Testimony of Erik R. Sirri, Director

Division of Market Regulation, U.S. Securities and Exchange Commission

Concerning Recent Initiatives Taken by the Commission

With Respect to Hedge Funds

Before the

Financial Services Committee

U.S. House of Representatives

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Chairman Frank, Ranking Member Bachus and Members of the Committee:

On behalf of the Securities and Exchange Commission, I appreciate the opportunity to speak with you today regarding recent initiatives being taken by the Commission with respect to hedge funds. Even as the Commission believes that private pools of capital, such as hedge funds, bring significant benefits to the financial markets, the Commission is also working diligently to protect hedge fund investors and other market participants against fraud and to ameliorate through its oversight of the internationally active US securities firms the broader systemic risks such funds potentially pose to our financial system.

As you know, the President's Working Group ("PWG")[1] released principles and guidelines regarding private pools of capital, such as hedge funds. These principles complement and inform the regulatory and supervisory work of each of the PWG agencies with respect to investors, fiduciaries, creditors, and counterparties.

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1 The PWG is composed of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission.

In my testimony today, I am pleased to speak with you about several SEC initiatives that the Commission believes will further these goals. These include our continuing vigorous enforcement of the federal laws in this area; a new rulemaking to clarify our ability to bring enforcement proceedings against an investment adviser who defrauds investors or potential investors in a hedge fund or other pooled investment vehicle; the Commission's rulemaking to add a new category of "accredited investor" under the Securities Act of 1933 with an increased net worth standard; and the Commission's Consolidated Supervised Entity Program.

Enforcement Against Hedge Fund Advisers

A critical component of our efforts to protect investors and the integrity of our trading markets is our enforcement program. The Commission has brought cases alleging frauds by hedge fund managers against the funds they manage and the investors in those funds, as well as violations of the securities laws by hedge fund managers that implicate the integrity and fairness of our trading markets, such as insider trading, market manipulation, illegal short selling, and fraudulent market timing and late trading of mutual fund shares. Insider trading by hedge fund managers is an area of concern to the Commission, and is a focus of our current enforcement efforts. In March of this year, the Commission filed cases alleging one of the most pervasive Wall Street insider trading rings since the days of Ivan Boesky and Dennis Levine. We alleged that participants in the scheme included several hedge funds and their portfolio managers. In another recent case, we charged a pharmaceutical company executive and his three sons with insider trading. We alleged that, in the course of a scheme, in which the father regularly tipped his sons with confidential information misappropriated from his employer, the family created a purported hedge fund to conduct the trading and further obscure their identities. Also in the past year, we have brought enforcement actions against hedge fund advisers and portfolio managers for illegally trading in advance of PIPEs or similar offerings. We alleged in those cases that the defendants made material misrepresentations to the issuers of the securities, and that some defendants engaged in insider trading in connection with the offerings. We have also brought enforcement actions in the past year against well known hedge fund advisers for allegedly engaging in illegal short sales in connection with multiple public offerings; against an adviser that allegedly engaged in cherry-picking of trades to favor a hedge fund client over other advisory clients; against hedge fund advisers we alleged engaged in fraudulent market timing and late trading of mutual fund shares; and against hedge fund managers we alleged stole money from their investors, and made misrepresentations about matters such as the performance of the funds' investments, strategies, and risk of loss. In some of these cases we have worked side-by-side with criminal authorities who have brought their own cases in connection with the illegal conduct.

Although there are many unregistered hedge fund advisers, more than 1,900 investment advisers to hedge funds are registered with the SEC. These firms, along with other registered advisers, are required by SEC rules to have a chief compliance officer and a compliance program that includes written compliance policies and procedures. They are also subject to SEC examination. During such an examination, the SEC's inspection staff may review the adviser's compliance program with respect to, for example, disclosures to investors, portfolio trading, pricing and valuation practices, its code of ethics, and personal trading activities.

Hedge Fund Related Rulemakings

This past December, the Commission proposed a new antifraud rule under the Investment Advisers Act of 1940 to clarify its ability to bring actions under the Investment Advisers Act against advisers who defraud investors in a hedge fund or other pooled investment vehicles. At an open meeting today, the Commission will consider adopting that rule, which would prohibit investment advisers to hedge funds from making false or misleading statements to, or otherwise defrauding, investors in hedge funds.

The Commission proposed the rule after a court decision, Goldstein v. SEC, created uncertainty regarding the obligation that investment advisers to pools have to investors. The court vacated a rule that the Commission adopted in 2004 that required certain hedge fund advisers to register under the Investment Advisers Act. In addressing the scope of the exemption from registration in section 203(b)(3) of the Investment Advisers Act, and the meaning of the term "client" as used in that section, the court expressed the view that, for purposes of sections 206(1) and (2) of the Investment Advisers Act, the "client" of an investment adviser managing the pool is the pool itself, not the investors in the pool. The proposed rule would address the uncertainty created by the Goldstein decision regarding conduct aimed at investors by prohibiting advisers from (i) making false or misleading statements to investors in pooled investment vehicles, or (ii) otherwise defrauding them.

