COALITION OF PRIVATE INVESTMENT COMPANIES

TESTIMONY OF JAMES CHANOS

CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

HOUSE OF REPRESENTATIVES FINANCIAL SERVICES COMMITTEE

HEARING ON REGULATING HEDGE FUNDS AND OTHER PRIVATE INVESTMENT POOLS

OCTOBER 6, 2009

415 Second Street, N.E. ◊ Suite 200 ◊ Washington, DC 20002 ◊ www.hedgefundfacts.org ◊ TEL 202-715-0840

Chairman Frank, Ranking Member Bachus, and Members of the Committee. My name is James Chanos, and I am President of Kynikos Associates LP, a New York private investment management company that I founded in 1985.[1] I am appearing today on behalf of the Coalition of Private Investment Companies ("CPIC"), a group of private investment companies that are diverse in size and in the investment strategies they pursue, with a wide range of clients that include pension funds, asset managers, foundations, other institutional investors, and qualified wealthy individuals.[2]

I want to thank you for this opportunity to testify on the regulation of hedge funds and other private investment pools. Among other subjects, my testimony discusses the "Private Fund Investment Advisers Registration Act of 2009," as proposed by the Administration and included in the Committee's discussion draft. This draft legislation addresses several recommendations that CPIC made in prior Congressional testimony regarding private fund regulation, including requiring that private investment companies register with the Securities and Exchange Commission ("SEC") and be subject to its examination and enforcement authority. It further provides for mandatory reporting to regulators and requires that private investment companies make disclosures to investors, counterparties and creditors, as the SEC may require by rule. CPIC strongly supports those provisions of the draft legislation, with the enhancements discussed in our testimony below.

---

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

[2] CPIC's website, www.hedgefundfacts.org, provides information on how hedge funds serve investors in U.S. and global markets. A primer can be downloaded from that site. CPIC's other website, www.financialdetectives.org, provides information about short selling.

The Administration's proposal and the Committee's draft seek to achieve effective regulation of private investment companies and their managers primarily through amendments to the Investment Advisers Act ("Advisers Act") and broad delegations of rulemaking authority to the SEC. CPIC has proposed in prior Congressional testimony that the Committee consider drafting a special "Private Investment Company" statute. This would have the advantage of being tailored to private investment funds, and would thereby address their unique characteristics and risks, while being less reliant upon a broad grant of rulemaking authority to the SEC.

Whatever approach this Committee decides to undertake, CPIC believes legislation to regulate private investment funds should include the following core requirements to protect investors and address the potential for systemic risks:

- Register private funds with the SEC. Each fund and its investment manager should be subject to SEC inspection, enforcement authority, and record-keeping requirements.
- Apply the registration requirement to all private funds, including venture capital, private equity, and hedge funds, without regard to their asset class or investment strategy.
- Subject private funds to tough, comprehensive custody and audit requirements to protect investors from theft, Ponzi schemes, and fraud.
- Require private funds to provide robust disclosures to investors, counterparties, and lenders, to assure that all of these parties have sufficient information to assess the risks of investing with, or doing business with, private funds.
- Direct private funds to provide basic census data in an online form, available to the public.

- Require private funds to implement anti-money laundering programs, just as broker-dealers, banks, and open-end investment companies must do.
- Mandate that larger private funds adopt risk management plans to both identify and control material risks, and address orderly wind-downs.
- Require larger funds to provide additional reports that enable regulators to assess potential systemic risks posed by large private funds and other large financial institutions.

CPIC believes that these statutory requirements will benefit investors by putting into place a comprehensive regulatory framework that enhances the regulators' ability to monitor and address systemic risks while providing clearer authority to prevent fraud and other illegal actions. We look forward to working with you and your staff as you consider the legislation.

