXMAN. It is the practice of this committee that all witnesses testify under oath. So I would like to ask if you would please stand and raise your right-hands.

[witnesses sworn.]

Chairman WAXMAN. The record will indicate that each of the witnesses answered in the affirmative. You had prepared statements, and we will insert your complete statements in the record. What we would like to ask each of you to do is to try to limit the oral presentation to around 5 minutes. We won't bang you out of order after 5 minutes, but there is a clock that will be green for 4 minutes, orange for the last 1 minute, and then it will turn red. And when you see that it is red, we would like you to then consider wrapping up the presentation to us. Professor Ruder, there is a button on the base of the mike. I ask you to press it in and pull it close enough to you so that it will pick up everything you have to say. We are pleased to hear from you first.

STATEMENT OF DAVID RUDER

Mr. RUDER. Chairman Waxman, Congressman Davis and committee members, I am pleased to be here today. Hedge funds are risk takers. They seek greater than market returns by identifying pricing anomalies, by engaging in hedging strategies, by using leverage, and by investing in derivative instruments. Hedge fund investments and hedging activities make positive contributions to capital formation, market liquidity, price discovery, and market efficiency. Hedge funds, however, may pose risks to investors and to the financial markets. They pose risks to their investors because they may suffer substantial losses, may not be able to repay investors in times of stress, or may simply dissolve without returning any moneys to their investors.

Dishonest hedge funds may injure investors by making misrepresentations when they sell fund securities, falsifying operating and valuation results, or by stealing fund assets. Hedge funds can create negative results to the financial system when their losses cause them to liquidate market positions, resulting in downward pressures on the asset classes they are selling. Their defaults may cause losses to their counterparties.

This danger was dramatically illustrated in 1998 at the time of the collapse of Long-Term Capital Management, when the implosion of one major hedge fund caused tremendous disruption in the financial markets. Although hedge funds have been active participants in the derivative and stock markets, they do not seem to have played a major causal role in the events precipitating the credit market crisis. Nevertheless, hedge funds that have suffered major losses have contributed to declines in stock and asset prices by liquidating assets in order to meet other obligations and in order to pay investors seeking to withdraw funds. Some hedge fund advisers are registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Under that Act, the Commission has power to inspect hedge fund advisers for compliance with Federal securities laws. In 2004, the SEC sought the power to inspect all hedge fund advisers, but lost a court case overturning the rule it adopted. Following that decision, the SEC adopted a rule giving it strong powers to bring enforcement actions against hedge fund advisers, whether registered or unregistered, who defraud investors. Nevertheless, the SEC still does not have the power to inspect unregistered hedge fund advisers.

A primary problem identified in the credit crisis has been the loss of confidence among market participants regarding the ability of counterparties to honor contractual obligations and to repay their debts. The main reason for this lack of confidence is lack of information. Despite the fact that hedge funds were not the primary actors in causing the credit crisis, I believe that the Securities and Exchange Commission should be given power to register and inspect all hedge funds. It should have power to require hedge fund advisers to disclose the size and nature of hedge fund risk positions and the identities of their counterparties. It should have the power to monitor and assess the effectiveness of hedge fund risk management systems.

Information the SEC receives should be shared on a confidential basis with the Federal Reserve Board as the Federal agency with primary responsibility for systemic risk regulation. Although these new regulatory powers are important, it is not desirable to impose regulation on hedge fund risk activities, including use of leverage and derivative instruments. Hedge funds should not be regulated in a manner that stifles their innovative financial market activities. The SEC is the proper entity to obtain hedge fund risk information and to monitor and assess the effectiveness of hedge fund risk management systems. The SEC understands the financial markets and the need to allow innovative risk taking.

If the SEC is charged with increased inspection, risk monitoring, and risk assessment responsibilities, it will need substantial additional funding. These new responsibilities would require increased numbers of SEC staff who can understand and evaluate the complicated hedge fund environment. Hedge funds are major users of non-exchange traded derivative instruments. A tremendous void exists regarding the specific characteristics of many of these instruments, the amounts at risks, and the identity of counterparties. The terms of these instruments are often unique and complicated. As a second method of addressing the opacity and impact of derivative instruments in our financial markets, I believe that the swaps exclusion included in the Commodity Futures Modernization Act of 2000 should be repealed so that trading in these non-exchange derivative instruments can be regulated. Some of the current uncertainties relating to derivative instruments can be overcome by standardizing terms and causing the instruments to be traded and settled on futures or options exchanges. I understand that efforts are currently underway to provide a platform for settling these instruments. Thank you for the opportunity to express my views on these important matters.

Mrs. MALONEY. [Presiding.] Thank you very much.

[Prepared statement of Mr. Ruder follows:]

******** INSERT 1-1 ********

Mrs. MALONEY. Professor Lo.

STATEMENT OF ANDREW LO

Mr. LO. Chairman Waxman, Ranking Minority Member Davis, and other members of the House Oversight Committee, thank you for inviting me to testify today at this hearing on hedge funds. In the interests of full disclosure, I would like to inform the committee that in addition to my faculty position at MIT, I am also affiliated with an asset management company that manages several hedge funds and mutual funds. I realize that the committee has a number of questions for the panel, so I will keep my introductory remarks brief. Over the past 10 years, much of my research at MIT has been focused on hedge fund and hedge fund industry. Part of that research has been devoted specifically--

Mr. LYNCH. Madam Chair, could we have the witness either-- I am not sure if your mike is on or you are not close enough to it.

Mr. LO. Sorry.

Mr. LYNCH. No problem. Thank you very much.

Mr. LO. Thank you. It used to be the case that systemic risk was the exclusive domain of central bankers, macroeconomists, regulators, and finance professors had little to do with the subject. But the events of August 1998, the collapse of LTCM and other hedge funds that year showed pretty clearly that the hedge fund industry does have an impact on what we think of as systemic risk. Since then, the hedge fund industry has grown even bigger, and it has become even more important to the growth and operations of the global economy. And that is no exaggeration. Hedge funds control approximately one and a half trillion dollars of capital, but which is more like three trillion with leverage.

Now has that has come down quite a bit from just a year ago, when it was $2 trillion of assets and $5.5 trillion with leverage. And this decline is likely to imply several thousand hedge funds going under between the years of 2007 to 2009. Hedge funds are now involved in virtually every aspect of economic activity, investing in every kind of market and asset, making loans for all purposes, including mortgages, engaging in market making activity, financing bridges, highways, tunnels and other infrastructure in many countries, and even providing insurance. It is the hedge funds' ubiquity, size, leverage, illiquidity and lack of transparency that creates systemic risk for the financial system.

Hedge funds now provide many of the same services as banks, but unlike banks, hedge funds are not regulated. They are outside the Federal Reserve system, which you may recall was originally set up to deal with systemic risk in the banking industry. Like banks, hedge funds provide liquidity. But unlike banks, they can withdraw that liquidity from the marketplace at a moment's notice. Like banks, hedge funds use leverage. But unlike banks, they face no limits, other than those imposed by their prime brokers and counterparties, nor do they face any capital adequacy requirements, which means that hedge funds can get wiped out completely. But of course, investors are prepared for that. And when hedge funds were a cottage industry consisting of small boutiques, that wasn't a problem.

In fact, that was very positive for the economy because there are some risks that only hedge funds are willing to bear. But when hedge funds become too big to fail, that poses a problem for the financial system. As the hedge fund industry has grown, so too has its contribution to systemic risk. And as early as 2004, my co-authors and I uncovered indirect evidence for increasing levels of systemic risk in the industry due to apparent increases in assets under management, leverage, illiquidity, and correlations among hedge funds in commercially available databases.

And I realize that this hearing is about hedge funds, so that has been the focus of my comments and my written testimony, but in the interests of fairness I should point out that while hedge funds have taken on many of the same functions as banks over the last decade, thanks to the repeal of the Glass-Steagall Act in 1999, many banks have become more like hedge funds. And over the past decade, commercial banks, investment banks, and hedge funds have been locked in heated competition with each other, all fueled by investors, including pension funds, sovereign wealth funds, and government-sponsored enterprises, seeking that extra bit of yield in a frustratingly low yield environment. This economic free-for-all between banks, hedge funds, government-sponsored entities, and Wall Street is one of the main reasons for the magnitude of the current financial crisis.

In my written testimony I provide several concrete proposals for addressing these issues, but let me mention two that pertain specifically to hedge funds. While I have written about the possibility of systemic shocks emanating from the hedge fund industry, the fact is that we cannot come to any firm conclusions because we simply don't have the data. Hedge funds don't have to report their monthly returns to any regulatory authority, much less details about their risk exposures.

So my first proposal is to require all hedge funds or their prime brokers to provide certain risk measures to regulators periodically and on a confidential basis. And I give examples in my written testimony of the types of risk measures that would be most useful from the systemic perspective. My second proposal is to create an investigative office like the National Transportation Safety Board to examine every single financial blowup, not just the headline grabbers, and to produce publicly accessible reports on what happened, how it happened, why it happened, who caused it to happen, and how to keep it from happening again. With greater transparency into the hedge fund industry and a better understanding of blowups that contribute most to systemic risk, both the public and the private sectors will be much better prepared to handle any financial crisis now or in the future. Thank you.

[Prepared statement of Mr. Lo follows:]

******** INSERT 1-2 ********

Mrs. MALONEY. Thank you very, very much. Professor Bankman.

STATEMENT OF JOSEPH BANKMAN

Mr. BANKMAN. Chair Waxman, ranking member Davis, members of the committee, thank you very much for asking me to come here to testify. The views I express are my own, and are not necessarily shared by Stanford University. I have been asked to provide an overview of hedge fund taxation, focusing on some of the benefits of hedge fund managers. My testimony, however, will also include private equity fund compensation agreements and tax benefits, since they are quite similar. Managers in both these fields receive a management fee, typically set at 2 percent of the amount under management. They also receive a profits interest, typically set at 20 percent of the fund's profits. The profits interest is sometimes called the carried interest, or simply a carry. The management fee is taxed as ordinary income. The profits interest is taxed as capital gain if and to the extent the fund itself is recognizing capital gains. If it is long-term cap gain, that is at a tax rate of 15 percent, as opposed to the 35 percent maximum tax rate on ordinary income.

In addition, carry is exempt from payroll tax. The benefits of this treatment have been estimated at over $30 billion over the next 10 years. However, as I note in my written testimony, most of the benefits treatment probably accrue to the private equity side of the ledger rather than the hedge fund side of the ledger. That said, the hedge fund and private equity industries to some extent overlap. Hedge fund managers do benefit from this preference, and change in trading strategies might make this preference even more important in the future. In my written testimony, I express my belief, and I believe the belief of an overwhelming majority of my colleagues and tax scholars, that this preference is misguided. The way to think about it is to think of the choice our sons and daughters face when they decide upon a career. If they are smart and ambitious, they might become doctors or scientists or lawyers. These occupations and countless other occupations are going to produce income that is taxed at ordinary income rates. Alternatively, they could go into the fund industry and recognize some, and in some cases most of their income at capital gain rates. That is simply unfair. It violates a common sense maxim that if you have two people earning the same amount, you ought to tax them at the same rate. It is also inefficient. It reduces the size of our economic pie by distorting the career choice our sons and daughters are going to make.

It is sometimes argued that hedge fund managers ought to be--and private equity managers--ought to be compared to entrepreneurs. As I mention in my written testimony, I don't think that comparison is apt. Hedge fund managers are more similar, I think, to investment bankers or to executives at public companies, all of whom recognize income at ordinary income rates. There are other arguments made in defense of the current tax treatment. It is said, for example, that this is recompense for the risk fund managers take, that it is a good way to favor certain industries, or to subsidize investment in general.

As I note in my written testimony, I believe all those arguments are incorrect. And I would be happy to discuss that with the members in question period. The capital gain preference isn't the only tax preference hedge fund managers receive. They have been able to defer recognition of gain, defer tax on their management fees simply by leaving those fees in the fund. And they have also been able to defer tax on the income those fees have generated. Tax applies only when the managers have decided, at their election, to withdraw the money from the fund. The value of this benefit has been estimated at about $20 billion over 10 years. This last benefit, the deferral of fees, might be of interest for the committee in discussing the relevant benefits and burdens of government regulations and tax on the industry. It is not, however, something of current interest in terms of legislation, since under the Economic Stabilization Act it is scheduled to end at the end of this year. However, the tax benefits of carry still remain. The House has voted in June to tax all carry at ordinary income rates. That was a measure I supported. Unfortunately, it died in the Senate. I am hopeful that the members here and the House in general will again reenact that measure.

In my written testimony, I suggest that the drafters look at the remarks of the New York State Bar Association as to how to draft that provision. And hopefully this time it will make it through the Senate and become law. Thank you.

Mrs. MALONEY. Thank you very much for your testimony.

[Prepared statement of Mr. Bankman follows:]

******** INSERT 1-3 ********

Mrs. MALONEY. Mr. Shadab?

STATEMENT OF HOUMAN SHADAB

Mr. SHADAB. Chairman, Ranking Member Davis, and distinguished members of the committee, it is an honor to testify in this forum today about the relationship between hedge funds and the financial crisis. I am privileged to join such a distinguished panel. My name is Houman Shadab, and I am a senior research fellow at the Mercatus Center, and a participating scholar in the center's financial markets working group. The Mercatus Center is a university-based education outreach and research organization affiliated with George Mason University. My own research focus is on financial regulation. I was asked to testify today on certain aspects of the role of hedge funds in the financial crisis. I also have submitted written testimony which provides more detail and background. There are three important findings that I would like to share with the committee. First, hedge funds did not cause the financial crisis. And they are, in fact, helping to reduce its damage and save taxpayers money. This may seem surprising, but in fact, hedge funds have historically made markets more stable, and have helped their investors conserve wealth in times of economic stress. In other words, hedge funds are often less risky than mutual funds. A typical hedge fund strategy seeks to achieve higher risk-adjusted returns, but not necessarily higher returns in other investment vehicles. And in fact, throughout this crisis hedge funds have conserved wealth much better than mutual funds have.

Second, short selling by hedge funds has helped draw attention to the poor investment choices made by financial companies in recent years, but did not cause them to collapse. When hedge funds short-sell stocks of unhealthy companies, they help to divert capital from companies that are fundamentally unstable. This not only prevents stock market bubbles from becoming worse, but it helps to ensure that companies that are making good decisions are rewarded and are better able to provide stable, long-terms jobs for their employees. Third, existing laws and regulations should be strictly enforced against hedge funds and their managers. And these include laws prohibiting fraud, insider trading, abusive short selling, and other types of market manipulation. But changing how hedge funds are regulated could actually undermine the interests of investors and heighten economic instability. While it may be easy to lump hedge funds together with the financial institutions that were directly involved with this crisis, we must be very careful to make the appropriate distinctions to ensure that policy responses to the crisis do not undermine the ability of the economy to recover.

So what is a hedge fund? A hedge fund is a private investment company that makes frequent trades in stocks and other financial instruments, and compensates its manager in part with an annual performance-based fee, typically 20 percent of profits. Hedge fund managers also typically invest in the funds they manage. This compensation agreement leads hedge fund managers to strike a relatively healthy balance between risk taking and risk management, and as empirical research has found, to make the survival of the hedge fund a greater priority than earning performance fees. Now, it may come as a surprise to some, but hedge funds are not even actually a part of corporate America. Hedge funds often take aggressive action against company executives they think are paid too much or are not properly running their companies.

Importantly, when hedge funds get other companies to more properly manage their businesses, hedge funds help those other companies provide more stable jobs for their employees. Now, the financial crisis is the result of distortions in the mortgage and banking sectors, and would have happened even if hedge funds had never existed. Indeed, hedge funds were never the major purchasers of mortgage-related securities. The major purchasers were banks, insurance companies, pensions, and mutual funds. The most meaningful role hedge funds have played during the financial crisis has actually been to dampen its cost to the economy. Large numbers of hedge funds, worth a total of approximately $100 billion, have increasingly been purchasing poorly performing assets, such as mortgage-backed securities, and are helping to reduce the need for economic bailouts funded by taxpayers.

Indeed, just yesterday the Treasury Department announced that it may start requiring companies that receive government funds to first raise private capital. Many hedge funds may be poised to provide such capital, as a recent estimate found that hedge funds are currently holding about $400 billion in cash. Given the massive losses that have resulted from the financial crisis, our system of financial regulation certainly needs rethinking. Yet based upon the empirical evidence, changing the already substantial body of law applicable to hedge funds will not stop this crisis or prevent another one from happening. Instead, lawmakers and regulators should focus on two things.

First, economic recovery may take place more quickly if lawmakers make it easier for hedge funds and other private investment funds to invest in banks. Second, lawmakers and regulators may want to take a look at making it easier for ordinary investors to have access to the investment strategies offered by hedge funds. For example, reducing the restrictions on mutual funds' investment activities may be a way for all investors to benefit from the protection that hedge funds provide, and not just the rich ones. Thank you very much for the opportunity to share my research with the committee.

[Prepared statement of Mr. Shadab follows:]

******** INSERT 1-4 ********

Mrs. MALONEY. Thank all the panelists for your testimony. The Chair recognizes herself for 5 minutes. The current financial crisis started over a year ago, with the collapse of the subprime market. Through our hearings, we have learned about the roles of lenders, bankers, brokers, and credit rating agencies. One question that I have is how hedge funds may have affected and contributed to this crisis. Since September, hedge funds have faced a massive increase in withdrawals from their investors. According to one report, they have faced redemptions of over $50 billion.

As a result, many have been forced to sell assets to raise cash. The hedge funds are selling into a down market, and this further drives down stock prices. Bloomberg News described the cycle recently as, and I quote, downdraft of market declines, client redemptions, demands from lenders for more collateral, and forced asset sales, end quote.

Professor Ruder, in your testimony you stated that hedge funds have contributed to the decline in stock and asset prices by liquidating stocks and other assets in order to meet other obligations and in order to pay investors seeking to withdraw funds. Is it your view that these hedge fund withdrawals are affecting the broader market?

Mr. RUDER. Indeed, they are. The hedge funds, at least by all reports, are selling massive amounts into the stock markets, causing the stock markets to--assisting in the stock market decline. We don't know how much they have contributed to declines in other assets. But surely they are engaged in sales of those assets as well. I know it is happening. I regard that aspect of it to be a rather natural effect coming from the credit crisis itself.

Mrs. MALONEY. And Professor Lo, what is your view?

Mr. LO. I agree with Professor Ruder that there is certainly an effect of hedge funds unwinding their positions on the marketplace. However, those effects are the unavoidable aspects of a free capital market, and something that while we need to be aware of and we need to prepare for, it may not require any direct oversight.

Mrs. MALONEY. Okay. Market analyst Jeff Bagley has estimated that hedge funds might be forced to sell half a trillion dollars worth of assets as a result of this financial crisis. And Professor Lo or Professor Ruder, what would be the impact of forced sales like this?

Mr. RUDER. Well, it is clear that forced sales will affect the markets. What we need to know in advance is what are these positions so that the financial regulators can have some way of attacking the problem of the massive amounts of moneys that are held by hedge funds.

Mrs. MALONEY. So there is a definite need for more transparency?

Mr. RUDER. I certainly agree with that.

Mrs. MALONEY. And Professor Lo, a recent report by the Organization for Economic Cooperation and Development found that hedge funds had purchased over 70 percent of the riskiest tranches of collateralized debt obligations, the financial instruments used to sell the subprime mortgages to investors that are at the root of this crisis before us. What impacts did these investments have on the financial crisis? And did hedge funds facilitate the growth of the market for the sale of these toxic CDOs?

Mr. LO. Certainly I think they did facilitate the growth of these markets by taking on the capacity for holding these so-called toxic waste tranches. However, that again has both a positive and a negative. The positive is that there are few other investors in the economy that are willing to take such risks, and so hedge funds provide a valuable service. However, on the down side, when these particular risky assets end up losing great sums of money, hedge funds are put under great stress. And the unwinding of these portfolios can create significant market dislocation.

