Perspectives on Hedge Fund Registration

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The Teacher's Retirement System of Texas is an $80 billion pension fund allowed (by law) to allocate up to 5% of total Trust assets to hedge funds. The allocation is made as a part of a more diversified strategy and serves three principle purposes. First, as a source of diversification, particularly during equity market corrections. Second, as an additional contributor to the Trust's long-term rate of return. Third, as a source of value added generated through skill (alpha) rather than market performance (beta). Hedge funds are not considered an important source of liquidity for our Fund.

Prior to selecting an individual firm, a strategic approach is established based on the objectives set out above. This results in the prioritization of certain investment approaches and in the de-emphasizing of others. This also establishes a set of expectations (before the fact) for how the overall strategy is expected to perform under various market conditions, relative to other investments made throughout the Trust, and in relationship to one another. This is central in the effective oversight to the investment process after funding, and in various market conditions.

Please describe in detail how your fund selects its hedge fund investments and the portion of its assets allocated to them.

The selection of individual investment firms is based on a multi-pronged process. First, a limited "Premier List" is established based on various parameters and the collaboration of all related experts employed by the Trust. That Premier List is updated at least twice annually and fully disclosed to the TRS Board. After placement on the Premier List each firm is subjected to a "Certification Process" that includes over 100 questions across eight key categories. The Certification Process is not intended to be a ranking system, but rather is designed to create a systematic and standardized body of information related to each firm. The results of this process form the minimum level of information that we require to warrant potential investment consideration. The eight categories are: Organization, Investment Process, Portfolio Exposure, Risk Management, Operations, Policies & Procedures, Transparency and Fund Terms. Investment firms that effectively pass through the Certification Process then enter into a risk management evaluation, where the final set of portfolios is based on risk systems rather than return outcomes. We are seeking the combination of portfolios that produces the highest projected return at a particular risk level and in the most reliable and understandable fashion. Due to the specific mandate that we have established at TRS, particular emphasis is now also placed on absolute return (e.g., positive results) during periods of equity market declines. The final portion of the selection process involves a detailed evaluation of the specific portfolio that the potential is likely to purchase, making sure that incentive structures are carefully established, and a thorough negotiation of legal terms.

This work is conducted by an internal team of dedicated and experienced investment professionals and presented to the senior investment management committee for approval prior to funding. Any funding approved is also reported to the full Board of Trustees by the first of the next month, along with a summary of the process, rationale and compliance with the Board's approved selection process.

Your views on H.R. 711, the Hedge Fund Advisor registration Act of 2009, and suggestions on how it can be improved.

It is first important to point out that no universally agreed upon definition of a "hedge fund" exists. Therefore, it becomes very difficult (if not impossible) to implement consistent legislation, which seeks to monitor and control the activities of a class of advisors which is not well defined. It is partly for this reason that it is difficult to draft an amendment to the existing Investment Advisor Act which will accurately target the class of advisors, typically referred as "Hedge Funds".

HR 711 proposes to eliminate the Private Advisors Exemption under Section 203(b)(3) of the Investment Advisor Act. The Private Advisors Exemption exempts advisors from registration under the Investment Advisor Act if it has less than 15 clients during the last 12 months, does not hold itself out to the public as an investment advisor, and does not act as an investment advisor to certain persons. A hedge fund manager falls squarely within the definition of an investment advisor as defined by the Investment Advisor Act, however the fund to which the manager advises is generally counted as 1 "client" for purposes of the Private Advisors Exemption. Accordingly, hedge fund managers have not typically had to register as an investment advisor under the Investment Advisor Act.

Before summarizing some of the issues with HR 711, it is worth noting that it essentially just revives a previous requirement for Hedge Funds (and other types of funds) to register with SEC. In and of itself this should not feel unreasonable to any market participant (including hedge fund managers). It is, after all, the norm for hedge funds to be registered in most other financial centers. Indeed, many managers claim to act 'as if they were registered' even if they have chosen not to.

However, a summary of issues raised by various leading law firms such as Dechert, Morrison Forester, Foley Hoag, and Hunton & Williams on HR 711 is listed below:

1. **<u>Sweeping Scope of Hedge Fund Advisers Registration Act</u>**: The title of the Bill suggests the aim is directed at HFs to register under the Investment Advisors Act. The proposed rule however would require many other advisers to register (i.e. investment managers and GPs of other pooled investment vehicles such as VC funds, PE fund, CDOs, and family limited partnerships.).   The SEC "Look-Through Rule" that effectively eliminated the Private Advisers Exemption for HFs, but later vacated by the Goldstein decision, was carefully drafted so that pooled vehicles with investors having more than a 2 year holding period (most VC and PE funds) was exempted from the Look Through Rule.