I. Investor Benefits and Risk Mitigation Functions of Private Pools of Capital

Your letter asked that witnesses address how private pools of capital contribute to, or mitigate, systemic risk. Let me begin by briefly addressing the significant benefits of hedge funds and other private investment funds in the U.S. and global markets — benefits that have been widely acknowledged over many years by government and private sector groups, including the President's Working Group on Financial Markets ("PWG"), the Commodity Futures Trading Commission, the SEC, and the Federal Reserve Board, as well as numerous investors who view private funds as essential to their investment programs.[3]

[3] *See, e.g.*, Remarks of Ben S. Bernanke, who called hedge funds a "positive force in the American financial system." Hearing, Nomination of Ben S. Bernanke to be a Member and Chairman of the Board of Governors of the Federal Reserve System, S. Comm. on Banking, Housing and Urban Affairs, S. HRG. 109–551 (Nov. 15, 2005), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_senate_hearings&docid=f:26610.pdf. Other financial regulators also view hedge funds as a positive force. For example, the United Kingdom's Financial Services Authority (FSA), releasing a March 2006 report on hedge funds, reiterated its view that hedge funds are "a vital segment of the financial services industry. In particular they play a fundamental role in the efficient

As this Committee knows, our markets benefit from the wide diversity of market participants: investment bankers and broker-dealers, commercial banks, savings institutions, mutual funds, commodity futures traders, exchanges and markets of all types, traders of all sizes, and a variety of managed pools of capital, including venture capital funds, private equity funds, commodity pools, and hedge funds.

Private investment funds play significant, diverse roles in financial markets and the U.S. and global economies. They offer investors opportunities to diversify their portfolios and thereby improve risk-adjusted returns and reduce market volatility. Venture capital funds are an important source of funding for start-up companies or turnaround ventures. Private equity funds provide growth capital to established small-sized companies, while still others pursue "buyout" strategies by investing in underperforming companies and providing them with capital and/or expertise to improve results. These funds may focus on providing capital in such particular sectors as energy, real estate, and infrastructure.

Hedge funds invest in or trade a variety of financial instruments worldwide, including stocks, bonds, currencies, futures, options, other derivatives, and physical commodities. Some invest in securities and hold long-term positions, such as some long-short funds and short-only funds.[4] Some are strictly traders. Many serve as important counterparties to other participants in

---

reallocation of capital and risk, and remain an important source of liquidity and innovation in today's markets." Press Release, FSA (Mar. 23, 2006) *available at* www.fsa.gov.uk/pages/Library/Communication/PR/2006/026.shtml. *See also* Statement of Joseph A. Dear, Chief Investment Officer, California Public Employees' Retirement System, S. Comm. on Banking, Housing, and Urban Affairs, Regulating Hedge Funds and Other Private Investment Pools (July 15, 2009), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e83f7ca1-6f94-4854-8aa9-ef0ac11b4bb0. In a survey by Preqin Ltd., 56 percent of institutional investors surveyed responded that their primary reason for investing in hedge finds was for "diversification purposes/to decrease volatility." *See Overview of the Global Hedge Fund Institutional Investor Universe: Special Report*, Nov. 2008, a*vailable at* http:/www.preqin.com/docs/reports/Preqin_Hedge_Research_November08.pdf.

[4] Using the components of the Credit Suisse/Tremont Hedge Fund Index as a proxy, 26.2 percent of hedge funds are event driven; 21.9 percent are long/short equity; 17.2 percent are global macro; 15.0 percent are multi-strategy; 8.0

the market who wish to offset risk. Hedge funds who short securities help mitigate the risk of upward price manipulations. Some hedge funds may become "activists" and use a large equity position in a company to encourage management to make changes to increase shareholder value. Hedge funds, as a group, add to the depth, liquidity, and competitiveness of the markets in which they participate. The individuals who run them bring their research and insight to bear on the value of various assets, thereby adding to the price discovery and efficiency of capital markets. Also, they typically commit their personal capital to the funds they manage.

The Chief Investment Officer of the California Public Employees' Retirement System ("CalPERS"), Joseph Dear, calls hedge funds and other alternative investments "indispensable elements" of many public pensions' investment programs.[5] Mr. Dear recently testified that CalPERS invests in private equity and hedge funds to diversify its investment portfolio, manage risk, and add value to the total fund. As he explained, the important benefits of investing in private funds include "effective risk management and investment value creation through allowance for the diversification of our portfolio across a broad array of asset classes."[6]

II. Risks Posed by Private Pools of Capital

For several years, prior to the recent economic downturn, some believed that hedge funds and other private pools of capital would be the source of the next financial crisis. However, as we have all learned painfully, the greatest danger to world economies came not from those entities subject to indirect regulation, such as hedge funds, but from banks, insurance companies,

---

percent are emerging markets; 3.9 percent are managed futures, 3.5 percent are fixed income arbitrage, 2.0 percent are equity market neutral; 1.8 percent are convertible arbitrage, and 0.4 percent are dedicated short bias. *Available at* http://www.hedgeindex.com/hedgeindex/en/weights.aspx?ChartType=PieChart&cy=USD&indexname=HEDG.