Mrs. MALONEY. Long-Term Capital Management hedge fund failed in 1998, and the Federal Reserve was so concerned about market turmoil that they organized investment bankers to come in and to really be supportive and to put them back on a sound financial footing. What concerns me now is there are no investment banks left to buy up hedge funds if they fail and are causing systemic risk in our financial markets. And would anyone like to comment on that? Yes, Professor Lo?

Mr. LO. Yes, I agree that this is a significant issue, which is one of the reasons that in my written testimony, I call for further transparency into the so-called shadow banking system. It is not at all clear that we need more regulation. I think it is clear that we need more effective regulation. But it is difficult for us to propose what that effective regulation looks like unless we have more transparency into the hedge fund industry. With that additional transparency we can develop a sense of what exactly is needed.

Mrs. MALONEY. Thank you very much. And I recognize ranking member Davis for 5 minutes.

Mr. DAVIS OF VIRGINIA. Well, thank you very much, Ms. Maloney. Do all of you believe that hedge funds are adequately regulated? And could you also comment on the adequacy of the disclosure requirements for these entities? I know you touched on it in your statements, but I just--

Mr. RUDER. I would be pleased to expand on that, Congressman Davis. There ought to be some way in which the aggregate risk positions of the hedge funds and the risk positions of their counterparties are revealed to a central regulator. I don't really know what the central regulator will do, but it is impossible for that central regulator to take adequate steps to forestall calamities without having that information. So the first step has to be an inspection system, an assessment system. And as my prepared testimony says, I think that the SEC should--or someone like the SEC should have an opportunity to look at the risk management systems of the hedge funds in order to see that they are not engaged in steps which are going to create the kinds of calamities we have had.

Mr. DAVIS OF VIRGINIA. Professor Lo?

Mr. LO. Well, Congressman Davis, I think that the possibility of legislating losses away is obviously impossible and unwise. Dislocation comes not from losing money, but from the wrong investors losing money. And if we provide greater transparency to the marketplace, I believe that a great deal of the problems that we have been facing will take care of themselves to a large degree. However, there is no mechanism currently for that information to be provided to the public or to regulators. So I agree with Professor Ruder that we do need to have a mechanism for providing that level of transparency. Beyond that, I think it is very premature to be able to say what kind of regulations should be imposed.

Mr. DAVIS OF VIRGINIA. Thank you. Professor Bankman?

Mr. BANKMAN. Yes.

Mr. DAVIS OF VIRGINIA. You want to answer?

Mr. BANKMAN. No, I am just a tax expert. You don't want my opinion on that.

Mr. DAVIS OF VIRGINIA. Okay. Mr. Shadab.

Mr. SHADAB. I think one of the underlying assumptions is that somehow all of these risks are out there in the economy and are known by some parties, and the only issue is simply gathering them in a centralized source and then making decisions on that basis. The problem with that perspective is that the risks that hedge funds and their counterparties pose to the economy are A, very highly complex, and B, constantly changing.

And in fact, in 2006, Federal Reserve Chairman Ben Bernanke rejected a proposal to create a centralized database of hedge fund positions for a couple reasons, one of which being that type of information, in order to be gathered, would be required to be gathered from all financial participants in the economy, not just hedge funds, but also banks, their lenders, their counterparties, and even investors and creditors to some extent, too. Second of all, when that type of information is created by regulators, it creates a false sense of security among market participants that these risks are adequately being monitored and managed.

And in fact, to a large extent the reason the investment banks took on so much leverage and collapsed was because market participants were under the false assumption that the

Securities and Exchange Commission, through their Consolidated Supervised Entities Program, was monitoring the risks of investment banks to their investors and to the economy, but it was not doing so. By contrast, hedge funds, it is widely known by market participants, have no oversight by any central authority, and we can rely upon the market discipline of their counterparties. And it is for that reason that losses from hedge funds typically do not spread to the entire economy. This idea of systemic risk is an idea, but it is really just a hypothetical. It has not come to fruition and practice.

A much more instructive example of large hedge funds collapsing is not Long-Term Capital Management in 1998, but actually Amaranth Advisors, which happened in 2006. That hedge fund was much larger by at least $2 billion than Long-Term Capital Management. It disappeared almost virtually overnight, or at least within one week, and the markets didn't even notice. Why? Because Amaranth and its counterparties were engaging in proper risk management, and it is true that investment banks are no longer there to provide capital to purchase failed hedge funds, but other hedge funds are there to purchase each other's. And in fact, as we speak right now, new hedge funds are being launched, which really displays and reflects the vitality of that industry compared to, for example, the banking sector. And I haven't heard many banks being created in recent times. Thank you.

Mr. DAVIS OF VIRGINIA. Thanks. Let me continue. Mr. Shadab, the briefing memorandum that was produced by the majority implies that hedge funds were major drivers of the subprime housing market through the large investments in collateralized debt obligations backed by subprime mortgages. They cite figures from the OECD estimating that hedge funds purchased 46 percent of all CDOs and over 70 percent of the most risky portions of these investment vehicles. But in your testimony you estimate that the hedge funds never had more than 29 percent of the CDO market, and probably less. I guess my question isn't debating what the facts are, but were hedge funds significant contributors to the growth of the subprime mortgage market or weren't they?

Mr. SHADAB. No, they were not. And this is not just based upon the numbers. We take a step back and think what is the purpose of a structured investment vehicle, a special purpose vehicle that is going to put together a collateralized debt obligation? The purpose of that vehicle is to provide higher interest rates paid out by investment grade securities for institutional investors such as pension funds and insurance companies to be able to invest under a certain class of security that has a certain safety rating, but nonetheless gives them a higher grade.

Hedge funds have no genuine interest in purchasing CDOs, because the CDO is to some extent another private investment fund. If hedge funds want exposures to those types of risks they can buy the underlying bonds or what have you. And in fact, the reason hedge funds concentrated their investments in the riskiest tranche was because first of all, it is an equity tranche, which pays out a much higher interest rate because it is more risky, and it is important to know that those equity CDO tranches were five to less percent of a typical equity CDO deal, which is primarily based upon, again, to get those investment grade ratings.

Mrs. MALONEY. Thank you. The Chair recognizes Congressman Cummings for 5 minutes.

Mr. CUMMINGS. Thank you all for your testimony. Let me make sure I got this right, Professor Bankman. I would like to ask you about your testimony that some hedge fund managers may currently pay taxes at a lower rate than Americans who make less money. If I understand your testimony correctly, the earnings of hedge fund managers are called carried interest. Is that correct?

Mr. BANKMAN. That is right.

Mr. CUMMINGS. And to the extent that these earnings can be tied to long-term gains, the tax rate is just 15 percent. Is that right?

Mr. BANKMAN. That is right.

Mr. CUMMINGS. I just want to make sure, because I thought I was hearing something different. And I want to compare that 15 percent tax rate to the tax rates of some other working Americans, very hardworking Americans. The Bureau of Labor Statistics has calculated the median earnings for various occupations in the American workforce. The median earnings for American school teachers were 43,000, Professor Bankman, to 49,000 per year. What is the tax rate for a school teacher with that income?

Mr. BANKMAN. Well, it depends on their marital status. But if they are single, the 25 percent rate would start at about $32,000, I believe. So they would be paying tax at 25 percent on that income, and there would be payroll tax they would be paying, too. So it would be a 40 percent higher rate, that is 25 as compared to 15.

Mr. CUMMINGS. Jesus Christ. The median earnings for a firefighter was 41,190. His or her tax rate would also I think be around that 25 percent range that you just talked about. Is that right?

Mr. BANKMAN. That is right.

Mr. CUMMINGS. Now, the median hourly earnings for a plumber, we have been talking about plumbers here a lot lately, were $20.65 per hour. And that is about $41,000 per year. That is also taxed about at the 25 percent rate. Is that right?

Mr. BANKMAN. That would be right. Of course, there may be deductions from that, too. So we may be slightly overstating the rate on some of those cases.

Mr. CUMMINGS. Let me get this, let me ask it this way. So Joe the plumber is being taxed at a higher rate than Joe the investment banker. Is that right? Is that a fair statement?

Mr. BANKMAN. That would be true if it were Joe the fund manager. The investment bankers actually don't get that break.

Mr. CUMMINGS. Okay. So the fund manager.

Mr. BANKMAN. Yes.

Mr. CUMMINGS. All right. Now Professor Bankman, does this seem fair to you?

Mr. BANKMAN. No.

Mr. CUMMINGS. On the average, the witnesses on the next panel made over $1 billion, $1 billion in 2007, yet at least some portion of their earnings is being taxed at just a 15 percent rate. Is that fair?

Mr. BANKMAN. No, I don't believe that is either fair or efficient.

Mr. CUMMINGS. And why do you say that? Let's concentrate on the word efficient. Why do you say it is not efficient?

Mr. BANKMAN. Well, a fundamental goal of tax policy is to try to tax everything at the same rate. Otherwise the tax system interferes with the flow of labor, the flow of resources. So it is inefficient to give a tax break to one occupation as opposed to another. We ought to start them off at the same rate. And we can all debate what that appropriate rate is, but nobody has ever offered a reason why this one slice of highly paid professionals should be taxed at a lower rate than other slices of either highly paid or less highly paid professionals.

Mr. CUMMINGS. Is there something that makes these guys so special that they get this 15 percent rate? I mean because I am sure people like Joe the plumber and others would like to try get into that category. I mean is there something special about these guys and ladies?

Mr. BANKMAN. Well, the rate has a long historical explanation to it, which doesn't make hedge fund managers that benefit from the rate special, but does give a little bit of an explanation how we to some extent slipped into a situation where so many of our most highly paid members are getting preferential tax treatment.

Mr. CUMMINGS. Let me just say this: This Congress, the House twice voted to close this loophole, and it would have generated more than $30 billion in tax savings according to the Congressional Budget Office. Unfortunately, this provision has not been passed by the Senate, and it was opposed, opposed by the Bush administration. I hope we can correct this injustice once and for all next year. Would you agree?

Mr. BANKMAN. Yes.

Mr. CUMMINGS. All right. I see my time is about up. I yield back.

Mrs. MALONEY. Thank you very much. Congressman Issa?

Mr. ISSA. Thank you, Madam Chair. Welcome all of you to the Ways and Means Committee. It is very clear we have moved onto tax policy. And I am actually glad we are, because I think it reveals what we are in for in this Congress and the next Congress. I am a Member of Congress who has got my capital gains treatment under the old tax law when I sold my business and came to Congress. So I didn't get the 15 percent, and I did pay 10 percent or so to the State of California in addition. But let me go through a couple of assumptions here since we are playing tax policy. Professor Bankman, you lump together the LBO firms, like the one that bought out my company, and the hedge funds. Now, isn't it true that a leveraged buyout firm in fact is a classic--I mean, these types of firms buy a company. They put skin in it.

And over a long period of time, or sometimes short, they hope to get a capital gains. Isn't capital gains over a hold of more than 1 year by definition, yes or no, the existing tax law?

RPTS REIDY

DCMN BURRELL

[10:56 a.m.]

Mr. BANKMAN. Yes.

Mr. ISSA. Okay. So we will just assume that you didn't really mean to say people who buy whole companies should be somehow not entitled to this. That is not the loophole that I think Mr. Cummings was going to close.

Let me go through another question. You talk about a doctor. Isn't it true that if a doctor forms a medical practice and builds it up and then sells it, he gets capital gains treatment on that?

Mr. BANKMAN. That's right.

Mr. ISSA. Okay. So the doctor really does have the same opportunity, he just has to avail himself of it. If he works for a hospital, and he doesn't own a piece of the clinic or hospital, then he doesn't avail himself. If he does invest in some sort of partnership, he gets that ability when it is sold; isn't that true?

Mr. BANKMAN. That's right. But I think there is a distinction when the doctor's regular income, which is taxed at ordinary income rates, and the very occasional capital gain he recognizes.

Mr. ISSA. And I appreciate your feeling on that. And, look, I am one of those people that thinks we should look at hedge fund income, including profit sharing, and ask whether or not that should be long term or short. I have no problem at looking at it, but of course I am not on the Ways and Means Committee normally, so I don't get that opportunity.

Let's go through a couple of other things--and by the way, Professor Bankman, thank you for supporting the flat tax. I appreciate that we should all be taxed at the same rate and we shouldn't use tax policy to manipulate the economy. Unfortunately, the Congress historically has not agreed with that and they have micro-managed it in the other Ways and Means Committee.

Professor Ruder, you sort of alluded to the problems of lack of regulation, the SEC not getting authority. I just have a brief question.

Would you agree that a size for SEC filing and regulating of hedge funds so as to take the small firm--let's say you have two clients, and no matter how much money, it is just two clients that you are investing on behalf of--that those wouldn't be sensible for a hedge fund or any fund to have to report to the SEC, but if you had 2,000 you probably would fit. Would you say that there are numbers, let's say a dozen or more clients and more than $100 million under management, that would trigger a SEC requirement?

Mr. RUDER. It is possible to arrange regulation in that way. The Investment Advisers Act today, the legislation--

Mr. ISSA. I believe it S. 17.

Mr. RUDER. Well, I am not talking about numbers of people, but there is an inspection split between the States and the SEC at $25 million. If there is less than $25 million under management, it is not regulated by the SEC. And I would support that kind of distinction. It is just a matter of deciding what the number is. Is it $25 million? Is it $100 million? One has to come to some conclusion about that.

Mr. ISSA. I appreciate that. And I think you are right, if we regulate we do have to recognize that we can't regulate every entity.

Mr. Shadab, I have got a couple of questions that you are probably very equipped to answer. First of all, this whole question of hedge funds, isn't it true that hedge funds normally hedge both, if you will, long and short, and as a result when they unwind they tend to unwind more neutral than other long-only investments?

Mr. SHADAB. That is fair to say, that is correct.

Mr. ISSA. And isn't it true that some of the biggest investors in hedge funds are union pension plans and even State plans, that they will have a percentage, usually 5 percent or less, but a percentage they are putting in hedge funds?

Mr. SHADAB. Increasingly so, yes.

Mr. ISSA. And isn't it true that the inefficiency in the market is partially because we have built up a strategy of most mutual funds not being able to go to all cash, not being able to essentially leave a certain paradigm that they are in and, to a great extent, if you want to limit risk and you are in a fund that is 100 percent invested in small caps, or whatever, that a hedge fund is often the way, if you are a big investor like a union pension plan, that you hedge against your other investments which are 100 percent long?

Mr. SHADAB. Correct. Hedge funds are more flexible.

Mr. ISSA. Thank you. Thank you, Madam Chair.

Mrs. MALONEY. Congressman Tierney.

Mr. TIERNEY. I want to thank the witnesses here today. But Professor Lo, I want to ask you something about what you said in your testimony. You talked about the fact that we had not yet seen the full impact of the unraveling and the deleveraging of the hedge fund industry. And I think you predicted that we could see thousands more of additional entities go under. So I guess about 9,000 different hedge funds out there, estimates, and you are talking about a good healthy percentage of them are going under. What would be the potential impacts of the collapse of that many hedge funds?

Mr. LO. Well, it is hard to say because, as I mention in my testimony, we don't have a lot of information about their holdings, their leverage, the counterparties, or other aspects of their exposures. I suspect that a large number of them will be taken over by larger financial institutions, so the impact for those may be relatively minimal. But there may be a small number of very large hedge funds that have a variety of different counterparty relationships that could cause some market dislocation. And that is really the purpose of transparency is to be able to tell whether or not we are looking at a significant event or not.

Mr. TIERNEY. I think the general perception of the public with respect to these hedge funds is that, if they go under, so what? They are super rich people who understand the risk, are somewhat sophisticated, what do we care? But I have heard discussed here through some of your testimony that increasingly State and local and private pension funds are invested in them. So we really have a concern here about ordinary people involved in this, whether they know it or not, retirees, students, it could be millions of other citizens that are getting affected by that. So tell me what the impact is, if they go under, how does it affect Main Street?

Mr. LO. Well, clearly there are going to be losses faced by individual investors because one of the largest amount of assets that have come into the hedge fund industry over the last 5 years is pension funds. So there will be an impact there. The question though is really whether or not that impact is anticipated or not.

I mentioned earlier that dislocation happens not when losses occur, but when losses by individuals that are not prepared for those losses occur. The hedge funds that invest in the worst risk tranches, they are prepared for losses; but when money market funds, pension funds, mutual funds invest in AAA securities that then lose substantial value, that is really the cause for dislocation.

Mr. TIERNEY. And that is where the transparency aspect comes in, I suspect. But the transparency you are talking about is disclosure to the SEC in sort of a confidential way.

Mr. LO. That's right.

Mr. TIERNEY. What transparency is there to investors from these hedge funds? My understanding is that you could invest in this hedge fund and have no particular rights to be able to get information as to just what the investments are and what the circumstances are; is that correct?

Mr. LO. That's right. Let the buyer or let the investor beware.

Mr. TIERNEY. So here you have a pension fund investing in a hedge fund. Not only is whoever is managing the pension fund unaware, but certainly the investors--the pensioners, or whatever--are totally unaware. Do you think if that continues to hold is a good policy, or do you think that there ought to be more transparency to the investors from the manager of these hedge funds?

Mr. LO. Well, for the most part, investors would probably not be able to make use of the kind of transparency that I am proposing to the regulators. Most investors delegate their decisions, particularly involving sophisticated and highly risky investments like hedge funds, to professional managers. So the managers and the ultimate institutional investors I think would have the responsibility to monitor those kinds of risks, and of course the regulators would be focused on a different issue, which is the risk to the entire financial system.

Mr. TIERNEY. Is it too late for transparency to help individuals who belong to a retirement fund that is invested in hedge funds that may go under at this stage?

Mr. LO. I don't think it is ever too late. I think that additional transparency even now will provide some sense of what we are likely to expect to see over the next year or two, and that could help investors with their own planning for financial market dislocations yet to come.

Mr. TIERNEY. Does anybody on the panel recommend any stronger intervention on behalf of these pensioners or the State, local or private pension funds that are being invested in hedge funds and that may stand the prospect of losing significant amounts of money if as large a portion of the hedge funds go under as some have predicted?

Mr. SHADAB. I would just like to say that it is very atypical, in fact unheard of, for hedge funds not to make substantial disclosures to their investors, especially when they are institutions like pension funds. Hedge fund investors typically demand quite a bit of information from the fund and funds in order to compete for investor wealth will make substantial disclosures, and in fact more disclosures and in fact higher quality and more easily understandable disclosures than mutual funds make to their investors. It is actually much easier to be able to contact and have a discussion with a hedge fund manager about your investments in the hedge fund as opposed to a mutual fund manager.

Mr. TIERNEY. That is interesting, Mr. Shadab, because some of the information we looked at from the second panel on their funds disclosed very little information. Professor Lo, would you agree with that? I mean, it is not like they give out very specific detailed information to their investors.

Mr. LO. Well, that is right. I think it depends on the hedge fund. But by and large, hedge funds are not obligated to provide transparency to investors, and in many cases that is one of the reasons managers decide to launch hedge funds as opposed to mutual funds, to protect their proprietary information that they are using to make money for their investors.

I wanted to add one more comment to Congressman Tierney's question about pension funds, which is that one issue that we haven't talked about today is the impact of potential hedge fund failures on the PBGC's ability to make good on pension fund claims. The PBGC recently has faced significant losses because of their internal investment policies. That might actually hamper their abilities to make good on these guarantees, and that is an issue that I think we need to consider.

Mrs. MALONEY. Congressman Souder.

Mr. SOUDER. I would like to continue to follow up a little bit with Professor Lo, because you have in your written statement an extended discussion on risk, and it seems to me that that is one of the fundamental questions here.

In a general way, other than temporary aberrations, do you know of any where the yield was disconnected from the risk? In other words, has the market accurately reflected that wherever you got a higher yield, you took more risk?

Mr. LO. That has typically been the case, yes.