2. **<u>Non US Adviser Registration:</u>** Foreign investment advisors are not currently required to count their "non-US" clients in determining whether the advisor has fewer than 15 clients under the Private Advisors Exemption and can have up to 15 US clients without registration, provided certain conditions are met. The proposed bill would effectively render this counting rule irrelevant. Under the proposed bill, it is possible that if a non US investment advisor has even 1 US client, registration may be required. This is contrary to previous SEC guidance and it is unclear what the jurisdictional basis will be to compel non-US investment advisors to register.

3. **<u>Restricted Ability to Charge a Performance Fee:</u>** Under the current Advisers Act, advisers cannot enter into a contract to share in the capital gains or capital appreciation of the client's account with certain classes of client. This would not affect institutional investors, which are qualified purchasers as well as other investors deemed to be a qualified client. It may be difficult for smaller investment managers to operate under this new registration regime without being able to charge performance fees, especially since HF registration would increase compliance costs. However, this is unlikely to affect investors like TRS.

4. **<u>No Grandfathered Provisions Record Keeping Requirements:</u>** As a registered investment advisor, extensive records are required. It is not clear from the proposed bill whether HFs can use information which may be of interest to investors even if those old records are not up to the Investment Advisors "standard" (i.e. past performance information presented to clients).

We would add that this amendment to existing legislation is likely to prove unsatisfactory, as:

- it is a piecemeal response and does not address the actors that actually caused the financial crisis – banks, brokers, rating agencies
- the Investment Company Act is designed primarily for investor protection and is not designed to control systematic risk
- the Investment Company Act was adopted in 1940, and as such is not tailored for the investment structures and strategies that have prevailed over the last 30 years.

It is a one-size-fits-all legislation and is not tailored for the risk areas – entities that have scale, are complex and are systematically important.

Furthermore, it does not address what regulators need to do to assess systematic risk and may be unduly burdensome for smaller funds and investors.

- While it may be appropriate to require that essentially all firms register with the SEC, it is not appropriate to require that all firms produce detailed reports for that, or any particular, regulatory organization. The results from the vast majority of smaller firms do not create any significant systemic risk to the overall system and collection of that data would be a distraction and unduly burdensome for both the managers and the regulatory bodies. However, basic and accurate information and reporting should be required for communication with all potential investors.

- Systemic risk stems from highly identifiable sources and it is those sources that should be most aggressively monitored. First, there are only a small number of investment managers who are large enough to potentially create a significant systemic event, either individually or collectively. That number is perhaps fifty to one hundred firms globally. Those firms are sufficiently important so that their investment processes should be monitored (on a confidential, non-invasive, and non-public means) and aggregated. The factors that should be monitored however are important, but few in number. Those factors would include: assets under management, leverage (including trends), liquidity (including trends), accuracy of valuation, concentration (including trends), leverage relative to a reasonable measure of the historically normal opportunity set, and exposure to counterparties.
- The regulator needs to engage with industry participants (e.g., President's Working Group, etc.) and collaborate on this and other issues.
- Information requirements should also be flexible enough to capture the different types of risks that will be identified by the industry and regulators over time.

How you believe the Congress can achieve the appropriate balance between providing appropriate regulation of the hedge fund industry aimed at protecting investors without unduly inhibiting the benefits hedge funds provide investors and the market more broadly.

The mission of the SEC is to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. Investment and capital markets function based on trust and a belief in the long-term effectiveness of specific economic theories, political policies, and legal structures. The principle issues that can prevent the SEC from fulfilling its mission are systemic risk, fraud and inequity between investors.

When regulation is ineffective it is generally because it was either inadequate or excessive. These two bi-model outcomes are common. Effective regulation does not overreach its reasonable bounds, based solely on the fact that more must always be better. Nor does it excessively regulate those who are not large enough to comply with regulations designed to prevent outcomes that those firms could never realistically create. It is also very important that regulation does not stifle innovation, reduce productivity and inappropriately skew the risk/reward system that creates an effective and productive society.

Congress can best achieve its mission by focusing only on a limited, but unusually important, set of key factors and also primarily on the types of investment organizations that might realistically create large and prolific problems. A one size fits all process is not appropriate and will not work. In addition, it is important that whatever appropriate regulations might be developed are fully resourced so that proper oversight and enforcement is possible and likely. It is unlikely that whatever organization might be created to oversee this process will be highly resourced or stable over long periods of time. For this reason, the factors and the firms that are fully monitored and fully included should be highly focused. Under these conditions, it will be much more important to monitor and regulate the few things that really matter than to over-reach and cover everything ineffectively. In fact, a strong argument can be made that the current "rules and regulations" are more than sufficient but were simply not adequately monitored and enforced due to various issues, but primarily limited resources and excessive distraction.