[5] *See* Statement of Joseph A. Dear, *supra* n. 3.

[6] *Id.*

broker-dealers, and government-sponsored enterprises that operated with charters and licenses granted by state and federal regulators and under direct regulatory supervision, examination, and enforcement. Indeed, Bernard Madoff used his firm, Bernard L. Madoff Investment Securities, LLC — which was registered with the SEC as a broker-dealer and investment adviser and subject to examination and regulation — to perpetrate his Ponzi scheme. The Stanford Group of companies used an SEC-registered broker-dealer and SEC-registered investment adviser to market, among other products, certificates of deposit of an affiliated offshore bank.

Private investment funds are not part of the federal government's "safety net," as are insured depository institutions. No federal guarantees are provided to their investors. Moreover, while some hedge funds are large, they are dwarfed by the sizes of such financial institutions as commercial and investment banks, the government-sponsored enterprises, and others. Despite the rapid growth and size of hedge funds (an estimated 8,900 funds, with an estimated $1.89 trillion in assets as of August 31, 2009), their relative size within the financial sector is small, accounting for about one percent of investments in the world's financial assets — including equities, government and private debt, and deposits.[7] Private investment funds do not participate as intermediaries in payment and settlement systems. Since counterparties to hedge funds and other private investment funds do not rely on a federal safety net or supervision, they typically require higher levels of capital and liquidity and strong collateral from private funds, as compared to their transactions with more heavily regulated financial institutions. Furthermore,

[7] The total number of hedge funds has been estimated at 8,900 as of June 30, 2009. *See* Hedge Fund Research, Inc., *HFR Global Hedge Fund Research Report, Second Quarter 2009*, at 18. *Available for purchase at* http://www.hedgefundresearch.com. Total hedge fund assets have been estimated at $1.89 trillion at the end of August 2009, according to HedgeFund.net. *See HFN Monthly Performance Report: August 2009,* Sept 21,2009, *available at* http://www.hedgefund.net/hfn_public/marketing_index.aspx?template=whatsnew.cfm?story_id=10438. The total value of the world's financial assets—including equities, government and private debt, and deposits—was $196 trillion in 2007. *See* McKinsey Global Institute, *Mapping Global Capital Markets: Fifth Annual Report* (Oct. 2008), *available at* http://www.mckinsey.com/mgi/publications/fifth_annual_report_Executive_Summary.asp.

leverage ratios for hedge funds are very conservative, about two to three on average compared to much higher levels of leverage at many banks.[8] For all these reasons, when a private fund fails, it is not as likely to set off a chain reaction, such as we saw when Lehman Brothers collapsed.

In a rare case, such as that involving the super-leveraged Long Term Capital Management in 1998, it is possible that a private fund could grow to a level of size, leverage, and interconnectedness that it might pose systemic risk. Yet, in our experience, the most prominent risks associated with hedge funds relate to the relationship between funds, their managers, their investors, and discrete counterparties. In a nutshell, these are the risks of unfair dealing with clients, lack of transparency, certain custody issues, potential fraud, and conflicts of interest.

Congress has sought to ensure that hedge funds and other private funds deal appropriately with their investors by imposing conditions on the exemptions from registration under the Securities Act of 1933, the Investment Company Act of 1940 ("Investment Company Act"), and in some cases the Commodity Exchange Act ("CEA"), under which they operate.[9] To meet these exemptions, the laws require hedge funds to limit their offerings to private placements with high-net-worth, sophisticated investors who are able to understand and bear the investment risks. A private fund must either limit its beneficial owners to not more than 100 persons and entities