Mr. SOUDER. And wouldn't it also be true that the more you invested in economies that were kind of away from established economies, you would assume there would be higher risk?

Mr. LO. That's right.

Mr. SOUDER. And wouldn't you assume that the less transparency there was there would be higher risk?

Mr. LO. That's right.

Mr. SOUDER. In other words, if you are a doctor or a lawyer and you are investing in a fund that isn't very transparent, I would think that you would assume in any logical way that you were taking more risk.

Mr. LO. You should, that's correct.

Mr. SOUDER. Now, what becomes fundamental here, and what a lot of people--and understand that I voted for both versions of the rescue package, but there is a lot of bitterness in my district of Indiana, which is relatively conservative, and as we see other parts of the country struggling, where they got great rewards and now are getting penalized and expect the rest of us to pick up some of their risk because they don't want to assume the risk. Now, in your written comments, you more or less compare that. You say people have a propensity to irresponsible behavior, more or less comparing drunks, people who drink too much and go out and drive, to some of the people here who weren't paying attention to the risk part. But then those of us who don't get drunk and go out and drive are now expected to bail them out. And this is why there is so much anger at the grass roots level because there seems to be a disconnection from reward and risk because in fact not everybody took those kinds of risks, not everybody invests in the higher risk parts.

In this risk, as we look at the debate over hedge funds and other things, how much do you believe this risk was a question of the mortgage market than being the core of all the other questions?

Mr. LO. Well, I think that certainly the mortgage market was the epicenter for this series of losses, and there is a fundamental issue about how those markets grew so quickly over time without the proper infrastructure to be able to support that. And the idea behind regulation is to try to correct those kinds of market failures.

Mr. SOUDER. Do you believe that the securitization of the credit card market is starting to look like what happened in the mortgage market?

Mr. LO. It does have the same elements, yes.

Mr. SOUDER. And part of the question here is because, in your discussion of risk and what you just said in response to Mr. Tierney, is that part of the problem here is people who really weren't thinking they were getting risk in their ability to absorb risk suddenly found risk. The question there is is, where were the pension managers? In other words, part of the debate here is how much does government provide the regulation? And I have a business degree and a management degree, and the more we have these hearings, the more I am thinking is did people pay any attention in class? Did any of them really know what being a manager means? That maybe an individual goes out and gets drunk and drives, maybe somebody does irresponsible behavior, but that is why you hire pension managers. Where were they?

Mr. LO. Well, part of the problem that I mentioned in my written testimony is that we didn't have enough expertise in financial markets to properly assess these risks.

Mr. SOUDER. Let me interrupt a minute. You said--this is basic stuff--that risk was correlated with return, that where you put your money was related, that the housing market, anybody could see it was going bananas out of doubling in growth, that anybody in elementary could see that as you extend it to six paths and different tranches, you are getting farther and farther out, which normal basic management would say, go check your base, the farther out you go, go check your base; normal management would say that as you are doing more overseas risky investment, you should do that. The pension fund managers, while I understand that it wasn't perfect information, that in a sense was a warning too, the less information you have.

I am trying to come back here. Some of this has to be blamed on incompetence of management, and yet nobody will take the blame, no individual manager will take blame, no government agency will take blame, and I would argue that in fact many people got out of these markets, some funds didn't get into these markets because in fact they saw it.

Mr. LO. Well, as Warren Buffett said, "a rising tide lifts all boats." And during periods of great prosperity there is a complacency that is induced by this kind of success that blinds people to risks. And that is one of the purposes for better transparency and, frankly, for regulation.

Mrs. MALONEY. Thank you very much.

Congressman Lynch.

Mr. LYNCH. Thank you, Madam Chair, for holding this hearing, and I want to thank the panelists as well for their thoughtful advice for the committee.

Just a quick comment. I know we are trying to make comparisons to the Amaranth situation, the Amaranth collapse, as well as Long-Term Capital Management, and it is difficult to make a broad projection from just a couple of examples. But I do want to note that the Amaranth collapse was simplified in some degree by the fact that it was largely an effort to corner the market on one commodity, natural gas. And fortunately it was a good time in the market. And you are right, Mr. Shadab, that they were able to dump other higher quality corporate equities into the market. And it was a good time to sell, so they were able to cushion some of their losses.

However, if you look at the Long-Term Capital Management example, there was less than $3 billion in the fund, but they had by leverage built that up to about $100 billion and actually, by the use of complex derivatives, had a notional value of over a trillion dollars; a trillion dollars notional value, they had $3 billion in the fund. So that really spells the possibility for systemic risk, at least to me.

Let me just go back. You all have said, to some degree, with the exception of Mr. Bankman, I think, that hedge funds didn't cause this collapse, they didn't cause it. And I agree with that statement. However, I want to ask you, do you think that the structure and the opacity--and let's remember now, hedge funds have purchased the vast majority of these complex derivatives and CDOs, they are the major purchasers here. Have they amplified the negative impact of this economic downturn? If they have not caused it, has their structure and the lack of transparency and the concentration in those complex derivatives and CDOs, has that amplified the impact of the crisis? I would like you all to comment.

Mr. RUDER. I would like to take the first crack at that if you don't mind. I think that is the case. I think that the participation in the complex derivative markets by hedge funds in large quantities have contributed to the complexity of the market and to the risks that are there in the markets. And that is why I think we should have some system for having the hedge fund positions be known to a central regulator so that regulator could look at all risk positions across the markets and see where the systemic risk problems are. It might also be able to identify the Long-Term Capital Management twin in which there is a single hedge fund participant who may itself bring down the market.

Mr. LYNCH. Professor Lo.

Mr. LO. The short answer to Congressman Lynch's question is, I don't know. I don't think anybody knows because we don't have that kind of transparency to be able to say for sure whether hedge funds have exacerbated or possibly ameliorated the kind of market gyrations that have gone on in this particular area. That is one of the reasons we need transparency. However, it is the case that hedge funds, because they take on these extraordinary risks, provide a valuable service, but when those risks end up causing great losses, the opposite side of that same coin is that they can provide great dislocation.

Mr. LYNCH. Mr. Shadab.

Mr. SHADAB. A couple of things. The real core of this crisis is that banking institutions, commercial banks and investment banks, had these CDOs and other mortgage-related securities on their assets. So to the extent that hedge funds had purchased them from the banking institutions and other investors, that purchase has been taken away from banks, they have ameliorated the crisis to that extent. If these banks had gotten all the bad assets off of their books, we wouldn't have that core epicenter of a crisis happening from a banking sector, which is so important for the entire economy happening in the way we did right now.

In addition, it is important to distinguish between credit default swaps, which are derivatives, and collateralized debt obligations, which are actually securities. Now, hedge funds were very large traders, but not the largest, it was banks, of CDSs, credit default swaps. And their trading of those instruments, along with banks' trading of those instruments, have really brought liquidity and some price discovery and transparency into the risks that are associated with their underlying credit obligations. And, in fact, the fall of any institution in relation to their--

Mr. LYNCH. I am sorry, Mr. Shadab, you are burning my time. Do you think it has amplified the impact, or no? And I appreciate it, and I don't mean to cut you short, it is just that with this structure we have very little opportunity.

Mr. SHADAB. It is hard to be sure. I don't think so though.

Mr. LYNCH. That is fair enough.

Professor Lo, just with the last few seconds I have, you did mention the idea about this NTSB type organization to be able to come in. The only problem I have with that is that the NTSB usually comes and does accident reconstruction. They are not very good proactively, but they are excellent in forensically telling us what actually happened. I am out of time, but at some point I would like to hear your thoughts on how that would actually operate because I think that is actually what we need.

And I thank all of the witnesses for your testimony today.

Mrs. MALONEY. Thank you, Congressman Lynch. And if Professor Lo would like to respond to your question.

Mr. LO. Thank you, Congressman Lynch. I believe that the National Transportation Safety Board is an incredibly valuable tool for developing deeper understanding into a variety of different failures and blowups. And while you are right that the NTSB does not have any oversight responsibilities, the FAA obviously controls issues regarding airline safety, the fact is that by publishing a publicly available report that describes the details of various accidents, the public learns an enormous amount of what happened and how to prevent it from happening in the future. And I think this is the most sensible starting point for thinking about new regulations in this industry.

Mrs. MALONEY. Thank you very much.

Mr. LYNCH. Thank you. Thank you, Madam Chair.

Mrs. MALONEY. Congressman Yarmuth.

Mr. YARMUTH. Mr. Shadab, I am going to start with you. We are going to have on the next panel several people who are very wealthy and who have been involved in these types of activities. From a practical perspective, is there any difference between what any one of these next panel of witnesses can do and what a hedge fund can do; they can do as individuals what a hedge fund can do?

Mr. SHADAB. Do you mean a distinction between their own personal--

Mr. YARMUTH. Yes. I mean, you have George Soros, with a net worth of billions of dollars, you have a Warren Buffett--not on the panel--but you have a Warren Buffett with billions of dollars, you have a Michael Bloomberg with billions of dollars. Is there anything that prevents them from doing what a hedge fund does?

Mr. SHADAB. With their own personal wealth, I don't think there is anything that prevents them from doing the same thing.

Mr. YARMUTH. So in your testimony, when you say that there is a danger in regulating hedge funds because they would lose their unique benefits, why does it present a unique benefit when any individual with a lot of money can do the same thing?

Mr. SHADAB. Because it allows an investment manager not to use their own personal wealth, but to pool it from others. Sure, there are exceptions when you have hedge fund managers who over time accumulate their own large personal wealth and can basically run their own hedge funds without having to go to investors. But typically a hedge fund manager, in order to implement their trading, will need wealth from other investors.

Mr. YARMUTH. So the hedge fund manager who is putting these deals together, when you mentioned the societal benefits of hedge fund managers, that is really not what the hedge fund manager is interested in, he or she is not interested in necessarily highlighting the deficient management style of a corporation?

Mr. SHADAB. They don't need to be to create those benefits.

Mr. YARMUTH. But that is not their motivation?

Mr. SHADAB. I would say unlikely that that is the case, correct.

Mr. YARMUTH. So if we are worried about the impact, whether or not, as Professor Ruder described, we can definitively describe what the systemic risk is, we similarly cannot describe the systemic benefit of hedge funds, it seems to me either, can we, Professor Ruder?

Mr. RUDER. We could, by aggregating information, know where the hedge funds as a group are headed and be able to find out where they are hedging and what they are doing. I don't think that would be the purpose of the aggregation of risk information, but a regulator gathering information from all sources would be able to reach some conclusions and take some action, and may also even be able to issue some public statements which would help the public to know what is going on.

Mr. YARMUTH. I mean, I have a little hard time grasping this philosophically because, again, if all we are talking about is a group of individuals, let's say the members of our next panel all got together and they say we are just going to do our own hedge fund, we are going to sit together in a living room and embark upon these strategies, there would clearly be no governmental interest that I could define except maybe some kind of a conspiracy to disrupt the market. So is that really what we are talking about, is a distinction without a difference?

Mr. RUDER. I think you are talking about the aggregation of assets by the hedge funds in ways that will far surpass the billions of dollars that these individual investors have. And that is the reason that we are concerned about it.

Mr. YARMUTH. So this is a question of size. This is the whole argument about being too big to fail that we have dealt with with AIG and some of the other entities that we are talking about.

Mr. RUDER. Well, I am not talking about too big to fail in the sense that when we find a hedge fund that is going to fail that we run to bail it out. I think we need to know what the effects of that failure will be on our system and, if necessary, take some preventative steps.

Mr. YARMUTH. I tend to agree with you, that is why I am trying to ask this series of questions. Because when I read that in some cases that all the trades on the New York Stock Exchange, 5 percent of all the trades were controlled by one trader in a particular session, that is very disturbing because that is an unbelievable amount of market power.

I want to ask one question of Professor Bankman, also. I have a friend who is a person I call upon to discuss these things. He is a master of the universe, he will remain nameless. And when I talked about carried interest with him several months ago, he said the problem with doing anything with carried interest is that all the hedge funds will do is restructure their organizations so that they will convert everything into pure capital gains. They will take equity interest in the entity and then take capital gains, in which case the revenue to the Federal Government will actually be delayed--it will not increase it, it will be delayed because they will just hold the investments longer. Do you have a response to that argument?

Mr. BANKMAN. Yeah. I don't think that is going to happen. Whenever you pass a tax measure, it is always imperfect and there is always ways to get around it. And so you are always trying to come up with a compromise that is going to get revenue and hopefully not make the law too complicated and improve efficiency and equity, and there will always be ways around it. I have read the arguments that the industry is going to reorganize. And you know, the two and twenty and present form of industry organization have been around for a long time even when, by the way, capital gain was not a factor as it is not with respect to certain hedge funds. And I think experience shows that reorganizing industries and changing the way people do business is very costly and it doesn't happen very easily.

So while I think that is something to watch, I amnot convinced that that is the concern that some people think.

Mrs. MALONEY. Thank you very much.

Chairwoman Norton.

Ms. NORTON. Thank you, Madam Chair.

I am interested in a subject that is raised time and time again during this crisis, and that is the notion of regulation. It appears that we may have moved out of the mode we have been in in a kind of to be or not to be--to regulate or not to regulate, that is--to something we don't hear a lot of discussion about, if you want to regulate, who is going to do it, who is going to do it? Not a lot of meat on those bones. Indeed, there may be a contest among various agencies. So I looked at your testimony.

Let's start with you, Professor Lo. You raised the idea, and it is interesting, you say that one would have to expand the scope--of course one would, one doesn't think of the Federal Reserve as such a regulatory agency--but you raise the notion of the Federal Reserve as the direct oversight agency for these largest of these funds. Why do you think the Federal Reserve is the best of the agencies to do such regulation?

Mr. LO. Well, primarily because the main issue regarding hedge funds and systemic risk is their impact on the liquidity of markets. And as we know, the Federal Reserve is the lender of last resort, they are the manager of market liquidity. So if it is a liquidity issue that threatens the global financial system through the hedge fund industry, the Federal Reserve would be the natural regulatory agency to focus on that.

Ms. NORTON. Chairman Ruder, in your testimony you suggest the agency you chaired, the SEC, to essentially have hedge funds register with the SEC. How do you think a rule to register with the SEC would improve its ability to monitor and--think this crisis now--would help to reduce the systemic risks we have seen?

Mr. RUDER. Well, first of all, I think that the registration provisions ought to extend to hedge funds, as they do not under the current law. Secondly, the registration would allow the SEC to engage in inspection activities. But currently they do not have the power, even in the inspection of investment advisers, to seek risk management information. And I would expand that inspection power so that they would be able to go into a hedge fund adviser and find out what are the risk management systems that are being used; what are the nature and extents of the risks, and who are the counterparties. And that would help the SEC, first of all, to make some judgments about whether the risk management systems are good and, secondly, to pass information on to a central regulator, such as the Federal Reserve Board, to aggregate that information and come to some decisions about how to manage the liquidity risk on the economy.

Ms. NORTON. I wish you would tell me the difference between what you are proposing now and the rule apparently in 2004 that the SEC actually passed. The hedge fund sector, however, heavily lobbied against the rule, and it was ultimately overturned by the courts. Chairman Cox from the

SEC did not seek to appeal it and did not come to Congress for new authority. So the SEC, I take it, has no authority now, not even the authority under that rule. What is the difference between that rule and the rule, if any, that you have in mind?

Mr. RUDER. Well, the Goldstein case overruled the SEC's attempt to have inspection rights over hedge fund advisers, and the Commission did not appeal that ruling.

Ms. NORTON. Did you support that rule?

Mr. RUDER. Yes. I support the fact that they should have inspection right over all hedge fund advisers. And as I said, I think that is going to take congressional action. And I think the inspection power ought to be increased so that they are able to get the kind of risk management information that is needed to protect society.

Ms. NORTON. Well, Professor Lo, do you see this kind of marriage between the SEC and the Federal Reserve that could come out of, listening to both of you, that the information would be passed on to the Federal Reserve and then you would have a regulatory setup that we could have confidence in?

Mr. LO. Well, no, I don't, Congressman Norton. I feel that there is a different--there is a different purpose for registration under the '40 act, which is investor protection. Investor protection is a separate issue from systemic risk. And I believe that even now, if you ask all hedge funds to register under the Investment Advisers Act, they will not provide the kind of information that we need in order to get transparency.

Ms. NORTON. So transparency is not enough, you need somebody to be a regulator; and you think that should be the Federal Reserve?

Mr. LO. That's right.

Mr. RUDER. Could I just comment? What I am saying is you need to have an expansion of the inspection power. The Federal Reserve already can receive information from the banking sector. And the Federal Reserve's administration of the banking sector has different objectives than the SEC's regulation of the securities sector. Banking regulators are concerned about safety and soundness of banks; the SEC is concerned about the capital markets and the matter of risk-based activities. I think we need two regulators sharing information rather than a single regulator.

Ms. NORTON. Professor Lo, would you like to respond to that?

Mr. LO. It is always dangerous to disagree with a former Chairman of the SEC, but let me say that I think the information regarding systemic risk is different from the information under the Investment Advisers Act. And with regard to garnering information about systemic risk, it is possible to obtain that, not necessarily directly from hedge funds, but from the prime brokers that have all of the positions, all the leverage and all of the counterparties among the hedge funds. So it is now possible to obtain that information very efficiently from a very small number of prime brokers.

Ms. NORTON. Thank you very much, Madam Chair.

Mrs. MALONEY. Mr. Cooper is recognized for 5 minutes.

Mr. COOPER. Investors need to know how to swim, but we have also got to keep the sharks out of the pool. When you have large pension funds investing in hedge funds, shouldn't there be truth in advertising so that they know whether it is a true hedge fund or whether it is not hedging at all, but in fact speculating heavily? And shouldn't, perhaps, the speculative funds be called speculative funds? But the current situation with trade secrets, a black box surrounding the true investment strategy, pension managers don't really know whether they are getting hedging or speculation.

Professor Lo.

Mr. LO. What I would argue is that it is always a good idea to have truth in advertising, and certainly that applies to the hedge fund industry as well as any other. Another example of truth in advertising is money market funds that have the one dollar NAV, but in fact don't have that kind of guarantee for that one dollar and they break the buck. That is another example of less than truth in advertising.

Mr. COOPER. What about volatility-only strategies? The roller coasters we see in the market, 500 point swings in a day, that is neither long or short. Is that productive behavior? When Joseph Schumpeter said capitalism is the process of creative destruction, he really didn't endorse the roller coaster at the same time, did he?

Mr. LO. Well, in a way I think Schumpeter did because his argument is that free flowing capitalism is going to require occasional blowups just like what we are going through now, and out of the ashes a much stronger capitalistic system should arise.

Mr. COOPER. Well, why not 1,000 point swings in a day, or 2,000 point swings; wouldn't that be even more productive?

Mr. LO. Not necessarily. It depends upon whether the underlying economics justifies it. But as I said, if you have the proper disclosure for investors, if they are prepared for those kinds of swings, then that would be fine.

Mr. COOPER. "If" can be the longest word in the English language. What about want-to-be hedge fund managers, not just rogue traders for folks inside perhaps large commercial banks who get enough leeway to pretend they are hedge fund managers, how significant a sector would this be and how dangerous are they?

Mr. LO. Well, clearly that does pose a danger, but hopefully over time those managers ultimately get weeded out.

And the process of hedge funds closing and new hedge funds rising I think really underscores that kind of birth and death process.

Mr. COOPER. Well, these wouldn't necessarily be authorized, the push for yield is so great. Sometimes you can look the other way and these operations are so vast you don't necessarily know what in fact is being done.

Mr. LO. I agree.

Mr. COOPER. Is there a way to measure the size or significance of a want-to-be hedge fund?

Mr. LO. Currently, no, there is no way because we don't have that level of transparency. That is one of the reasons that I think all of us are calling for that.

Mr. COOPER. I think the key area is going to be the interaction between hedge funds and derivatives. As I understand derivatives, it is possible to buy derivative products with embedded leverage. So when you, in your excellent testimony, cited relatively low leverage ratios, especially recently, you have to really look at the combined measure of leverage, don't you? And still the committee is without information on that, the true leverage that is in fact involved.