Finally, simplicity should be preferred over complexity and a "common language" should be developed to assure accurate interpretation of whatever data is eventually required.

Describe the benefits of having a diverse asset allocation.

Diversification has been called the only "free lunch" in investing. Its premise is that the combination of two, or more, investments with low correlations will allow the projected return of the combined portfolio to remain "high" while the combined risk of the portfolio falls. This is a well documented and highly accredited phenomenon and has largely served long-term investors well. Many say that the route to wealth is through concentration, but that the way to remain wealthy is through diversification. Those statements are for the most part correct. In addition, either concentration of assets or attempts to aggressively forecast market movements have generally proven unsuccessful strategies for the vast majority of investors.

However, proper diversification is sometimes more difficult than it appears, principally for the following reasons. First, long-term correlations are often inadequate guides to what the actual correlations will be when periods of significant stress arise. Specifically, when significant equity market corrections occur many correlations that were projected to be relatively low often rise dramatically. Secondly, dollar allocation is a poor guide to actual diversification when measured as the marginal contributor to risk. For instance, while most funds allocate approximately 60% to equity investments it is generally the case that equity investments contribute more than 90% of the actual risk of the portfolio. Of course, this is using the standard measures of risk relative to prospective returns that vastly mismatches time horizons (e.g, long term investment planning with short-term risk measures). Third, the number of asset classes for use in diversifying is highly limited and more correlated than desired.

Many of the strategies followed by hedge funds are attempts to address the problems with traditional diversification just cited. The fact that the potential for achieving a satisfactory long-term return generally requires a large equity position is addressed by some hedge funds by rebalancing risk (say, 50% equity, 50% bonds) and using leverage to return the total portfolio to the original target return. In addition, the ability to identify and combine uncorrelated alphas, while difficult, is virtually unlimited. The desired result by most large institutions is to use hedge funds as a new source of return that is largely uncorrelated with either stocks or bonds.

Describe the dialogue that occurs between investors and hedge fund managers and the due diligence you conduct in selecting asset managers.

At TRS, each hedge fund investment is viewed as a relationship and maintaining an open dialogue with a manager is vital to the success of the program. Formal calls and meetings are held monthly/quarterly, but the informal calls are every bit as important.

Hedge funds are viewed as a "head light" system in order to help TRS navigate towards opportunity and away from risks. TRS conducts extensive due diligence prior to making an investment in any hedge fund. This is called the Certification Process and consists of thorough documentation, on-site visits, operations checks and background analysis. Additional due diligence is conducted by our consultants, who sign-off on each hedge fund manager in which TRS invests.

The types of questions that regulators should be asking hedge fund managers to better understand their trading strategies.
The primary role of regulators is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Stated differently, they prevent fraud, protect against systematic risks and encourage trust in the system. The questions regulators ask should help them achieve those objectives.

The following areas of inquiry, as recommended by the President's Working Group (Investors Committee) would be relevant to regulators in their oversight capacity. They address systematic risks (leverage, liquidity, counterparty risk) and ensuring the integrity of the system (reporting and transparency)

Managing Liquidity and Leverage Risk

- Definition of leverage, as well as which investment strategies and instruments utilized by the hedge fund will generate levered exposure.
- Plans for reducing leverage if limits are exceeded.
- Source of leverage capital in any investment strategy
- Financing arrangements of the fund and constraints those arrangements place on the fund in terms of leverage, liquidity, operations, or otherwise
- Risks to the continued availability of financing and alternatives available to replace existing leverage financing in case of market dislocation or problems with an existing leverage provider.
- How frequently managers conduct liquidity stress - testing and scenario analysis, and understand its scope.
- Liquidity terms of their investment in the context of the fund's underlying asset liquidity and redemption policy
- Circumstances in which a fund can suspend redemptions and measures that managers employ to mitigate the risk of such suspensions.

Counterparty Risk

- Prime broker(s) and other material credit or trading counterparties of the fund and the manager's process for analyzing and diversifying prime broker and counterparty risk.
- Frequency the manager trades over-the-counter instruments, and what portion of the hedge fund's portfolio is exposed to the risks of over-the-counter markets.
- Stress-testing of counterparty arrangements to understand the circumstances in which a trading relationship can be unwound or margin/collateral requirements increased.