---

[8] *See, e.g.*, the report by Lord Adair Turner, Chairman of the FSA, noting that "[h]edge fund leverage is typically well below that of banks – about two to three on average," compared to levels of 40 or 50 times that at some European banks. The Turner Review, *A Regulatory Response to the Global Banking Crisis*, March 2009, at 72-3 and Exhibit 2.5, *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf. *See also Hedging the Blame*, Wall St. J. Europe, Mar. 20, 2009, *available att* http://online.wsj.com/article/SB123749754096088683.html; *AIMA Statement on the Turner Review*, Mar. 18, 2009, *available at* http://www.aima.org/en/announcements/other-recent-announcements/aima-statement-on-the-turner-review.cfm. In addition, a December 2008 survey of more than 6,000 hedge fund managers by PerTrac Financial Solutions found that 26.9% of managers reported using no leverage, and as many as 42% of hedge funds may be using less than 2:1 leverage. *See* Press Release, *A Broad View of Hedge Fund Performance Reveals Plenty of Strong Performers, Low Leverage and Additional Myth-Busters*, Dec. 4, 2008, *available at* http://www.hedgefundlawblog.com/hedge-fund-performance-performance-better-than-expected.html.

[9] *See Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, at 11-18, 23-25 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf ("Staff Report").

(typically all or most of whom are “accredited investors”), or limit its investors to super-accredited “qualified purchasers,” such as individuals with more than $5 million in investments and institutions with more than $25 million in investments. Private funds typically file exemptive notices with the SEC and state securities commissioners under Regulation D of the Securities Act of 1933. Many also file notices with the National Futures Association under the CEA exemptions by which they operate (which impose their own additional restrictions on sophistication and qualifications of investors).

Moreover, the SEC and criminal prosecutors have significant regulatory and enforcement authority to address potential risks posed by private funds — both risks to their clients and other market participants. For example, private investment funds are subject to the same restrictions on their investment and portfolio-trading activities as most other securities investors, including margin rules[10] (which limit the use of leverage to purchase and carry publicly traded securities and options); SEC Regulation SHO[11] (which regulates short-selling); the Williams Act amendments to the Securities Exchange Act of 1934 (“Exchange Act”)[12] and related SEC rules (which require public reporting of the acquisition of blocks of securities and regulate other activities in connection with takeovers); and the Financial Industry Regulatory Authority, Inc. ("FINRA”) “new issues” Rule 5130 (which governs allocations of IPOs).[13] Private investment funds also must abide by the rules and regulations of the markets in which they seek to buy or sell financial products. Perhaps most important, they are subject to antifraud and anti-

---

[10] 12 C.F.R. §§ 220, 221.

[11] 117 C.F.R. §§ 242.200-204.

[12] The Williams Act added Exchange Act §§13(d), 13(e), 14(d), 14(e) and 14(f), 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e) and §78n(f) in 1968. Related legislation added Section 13(g), §78m(g), in 1977.

[13] The SEC approved FINRA’s proposal to adopt former NASD Rule 2790 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) as FINRA Rule 5130, with only minor changes, on August 25, 2008. *See* Release No. 34-58421, 73 Fed. Reg. 51032 (Aug. 29, 2008).

manipulation requirements, such as Section 10(b) of the Securities Exchange Act of 1934[14] and Rule 10b-5,[15] and insider trading prohibitions that apply to both the funds' investment and portfolio trading activities and the funds' offers and sales of units to their own investors. Private fund advisers also are subject to the antifraud provisions in Section 206 of the Advisers Act, which applies to registered and unregistered investment advisers.[16]

However, regulators' lack of detailed information about private investment funds — the absence of a registration requirement and the inability of a regulator to subject unregistered private funds to periodic reporting and examination — may handicap the SEC in meeting its investor protection mandate, and may limit financial regulators in addressing potential systemic risks. Therefore, CPIC for many years has advocated that the SEC, at a minimum, should have authority to collect certain "census" data regarding all private investment funds. We have also advocated basic protections for investors in private funds, including disclosure requirements (particularly with respect to valuation of fund assets) and custody requirements, as well as audits by accounting firms registered with the Public Company Accounting Oversight Board ("PCAOB").

III. Private Sector Recommendations for Best Practices

Private sector groups, often working with regulators, have developed best practices for hedge funds, and the industry continues to improve in the areas of risk management and client protection. For example, the Managed Funds Association has initiated and updated a "Sound

[14] 15 U.S.C. § 78j(b).