Mr. LO. That's right. That is another area where I think greater transparency is necessary. Leverage by itself is not necessarily a bad thing, but undisclosed it can be.

Mr. COOPER. Should there be capital requirements for derivatives?

Mr. LO. I agree with Mr. Ruder that we need to have organized exchanges, standardized contracts, and a clearing corporation for certain OTC derivatives like credit default swaps.

Mr. COOPER. How are these hedge funds going to operate without investment banks now that all the major investment banks have converted into bank holding companies? And I guess the real question is, how are they going to operate without the deep capital markets that they were accustomed to?

Mr. LO. Well, hedge funds are nothing if not adaptive. And my sense is that they will certainly adapt to this new economic reality very quickly; in fact, I believe that they already have. And new hedge funds are being started to take advantage of the kind of opportunities that are presented by current market conditions.

Mr. COOPER. I see that my time is expiring.

Chairman WAXMAN. Mr. Sarbanes.

Mr. SARBANES. Thank you, Madam Chair. I thank you all for your testimony.

I wanted to get to this concept of the sophisticated investor a little bit more because it is sort of the underpinning of the original exemptions from the statutes that are quite old now, and must have been based on premises and a rationale that is obsolete in many ways. And as I listen to this discussion, the exemptions are designed for people who are sophisticated, for institutional investors and so forth. But it seems like the standard for exemption ought not to be so much the sophistication, although I would like you to tell me if you think, Professor Bankman, for example, whether anyone can be sophisticated enough these days to warrant an exemption? But the standard maybe ought to be not how "sophisticated" you are, but what kind of investments you are holding, who is giving you their money to invest and how much damage can you do with it.

So speak to that, because I think that is going to--reassessing this concept of the sophisticated investor may be the foundation for the overall redesign of the regulatory framework in this particular arena. So maybe you can talk to that.

Mr. BANKMAN. Well, you probably don't want the tax guy on the panel. So I think I should throw that to my colleagues here probably.

Mr. RUDER. Well, the Securities and Exchange Commission has recognized the need for higher dollar limits to create a threshold for accredited investors. And it has a proposal it has made but not adopted saying that you have to have $5 million in investable assets in order to become a sophisticated investor and be able to invest in a pool of vehicles. That is a very good step in the right direction. The problem is, as we begin to say who is sophisticated and who is not sophisticated, it is not always that dollar levels are going to be the determining amount.

We have already been wondering how some of the pension funds got involved in the hedge fund area, and there all I can say is that we have to draw a line someplace and say we are going to put the responsibilities on the stewards of other people's money to make proper investigations. We can't proceed by bright line dollar numbers in every case to make distinctions because at some point by putting bright dollar levels at the high, high levels we are going to prevent the kind of investment we have had.

So I think the Commission is on the right track going towards a $5 million assets under investment as a bright line.

Mr. SARBANES. Professor Lo, do you want to talk about this sophistication concept?

Mr. LO. Sure. You know, in financial markets there is a common risk of confusing your W-2 with your IQ. Just because you are wealthy does not necessarily make you sophisticated. So I have always thought that the sophisticated investor threshold was really more about the ability to withstand losses. But I think when it comes to institutional investors where there is a fiduciary responsibility, for example, pension plan sponsors, it may make sense to actually impose some kind of an educational minimum so that we can be assured that a pension plan sponsor that has fiduciary responsibilities to pension plan participants would be investing wisely.

Mr. SARBANES. I guess what I am struggling with is you are looking at this in terms of what the burden is on the investor to demonstrate their sophistication and I am thinking about it in terms of the arena into which that investor goes and whether that arena is regulated. The concept seems to be that once a group of people are determined to be sophisticated then you are going to let them into a ring that is completely unregulated because they are sophisticated. But you may be letting them into a ring where they can do a lot of damage, where they can run over a lot of innocent bystanders and so forth. So that standard ought to be operating more than it has in terms of deciding whether to regulate that area.

Mr. LO. Well, I would agree with that wholeheartedly, but I would also add that, in defense of pension plan sponsors that have put money in hedge funds, first of all, by and large their amount of investments that they have put into hedge funds is fairly low, probably less than 5 percent of pension assets in the aggregate.

Second, if you look at the performance of hedge funds as a category, as a broad group for 2008, hedge funds are probably down on average 10 percent to 15 percent for the year, where as the S&P is down about 30 to 35 percent for the year. And so the idea behind hedge funds being able to take short positions and benefit from down markets, that is something that pension plans have benefited from. However, there are blowups that occur, and that is one of the reasons I have argued that we need to examine those blowups to make sure that other investors, including pension plan sponsors, are fully aware and fully prepared for those eventualities.

Mr. SARBANES. And of course, as we discussed with Chairman Greenspan, when blowups occur the people that get hurt are not just the ones that are driving the train or driving the car, or whatever, it is this group of bystanders that gets pulled in as well.

Thank you.

Chairman WAXMAN. [Presiding.] Thank you, Mr. Sarbanes.

Mr. Van Hollen.

Mr. VAN HOLLEN. Thank you, Mr. Chairman. And I thank all of you gentlemen for your testimony.

Professor Ruder and Professor Lo, I have some questions related to your proposal to require greater transparency. I think we have talked a little bit about the history of efforts to provide greater transparency and reporting requirements, for example, putting hedge funds under some of the reporting requirements and jurisdiction of the SEC, both to protect investors, including, as we have heard, lots of pension funds, as well as to address the potential for systemic risk and have an early warning system to detect that.

Let me just take that one step further. Assuming we change the law and provide for greater transparency and allow the SEC to get this information--I understand you are suggesting on a confidential basis--what powers would you suggest the SEC have when it looks at that information and says that either the investors are at risk or you face a systemic risk? Would you be proposing the SEC also have additional powers, for example, changing leverage requirements with respect to a particular hedge fund if, based on the information they collect, they say hey, we have a real problem here? What additional powers would you give to the SEC if they reveal, through their investigation, a serious threat either to the investors or a systemic risk?

Mr. RUDER. I am not suggesting that the SEC be given that kind of power. I think the SEC should learn what the management systems are, inspect those management systems, risk management systems, and criticize the way they are operating.

With regard to the broad information about leverage, about risk positions, I think that should go to a regulator such as the Federal Reserve Board, which would then be able to aggregate that information and take some steps regarding the entire economy. I think it would be wrong for the result of this regulatory reform that we are going through to have some government agency try to tell investors what their leverage should be. The exception of that, of course, is in the banking area, where the banking credential regulators do impose leverage requirements. But I think for the high-risk individuals, including the hedge funds, we should not be doing that.

Mr. LO. Well, at this point, I think it would be premature for me to propose any kind of additional powers to be granted to the SEC or any agency since there is so little that we know about the sector. But as a hypothetical, if the kind of information that Professor Ruder and I propose to be disclosed shows a very large and isolated risk for one or two too-big-to-fail organizations, at that point it may be the case that the Federal Reserve would be called in to impose either capital adequacy requirements or maximum leverage constraints on that too-big-to-fail institution. But that is still very much a hypothetical.

Mr. VAN HOLLEN. Let me just follow up a little bit on that point. I mean, the Federal Reserve today would have the power to go and do that now, so let me make sure I understand both your testimony. You, Professor Ruder, wouldn't give that to the SEC. And I understand, Professor Lo, you would say that if the SEC found something that would be a big problem for the economy, they would then go to the Federal Reserve. But let me just make sure I understand. Would that require that Congress provide the Federal Reserve with additional authorities with respect to hedge funds in this area to take action?

Mr. LO. I believe so.

Mr. RUDER. I believe so, too. It probably should be the Federal Reserve, but you have the Treasury blueprint talking about a market stability regulator, somebody that might play that function. I happen to think that the Federal Reserve is the right agency to do that.

Mr. VAN HOLLEN. If I could just ask you a quick question on the short positions. There is a lot of discussion about the role of hedge funds and naked short selling. Of course the SEC took action. Do you think that hedge funds should be required to disclose their short positions on an ongoing basis?

Mr. LO. Well, I believe that under certain conditions it may be advisable for hedge funds to disclose, but not necessarily publicly. Hedge funds spend a lot of time and effort developing models and information about over-valued companies. That information is extraordinarily important to get into the capital markets. If we eliminate the incentives for them to do so, we will hurt the informational efficiency of markets. But there are certain situations that may call for kind of a 13-F filing for short positions, but not necessarily to be made public, but to be given to regulators.

Mr. VAN HOLLEN. But let me just ask you; would you, on a confidential basis to the regulator, would you have that on an ongoing basis, the short selling disclosed?

Mr. LO. Yes.

Mr. VAN HOLLEN. Professor Ruder.

Mr. RUDER. I agree with that. He refers to 13-F. That is the kind of filing that is required when the numbers get fairly high. So that we wouldn't be just asking for all short sale positions to be revealed, but only the very large ones.

Mr. VAN HOLLEN. Thank you, Mr. Chairman.

Chairman WAXMAN. Mr. Shays.

Mr. SHAYS. Let me ask you this basic question: What is the greatest value--I realize you can't repeal the law of gravity, so I am not looking to get rid of hedge funds. But tell me the greatest advantage or value to society of hedge funds and the greatest disadvantage of hedge funds. I would like to go down the line.

Mr. RUDER. Well, the hedge funds provide liquidity to the system because they invest and they sell short. They provide price discovery by choosing the way they invest. They provide the additional benefits of being large participants in the system.

Mr. SHAYS. Would anyone add any additional advantage to a hedge fund? Yes, sir.

Mr. SHADAB. One additional social benefit that hedge funds have created is disciplining corporate managers with whom they invest. Not a large percentage of hedge funds are devoted to being corporate activists, but the ones that are corporate activists actually do very well at disciplining management. For example, a recent study has shown that if a hedge fund takes a corporate activist position in a company, CEO compensation would typically decrease by, let's say, a million dollars, and an overall long-term value is created for the other company shareholders.

Mr. SHAYS. Any other advantage?

Tell me the greatest disadvantage or greatest risk of hedge funds.

Mr. RUDER. Well, the hedge funds do take positions, particularly in the derivatives market and particularly at using leverage, which create tremendous risks. And it may be that one hedge fund would be in a position to create calamity in the market, or it may be the aggregation of a number of hedge fund positions might cause problems.

Mr. SHAYS. Anybody want to add something to that?

Mr. RUDER. I would add one more. When they begin to sell in times of stress, they do cause dislocations in the market in terms of asset sales and stock sales.

Mr. SHAYS. I represent--at least until the end of next month--the largest concentration of hedge funds I think in the world in the Fairfield County/New York area. In other words, they either sleep in the district and work in New York or they actually work in the district as well. And their argument to me constantly was, you know, these folks know what they are doing, they have got the money to risk and they know what they are doing, they are wise investors and they would suggest large, you know, universities and so on who know the risks. And never then was it discussed that, in a sense, Wall Street could bring down Main Street.

Was it obvious to all of you in the last 5 or 6 years that we were going to encounter what we are encountering now? I would like to ask each of you. And let me start backwards.

Mr. Shadab.

Mr. SHADAB. Yes, because housing prices could not keep going up forever.

Mr. SHAYS. But this was obvious to you, that we would be dealing with the kind of mess we are in right now?

Mr. SHADAB. Not necessarily the extent of it, no.

Mr. BANKMAN. Well, I am just a tax guy. So I am going to pass to Professor Lo.

Mr. SHAYS. You are just a coward.

Mr. LO. Well, I may not use the word "obvious," but starting in 2004 I published a series of papers highlighting the fact that there was growing indirect evidence that a dislocation in the hedge fund industry was building, and so certainly the indirect evidence seemed to show that that was the case.

Mr. RUDER. In 1998, I testified before the House Banking Committee suggesting that there be the kind of information disclosure I suggested today, so that 10 years ago I was concerned about this problem of opacity in this market.

Mr. SHAYS. Well, part of my question for asking is--good for you. And, you know, sometimes we don't notice the people who were out in front years ago attempting to make this point heard.

The head of Lehman Brothers, Dick Fuld, in a hearing before this committee, laid a large deal of blame for Lehman's collapse on hedge funds shorting the stock. Would any of you care to comment on that?

Mr. SHADAB. I think that is sort of reversing the cause and effect. A prominent hedge fund manager, David Einhorn, back in March of this year, he called out Lehman Brothers' financial statements and saying, wait a second, you are not fully disclosing all of your risks with investors. He sold the stock short. So the problem was Lehman Brothers, not the short sellers. They attracted the short sellers because of their financial mismanagement.

Mr. SHAYS. So the bottom line is you don't agree?

Mr. SHADAB. Correct.

Mr. LO. I would say don't kill the messenger.

Mr. RUDER. And I don't, no.

Mr. SHAYS. Don't kill the messenger. Who is the messenger?

Mr. LO. The messenger in the sense are the short sellers that are trying to get the message across that a company is overvalued.

Mr. SHAYS. Is it necessary to increase regulation on hedge funds, or would creating an exchange for derivatives trading be sufficient?

Mr. RUDER. I think the creation of standardized derivative contracts and this clearing and settlement and exchange trading would be a very fine step in the right direction. We are having today steps towards creating a clearance and settlement platform for derivative contracts. I think that is a very good step in the right direction to overcome the opacity and counterparty risk problems we have.

Mr. LO. I agree, but I don't think that we know whether or not it would be sufficient.

Mr. SHADAB. I think that goes too far to push all derivatives onto a centralized exchange. I think the only problems that we have had with the credit default swaps is with either involvement with insurance companies and model line insurers, not a typical derivatives trader.

Mr. SHAYS. Thank you, Mr. Chairman.

Chairman WAXMAN. All members having asked questions, I want to thank this panel for your testimony. It has been very helpful to us, and we appreciate you being here.

RPTS STRICKLAND

DCMN SECKMAN

Chairman WAXMAN. We are going to take a 5-minute recess while we seat the next panel. So we will reconvene in 5 minutes.

[Recess.]

Chairman WAXMAN. The committee will please come back to order.

Our second panel consists of five of the most successful hedge fund managers of 2007. George Soros is the Chairman of Soros Fund Management. James Simons is the President of Renaissance Technologies. John Paulson is the President of Paulson & Company. Philip Falcone is the senior managing partner of Harbinger Capital Partners. And Kenneth Griffin is the president and chief executive officer of Citadel Investment Group.

And we are pleased to welcome all of you to our hearing today.

I appreciate your being here and cooperating with our committee. I understand Mr. Falcone had to reschedule an overseas business trip to join us today, and I particularly appreciate the fact that he is here.

STATEMENTS OF JOHN ALFRED PAULSON, PRESIDENT, PAULSON & CO., INC.; GEORGE SOROS, CHAIRMAN, SOROS FUND MANAGEMENT, LLC; JAMES SIMONS, PRESIDENT, RENAISSANCE TECHNOLOGIES, LLC; PHILIP A. FALCONE, SENIOR MANAGING PARTNER, HARBINGER CAPITAL PARTNERS; AND KENNETH C. GRIFFIN, CHIEF EXECUTIVE OFFICER AND PRESIDENT, CITADEL INVESTMENT GROUP, LLC.

Chairman WAXMAN. It is the practice of this committee that all witnesses that testify before us do so under oath. So I would like to ask each of you before you even begin giving your testimony that you stand and raise your right hand.

[Witnesses sworn.]

Chairman WAXMAN. Thank you.

The record will indicate that each of the witnesses answered in the affirmative.

Your prepared statements will be in the record in full. What we'd like to ask each of you to do is to make a presentation to us, mindful of the fact that we will have a clock that will be green for 4 minutes, orange for 1 minute and then red at the end of 5 minutes. And at that point, if you see that it is red, we would like to ask you to conclude your oral presentation to us. We are going to want to leave enough time for questions by the members of the panel.

Mr. Soros, we'd like to start with you. There is a button on the base of the mike, be sure it is pressed in. Proceed as you see fit.

STATEMENT OF GEORGE SOROS

Mr. SOROS. Thank you, Mr. Chairman.

We are in the midst of the worst financial crisis since the 1930s. The salient feature of the crisis is that it was not caused by some external shock, like OPEC raising the price of oil. It was generated by the financial system itself.

This fact, that the defect was inherent in the system, contradicts the generally accepted theory about financial markets. The prevailing paradigm is that markets tend towards equilibrium. Deviations from the equilibrium either occur in a random fashion or are caused by some sudden external event to which markets have difficulty in adjusting.

The current approach to market regulation has been based on this theory. But the severity and amplitude of the crisis proves convincingly that there is something fundamentally wrong with it.

I have developed an alternative paradigm that differs from the current one in two important respects: First, financial markets don't reflect the underlying conditions accurately. They provide a picture that is always biased or distorted in some way or another.

Second, the distorted views held by market participants and expressed in market prices can under certain circumstances affect the so-called fundamentals that market prices are supposed to reflect. I call this two-way circle of connection between market prices and the underlying reality "reflexivity." I contend that financial markets are always reflexive, and on occasion, they can be quite far away from the so-called equilibrium. In other words, it is an inherent characteristic of financial markets that they are prone to produce bubbles.

I originally proposed this theory in 1987, and I brought it up to date in my latest book, "The New Paradigm For Financial Markets: The Credit Crisis of 2008 and What It Means." I have summarized my argument in the written testimony I have submitted. Let me recall briefly the main implications of the new paradigm for the regulation of financial markets.

The first and foremost point is that the regulators must accept responsibility for controlling asset bubbles. Until now, they have explicitly rejected that responsibility.

Second, to control asset bubbles it is not enough to control the money supply. It is also necessary to control credit because the two don't go in lock step.

Third, controlling credit requires reactivating policy instruments which have fallen into disuse, notably margin requirements and minimum capital requirements for banks. When I say reactivate them, I mean that the ratios need to be changed from time to time to counteract the prevailing mood of the markets because markets do have moods.

Fourth, new regulations are needed to ensure that margin requirements and the capital ratios of banks can be accurately measured. The alphabet soup of synthetic financial instruments, CDOs, CDSs EDSs and the like, have made risk less apparent and harder to measure. These new products will have to be registered and approved before they can be used and their clearing mechanism has to be regulated in order to minimize counterpart risk.

Fifth, since financial marketings are global, regulations must also be international in scope.

Sixth, since the quantitative risk management models currently in use ignore the uncertainties inherent in reflexivity, limits on credit and leverage will have to be set substantially lower than those that have been incorporated in the Basel Accords on bank regulation. Basel 2, which delegated authority for calculating risk to the financial institutions themselves, was an aberration and has to be abandoned. It needs to be replaced by a Basel 3 which will be based on the new paradigm.

How do these principles apply to hedge funds? Clearly hedge funds use leverage and they contribute to market instability in times like the present when we're experiencing wholesale and disorderly de-leveraging. Therefore, the systemic risks need to be recognized and more closely monitored than they have been until now. The entire regulatory framework needs to be reconsidered, and hedge funds need to be regulated within that framework. But we must be aware of going overboard with regulation.

Excessive deregulation is at the root of the current crisis, and there is a real danger that the pendulum will swing too far the other way. That would be unfortunate because regulations are liable to be even more deficient than the market mechanism itself. That's because regulators are not only human but also bureaucratic and susceptible to political influences.

It has to be recognized that hedge funds were an integral part of the bubble which has now burst, but the bubble has now burst, and hedge funds will be decimated. I will guess that the amount of money that they manage will shrink between 50 and 75 percent. It would be a grave mistake to add to the forced liquidation currently depressing markets by ill-considered or punitive regulations. I'd be happy to expand on these points in greater detail in answering your questions.

[Prepared statement of Mr. Soros follows:]

******** INSERT 3-1 ********

Chairman WAXMAN. Thank you very much, Mr. Soros.

Mr. Simons.

STATEMENT OF JAMES SIMONS

Mr. SIMONS. Okay. Well, good morning.

Chairman WAXMAN. There is a button at the base of the mike you have to press--

Mr. SIMONS. I think it's on.