Reporting and Transparency

- Scope and timeliness of a fund's transparency and disclosure.
- Sample reports and the firm's commitment to providing these metrics on an ongoing basis.
- Information regarding a hedge fund's strategies, terms, conditions and risk management.
- Critical disclosures and metrics on a consistent and timely basis including:
    - General asset classes to which the portfolio is allocated.
    - Individual holdings to evaluate the associated risk exposures, (i.e. types of securities the fund holds, broken down by sector, duration, credit quality, geographic region, and exposures related to derivative positions.)
    - Percentage of hedge fund portfolio that managers classify as "illiquid."
- Disclosure of conflicts of interests
- Audit procedures and histories

What kinds of information hedge fund managers should voluntarily provide to investors and regulators.
Hedge fund managers should voluntarily provide sufficient transparency to enable investors to comply with the PWG Investors' Committee's principles and best practices. This would include:

- Description of strategy
- AUM at the fund, strategy and firm level
- Returns/performance of the fund (monthly, ideally daily/weekly)
- Pending redemption profile (e.g. what is gated, when do gates roll off)
- Service Providers, in particular changes to service providers
- Aggregated risk information, including leverage usage or gross and net exposures (this may include position level data)
- Liquidity profile
- Large position concentration
- Hard to price assets and methodology used
- Key personnel and changes to them
- Counterparties and exposures to them
- General market and fund specific updates (e.g. monthly newsletter)
- Prospectus, DDQ, financial statements, incorporation certificate

Your views on the recent publicized attempts by some pension funds to increase hedge fund transparency on their own and to re-negotiate the standard fee structure funds charge.
Recent conditions have highlighted the need to increasingly implement a system organized around the phrase "trust but verify". No longer should investors readily accept statements from managers such as "we don't disclose" or "that is proprietary". However, with that said, it should not be concluded that infinitesimal transparency is always

preferred and worthwhile. Reports are needed that effectively describe the overall portfolio and reveal its most important position and its most significant risks. This may, or may not, mean that position level reporting is required. In fact, position level reporting can sometimes be both a distraction for the investor and a competitive disadvantage for the manager.

In addition, transparency should presumably be separated into two categories. The first category would be the risk issues that could significantly disrupt the investment process and create an outcome that was both negative and largely unanticipated. These risks are described above but will be repeated here for convenience. They are (i) assets under management, (ii) leverage, (iii) liquidity, (iv) concentration, (v) counterparty exposure, trends in these factors, (vi) fat tail risks and (vi) and changes in the opportunity set specified for the manager.

The second category would be risk compliance and more oriented to policy guidelines and less likely to produce large and unanticipated losses. These kinds of risks are what is usually reported and can be a distraction if the objective is to monitor for “catastrophic” risks.

The second major category of risk – fraud – is somewhat more difficult to capture after the fact. Thankfully, it also seems rare – at least in the high end institutional world. Nonetheless, there are certainly notable exceptions and whatever reasonable steps that can be taken to reduce its occurrence should be considered. There is little that can be done to prevent a determined “swindler” from initiating a fraud. However, here is a list of items that can be helpful: use of segregated accounts, limitations on self dealing, use of a properly qualified accounting and performance firm, use of a high quality custodian, and the monitoring of unusually lengthy settlements. It is also helpful to have direct and personal long-term relationships with key personnel in both the trading and the custodial world. Finally, detecting fraud often requires the use of common sense and the willingness to question things that seem “to good to be true”.

TRS has adopted the recent recommendations established by the President’s Working Group. Thus far, 35 of our 44 hedge fund relationships have stated that they are fully compliant. The majority of the remainder has indicated that they will be appropriately compliant no later than year end.

Regarding fees, there are two significant considerations. First, performance related fees should be properly aligned between investors and managers thereby creating productive incentives for long-term performance. Second, hedge fund fees should generally be paid solely for alpha (market outperformance) and should be largely independent of market performance. The production of “alpha” is often exceedingly difficult and “zero sum”. However, when it is achieved it can be particularly helpful in creating long-term returns. New arrangements should now be considered that reduce the typical hedge fund management fees while continuing to allow for mutually acceptable arrangements regarding performance fees.

What the Congress should do—besides mandating registration- to increase transparency of hedge funds and better protect investors.

Congress should look at encouraging investors to take responsibility for their own due diligence and risk monitoring because this becomes a powerful catalyst for improving the standards within the hedge fund industry. In some circumstances, such as when a hedge fund blow-up turns out to be a fraud, investors can actually be effectively penalized for actively getting out of the fund because it failed to meet its due diligence standards as opposed to claiming it was just redeeming in the regular course of that investors activities. This sends a perversely mixed message to the investor community. "Buyer beware" should augment the law, not contradict it.