[15] 17 C.F.R. § 240.10b-5.

[16] 15 U.S.C. § 80b-6.

Practices" guide for hedge funds.[17] Institutional investors have strengthened their "due diligence" processes and have demanded more information and stronger risk management approaches from the funds in which they invest.[18] As a report by the Government Accountability Office ("GAO") in May 2009 noted, "hedge fund advisers have improved disclosure and become more transparent about their operations …."[19]

Since its formation in 1999, the PWG has shared information regarding private investment funds with regulators and also has launched initiatives with the private sector, including the PWG's appointment in 2007 of an Asset Managers' Committee, on which I served, and an Investors' Committee. Each committee issued reports earlier this year on best practices for private fund managers and investors, respectively.[20]

In my view, one of the most important recommendations of the report of the Asset Managers' Committee ("AMC Best Practices") is that managers should disclose more details — going beyond Generally Accepted Accounting Principles — regarding how their funds derive

---

[17] *Sound Practices for Hedge Fund Managers*, Managed Funds Association, 2009 ed., *available at* http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf.

[18] A survey by Constellation Investment Consulting found that hedge fund managers now expect intensive due diligence. The study included over 300 participants consisting of money managers, investors and service providers. Eighty (80) percent of the managers and 75 percent of the service providers stated that they expect due diligence teams to conduct valuation analysis, test trades, review trade tickets, and perform additional risk management procedures. In addition, to ensure additional oversight, 83 percent of the investors are insisting that funds use independent administrators to perform accounting and bookkeeping functions. The study also showed that investors are "shaken, but not deterred" from including hedge fund investment in their portfolios. *See Constellation Investment Consulting Announces that Hedge Fund Managers Welcome Invasive Due Diligence*, Business Wire, Mar. 18, 2009, available at http://www.reuters.com/article/pressRelease/idUS139769+18-Mar-2009+BW20090318.

[19] *Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges*. GAO-09-677T, May 7, 2009, at 11, *available at* http://www.gao.gov/new.items/d09677t.pdf.

[20] *See, e.g., Best Practices for the Hedge Fund Industry: Report of the Asset Managers' Committee to the President's Working Group on Financial Markets,* Jan. 15, 2009, *available at* http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf; *Principles and Best Practices for Hedge Fund Investors: Report of the Investors' Committee to the President's Working Group on Financial Markets*, Jan. 15, 2009, *available at* http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf.

income and losses from Financial Accounting Standard ("FAS") 157 Level 1, 2, and 3 assets.[21] Another recommendation in our report is that a fund's annual financial statements should be audited by an independent public accounting firm that is subject to PCAOB oversight. Still another recommendation would assure that potential investors are provided with specified disclosures relating to the fund and its management before any investment is accepted. This information should include any disciplinary history and pending or concluded litigation or enforcement actions, fees and expense structure, the use of commissions to pay broker-dealers for research ("soft dollars"), the fund's methodology for valuation of assets and liabilities, any side-letters and side-arrangements, conflicts of interest and material financial arrangements with interested parties (including investment managers, custodians, portfolio brokers, and placement agents), and policies as to investment and trade allocations. Our report also recommended specified disclosures to counterparties and creditors to assure that they can fully assess the risks of their relationships with private funds.

Notwithstanding the improvements made by the private sector through these various efforts, those of us who are in the private investment fund industry recognize that a modernized financial regulatory system — one that addresses overall risk to the financial system and that regulates in a consistent manner market participants performing the same functions — should include appropriate regulation of hedge funds and other private pools of capital. Therefore, CPIC believes many of the recommendations put forward by the Asset Managers' Committee should be given legal effect. I would urge this Committee to carefully tailor the legislation to

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

preserve the flexibility of private funds and their capacity for innovation that has long benefited investors and capital markets.

IV. Proposed Legislative Changes

As this Committee is aware, private investment companies and their advisers are not required to register with the SEC if they comply with the conditions of certain exemptions from registration under the Investment Company Act and the Advisers Act.[22] Congress created exemptions under these laws, because it determined that highly restrictive requirements applicable to publicly-offered mutual funds and advisers to retail investors were not appropriate for funds designed primarily for institutions and wealthy investors.