Chairman WAXMAN. Okay. Good.

Mr. SIMONS. Good morning, again Chairman Waxman and Ranking Member Davis. Members of the committee, I'm James Simons. I'm Chairman of Renaissance Technologies, and in my opinion, this series of hearings is quite important. And I appreciate your interest in trying to understand what this is all about.

Now, in my view, this crisis has a number of causes: The regulators who took a hands-off position on investment bank leverage and credit default swaps; everybody along the mortgage-backed securities chain who should have blown a whistle rather than passing the problem on; and in my opinion the most culpable, the rating agencies, which in effect allowed sows' ears to be sold as silk purses.

Before addressing the committee's questions, I would like to say a little bit about myself and my company because Renaissance is a somewhat atypical investment management firm. Our approach is driven by my background as a mathematician. We manage funds whose trading is determined by mathematical formulas. We operate only in highly liquid publicly traded securities, meaning we don't trade in credit default swaps or collateralized debt obligations or some of those alphabet soup things that George was referring to. Our trading models actually tend to be contrarian buying stocks recently out of favor and selling those recently in favor.

We manage three funds. Our flagship fund, Medallion, accounts for nearly all of our income and is almost entirely owned by Renaissance employees. We charge ourselves fees, which has the effect of shifting income away from the largest owners of the firm, like me, to the rest of the employees. Our two new funds designed for institutional investors are both lightly leveraged and charge fees roughly half of those charged by most hedge funds.

I will now turn briefly to the questions that the committee asked. Do hedge funds cause systemic risk? In my view, hedge funds were not a major contributor to the recent crisis, and generally, hedge funds have increased liquidity and reduced volatility in the markets. Moreover, because of their remarkably diverse strategies, hedge funds as a class are unlikely to create systemic risk, although it is not out of the question that they could.

Hedge funds do use leverage, and--but here is an important point--each hedge fund's leverage is controlled by its lenders which is far more than one could say for investment banks.

Will hedge funds require further regulation? I do think additional regulation focused on market integrity and stability will be useful, and I will get back to that.

Should hedge funds be registered with the SEC? Well, we have always been registered, at least for 10 years, and we are certainly not opposed to an appropriate registration requirement.

Should hedge funds be more transparent? Well, transparency to appropriate regulators can be helpful. And as Professor Ruder said very well--described a procedure which was also in my written testimony--you may wish to consider requiring all market participants to report their positions to an appropriate regulator and then allowing the New York Fed to have access to aggregate position information and to recommend action if necessary.

This is pretty much what Ruder said. I'll say it again. I stress, however, that the fund-specific information should not be released publicly, which could do more harm than good.

Does the compensation structure of hedge funds lead to excessive risk taking? This question doesn't really apply to us as almost all of our income is based on profits on our own capital, but generally speaking, I think not. The statistics bear this out to some extent. Compare the 7 percent annual volatility of the hedge fund index to the 15 percent annual volatility of the S&P over the last 10 years. Thus hedge funds appear to be at least on the cautious side. Moreover--obviously there are exceptions. Moreover, typically a manager's largest investment is in his own fund.

Is special tax treatment for hedge fund managers warranted? Well, I would only say that, if Congress decides that it is good policy to alter the tax treatment of carried interest, that change should apply to all partnerships, private equity, oil and gas, real estate, et cetera, all of which are based on that same principle, not just hedge funds. And I personally would have no objection whatsoever to such a change.

Before concluding I would like to reflect on how we could help get out of this hole and make proposal to prevent us getting back in.

So I think that in the near term the most important thing we can do is keep people in their homes, even if their mortgages are in default. This would help millions of families already coping with a tough economy and would maintain higher home values than would foreclosure. This would also mitigate losses on the securities collateralized by these mortgages. Now, there have been a member of proposals on how to do this, and I won't opine on which is best.

Now, Mr. Chairman, you mentioned you had a hearing on the failure of the credit rating agencies. And I particularly appreciate your attention to that issue. I propose a new rating agency. Historically the bond rating agencies were paid by the bond buyers, which was natural because it was they whom they were supposed to be serving. But in the 70s, the agencies began to be paid by the bonds issuers. Now, despite the obvious conflict of interest, the new model worked okay with conventional type bonds, but until the advent of financially engineered products.

Now even though I don't trade these products, I believe in their value. I think they are good. But the organizations rating them must owe their allegiance to buyers, not to issuers.

I, therefore, encourage the major holders of these bonds such as CalPERS, TIAA, PIMCO, et cetera, to sponsor a new nonprofit rating agency focused on derivative securities. Congress might consider chartering such an organization, having board representation from appropriate regulators. Revenues come could from buyer-paid fees on each transaction, which I think would be minuscule. These complex instruments would then be subject to proper analysis and rating. The interests of buyers and raters would be aligned, and the likelihood of again seeing a problem like this one would be dramatically reduced.

Thank you, and I look forward to your questions.

[Prepared statement of Mr. Simons follows:]

******** INSERT 3-2 ********

Chairman WAXMAN. Thank you very much, Mr. Simons.

Mr. Paulson.

STATEMENT OF JOHN ALFRED PAULSON

Mr. PAULSON. Chairman Waxman, Ranking Member Davis, and members of the committee, thank you for inviting me to appear today.

Paulson & Co. is an investment advisory firm that was founded in 1994. We currently manage assets of approximately $36 billion using event driven strategies. We are based in New York and also have offices in London and Hong Kong. We have approximately 70 employees.

Chairman WAXMAN. There is a question whether your mike is on. Is the button pressed?

Mr. PAULSON. All of the investment funds we manage are open only to qualified purchasers, those with a minimum $5 million in investable assets if they are individuals and $25 million in investable assets if they are institutions. Our investors include pension funds, endowments and foundations.

These investors look to us to protect their capital and to show positive returns in both good and bad markets. We do this by going long securities that we think will rise in value and by going short securities that we think will decline in value.

We have been able to operate profitably in 14 out of the last 15 years, including this year when the S&P is down over 40 percent.

We believe that our ability to protect our investors' capital and generate positive returns over the long term is the reason we have grown to be one of the largest hedge funds in the world.

Regarding compensation, we share profits with our investors on an 80/20 basis, where 80 percent of the profits go to the investors and 20 percent remains with us. We only earn performance allocations if our investors are profitable. All of our funds have a high water mark, which means that if we lose money for our investors, we have to earn it back before we share in future profits. Some of our funds also have a claw-back provision which requires us to return profits earned in prior periods if we lose money in subsequent periods. In addition, we invest or own money alongside that of our clients, so we share investment loss along with gains.

We are a private company and have no public shareholders. We receive no taxpayer subsidies. All of our investors invest with us on a voluntary basis. We also use very little leverage. Over the past 5 years, for over half the time, our base portfolios were not funded with any borrowed money, and our maximum borrowing over the last 5 years as a percentage of equity capital was only 33 percent.

In February 2004, we voluntarily registered with the SEC as an investment advisor. As a Registered Investment Advisor we are subject to periodic inspections, focused reviews, and ad hoc requests for information. We are also subject to stringent recordkeeping requirements and have to file information regularly with the SEC.

We comply with all rules and regulations, not only in the U.S. but in each of the over 15 countries where we invest.

As Americans, we are proud of the leadership position the United States occupies in this industry, the jobs our industry has created, the export earnings we have produced our country, and the taxes that we generate for the Treasury. For example, over the last 5 years, our firm has increased our employee count by 10 times, creating numerous high-paying jobs for Americans.

In addition, 80 percent of our assets under management come from foreign investors. The revenues we receive from foreign investors allow us to contribute to the U.S. economy like an exporter of goods bringing in money from abroad.

In 2005, our firm became very concerned about weak credit underwriting standards, excessive leverage amongst financial institutions, and a fundamental mis-pricing of credit risk. To protect our investors against the risk in the financial markets, we purchased protection through credit default swaps on debt securities we thought would decline in value. As credit spreads widened and the value of these securities fell, we realized substantial gains for our investors.

We have offered suggestions on the causes of the credit crisis and what the U.S. Government can do to help the situation. I also have some recommendations on how future purchases of preferred stock under the TARP can be structured both to protect taxpayers better and to provide greater stability to financial institutions, and I would be pleased to share those thoughts with you.

Again, thank you for the opportunity to address this committee.

[Prepared statement of Mr. Paulson follows:]

******** INSERT 3-3 ********

Chairman WAXMAN. Thank you very much, Mr. Paulson.

Mr. Falcone.

STATEMENT OF PHILIP A. FALCONE

Mr. FALCONE. Thank you, Chairman Waxman, Ranking Member Davis, and other members of the committee.

My name is Philip Falcone. I am the senior managing director and cofounder of the Harbinger Capital Partnership fund. I'm extremely proud of the work that we have done at Harbinger. Year in, year out, we have generated substantial returns for our investors, which include pension funds endowments and charitable foundations. We have achieved our success for our investors by doing things the right way. Through our investments we have also provided much-needed Capitol to American companies, supporting them as they pursue their business plans and giving them a second chance to reach their potential.

I appreciate the committee holding today's hearing in order to learn more about hedge funds and their positive role in the financial markets. I am hopeful that this committee can take four points away from today's testimony.

Number one, compensation in the hedge fund industry is performance based. I think that is the right way to do business because it creates incentive for hard work and innovation.

Number two, hedge funds use a variety of investment strategies, including traditional approaches. Investors, especially large institutions, want a broad array of strategies and disciplines so they can diversify their portfolios.

Number three, short selling is a valuable long-standing feature of our markets. It isn't short selling that puts companies out of business but rather over-leveraged balance sheets, poor management decisions, and flawed business plans.

Number four, I support greater transparency and better reporting in the hedge fund sector.

I would like to take a moment to tell you a little bit about myself. I currently reside in New York City with my wife of 11 years and two children. By way of background, I was born in Chisholm, Minnesota, population 5,000 on the Iron Range of northern Minnesota. I was the youngest of nine kids who grew up in a three-bedroom home in a working class neighborhood. My father was a utility superintendent and never made more than $15,000 per year, while my mother worked in the local shirt factory.

The point of all this is I take great pride in my upbringing, and it is important for the committee and the public to know that not everyone who runs a hedge fund was born on Fifth Avenue. That is the beauty of America and the beauty of the potential in our industry.

Through hard work and perhaps a little bit of luck, Harbinger Capital Partners has been able to generate substantial returns for our investors since 2001. Our investment philosophy is very simple: We study, often for months, the fundamentals of companies to identify those that are undervalued or overvalued, and we act decisively when opportunities present themselves. We are not momentum traders nor are we day traders. We are investors. It is not magic. My analysts perform thorough due diligence rather than relying on rating agencies or other research reports, like many of the reports that improperly valued securitized mortgage products over the past few years.

My compensation is based upon the returns that we generate for our investors, which have far exceeded the performance of the overall market. There is no doubt that as result of the success of Harbinger Funds, I have done extremely well financially. But this is not the case where management takes huge bonuses or stock options while the company is failing. My success is tied to that of my investors, and I have reinvested a substantial portion of my compensation over the years back into the funds alongside my investors who are fully aware of the compensation formula when deciding whether to place their money with us.

Because of the events of the past few months, the American public, including my investors, have justifiable concerns about our financial markets and the economy. The important thing to remember, however, is that we must keep things in perspective and not overreact, misperceive or misrepresent what has happened. We are a resilient society. We must focus on the positives and continue taking the positive steps forward, rather than backward.

Hedge funds play an important role in the economy by providing needed capital and encouraging creativity and outside-the-box thinking. Many viable companies struggling under a huge debt load or poor cash flow have not only survived but flourished through an infusion of hedge fund capital, saving thousands of jobs. I am proud of Harbinger's track record of helping these types of companies emerge from bankruptcy and helping others avoid filing in the first place.

Finally, I would like to offer a thought or two on how Congress and the hedge fund industry can work together to increase public confidence not only in our industry but in the financial markets as a whole.

I support some additional government regulation requiring more public disclosure and transparency for hedge funds as well as for public companies. All investors, whether individual or sophisticated institutions, have a right to know what assets companies have an interest in, whether on or off their balance sheets, and what those assets are really worth.

I also support the creation of a public exchange or clearing house for derivatives trading, especially credit default swaps. An open and transparent market for these transactions would reduce confusion and improve understanding as well as help with valuation issues.

In summary, while was growing up, my family may have lacked money, but one thing we didn't lack was integrity and pride in what we did and how we did it. It was a cornerstone then, and it remains the cornerstone of my family and my business today. In 1990, one of my investors once told me something that continues to resonate with me today. He said, I can't guarantee that if you work hard, you will be successful; but I can guarantee that if you don't work hard, you won't be successful. We should never lose sight of that.

Needless to say, I love this country, and I am grateful for the opportunity that I have been provided. That being said, we are living in difficult times now. Consequently, I hope that this committee and indeed the entire Nation will look the at hedge fund industry as part of the solution to our economic turmoil.

Given the tightening of credit markets, access to capital is more important than ever, and I believe that hedge funds can and should be a source for this capital. Thank you for permitting me the opportunity to make this statement, and I would be happy to answer any questions that you may have.

[Prepared statement of Mr. Falcone follows:]

******** INSERT 3-4 ********

Chairman WAXMAN. Thank you, Mr. Falcone.

Mr. Griffin.

STATEMENT OF KENNETH C. GRIFFIN

Mr. GRIFFIN. Mr. Chairman, Congressman Davis, and distinguished members of the committee, my name is Kenneth Griffin, and I am the founder and CEO of Citadel investment Group. Thank you for the opportunity to address this committee.

Today, our Nation is working through the worst financial crisis since the 1930s. It is imperative that we as a Nation continue to take actions to mitigate the impact of the credit crisis on our broader economy in the hopes of keeping Americans employed and productive. I appreciate your leadership on this important undertaking.

I am proud that in the 18 years since I founded Citadel, it has grown into a financial institution of great strength and capability. With a team of over 1,400 talented individuals, Citadel manages approximately $15 billion of investment capital for a broad array of institutional investors, high net-worth individuals, and Citadel's employees.

Citadel's Capital Markets Division plays an important role in our Nation's market. Our broker dealer is the largest market maker in options in the United States, executing approximately 30 percent of all equity option trades daily. In addition, Citadel accounts for nearly 10 percent of the daily trading volume of U.S. equities.

All businesses take risks. In some industries we refer to risk-taking as research and development. At financial institutions, we often take risks by investing in securities. Failure to understand and manage risk can be severe, as we have seen far too often in recent weeks. Although the financial crisis as affected virtually every participant in the financial markets, including Citadel, I believe that Citadel's constant and consistent focus on risk management has been a key asset in successfully navigating this financial crisis and will continue to serve us well in the years to come.

In this crisis, the concept of "too interconnected to fail" has replaced the concept of "too big to fail." The rapid growth in the use of derivatives has created an opaque market whose outstanding notional value is measured in the hundreds of trillions of dollars. As a result, there is great concern about the systemic effects of the failure of any one financial institution.

In the area of credit default swaps, for example, there is an estimated $55 trillion of outstanding notional contracts between market participants. This number is almost four times the GDP of our Nation.

The creation of central clearinghouses to act as intermediaries and guarantors of financial derivatives such as credit default swaps represents a straight-forward solution to the issues inherent in today's opaque over-the-counter market. Of greatest importance, such a clearinghouse will dramatically reduce systemic risk, allowing us to step away from the "too interconnected to fail" paradigm. Numerous other benefits will accrue to our economy. Regulators, for example, will have far greater transparency into this vast and important market.

In recent months, Citadel and the CME Group have partnered in building such a clearinghouse for credit default swaps. Our solution is an example of how industry in cooperation with regulators can solve complex market problems.

I believe and have said before that our financial markets work best when they are competitive, fair, and transparent. Proper regulation is critical, but the best regulation is created with an eye towards unleashing opportunities, not limiting possibilities. To achieve this, Congress, regulators and industry must all work together. Our markets are complex, and they must be well understood if they are to be well regulated.

We must solve the serious issues we face but not in a way that stifles the best innovative qualities of our great capital markets.

I thank the committee for holding this hearing today, and I look forward to answering your questions, thank you.

[Prepared statement of Mr. Griffin follows:]

******** INSERT 3-5 ********

Chairman WAXMAN. Thank you very much, Mr. Griffin.

We are now going to proceed to questions by members of the panel, who will each have 5 minutes each.

I want to remind the members that the hearing today is about hedge funds and the financial markets, and questions about other topics are not relevant to the hearing. The Chair won't bar any member from asking any particular question or a witness from answering a particular question, but witnesses will not be required to answer questions unrelated to the topic of today's hearing. So I urge members and witnesses to keep their questions and answers focused on the topic of today's hearing.

I'm going to start with myself. Let me start off by asking about systemic risk. In 1998, there was Long-Term Capital Management was one of the Nation's largest hedge funds. It had about $5 billion in capital and was leveraged at a ratio of 30 to 1. It had made investments worth about $150 billion, and when those investments went bad, its capital was quickly wiped out.

The Federal Reserve became so concerned about the broader impacts of this collapse that it organized a multibillion dollar bailout. That was in 1998 when only about 3,000 hedge funds managed approximately $2 billion in assets. Current estimates suggest that there may be 9,000 hedge funds managing assets worth more than $2 trillion.

Some say hedge funds have become a shadow banking system.

So I'd like to ask each of you two questions: Do you believe that the collapse of large hedge funds could pose systemic risks to the economy? And if so, do you believe this justifies greater Federal regulation?

Mr. Soros, why don't we start with you and go straight down the line?

Mr. SOROS. Yes, I think that some hedge funds do pose systemic risk. And I think particularly leveraged capital was built on a false conception--I talked about the false paradigm on which our financial system has been built. And that was actually embodied in leveraged capital, which was very--which basically assumed that deviations from--are random.

Chairman WAXMAN. Do you believe this justifies greater Federal regulation?

Mr. SOROS. Pardon?

Chairman WAXMAN. Do you believe this justifies greater Federal regulation?

Mr. SOROS. Yes, it does.

Chairman WAXMAN. Thank you.

Mr. Simons?

Mr. SIMONS. Yeah, well, certainly--

Chairman WAXMAN. Is your mike on?

Mr. SIMONS. Certainly the possibility exists that an individual hedge fund or hedge funds in aggregate could be a cause of systemic risk. And I think that regulation in the form of reporting up to the SEC, for example, in a more detailed manner than is presently done with those things aggregated--that information aggregated, passed on to the Federal Reserve or some such would be a good approach. So, yes.

Chairman WAXMAN. Thank you.

Mr. Paulson.

Mr. PAULSON. I think the risk--I think the systemic risk in the financial system, and that includes hedge funds as well as banks and other financial institutions, is due to too much leverage; that when banks or hedge funds use too much leverage, you only need a small decline in the value of the assets before the equity is wiped out and the debt is impaired. I do think there is a need for more stringent leverage requirements on banks, financial institutions and, where, necessary on hedge funds.

The amount of common equity that institutions are operating with is simply too thin to support their balance sheets. The primary reasons why financial firms have run into trouble, whether Lehman Brothers, Bear Stearns or AIG, is they have way too much leverage. Lehman Brothers, as an example, had over 40 times the assets compared to their tangible common equity. They just didn't have enough equity.

Every hedge fund that has had a problem, whether it was the Carlisle funds, the Bear Stearns funds or Long-Term Capital before, was because of the use of too much leverage.

Chairman WAXMAN. Do you think, therefore, that there ought to be more government regulation of the hedge funds and particularly on leverage?

Mr. PAULSON. Yes, I think the equity requirements of financial institutions need to be raised, and the margin requirements, the amount capital institutions or investors have to hold to support individual securities, should also be raised. And by doing that, that would reduce the risk in the system.