The Commission is currently considering increasing financial thresholds for investors in private offerings of hedge funds and private equity funds.

Consolidated Supervised Entities Program

In general, the growth in private pools of capital, such as hedge funds, has made the financial markets wider and deeper, supported significant product innovation, and allowed for greater risk transfer. At the same time, this development has created numerous challenges for regulated financial institutions and their supervisors.

At present, the Commission supervises five securities firms on a consolidated or group-wide basis – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan

Stanley – also known as the CSEs. For such firms, the Commission oversees not only the U.S.-registered broker-dealer, but the consolidated entity, which may include other regulated entities such as foreign-registered broker-dealers and banks, as well as unregulated entities, such as derivatives dealers and the holding company itself.

The Commission's CSE program is designed to provide holding company supervision in a manner that is broadly consistent with the oversight provided to bank holding companies by the Federal Reserve. The aim of this program is to diminish the likelihood that weakness in the holding company itself or any of its unregulated affiliates places a regulated entity, such as a bank or broker-dealer, or the broader financial system, at risk. CSEs are subject to a number of requirements under the program, including monthly computation of a capital adequacy measure consistent with the Basel II Standard, maintenance of substantial amounts of liquidity at the holding company, and documentation of a comprehensive system of internal controls which are subject to Commission inspection.

All five of the CSEs are of potentially systemic importance, trading a wide range of financial products, connected through counterparty relationships to other large institutions and providing services to a variety of market participants. Prudential supervision of CSEs differs from the investor protection activities previously discussed. The primary concern of the CSE program with regard to hedge funds revolves around the risks they potentially pose to the CSE firms specifically and, through the CSEs, to the financial system.

Hedge funds present a variety of management challenges to CSEs. For example, a hedge fund may grow so large in absolute terms that a forced liquidation could lead to a broader unwinding of positions and otherwise disrupt the markets. The demise of Long Term Capital Management in 1998, Amaranth's losses related to natural gas derivatives last year, and the

BSAM hedge funds' losses on securitized products referencing subprime mortgages this year highlights concerns associated with such risks.

In addition, the rapid development of risk transfer mechanisms (such as credit derivatives and securitization) is often cited as evidence that today's markets have better shock absorbers than in the past. However, the transfer of risk from banks and securities firms to hedge funds and other market participants may not be as definitive as some believe. Financing arrangements for certain exposures through repurchase (repo) facilities and derivative transactions serve not only to increase the amount of leverage in the system, but may also bring risk back to regulated financial institutions in ways that can be challenging for the firms to measure and manage.

The Commission's CSE program monitors and assesses these risks in several ways.

First, Commission staff meets at least monthly with senior risk managers at the CSEs to review market and credit risk exposures, including those to hedge funds. This process provides information not only concerning the potential risks to CSEs, but also a broad window into their relationship with hedge funds and these hedge funds' potential impact on the broader financial markets. Importantly, these meetings allow Commission staff to monitor trends in the extension of credit to hedge funds through a variety of channels, including prime brokerage relationships, secured financings such as repos and OTC derivative trades. Regulators have expressed concerns in recent years that competition for lucrative hedge fund business, in some instances, may have led to erosion of financing terms. Through this monthly process, we endeavor to track changes in margin terms and other credit mitigants. Where warranted and where the information we obtain is timely, we can respond with respect to CSEs by requiring that they hold additional capital against such exposures.

Second, Commission staff has recently engaged in targeted discussions with the CSEs about the challenges of measuring credit exposures to hedge funds. For example, risk managers cite the need for stress testing their exposures to hedge fund counterparties. There is a general consensus that measures such as value-at-risk (VaR) may not be sufficient for judging the risk presented by hedge fund counterparties implementing complex strategies, and hence the adequacy of the collateral protecting the bank and securities firms that provide financing. Firms have found it challenging to design and implement stress tests that can be applied effectively and efficiently to the wide variety of fund strategies, especially given that these strategies are continually evolving. The internationally active banks and securities firms, including CSEs, have devoted appreciable time and resources to this task, and further work continues.

Finally, over the past nine months, the Commission's staff has embarked on a joint project with the Federal Reserve and the U.K. Financial Services Authority to understand current industry practices of banks and broker-dealers in managing their exposure to hedge funds. All three agencies met with nine major U.S. and European banks and securities firms in December to discuss broadly their risk management policies and procedures related to interactions with hedge funds both through prime brokerage, the direct financing of positions, and OTC derivatives transactions. Germany's Bundesbank and Financial Supervisory Authority, the Swiss Banking Commission, and the U.S. Office of the Comptroller of the Currency also participated in the meetings with institutions for which they were the principal regulator. The agencies have identified a number of issues related to the extension of credit to hedge funds, and are now addressing those issues in a second phase which entails more detailed work by the principal regulator of each firm.