To date, legislative proposals to regulate private investment companies have focused primarily on limiting the exemptions from regulation of private investment companies under the

---

[22] Section 3(c)(1) of the Investment Company Act excludes a company from the definition of an "investment company" if it has 100 or fewer beneficial owners of its securities and does not offer its securities to the public. Under the Securities Act of 1933 and SEC rules, an offering is not "public" if it is not made through any general solicitation or advertising to retail investors, but is made only to certain high-net-worth individuals and institutions known as "accredited investors." "Accredited investors" include banks, broker-dealers, and insurance companies. The term also includes natural persons whose individual net worth or joint net worth with a spouse exceeds $1 million, and natural persons whose individual income in each of the past two years exceeds $200,0000, or whose joint income with a spouse in each of the past three years exceeds $300,000, and who reasonably expect to reach the same income level in the current year.

Section 3(c)(7) of the Investment Company Act excludes a company from the definition of an "investment company" if all of its securities are owned by persons who are "qualified purchasers" at the time of acquisition and if the company does not offer its securities to the public. Congress added this section to the Investment Company Act in 1996 after determining that there should be no limit on the number of investors in a private investment fund, provided that all of such investors are "qualified purchasers." In brief, "qualified purchasers" must have even greater financial assets than accredited investors. Generally, individuals that own not less than $5 million in investments and entities that own not less than $25 million in investments are qualified purchasers.

Section 203(b)(3) of the Advisers Act exempts from registration any investment adviser that, during the course of the preceding twelve months has had fewer than fifteen clients and that does not hold itself out as an investment adviser nor act as an investment adviser to any investment company. Advisers to hedge funds and other private investment companies are generally excepted from registration under the Advisers Act by relying upon Section 203(b)(3), because a fund counts as one client.

In some cases, where these companies and their advisers engage in trading commodity futures, they also comply with exemptions from registration under the "commodity pool operator" and "commodity trading advisor" provisions of the CEA. These exemptions generally parallel the exemptions from registration under the securities laws.

Investment Company Act or removing an exemption under the Advisers Act and thus subjecting private investment companies or their advisers to the requirements of one of those Acts.[23] I have testified that simply eliminating the exemptions under the Investment Company Act or the Advisers Act is insufficient to address the potential risks posed by private investment companies, the types of investments they hold, and the contracts into which they enter.[24] Moreover, because the Advisers Act and the Investment Company Act were designed primarily for retail investor protection in individual accounts that invest in publicly traded stocks and bonds, they contain many provisions that would either be irrelevant to oversight of private investment companies or unduly restrictive of their operation.[25]

---

[23] For example, H.R. 711 simply strikes the "private adviser" exemption under Section 203(b)(3) of the Advisers Act and makes private funds subject to the Advisers Act in its entirety. A bill introduced in the Senate, S. 344, attempts a more tailored approach by altering the current private fund exemptions under the Investment Company Act to make them conditional exemptions, available only where a fund registers with the SEC and provides specified disclosures. Another Senate bill, S. 1276, strikes the private adviser exemption and includes additional provisions to assure SEC authority to examine both the adviser and its funds, and enhances the ability of the SEC to tailor its rules for different types of advisers.

[24] In my testimony before the SEC's public roundtable on hedge funds in 2003, I recommended that, as a further condition to exemption under the Advisers Act, hedge funds should be subject to specific standards relating to investor qualifications, custody of fund assets, annual audits and quarterly unaudited reports to investors, clear disclosure of financial arrangements with interested parties, clear disclosure of investment allocation policies, and objective and transparent standards for valuation of fund assets that are clearly disclosed, not stale, and subject to audit. Statement of James Chanos, President, Kynikos Associates, SEC Roundtable on Hedge Funds (May 15, 2003) (*available at* http://sec.gov/spotlight/hedgefunds/hedge-chanos.htm).

When I testified before the Senate in 2004, I expanded upon these points and recommended that the SEC require, as a condition to a hedge fund's exemption under the Advisers Act, that hedge funds file basic information with the SEC and certify that they meet the standards outlined above. Testimony before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on Regulation of the Hedge Fund Industry (Jul. 15, 2004) (*available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=79b80b77-9855-47d4-a514-840725ad912c). *See also* Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) (*available at* http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf). This would have provided the SEC with hedge fund "census" data it has long said it needs; it also would have provided a basis for SEC enforcement action against any fund failing to meet the above standards. Had the SEC adopted this recommendation, the agency would have avoided the legal challenge to the rule it adopted later that year to change its interpretation of the term "client" under the Advisers Act in order to require hedge fund managers to register. See *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). As this Committee knows, the SEC's hedge fund adviser registration rule was struck down in 2006 (*id*.) and the SEC decided not to appeal.