I may add just one point is that in all the trillions of government support globally to try and stem this financial disaster, not $1 yet has been used to support a hedge fund. So the problems have been with our investment banks with other financial institutions. And although Long-Term Capital was large, a $4 billion hedge fund, that problem was also solved privately without any government intervention. And the problems of Long-Term Capital, which today was the largest hedge fund to experience a problem, are minuscule compared to the $150 billion that was required to bail out AIG, the $700 billion billion in the TARP program, or the $139 billion that was just advanced to GE in the form of guarantees.

Chairman WAXMAN. Good point. Thank you.

Mr. Falcone?

Mr. FALCONE. Yes, I think that any institution that has a pool of capital at its availability and uses reckless leverages indeed poses a systemic, potential systemic risk to the marketplace. I think that when you look the at hedge fund industry with the trillion or trillion and a half dollars outstanding, that the leverage aspect of it is a bit isolated. And there are certain institutions that may pose risks, but I would suspect that for the most part the industry in general is not nearly as leveraged as some of the banking institutions that we were dealing with over the past 4 or 5 months.

And I do support additional regulation as it relates to that, because I don't think it's in anybody's best interest to see these institutions unravel and create a domino effect.

Chairman WAXMAN. Thank you.

Mr. Griffin.

Mr. GRIFFIN. Mr. Chairman, as you referred to Long-Term Capital's consortium bailout in 1998, it is important to remember, it was a private market solution to a very challenging problem. Just a few years ago, Citadel and JP Morgan created a private market solution to the challenges faced by Amaranth and its shareholders when they incurred even greater losses in the natural gas market. Private market solutions can address crises. And we should keep in the center of our mind that we want to foster private market solutions as the way to handle crises first and foremost.

Of second point, hedge funds are already regulated indirectly by the fact that the banking system is regulated and the banking system is the primary extender of credit to hedge funds. And last but not least, I think it's important that we keep in mind, it's very convenient to say we should simply have more equity in the system, but equity is very expensive, and if we wish to reduce the cost of loans to consumers and loans to homeowners, we need to think of capital structures that have the right mix of equity to debt.

Thank you.

Chairman WAXMAN. Well, the private market solution was organized by the Fed. So it wasn't without some public intervention. Is it your conclusion that we do need some greater Federal regulation because of the systemic risks?

Mr. GRIFFIN. No, it is not my belief that we need greater government regulation of hedge funds with respect to the systemic risks they create. And to be very direct, we have gone through a financial tsunami in the last few weeks, and if we look at where the failure stress points have been in the system, they have been in the regulated institutions; whether it is AIG, an insurance company, Fannie or Freddie, the banking system. We have not seen hedge funds as a focal point of carnage in this recent financial tsunami.

Chairman WAXMAN. Well, our expert witness in the first panel testified they believe hedge funds do pose systemic risk.

Former SEC Chairman David Ruder said this: Highly leveraged hedge funds that borrow large sums and engage in complex transactions using exotic derivative instruments may severely disrupt the financial markets if they are unable to meet counterparty obligations or must sell assets in order to repay investors.

And Professor Andrew Lo gave similar testimony.

My concern is that our regulatory system has not recognized these potential risks. The hedge fund industry is getting bigger. The systemic risks are growing larger, and yet Federal regulators have virtually no oversight of your industry, and that is a potentially dangerous situation. So I appreciated hearing each of your views on that subject.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman.

I would ask, let me just amplify your question, and they can answer the question you just posed. Because our first panel of witnesses did propose requiring hedge funds to divulge comprehensive risk to regulators. But I have heard some concern here and elsewhere that you need to keep such data in an aggregated and confidential format. And so I would ask, along with Mr. Waxman's question, is there a danger of too much transparency in the hedge fund industry, and what is that?

Mr. Griffin, I will start with you. I think you have some limits on regulation and ask you to address that, and then I will move right down.

Mr. GRIFFIN. On the issue of disclosure of positions or aggregate risk factors, we at Citadel would not be adverse to that so long as the information was maintained confidential and in the hands of the regulators. To ask us to disclose our positions to the open market would parallel asking Coca-Cola to disclose their secret formula to the world.

Mr. FALCONE. I agree. I think that it is important to disclose the information to the appropriate regulatory agencies. We work long and hard in developing our ideas, and to make them public I don't think is the right thing to do. And the public would not necessarily use them in the same way, shape, or form that we would use our ideas.

Mr. DAVIS OF VIRGINIA. Mr. Paulson?

Mr. PAULSON. Yes, as you know, we voluntarily registered with the SEC in 2004. We believe, to the extent, having a regulatory oversight over the policies of hedge funds, to the extent it provides greater comfort to the public sector and to private investors is a beneficial thing.

Mr. SIMONS. I don't have much to add. I have already said that reporting up to the regulators is a good idea, more so than is now reported. I agree with the others that it should stay with the regulators or with the Federal Reserve. It should not be reported in The New York Times.

Mr. SOROS. As I have said, I think the regulators need to monitor positions more closely than they have done until now. But disclosing it to the public can be very harmful in many ways. And I think that the publication of short positions, for instance, practically endangers the business model of long-short equity investors--it is not our business, it is the other hedge funds that do that--because of the reaction of the companies whose shares they were selling short.

Mr. DAVIS OF VIRGINIA. Let me ask this. I asked Mr. Waxman, and he is comfortable with me asking this. Do you have any opinions on what the Treasury Department is doing now with the Troubled Asset Recovery Plan? How they can deploy that maybe better than they are doing? In light of the fact that the $700 billion is not actually being used to buy up troubled assets but to purchase equity stakes in financial firms, Secretary Paulson has indicated that Treasury may start purchasing stakes in nonbank financial firms. And do you think any hedge funds might take advantage of such an offer? Anybody want to opine an opinion on that?

Mr. Griffin, I will start with you.

Mr. GRIFFIN. Congressman Davis, I believe that the decision to focus on injecting equity or preferred equity into the banking system versus buying assets will create a larger effect for all of us and is a good decision on a relative basis. So, in other words, I applaud the Secretary of Treasury for making the decision to increase the equity capital base of the banking system at this moment in time.

Of course, we have a difficult decision to make ahead of us: Do we expand TARP to include the nonbanking sector? And if we do so, where do we draw the line? I think that is a very difficult decision that we have to make in the weeks and months ahead. Obviously, the economy as a whole is slowing down, and we need to keep Americans employed. And I believe that we are going to need more stimulus packages to keep our economy as close to full potential as possible.

Mr. FALCONE. I have been in favor of TARP to a certain extent considering that it could be a safety net for isolated incidents. I don't believe, however, that the money should be used for random purchases of assets because of the lack of clarity as it relates to what the institutions will do with that capital and what benefits it will do for the individual consumer. And I furthermore do not think that it should go above and beyond the financial institutions.

Mr. PAULSON. Congressman Davis, I do think it was a tremendous improvement shifting the focus of TARP from buying assets, which has very little impact on recapitalizing banks, to directly buying equity. I think the problem in the financial sector is one of solvency. Financial firms don't have enough equity. And injecting equity is the solution to the problem.

I also think the list of recipients needs to be expanded to include other types of financial firms whose failure could pose systemic risk. That may include auto finance companies other finance companies, and insurance companies.

However, I do think the structure of TARP investments can be improved. I think the current terms are overly generous to the recipients, and I will give you some examples. When Berkshire Hathaway bought preferred stock in one of the investment banks, they received a 10 percent dividend and warrants equal to 100 percent of the value of the investment. Under the TARP program, the yield was only 5 percent and warrants equal to only 15 percent.

In the U.K. And Switzerland, when they invested preferred knock their financial companies, they got a 12 percent yield, also substantial equity stakes.

By investing proceeds at less than market rates and less than other governments are doing, it's in effect an indirect transfer of wealth from the taxpayers to these financial institutions.

In addition, in the U.K., Switzerland and all other governments, when government money was required to help out financial institutions, there were restrictions on common dividends and on executive compensation. In the U.K. And in Switzerland, as long as government money is inside these companies, there are prohibitions on the payment of common dividends and caps on executive compensation. And this is essential in order to increase the retained earnings and common equities of the banks. It doesn't seem to make sense to me that the banks are short of capital, the government puts in capital, and then that capital comes out the other door in the forms of dividends and compensation.

I would make two suggestions that I think should be required of any financial firms that receive preferred stock investments or any form of guarantee from the Federal Government on their debt or other securities. One would be, while that guarantee is outstanding or while the preferred investment is made, that cash common dividends be eliminated and any dividends be restricted to dividends in additional shares of common stock.

Secondly, as other governments have required, there should be restrictions on cash compensation, and any bonuses or payments above that amount should be paid in common stock. By making those three adjustments, first increasing the terms of the preferred in terms of yield and equity to benefit the taxpayer; second, eliminating cash dividends; and third capping executive compensation, that would both protect taxpayers and restore the badly needed equity capital to these institutions.

Mr. SIMONS. Okay. Well, it was generally agreed that the original goal of TARP to buy some of this paper was perhaps not the best idea and more leverage would be created by capitalizing the banks and so on. On the other hand--and I more or less agree with that--but nonetheless, something has to be done about this paper. No one knows what much of it is worth, and it's in weak hands. People don't know how to, you know, appraise the balance sheets of the companies that are holding it and so on. So it is a problem, and it is a big problem.

I had suggested to Bob Steel when he was Under Secretary of the Treasury that rather than buy this stuff, they organize an auction, a two-sided auction dividing the paper up into various categories and so on and conducting auctions that people could buy and sell. And hopefully buyers would come in, and sellers would put up, and the market would kind of get cleared.

RPTS JOHNSON

DCMN BURRELL

[12:53 p.m.]

Mr. SIMONS. It is a pretty good idea, but it is a dangerous one because the prices might not make some folks very happy, people who maybe aren't selling but all of a sudden their balance sheets get whacked way down. But sooner or later we have to face the question what is this stuff worth and how do we get it out of weak hands, where much of it is, and into strong hands? And because only with the paper being in strong hands can the issues, some of these issues be dealt with. If a mortgage is chopped up into a million pieces and owned, fractions of its cash flow is owned by all kinds of people, it is very hard to deal with that homeowner and renegotiate the terms. But if you have bought this mortgage at, okay, a discount, then you can go to the fellow, and I am of course projecting this on a much wider scale, and say, okay, you can't make your monthly payments, but could you make it half? And can we make a deal here? And because he or she bought this paper at a substantial discount, everyone can make out okay in a reduced way. Somehow or other that paper has to be dealt with. And that is all I have to say.

Mr. DAVIS OF VIRGINIA. Mr. Soros?

Mr. SOROS. I am on record being very critical of the original TARP proposal. And I would like to go on record saying that while it is a great improvement that it is not used for removing toxic securities, but for equity injection, the way it is done is not an adequate or acceptable way, that if it were properly done then $700 billion would be more than sufficient to replenish the gaping hole in the banking system and to encourage the banks to start lending again. And the way that this should be done would be to ask the examiners to determine how much capital each bank needs to bring it up to the required 8 percent. Then the banks would be free to raise that capital or go to TARP and get an offer. But TARP should only underwrite the issue, and not actually take it on. But underwrite it on terms that the shareholders would be likely to take it on. And only if the shareholders don't take it would TARP take it on. Then you would have replenished the banking system, you would then reduce the minimum lending requirements from 8 percent, let's say, to 6 percent--the minimum capital requirements--and the banks would be very anxious to put that very expensive capital, because equity capital is expensive, to good use to get a good return on it by actually lending.

So that would solve that problem. And as far as the toxic securities are concerned, I think the first thing is to renegotiate the mortgages so that people would actually stay in their houses, and you remove the pressure of foreclosures, which are liable to push down the value of mortgage securities way below that. That is an undone business that has to be urgently attended to.

Mr. DAVIS OF VIRGINIA. Thank you all.

Mr. TOWNS. [Presiding.] Let me tell my colleague he has no time to yield back. Let me just ask the question and just go right down the line and get an answer from each of you.

All of you have successfully navigated the recent problems in the economy which appears to have blind-sided the people on Wall Street, and of course the people here in Washington. I don't think we can pass up this opportunity to explore what it is that you knew that allowed you to get so far ahead of everyone else when it came to predicting what would happen in the markets.

I would like to go right down the line. Right down the line. We will start with you, Mr. Griffin, go right down the line.

Mr. GRIFFIN. Sir, the last 8 weeks have been a challenging 8 weeks for Citadel. We have had a very successful 18 years holistically, but we have had a tough time in the last 8 weeks as the banking system around the world came close to the verge of collapsing. I think what is very important to note is what has happened in the last 8 weeks looks like nothing that any of the traditional risk management metrics would have shown as a realistic possibility.

I think it is very important for everyone to keep in mind in terms of policy decisions on a going forward basis we had a panic in the money market system, we had a panic in the banking system, and we have had very negative consequences as a result of that in the entire Western world's financial system.

I think if we look at the firms that have done well over the last 8 weeks, they came into this position with portfolios of both credit risk and equity market risk that could tolerate extreme moves, which we have witnessed. And they have come into this crisis with very solid financing lines, which have been important in terms of weathering the storm that we have just gone through.

Mr. TOWNS. Mr. Falcone?

Mr. FALCONE. I think in looking at what has happened over the past 8 weeks versus what has happened over the previous history in the financial markets is a very unique point in time. The markets are very irrational right now. And I have always said you could be right fundamentally and wrong technically. And the technical situation in the marketplace is putting a lot of pressure on a lot of institutions.

How we have weathered the storm and how we have done over the past has really been a function of our diligence. And I think in looking at where we have been successful, we have taken our time and been methodical and really thought things through. And we were very involved in the mortgage market over the past couple years. And it has been to a point--it was to a point where it took me about 8 to 12 months of some pretty substantial analysis before we put that trade on, or trades like that on.

So I would say that over the past couple of months it again has been very irrational, and been very difficult to avoid, no matter what type of institution you are, to avoid the pitfalls of what has been taking place. And I think in order to succeed going forward, the proper liquidity and the proper lines with the right institutions are a very critical and very important thing.

Mr. TOWNS. All right. Mr. Paulson?

Mr. PAULSON. Mr. Chairman, we conduct a lot of detailed analysis independent of the rating agencies.

Mr. SHAYS. Lower your mike just a bit.

Mr. PAULSON. Yes. Our firm conducts a lot of detailed independent research that is independent of what the rating agencies do. And we determined late in 2005 and early in 2006 there was a complete mispricing of risk of mortgage securities. We found Moody's and S&P rating various securities investment grade, including as high as triple A, that we thought would become worthless. The reason we had this opinion was we looked at the underlying collateral of these securities. The subprime securities were comprised of mortgages that were made with 100 percent financing and no down payment. They were made to borrowers that had a history of poor credit. There was no income verification. And the mortgage value was based on an appraisal that was typically inflated. We felt this was very poor underwriting quality, that the default rates in these mortgages would be very high, and that securities backed by these mortgages would also--would likely also have very high defaults. And it was that analysis that allowed us to buy protection on these securities, which resulted in large gains for our funds.

Mr. TOWNS. Thank you. Mr. Simons?

Mr. SIMONS. Okay. Well, I didn't have that kind of wisdom. Happily, the funds that we operate didn't require that kind of wisdom. So our principal fund, called Medallion, is long and short equal amounts of equity, and is not necessarily affected by the rises and falls in the stock market, and in fact has done fine through this period.

A second fund which is designed to be a dollar long, that is for outsiders, not employees, obviously has--it is long more than it is short, so it is net long a dollar if you invest a dollar. That has obviously had some declines with the stock market down 40 percent, but considerably less than the declines of the market. And our investors in that fund are quite happy, because that is what they--that is what we advertised would happen, and so that is fine.

An outside futures fund we have was hurt by the explosion of volatility in October. I couldn't have predicted that. Maybe I should have. I didn't. It was on the wrong side of a few things and suffered some losses in October. But by and large, our business is not highly correlated with the stock market. And so that is how we have skated along here.

Mr. TOWNS. Mr. Soros.

Mr. SOROS. What was your question? I didn't fully understand your question. Was it how it affected our--

Mr. TOWNS. Yes. How you seemed to have been able to anticipate when others were not able to anticipate, especially Wall Street and Washington.

Mr. SOROS. I fully anticipated the worst financial crisis since the 1930s. But frankly, what has happened in the last 8 weeks exceeded my expectations. The fact that Lehman Brothers was allowed to go declare bankruptcy in a disorderly way really caused a meltdown, a genuine meltdown of the financial system, a cardiac arrest. And the authorities have been involved since then in resuscitating the system. But it has been a tremendous shock, the impact of which has not yet been fully felt.

Now, as far as my own fund is concerned, I came out of retirement to preserve my capital, and I have succeeded in doing that. So we are flat for the year, because by taking the necessary steps I was able to counterbalance the losses that we would be suffering otherwise, which would be quite substantial.

Mr. TOWNS. Thank you very much. Thank all of you for your answers.

The gentleman from Indiana.

Mr. SOUDER. Thank you, Mr. Chairman. And I understand this is a financial hearing, and I am not going to get into other questions, but I just want to say, Mr. Soros, we have had deep disagreements over the years on the heroin needles promotions and your promotion of different what I believe are back-door legalization of marijuana. And I believe while you have done humanitarian efforts around the world, your intervention in the drug area has been appalling. And I haven't had the chance to talk to you directly, and I wanted to say that because I believe it has damaged many Americans. And I hope you will reevaluate where you put your money.

But I do have a question directly to you on your question on equilibrium, that don't hedge funds provide some of that equilibrium by buying long and selling short and going after companies that haven't been responsible? And why do you think there wasn't more of that in this case?

Mr. SOROS. Well, to some extent hedge funds do. And of course we shouldn't put all the hedge funds in one category. There are different strategies and they have different effects. And definitely selling short is a stabilizing factor, generally speaking, in the market. In other words, there is markets that allow and facilitate short selling tend to be more stable than those that prohibit them.

At the same time, hedge funds do use leverage. And leverage by its very nature has the potential of being destabilizing, because as the market goes up the value of the collateral increases, you can borrow more, and also maybe since you are making profits your appetite for borrowing more is increasing. So there is greater willingness to lend by the banks.

So this is the--generally speaking, bubbles always involve credit. And since hedge funds use credit, they are contributors to the bubbles. It is nothing specific to hedge funds, it relates to everyone who uses credit.

Mr. SOUDER. Mr. Paulson, you said a little bit ago that you felt that the government needed to get more involved in the fact that some use too much leverage, and that it is kind of a slippery slope because, as Mr. Soros just suggested, that in fact hedge funds use some leverage as well, and in fact while you serve a function for equilibrium, you often exaggerate the extremes of that through selling short or buying long.

Could you respond some to what Mr. Soros said? How do you feel? Do you still feel you shouldn't have additional regulation with that? And how do you respond to the fact that you do in fact exaggerate some of these trends?

Mr. PAULSON. Well, I think what leverage does is it exacerbates any move--

Mr. SHAYS. Is your mike on, sir?

Mr. PAULSON. Yeah. The danger of leverage is that exacerbates any type of market move. So almost every financial firm that has run into problems, not only hedge funds like Long-Term Capital, but Lehman Brothers, AIG, has because they used too much leverage. And a small decline in the value of their assets wiped out their equity. So I think that there is a need to raise the margin requirements on particular asset classes and to require stronger equity positions in banks so that--and that would reduce the risk of failure.

Mr. SOUDER. Mr. Griffin, you have been the most aggressive in saying that there shouldn't be regulation. How would you respond to the comments there?

Mr. GRIFFIN. Let me be very direct on the point of regulation. Good regulation is good for every market participant. I mean, for example, in the middle of the financial crisis we worked hand in hand with the SEC to create the necessary exemptions to allow Citadel to continue to make markets every day in options to millions of retail investors. And every day during this crisis we have provided liquidity in the equities markets to millions of retail investors, whether they are at Schwab or Fidelity or Ameritrade or E-Trade. I am very proud of my firm's commitment to providing liquidity to retail investors in America. We have also worked hand in hand with the Federal Reserve Bank of New York for creating a clearinghouse for credit default swaps.