Taken together, these efforts allow us to identify some trends that we and our regulatory colleagues, as well as risk managers at the large banks and securities firms, will surely continue to follow closely. The demise of Amaranth and the issues associated with the BSAM hedge funds also provide some interesting data points to consider.

First, some of the largest, more systemically important hedge funds are beginning to look more and more like mature financial institutions, diversifying their portfolios beyond leveraged equity or fixed income strategies, and diversifying their activities beyond just proprietary trading. From private equity to middle-market lending, there are few markets where these large hedge funds are still on the sidelines. Likewise, some hedge fund complexes have traditional asset management and market-making divisions that compete with those of established investment banks. Along with this widening scope of investments and activities, a number of hedge funds appear to be strengthening their independent control functions, such as market and liquidity risk management.

Second, hedge funds generally have become more sophisticated about liquidity risk management, in part by negotiating more flexible credit terms with dealer banks. During recent episodes of heightened market volatility – for instance in the energy markets last year, equities and emerging markets this spring, and the mortgage market recently – Commission staff consistently heard that most hedge funds met their margin calls in a timely manner, without difficulty (with a few notable exceptions, of course). To be sure, this increase in sophistication is both a blessing and a curse. On the one hand, more favorable credit terms means more flexibility in times of market turmoil, leading to a lower probability of a forced unwinding of positions and destabilized markets. On the other hand, more favorable credit terms mean more concentrated counterparty credit risk for the banks. In the case of Amaranth, it was able to sell large portions of its portfolio in an orderly way to satisfy all of its creditors; had it not, the credit risk losses at its creditor banks could have been significant. Assessing whether a healthy balance is being struck will continue to be a challenge for dealer banks and their supervisors.

Third, in some markets, hedge funds are the major providers of liquidity – in short, what they giveth, they can taketh away. The impact that the BSAM hedge funds' losses is having on the subprime mortgage market illustrates the point. The funds were major players in the market for structured mortgage products such as collateralized debt obligations containing asset backed securities ("ABS CDOs"). When it became apparent that the funds needed to liquidate large portions of their portfolios to meet creditor demands, a number of hedge fund market participants moved to the sidelines and market liquidity fell sharply.

Finally, leverage can be achieved in a myriad of ways. The economics of a margin loan can be replicated in synthetic form through derivatives or achieved through repurchase agreements. Even if financial leverage could somehow be constrained, the ability to engineer economic leverage through structured products is virtually infinite, as seen in the CDO markets. The regulatory focus on excessive leverage is the right one, but this is far from simple in today's innovative financial markets.

While these trends will continue to challenge regulated institutions and their supervisors, the focus in recent years on counterparty credit risk management has clearly been good for financial institutions and the financial system as a whole. After the failure of Long-Term Capital Management in 1998, the Counterparty Risk Management Policy Group brought together senior risk managers from the major commercial and investment banks to consider the lessons of that event. Their report addressed systemic risk concerns by articulating best practices in counterparty risk management appropriate to regulated entities such as banks and securities firms. Many regulated firms responded to the recommendations by building the infrastructure necessary to quantify and monitor exposures that are tied to the value of complex financial products. Other efforts to reflect the best practices described in the report entailed tightening standards for, and discipline around, the extension of credit to counterparties, from obtaining initial margin to establishing the right to close out contracts should a counterparty fail to meet its obligations.

The Counterparty Risk Management Policy Group issued a second report in July of 2005 that dealt with developments since the initial report, including the proliferation of products with embedded leverage and securitizations. The new report reemphasized the essential conclusion of the first report that, “[C]redit risk, and in particular counterparty credit risk, is probably the single most important variable in determining whether and with what speed financial disturbances become financial shocks with potential systemic traits.” And the second report contained new recommendations, intended to deal with the myriad developments in financial markets, including the growing role of hedge funds and proliferation of credit derivatives, since the first report.

Thus we must not become complacent, and there remains work to be done, even in implementing the recommendations in the Counterparty Risk Management Policy Group reports. The lack of contagion from the Amaranth losses must be viewed against the backdrop of a favorable market environment with ample liquidity and tight credit spreads across a range of markets. These conditions allowed time for an orderly closing out of positions. Although the situation remains in flux, it appears, thus far, that the BSAM funds will similarly be able to unwind in an orderly fashion, with limited impact on the broader markets. But there is no guarantee that such favorable conditions will persist, and we must be prepared to assume that they will not. Thus, the regulatory community must continue to engage with the systemically important banks and securities firms encouraging additional efforts to improve and expand risk management capabilities. We will work with our PWG colleagues and other market participants, hopefully including some of the larger hedge funds, to further this agenda.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you might have.