[25] For example, Advisers Act restrictions on transactions with affiliates conducted as principal that require client consent on a transaction-by-transaction basis may work against investors' needs by impinging on a fund's ability to seize rapidly emerging opportunities, particularly in the case of private equity and venture capital funds. Such funds

For that reason, CPIC has proposed in prior testimony that Congress consider drafting a stand-alone "Private Investment Company" statute. This would have the advantage of being tailored to private investment funds, and would thereby address their unique characteristics and risks, while being less reliant upon a broad grant of rulemaking authority to the SEC.

The Administration's proposal and the Committee draft have instead taken the approach of amendments to the Advisers Act. Both proposals remove the private adviser exemption under the Advisers Act and then go several steps further, giving the SEC examination authority over funds advised by a registered adviser and also giving the SEC broad rulemaking authority for record-keeping, reporting, and disclosure. They also enhance the SEC's existing authority to write rules to address different types of advisers. Thus, we believe these proposals offer a way to provide effective oversight and regulation of private fund managers, if they are sufficiently strengthened and tailored, as further discussed below.

Registration of Private Funds

The proposals would generally apply to investment advisers to any "private fund," which would include any investment fund that relies on the exemptions from registration under Section 3(c)(1) or 3(c)(7) of the Investment Company Act, and that is either organized in or created under the laws of the U.S. or has 10 percent or more of its outstanding securities owned by U.S. persons. The existing mandatory threshold for SEC registration of $30 million in assets under management would continue to apply.[26] The proposals would not require registration of "foreign

---

routinely conduct transactions as principal or as a co-investor alongside affiliated funds, and transaction-by-transaction consents from large numbers of private fund investors are, as a practical matter, not possible to collect.

[26] Section 203A of the Advisers Act states that no investment adviser that is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business is required to register with the SEC under section 203 of the Advisers Act unless the investment adviser has assets under management of $25 million or more (or such higher amount as the SEC prescribes by rule), or is an adviser to a registered investment company. Under Rule 203A-1 of the Advisers Act, the SEC raised the mandatory threshold for registration to $30

private advisers" — those with no place of business in the U.S. and fewer than 15 clients in the U.S. and less than $25 million in assets under management (or such higher amount prescribed by the SEC) if the foreign adviser does not generally hold itself out in the U.S. as an investment adviser, and is not an investment adviser to a registered investment company or business development company.

The Committee draft (but not the Administration's proposal) would exempt advisers to venture capital funds from SEC registration, although the SEC would be given authority to request information from such advisers concerning the funds. We question whether a category of private funds should be relieved of SEC registration, record-keeping, and inspection solely by virtue of its asset class and operations. Indeed, Ponzi schemes and frauds can be run with any asset class, and the lines between different categories of private funds tend to blur over time. We believe the registration requirement should apply to all private funds, whether they are hedge funds, private equity funds, or venture capital funds. In addition, registration should entail requirements for the filing of basic census data in an online publicly available form.

SEC Examination Authority

The proposals provide that records of the registered adviser's related private funds (those exempted under sections 3(c)(1) and 3(c)(7) of the Investment Company Act) are deemed to be records of the adviser and subject to SEC inspection. Thus, the SEC would have authority under the Advisers Act over all private fund managers (other than foreign advisers and venture capital funds) meeting the specified threshold, and would have broad inspection authority over all

---

million of assets under management for advisers in states with an investor adviser statute. SEC registration is optional for certain investment advisers that have between $25 and $30 million of assets under management. The proposed legislation does not change these provisions.

records of related private funds, even though the funds themselves would not be registered. We support this provision.