I think that as a Nation we need an intelligent dialogue about the right regulatory frameworks to encourage markets that are transparent, that have the appropriate amount of leverage in the system, and that create value for society. The point of our capital markets is to allocate capital efficiently, to allow corporate America to raise equity, to grow, and to allow America to be more competitive in the world markets. And any regulation that furthers those key goals of our capital markets is regulation I would support.

Mr. SOUDER. May I ask a brief--if regulation goes too far would your funds, because I assume you all have foreign investment, would we see this move offshore either to Europe or Asia or other places?

Mr. GRIFFIN. It breaks my heart when I go to Canary Wharf and I look at the thousands and thousands of highly paid jobs in London in the derivatives markets that belong in America. We went through a period of regulatory uncertainty with respect to derivatives that pushed thousands of high-paying jobs abroad, jobs that belonged in our country.

Mr. SOUDER. Thank you.

Mr. TOWNS. Thank you very much. The gentlewoman from New York.

Mrs. MALONEY. Thank you. Thank you very much. And I would like to ask a question about a specific regulatory proposal, which is to require hedge funds to disclose information to regulators. This is an idea that was proposed in the prior panel by both Mr. Ruder and Professor Lo.

Right now the SEC, the Fed, and other entities have virtually no information about hedge funds. As a result, they have very limited ability to assess systemic risk. As Professor Lo testified, one cannot manage what one cannot measure. He said that it is, and I quote, obvious an indisputable need to require financial institutions to provide additional data to regulators. Chairman Ruder made the same point when he said, and I quote, I continue to believe that a system should be created requiring hedge funds to divulge to regulators information regarding the size, nature of their risk positions, and the identities of their counterparties. And I see you have your book with you, Mr. Soros, and in your book you said, and I quote from you, there are systemic risks that need to be managed by the regulatory authorities. To be able to do so, they must have adequate information. The participants, including hedge funds and sovereign wealth funds and other unregulated industries, must provide that information even if it is costly and cumbersome. The costs pale into insignificance when compared to the costs of a breakdown. And we are now experiencing a major breakdown.

And so Mr. Soros, would you support a requirement for hedge funds to report financial information to regulators?

Mr. SOROS. Yes.

Mrs. MALONEY. And Mr. Simons, you also in your testimony made a similar statement about transparency and appropriate regulation. So would you agree also that it is correct to have more--

Mr. SIMONS. Yep.

Mrs. MALONEY. And also Mr. Paulson, Mr. Falcone, and Mr. Griffin, would you support additional information and transparency to regulators?

Mr. PAULSON. Congressman Maloney, you make a very good argument. I think given the size of the industry and the potential for systemic risk--

Mr. TOWNS. We are having trouble hearing you.

Mr. PAULSON. Congressman Maloney, I think you make a very good argument that given the size of the industry and the potential for systemic risk, greater disclosure and transparency would be warranted.

Mrs. MALONEY. Mr. Falcone?

Mr. FALCONE. I agree. I think providing information to the regulatory agencies is very important. I think, however, it is very critical what they do with that information, and that we have to make sure that it is properly analyzed. And I think that can go a long way, as opposed to providing the information and just seeing it filed away.

Mrs. MALONEY. Mr. Griffin?

Mr. GRIFFIN. I think one of the challenges that we need to address before we can get to the goals that you want to get to is to have a common language to describe derivatives.

Mrs. MALONEY. That is important.

Mr. GRIFFIN. Every firm uses a different set of terminologies, a different set of representations to describe their derivatives portfolios. Until we create central clearinghouses for over-the-counter derivatives, any reporting that we are likely to create will be inscrutable to regulators.

Mrs. MALONEY. We are moving towards that direction. As you have read and know, the Fed is moving in that direction.

Mr. Paulson, I would like to ask you to comment on an article that you wrote for the Wall Street Journal on the TARP when it first came out. Along with many of us in

Congress, you argued that we should not be investing in these--in a toxic asset purchase, but to move into an equity injection. And some people, including yourself and others, have argued that why are we being treated differently as taxpayers in America as opposed to Great Britain. We have a 5 percent return, they have a 12 percent. Switzerland a 12-1/2 percent. Mr. Buffett got a 10 percent.

Would you comment further on this and how the TARP possibly should be structured in a way that is more beneficial to the economy and to the American taxpayer?

Mr. PAULSON. Well, certainly. In terms of--

Mrs. MALONEY. And could you speak up?

Mr. PAULSON. Certainly. In terms of using the TARP money for equity instead of buying assets is much more beneficial. And the benefit can be described very simply. If you put a dollar of equity in a bank and a bank uses 15 to 1 leverage, then that dollar would support $15 of new lending. If you merely use that dollar to buy a toxic asset from a bank for a dollar, it doesn't increase the equity and doesn't provide for any new lending besides the dollar of equity provided.

So the leverage to support the system and provide for liquidity and new lending is far more efficient by putting it in equity rather than buying assets. So I think the--

Mrs. MALONEY. And could you comment on the difference between the equity return to the taxpayer, 5 percent versus Great Britain, Switzerland--

Mr. PAULSON. Yes.

Mrs. MALONEY. --and even Mr. Buffett?

Mr. PAULSON. Yes. So the change in TARP to buy equity instead of assets is very beneficial. But secondly, the terms that the Treasury has been providing equity, it seems to be very generous to the recipients, that it is way below what market terms are, what the firms would have to pay if they raised this money privately, and is also considerably below the returns that other governments get when they are forced involuntarily to support the financial institutions with equity.

So I think the three--

Mrs. MALONEY. Thank you. Go ahead.

Mr. PAULSON. The three changes I would recommend is that for future equity injections the government should get a higher dividend, perhaps around 10 percent, and warrants that equal a greater percentage of the investment than they are currently getting.

Secondly, in order to restore the equity in the financial firms, I think it is imperative that while that preferred stock is outstanding that common--cash dividends on common be prohibited. And as an additional means of creating more equity that ultimately will allow the company to pay back the preferred, that cash compensation be capped and bonuses above that amount be paid in additional shares of common stock. That will go a long way to restoring the equity in these financial firms.

Mrs. MALONEY. My time has expired. I wish I could ask many more questions. Thank all of you for your very insightful and important testimony. I yield back.

Mr. TOWNS. Thank you very much. And the gentleman from Connecticut.

Mr. SHAYS. Thank you, Mr. Chairman. I only have 5 minutes, so I would love some short answers, and then I am going to just focus on one individual, just so I can pursue a little more in detail. I would like to ask each of you, and I will just preface it when I meet with hedge fund partners and they are in a room and I ask them about treating capital gains--income as capital gains or as regular income, when they are with their colleagues they say we should have capital gains treated the way it is. And when they meet with me privately, they put their arm around me and say Chris, this is crazy, they should be treated as ordinary income. So, you know, the people that I respect look me in the eye and say it should be treated as regular income. I would like each of you to tell me capital gains or regular income? Mr. Soros?

Mr. SOROS. I think earned income should be taxed as earned income. If you have a partnership arrangement and you--and that allows you to take capital gains and you want to change that, I think that would be appropriate. It would be inappropriate to--

Mr. SHAYS. Let me just cut you off, Mr. Soros, because you have all answered the question. Do you all agree with or disagree with--

Mr. SOROS. I am in agreement with it being taxed as earned income. But I would take exception if this was only applied to hedge funds, and not other forms of partnership.

Mr. SHAYS. I am sorry. I thank you for finishing the answer. Do any of you disagree with that answer?

Mr. FALCONE. I disagree to a certain extent. I think that hedge funds shouldn't be looked at differently. And it is really a function of the underlying asset. If you have an asset and you hold it for longer than 12 months, then you should be subject to capital gains tax like any other individual or real estate partnership or any investor.

Mr. SHAYS. Okay. You have answered the question. I just have so little time. I don't mean any disrespect.

Mr. FALCONE. Okay.

Mr. SHAYS. Mr. Griffin, I am just going to focus in on you because I just have to isolate one, and you are the furthest away from my district, so if I offend you it won't bother. I am told you can only have 99 members as part of a particular hedge fund. It is 99 or less. Is that correct?

Mr. GRIFFIN. The rules have changed over the years. That is not necessarily applicable any more.

Mr. SHAYS. But it is limited?

Mr. GRIFFIN. Yes.

Mr. SHAYS. What concerns me is that some funds say 20 percent profit, 1 percent management fee. I am told that you don't do 1 percent management fee, you do costs. And that can be closer to 8 percent. Is that accurate or not?

Mr. GRIFFIN. We do pass through costs. Costs as we define will include, for example, commissions paid to other firms.

Mr. SHAYS. So does it amount to more than 1 percent?

Mr. GRIFFIN. Yes, it does.

Mr. SHAYS. Okay. I am also told that some of your funds have done well and some haven't. And the accusation was that the funds that have done better are the ones you have your own money in, your own personal money, and the funds that haven't have not. And I want to know if that is accurate.

Mr. GRIFFIN. That is completely inaccurate. I am the single largest investor in our largest funds by a significant margin. I am also the largest investor in some of our funds that have been very profitable this year.

Mr. SHAYS. So would your statement for the record be, and under oath, that you have investment in every fund that you have or just some of the funds?

Mr. GRIFFIN. I have a material, several billion dollar investment in Wellington and Kensington.

Mr. SHAYS. Right.

Mr. GRIFFIN. And I have an investment in the several hundred millions of dollars in our other funds.

Mr. SHAYS. And the one that you have the most investment in, has that done the best or the worst or somewhere in between?

Mr. GRIFFIN. Regretfully, it has done the worst.

Mr. SHAYS. Okay. Let me ask all of you then, do you think that you should be required to have your funds, your own personal funds in every fund that you have? The implication is that since you make 20 percent of the profit, that you might tend to be more risky with the funds you may not have your own money in because you still make 20 percent. And if you lose, if the funds lose, you don't lose anything.

So let me ask you about that. Mr. Soros?

Mr. SOROS. Exactly in order to avoid this kind of conflict of interest, I only have one fund and all my assets are in that fund.

Mr. SHAYS. I see. Has that fund done better or worse than your other funds?

Mr. SOROS. There is no comparison. It is the only one.

Mr. SHAYS. I am sorry, you just have one fund. I am sorry. Thank you.

Mr. SIMONS. Okay. Well, no, I have--

Mr. SHAYS. I can't hear you. You are mumbling.

Mr. SIMONS. Well, all right. Is that better?

Mr. SHAYS. Yeah.

Mr. SIMONS. All right. I have substantial amounts of money in the three different funds that we manage. I think that that question is generally asked in due diligence by people considering investing in hedge funds. We always do. We invest--the family invests in many, many hedge funds. And that is the first due diligence question, does the fellow have skin in the game or whatever? Does he have--so to a large extent I think that issue is taken care of by the market.

Mr. SHAYS. You have answered the question. Thank you. Mr. Paulson?

Mr. PAULSON. Yes, all my assets are invested in the funds that we manage. I don't have any outside investments.

Mr. FALCONE. I think it is very important that the manager aligns himselves with the investors, and in my situation I am the largest investor in both of my funds.

Mr. SHAYS. Thank you all. Thank you.

Mr. TOWNS. Thank you very much. The gentleman from

Maryland.

Mr. CUMMINGS. Thank you very much, Mr. Chairman. Mr. Soros, Mr. Souder had some comments about you a little bit earlier, and I just want to let you know that I thank you for what you all have done for the citizens of Baltimore in my district. It has been simply phenomenal, and I thank you and the Open Society Institute.

Let me go to all of you and just to kind of piggyback on some of the things that Mr. Shays was just talking about. Each of you appearing here, my neighbor on his way to work this morning said to me, he said how does it feel to be going before five folks who have got more money than God? And I am sure you will disagree with him. But you are private citizens, and your income is not required to be publicly disclosed, so I am going to respect your privacy and not disclose your specific compensation. But you have provided information about your income to the committee, and it shows that although there are individual variations, on the average each of you made more than $1 billion in 2007. I got to tell you that is a staggering amount of money. And I am not knocking you for it. But even though you made enormous sums, you are not taxed like ordinary citizens, like the guy that said what I told you. Your earnings are not taxed as ordinary income. Instead, the fees you receive are called carried interest, which means that they are taxed at capital gains rates. There are two capital gains rates, a low 15 percent rate for long-term gains, and a higher rate for short-term gains. What this means is that to the extent your earnings are based on long-term gains, the tax rate is just 15 percent.

My question for you is whether this is fair. A school teacher or a plumber or policeman makes on the average of $40,000 to $50,000 a year, yet they have to pay 25 percent tax. You make a billion dollars, yet your rate can be, can be as low as 15 percent. Is that fair, Mr. Paulson? I want to start with you, because I understand that a significant part of your earnings can be short-term gain, but not all of it is. And Mr. Paulson, press accounts say that you earned over $3 billion in 2007. If just 20 percent of your income is long-term gain, that is over $600 million in income that is being taxed at a low rate. And so I will start with you, and we will just--

Mr. PAULSON. Well, we certainly appreciate--

Mr. CUMMINGS. I want you to keep your voice up for my questions.

Mr. PAULSON. Yeah. We certainly appreciate your concern for fairness in the Tax Code. But what I will say, I believe our tax situation is fair. If your constituents, whether they are a plumber or a teacher bought a stock and they owned that stock for more than a year, they would pay a long-term capital gains rate. So for our investments, to the extent I own investments for more than a year, I also pay a long-term capital gains tax. If we own an investment for less than a year, we pay short-term capital gains, which is taxed as ordinary income. And any fee income we receive, such as management fees, for that it is strictly ordinary income.

Mr. CUMMINGS. But this is about money that you are managing for other people. It is not your money, right? In other words, you said if I hold certain things for someone. But you are actually getting paid for what you do, the work that you perform. Isn't that right?

Mr. PAULSON. The way partnership accounting works, if the partnership owns an asset for more than a year, that asset is taxed at long-term capital gains. And that tax is passed along to all the partners in the same way. If the asset in the fund, in the partnership is a short-term capital gain, then all the partners, including the general partner, pay short-term capital gain.

Mr. CUMMINGS. Do you have an opinion, Mr. Falcone?

Mr. FALCONE. Yes, I do. I think that the important thing to realize is that hedge funds, quite frankly, are not and probably should not be treated any differently than any other investor. And as the case may be with my particular situation, last year approximately 98 percent of my taxable income was taxed under ordinary income. But I think it is important not to differentiate between hedge funds and the rest of the investment community, whether a private equity or real estate, or even individuals or the doctor that may own his hospital and decide to sell it.

Mr. CUMMINGS. So would any of you support repealing this tax loophole and taxing your income at regular income rates? Mr. Soros?

Mr. SOROS. I do.

Mr. CUMMINGS. I can't hear you.

Mr. SOROS. I agree to it. I have no problem with it.

Mr. CUMMINGS. Mr. Simons?

Mr. SIMONS. Yeah, I said the carried interest portion represented by other people's money, if that were raised to higher levels that would be okay with me.

Mr. CUMMINGS. Mr. Falcone? You just stated your position, I think, right?

Mr. FALCONE. Yes, I did.

Mr. CUMMINGS. Mr. Paulson?

Mr. PAULSON. Yeah, I would--I don't think it is a loophole. The carried interest merely passes through the nature of the income to the partners. If it is short-term capital gain, we are taxed at short-term capital gain. If it is long-term capital gain, it is taxed at long-term capital gain.

Mr. CUMMINGS. Mr. Griffin?

Mr. GRIFFIN. I think tax equity is incredibly important. And most of the income, if not all of the income that I generate is subject to either ordinary or short-term tax rates, the highest marginal rate. But if you and I were to start a restaurant together, and I was to be the chef and operator and you were to put up the capital, even though my labor goes into making that restaurant work every day, if we sell that business 2 or 3 years down the road I will get long-term capital gains. Our society preferences long-term capital gains from a tax perspective. And I think what we should seek to have is consistency in how we treat long-term capital gains, whether it is the hedge fund manager, the private equity manager, or the entrepreneur who starts a restaurant together.

Mr. CUMMINGS. I see my time is up. Thank you.

Mr. TOWNS. Thank you very much. Mr. Tierney?

Mr. TIERNEY. Thank you. Just to follow up on that, Mr. Griffin, when you use your analogy about the restaurant, when you are the chef the money you earn from being the chef gets taxed at a regular income rate.

Mr. GRIFFIN. That is correct, sir.

Mr. TIERNEY. When you are managing other people's money, you are in effect the chef of that process, you get taxed for those earnings at the regular income tax rate.

Mr. GRIFFIN. And management fees are taxed as ordinary income, sir.

Mr. TIERNEY. Well, which way do you determine the management fees? The 1 or 2 percent or the 20 percent?

Mr. GRIFFIN. The management fees are generally taxed as ordinary income for most firms.

Mr. TIERNEY. What are you referring to as the management fees?

Mr. GRIFFIN. The 1 or 2 percent.

Mr. TIERNEY. 1 or 2 percent. Set that aside. You get 20 percent and the other partners get 80 percent of the earnings, correct?

Mr. GRIFFIN. That is correct.

Mr. TIERNEY. You get 20 percent for the effort you made in managing those funds, making those investments, and doing that type of work. That is being the chef, not in terms of selling the product. I know what you want to do, you want to wash it all through and come out the other end. But the fact of the matter is that is compensation for your day-to-day efforts of managing those funds, is it not?

Mr. GRIFFIN. Well, let's go back to the story of the chef. The chef in his salary every year is taxed as ordinary income. But if the restaurant has capitalizable value--

Mr. TIERNEY. But you are not selling anything when you are getting compensated for the day-to-day management efforts that you make.

Mr. GRIFFIN. If I make an investment that creates long-term capital gains, so I invest in a biotechnology company where the stock appreciates--

Mr. TIERNEY. A good portion of that money isn't yours. Right?

Mr. GRIFFIN. That is correct.

Mr. TIERNEY. So when you get 20 percent, it is for investing other people's money as well as your own.

Mr. GRIFFIN. That is correct.

Mr. TIERNEY. And some of that compensation is for your efforts in managing and investing those other moneys.

Mr. GRIFFIN. That is correct.

Mr. TIERNEY. Right. And that, my friend, I suggest to you is what we are saying ought to be taxed as regular income. You can disagree, but I just don't want you to take the chef analogy too far on that.

Mr. GRIFFIN. Just to be very clear, all of my income, or virtually all is taxed at the highest marginal rates.

Mr. TIERNEY. As it should be.

Mr. GRIFFIN. All right. So I speak to you from a conceptual--

Mr. TIERNEY. We don't disagree on that. I don't want you to take your chef analogy and confuse people with that.

Mr. Paulson, except for our disagreement on that particular issue, I was thinking that we probably had the wrong Paulson handing out the TARP moneys here, because I agree with you in essence about us not getting the deal as taxpayers that we ought to be getting. And fairly adamant. And I can daresay that you can't walk down the street at home in any of our districts that people don't make that point, is what the heck are we doing giving money to these institutions, and they are out there giving bonuses, paying high salaries without being capped, and then waltzing around giving dividends. I think that is an important point, and I know you have already mentioned that twice now, but I think it probably can't be mentioned loudly enough and clearly enough while the other Mr. Paulson is busy determining what he is going to do.

What I would like to know is whether the other four panelists here agree with our Mr. Paulson here that if we are going to have taxpayer money go to any of these institutions, we ought to get a better deal, you know, better security on that, make sure the compensation isn't excessive, and make sure in fact that dividends aren't given out in cash during that period of time when we have the guarantee of the investment made. Mr. Soros?

Mr. SOROS. I am sorry, I didn't follow the question properly. I am sorry.

Mr. TIERNEY. In my old business we used to be able to have it read back. Do you agree with Mr. Paulson that as long as taxpayers' money is being given to these institutions for the purposes of thawing out the so-called credit freeze that we ought to be getting a better deal for the taxpayers? We ought to be getting better security for that investment? We ought to be making sure that the banks or the entities are not giving excessive compensation with it, bonuses and things of that nature, and are not giving cash dividends while the stockholders, the taxpayers' money is there?

Mr. SOROS. I am not sure that I would agree with Mr. Paulson on that.

Mr. TIERNEY. Why not?

Mr. SOROS. I think that if you have a capital increase in the banks, then I think that as long as the money is put up by the shareholders, there should be no change in the--it is up to the shareholders how they compensate.

Mr. TIERNEY. But this is taxpayer money, not shareholders' money we are talking about.

Mr. SOROS. When it is taxpayers' money, no, that I agree. Yes. Yes.

Mr. TIERNEY. Thank you.

Mr. Simons, do you also agree?

Mr. SIMONS. Generally speaking I do, although I will make the point that when this first round of money was put into these banks some of them didn't want to take it. And the Paulson said everyone has to take it. And therefore, if you are going to--because he didn't want the public to distinguish which bank is stronger and which bank is weaker or so on, which maybe was a good idea, maybe wasn't. But the result is that everyone had to take it. And if you have to take it, well, then you can mitigate that a little bit by saying, okay, I won't gouge you too much or whatever it would be. So I am not saying the 10 percent is gouging, by the way, but some of this money was not requested by some of these banks. To the extent that it was, I think it was quite a sweet deal.

Mr. TIERNEY. I think whether you request it or not, you ought to have a fair deal, not a lopsided deal on that. But we can discuss that later.

Mr. Falcone?

Mr. FALCONE. I agree. I think that to the extent that the capital is infused into some of these companies it should be more along the lines of market rates.

Mr. TIERNEY. Mr. Griffin?

Mr. GRIFFIN. I believe that market rates for many of these companies would be extremely high. And if one of our goals is to reduce the cost of consumer credit, this is in essence an indirect subsidy to the banking system that I hope they will pass on in some form or another to the ultimate consumers to whom they lend to.

Mr. TIERNEY. Thank you all for your answers. Thank you, Mr. Chairman.

Mr. TOWNS. Thank you very much. Mr. Yarmuth?

Mr. YARMUTH. Thank you, Mr. Chairman. I want to thank the panel. The testimony has been, I think, unusually candid and thoughtful, and I appreciate that very much. I am going to probably cross the line a little bit that Chairman Waxman set down, but I am going to try to draw the connection.

We have had a number of hearings related to the immediate financial crisis. And even going back some months we had a hearing on corporate compensation and its connection to the housing crisis. And we had a panel back then that included the former CEO of Time Warner, the former CEO of Merrill Lynch, Citigroup, and we had Mr. Mozilo from Countrywide. And one of the questions that I asked was when all these corporate executive compensation committee meetings met, was there ever a discussion of things like employee welfare, the communities that the corporation served, so forth, general corporate policies, or was there--the discussion always about stock price? And with unanimity they said the conversations were always about stock price. And one of the things that has become a common theme in hearings we have had is that when you tie everyone's compensation to stock performance, and relatively short-term stock performance, then you have an incentive or pressure for maybe riskier behavior that might have contributed to a lot of the crisis that we have.

So I ask you, as people who own significant positions in some of these companies, whether you have a concern about the corporate governance structure in this country and whether we should be doing things, whether it is related to corporate compensation generally or general corporate governance laws that might ameliorate some of this issue if you think it is a problem? Mr. Soros, would you like to start?

Mr. SOROS. I am definitely at a loss because it is not a subject that I have really given a lot of thought to.

Mr. YARMUTH. Chairman Waxman excused you.

Mr. Simons?

Mr. SIMONS. I haven't thought about it a great deal, but generally speaking I am more of a fan of profit sharing for CEOs than I am of stock options. The latter is very volatile, and you never know quite what he is getting.

Mr. PAULSON. In this case I would echo Mr. Simons' comments.

Mr. FALCONE. I am inclined to agree with Mr. Paulson and Mr. Simons that it is important to participate, from a compensation perspective as it relates to profit sharing, along those lines.

Mr. YARMUTH. Mr. Griffin?

Mr. GRIFFIN. I will concur with the other panelists.

Mr. YARMUTH. In today's Financial Times, Professor Malkiel from Princeton suggested that one of the things that might be considered is when you have compensation tied to stock options and so forth that it involve restricted stock that the CEO could not sell until sometime after he or she left the company, and therefore the concern would be more in the long-term interests of the corporation rather than short-term stock performance. Is that something that resonates with any of you that you think might be a good idea? You can say you didn't think about it.

Mr. GRIFFIN. I think that would be a terrible idea.

Mr. YARMUTH. Terrible idea?

Mr. GRIFFIN. And part of the reason is that we need executives in America to take risks. Whether it is to put the money down on the line for R&D in drugs or willing to try to create new ways to power America, we need executives to take risk. And what we find is as executives become more successful, they actually become more risk averse often. And so if you have their entire net worth tied up in stock options, which are inherently risky, and then they cannot monetize any portion of that until after they retire, I would be gravely concerned about the reduction in risk taking by America's corporate leaders. It sounds good on paper. I don't think it will give us what we need as a country. We need innovation.

Mr. YARMUTH. Does anybody else want to address that? I don't have any other questions. But if you don't, that is fine. Thank you, Mr. Chairman.

Mr. TOWNS. Thank you, very much. Thank you. The gentleman from Tennessee, Mr. Cooper.

Mr. SIMONS. I would like to excuse myself for a moment. I will be right back.

Mr. TOWNS. Sure.

Mr. COOPER. Thank you, Mr. Chairman. The headline of this hearing is definitely Paulson v. Paulson. As has been enumerated, John Paulson accuses Henry Paulson of botching the bailout. Because taxpayers do want a good return for their money, and they are very worried when we are only getting 5 percent interest on the preferred stock, and not getting sufficient warrant positions. But I think the real purpose of this hearing is to understand better the role that hedge funds play. And I asked the previous panel, professors largely, if it is possible to distinguish between hedge funds that hedge and funds that are more speculative. Because Mr. Paulson, for example, bet right on the down housing market, but that was not necessarily a position--you know, for example, if you had taken that position 3 or 4 years ago you wouldn't be as wealthy as you are today. The only thing worse than being wrong about the market is being right too early. So is it possible to distinguish between hedge funds that hedge and those that are speculative?

Mr. PAULSON. Well, let me first say I hope this is not Paulson v. Paulson, or that I am accusing a Paulson of botching anything.

Mr. TOWNS. Would you pull that mike? We have a great difficulty hearing you, so could you pull the mike closer to you or talk a little louder?

Mr. PAULSON. Absolutely. I will be glad to do that, Mr. Chairman.

I in no way want to be critical of Mr. Paulson. He has done a tremendous amount for our country, is willing to change his position when the circumstances change, and I think he has reoriented the TARP program in the right direction.

The second part of your question--or I really wasn't sure what it was again.

Mr. COOPER. For example, Mr. Simons doesn't purchase credit default swaps, he is not leveraged much. Other hedge funds have quite different strategies. We will never know because it is a black box trade secret. But is it possible for the pension fund and other investors to know in advance whether they are buying interests in a hedge fund or a speculative fund? I know in the private conversations you reveal a little bit more of your operations. But most people have no idea whether it is a hedge fund that hedges or it is not. It is a question about truth in advertising.

Mr. PAULSON. Congressman Cooper, that is a very good question. Investors never have to invest in a hedge fund.

Mr. COOPER. I know.

Mr. PAULSON. If they don't get the proper transparency--

Mr. COOPER. They don't, but there is a Wisconsin school board that put money in SIVs that got traced all around the world. You know, a lot of investors don't necessarily know. So right now we have a hedge fund as a category that is not defined, and some of which hedge, but many of which do not. And people have no advanced notice. So there is no truth in advertising.

Mr. PAULSON. Well, we for one give a lot of transparency to our investors. And while we don't disclose them publicly, we do disclose a great deal about what we are doing to our investors. So I would encourage investors such as pension funds, that they invest with managers that give disclosure so the pension funds know what they are investing in.

Mr. COOPER. Do any of the witnesses know? Mr. Soros?

Mr. SOROS. I think that hedge funds, several hedge funds have claimed to follow a market neutral strategy exactly because institutional investors want to see low volatility, and I think that was rather misleading. I don't think it was deliberate misleading, but actually because there is this false paradigm that has prevailed, that has pervaded the thinking on this subject, people thought that they were market neutral, and in actual fact when an event occurred that was not a random fluctuation or deviation, then it turned out to be non-market neutral.

Mr. COOPER. Thank you. You mentioned that investors usually want low volatility. The markets have been unusually volatile recently, and some trading strategies depend on volatility. How much volatility is enough?

Mr. SOROS. Well, see--

Mr. COOPER. 200 points a day, 500 points a day, a thousand is more better?

Mr. SOROS. --basically, what the prevailing paradigm has neglected is the uncertainty that is connected with this reflexive connection. We have become very adept in calculating risk. And by focusing on risk, we have left out uncertainty. And that has been our undoing in this particular case.

Mr. COOPER. How about the other panelists? Is a volatility only strategy appropriate? And if so, is more volatility always better?

Mr. SOROS. Well, you see, I think volatility is an indication of uncertainty. And the fact that normal volatility is 30, and it shot up to 50 and 70 and 80, it just shows the increased uncertainty that is currently pervading the markets.

Mr. COOPER. Does the government have a role in limiting excessive uncertainty?

Mr. SOROS. Well, I think that regulators have to understand that there is this uncertainty in markets. And that is why the risk management methods used by individual participants who are only thinking of their own risk is not appropriate in calculating systemic risk. And to protect against systemic risk, you have to impose restrictions on the amount of credit or leverage market participants can use. That is actually the core of my argument that I am putting forward.

Mr. GRIFFIN. Congressman Cooper, if I may.

Mr. COOPER. Yes.

Mr. GRIFFIN. Good regulation, good policy helps to reduce volatility in the market. And we are extremely invested in the safety and soundness of our financial system.

Mr. COOPER. But doesn't your firm have a conflict of interest in grouping with CME to create clearinghouses and other means that might somehow prejudice the market?

Mr. GRIFFIN. In the sense of?

Mr. COOPER. Well, if you are partnering with the market maker or the clearinghouse, how do people know it is going to be a fair market?

Mr. GRIFFIN. Well, we would clearly have a very sharp distinction between our role as a contributor of intellectual property and know-how to the CME to expedite the launch of this clearinghouse from the day-to-day management of the clearinghouse. We will have no involvement in the day-to-day management of the clearinghouse. Because the positions of other market participants should not be made available to Citadel.

Mr. COOPER. That makes investors rely on a Chinese Wall instead of a greater separation.

Mr. GRIFFIN. Well, CME will be running the clearinghouse. So we are not running it, just to be very clear on the record.

Mr. COOPER. Thank you, Mr. Chairman. I see my time has expired.

Chairman WAXMAN. [presiding.] Thank you, Mr. Cooper.

Mr. Van Hollen.

Mr. VAN HOLLEN. Thank you, Mr. Chairman, and thank all of you gentlemen for your testimony. We have had a lot of discussion about trying to create greater transparency over hedge funds. And as I understand all of your testimony, you agree with the idea that at least on a confidential basis it would be appropriate for some Federal agency, the SEC or some other Federal agency, to monitor and obtain that information for the purpose of making a determination whether there is systemic risk, putting the taxpayer at risk. Am I right about that?

Mr. SOROS. Yes.

Mr. SIMONS. Yes.

Mr. FALCONE. Yes.

Mr. VAN HOLLEN. Now, we had just before you a panel of a number of professors, including Professor Lo and Professor Ruder. And the question I posed was okay, let's say you are the SEC or the regulator and you are getting this information and data and you see your alarm bells go off. You say look, we really do think we have a problem here, whether it is to the investors or systemic risk. What authorities should they have then with respect to the hedge fund? And the response we got was maybe the SEC shouldn't have that authority, but they would provide the Federal Reserve with that authority, which according to their testimony would require additional congressional action.

So my question of you gentlemen is, is that something you think would be necessary? Because the obvious question that comes up once you say it is okay to collect the information is okay, you got it, now you make a determination that something is going wrong, shouldn't we also make sure they have the authority to deal with it? Especially in light of the fact that what we have learned, at least with respect to the investment banks, is that the taxpayer is of course sort of holding the risk as a last resort and is going to be asked and has been asked anyway to go in? So I would pose that question to you, gentlemen, whether you think, whether it is the SEC or the Federal Reserve, they should also have additional authorities, whether it is leverage requirements or some other powers that they can intervene with respect to a particular hedge fund that they determine is causing systemic risk?

Mr. SOROS. Well, I would definitely argue that that is exactly what you need. That is what currently is missing and it needs to be introduced. We used to have that kind of authority. In earlier years, in my youth I used to be aware of them. They have fallen into disuse. And I think they have to be brought back, because there is a distinction between money and credit, and markets don't tend towards equilibrium, and it is the job of the regulators to prevent asset bubbles from developing.

Mr. SIMONS. Yes.

Mr. PAULSON. I would agree with that.

RPTS REIDY

DCMN ROSEN

Mr. FALCONE. I would agree as well. I'm not so sure it should be the SEC or the Federal Reserve or a new regulatory agency, but I think it's a very good idea.

Mr. GRIFFIN. I think what is important in the concept is for the hedge funds that are subject to this new paradigm to understand the rules of the road. Are we heading towards a Bozzle 2 requirement for hedge funds, for example? So long as I know what the rules of the road are, I can conduct my business in a way to be well within the lines.

Mr. SIMONS. That's a very good point, I think.

Mr. GRIFFIN. And I would like to clarify one previous statement. On the issue of clearinghouses for credit default swaps, there were two primary solutions proposed over the last couple of weeks; one was the dealers in the consortium called TCC, the other is a solution by Cidadel on the CME. A key distinction between these two solutions just a few weeks ago was that the CME solution is open to all financial market participants, both the buy side and the sell side.

Whereas the TCC solution, the dealer solution, was to be open only to the dealer community. And I believe that all of us on the buy side, whether we are Pemco, Black Rock, Citadel, Paulson, would want a platform that is open to all. It goes back to transparent and fair markets. And we have seen the dealer community trying to create doubts as to why the CME solution is the best one, this issue of Chinese walls. Let me just make it clear; we need a solution to meet the needs of all market participants. And I believe that our work with the CME to do so is in the best interest of our Nation and the entire world's financial system.

Mr. VAN HOLLEN. Thank you for that. Let me also just say, with respect to your answer to the previous question, we appreciate it. We may need all of you gentlemen to continue to provide that input as we go forward. Because, as you know, just the notion of providing greater transparency has been proposed in the past, it was proposed after the failure of Long Term Capital Management took a case to the Supreme Court that you are all very familiar with. And the fact of the matter is, not you as individuals, but certainly the industry, fought efforts to provide greater transparency, to provide greater oversight and some of these things. So as we go through this effort to provide reasonable regulation of the financial markets, we appreciate your input going forward as well as today.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Van Hollen.

Mr. Issa.

Mr. ISSA. Thank you, Mr. Chairman.

Mr. Soros, it's good to meet you at last. I'm very intrigued at some of your comments, and one of them particularly has to do with leverage. Is it enough, or would it be at least a good quick beginning if the Congress--obviously with the President--were to create a truth in, if you will, transparency of leverage, require standards and disclosure as to leverage, and of course that means that, derivatively, if you leverage something and then you go to resell it, it would be standard so that if you leverage a leverage a leverage, then that would have to be transparent and flow through. If that were one of the items on President Obama's short list of things to be done in that first 100 days, would it go at least a long way toward preventing the kind of over-leveraging that you're speaking of, at least the lack of visibility on over-leveraging?

Mr. SOROS. Well, certainly the introduction of newfangled financial instruments has made it much harder to calculate leverage because some of those instruments are leveraged instruments. So, given all the derivatives that have been introduced, calculating the leverage becomes a very, very complicated problem. And especially if you have tailor-made instruments, then it becomes even more difficult. So I think that it may be necessary to actually--while it is certainly necessary for the regulators to understand what they are regulating, and if they don't, they should perhaps not allow some of those instruments to be used. So I think that the instruments themselves would have to be authorized, approved by the SEC, or whatever, before they could be used.

Mr. ISSA. Good point.

Mr. Paulson, first of all, congratulations. I'm not an investor with your fund, but I've noticed that you manage to be still up about 1 percent at a time in which the walls are falling all around most other people. In order to have the kind of stellar gauge you've had, including obviously dealing with some of what we rename, we call them, you know, caustic and corrosive and acidic products, were you able to make sound decisions as to the real leverage that you were buying into in your investments?

Mr. PAULSON. Absolutely. What we did was primarily buy protection on debt securities. And at the time, we bought this protection, it's like buying an insurance policy, the premium was very, very low, on the order of 1 percent. So if the debt security never fell, we would lose the value of that premium. But that premium in our base funds was only about 1 to 2 percent, and that was the extent of loss we would realize if our investments didn't pan out.

Mr. ISSA. So to characterize what you've just said, you gambled less than those who went routinely long on any investment.

Mr. PAULSON. I believe that's the case.

Mr. ISSA. So the people who invested with you, including the pension funds and so on, were gambling less because of your technique--which was available to them and you have a track history since 1994--they were gambling less because you told them that you had, in fact, hedged outcomes in order to protect their investment.

Mr. PAULSON. I prefer not to use the word "gambling."

Mr. ISSA. And I didn't use it for you, I used the word "hedge" for obvious reasons. And the term "gambling," and just correct me if I'm wrong, most mutual funds, whether they're in small cap, mid cap, large cap, foreign, they basically tell you they're going to be 100 percent invested or they're going to have a ratio. And no matter what happens in the market, they don't go to all cash, and many of them refuse to go short to market as a matter of it's in the prospectus; isn't that right?

Mr. PAULSON. That's correct.

Mr. ISSA. So your technique and the technique of virtually all hedge funds is, in fact, to limit risk by stating how you will maneuver in a market as it becomes less than one directional up; isn't that true?

Mr. PAULSON. That's true. An important goal of our funds is to limit risk and reduce volatility.

Mr. ISSA. Last question, if I could, Mr. Chairman.

There was some talk on the earlier panel about tax treatment--and I know this isn't the Ways and Means Committee so I want to limit it, but do any of you see a way in which we could look at the long term gains that you and your investors achieve when you're long for a period of more than a year and differentiate between those and any other investor in stocks and other equity products or debt products? Do any of you see a way in which you could effectively differentiate, because we're often talking about hedge funds and saying, well, we've got to get rid of their capital gains treatment, the only reason I ask is, can any of you--because you're very smart people--think of a way that we would separate your category from every other mutual fund, if you will, and the capital gains treatment they get?

Mr. FALCONE. If I may, if you plan to go down that road, there might be one possibility where--

Mr. ISSA. By the way, I don't plan to go down that road.

Mr. FALCONE. Instead of having the horizon be 12 months, maybe make it a little bit longer for hedge funds. I would hate to see that eliminated in its entirety because there are truly individuals in the hedge fund market that are investors, and if you extend that time frame, that could be one way of looking at it.

Mr. ISSA. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Issa.

I want to thank the members of this panel. The members, I think, have asked very important questions, and you gave very thoughtful answers which is very helpful to us. Congress usually has trade associations at hearings, and they give the predictable responses, which are in what they see their self interest. And that's why we wanted to have you testify here today to get an unfiltered response, and your comments and recommendations were very helpful.

I believe there has been a consensus or near consensus that hedge funds can pose systemic risks. And there has been a similar consensus that there should be more disclosure about the activities of such hedge funds. Several of you have urged more oversight and reasonable restrictions on leverage and closing the tax loophole that benefits hedge fund managers. You have also provided insightful criticisms of the Federal response to the financial crisis.

We're facing a terrible economy and enormous disruption in our financial markets, and I think your testimony is very helpful to us in pointing out ways that Congress and Federal regulators can help restore our markets. So I thank you very much for what you have done today.

That concludes the business before the committee, and we stand adjourned.

[Whereupon, at 2:03 p.m., the committee was adjourned.]

****
SPEAKER LISTING
****

****
CONTENTS
****

****

INDEX OF INSERTS

****