Record-Keeping and Reporting/Systemic Risk Oversight

The proposals would authorize the SEC by rule to require investment advisers to keep records and submit reports necessary for the assessment of systemic risk by the Federal Reserve (and, under the Administration's proposal, the proposed new Financial Services Oversight Council); authorize the SEC to require investment advisers to maintain those records for a period of time; and authorize the SEC to share information with the Federal Reserve, but otherwise provide that the SEC shall not be required to disclose any of the reports filed. We support these provisions and also believe that any broader systemic risk regulation the Committee develops should include private funds, depending, of course, on their size and level of leverage and interconnectedness.

Special Requirements for Large Funds

We also believe consideration should be given to establishing requirements for a fund (or a family of funds and/or its manager) that controls gross assets in excess of a specified amount that would not apply to smaller private investment companies. For example, larger funds should be required to implement disaster recovery, business continuity, and risk management plans to identify and control material operational, counterparty, liquidity, leverage, and portfolio risks.[27] In addition, such a fund should be required to adopt a detailed plan to address liquidity and to conduct an orderly wind-down that assures parity of treatment of investors in the event of a major liquidity event.

[27] These requirements are consistent with the AMC Best Practices.

Tailored Rules for Different Types of Advisers

The proposals would further amend existing section 211 of the Advisers Act to enhance the SEC's authority to adopt different sets of rules to address different types of advisers. Under this authority, the SEC could, for example, write a set of rules under the Advisers Act applicable only to advisers to private funds and tailored for those advisers.[28]

Disclosures to Investors, Creditors, and Counterparties

The proposals also would require that advisers make disclosures to investors, counterparties, and creditors, as the SEC may prescribe by rule — but without specification as to what those disclosures should be. Here, we suggest that the Committee may wish to do more than simply delegate this task to the SEC. We recommend providing more direction and more specificity, such as requiring that private funds or their managers provide potential investors with specific disclosures before accepting any investment, and provide existing investors with ongoing disclosures.[29] Among other things, a private fund should be required to disclose in detail its methodologies for valuation of assets and liabilities, the portion of income and losses that it derives from FAS 157 Level 1, 2 and 3 assets,[30] and any and all investor side-letters and side-arrangements. Likewise, private funds should have to disclose the policies of the fund and its investment manager as to investment and trade allocations. They should also disclose conflicts of interest and financial arrangements with interested parties, such as their investment managers, custodians, portfolio brokers, and placement agents. Funds should also be transparent

[28] For example, the SEC could address current Advisers Act restrictions on transactions with affiliates conducted as principal that require client consent on a transaction-by-transaction basis. *See* n. 25, *supra*.

[29] This requirement is consistent with the AMC Best Practices.

[30] *See* n. 21 *supra*.

with respect to their fees and expense structures, including the use of soft dollars. Investors should receive audited annual financial statements and quarterly unaudited financial statements.

Lenders and counterparties should be provided with information sufficient to assess the risk of doing business with the private fund, including the company's audited annual financial statements, current private placement memorandum, information as to the fund's valuation methodology, the existence of side-letters and side-arrangements and any material conflicts of interest or financial arrangements.

Custody Requirements

We believe the legislation should include provisions to reduce the risks of Ponzi schemes and theft by requiring money managers to keep client assets at a qualified custodian, and by requiring investment funds to be audited by independent public accounting firms that are overseen by the PCAOB.[31] Custody requirements should be extended to all investments held by covered funds. Fund assets should be held in the custody of a bank, registered securities broker-dealer, or for futures contracts, a futures commission merchant. While the SEC has adopted custody rules for registered advisers pursuant to its antifraud authority under the Advisers Act (and recently proposed amendments to those rules), we believe Congress should provide specific statutory direction to the SEC to adopt enhanced custody requirements for all advisers.[32]

[31] This requirement is consistent with the AMC Best Practices, and should be designed to close gaps in the protections provided by the Advisers Act custody rule.

[32] We believe the SEC's custody rules under the Advisers Act are insufficient to protect private investment fund assets from theft or prevent other forms of fraud. For example, the rules exclude from custody requirements certain types of instruments that are commonly owned by private investment funds, an exclusion that would deprive investors in those funds of the protection that a custodian provides. These instruments are privately-issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, as well as shares of mutual funds, which, under current law, can simply be titled in the name of the private investment fund in care of the manager, and the evidence of ownership held in a file drawer at the manager of the private investment fund. The issuers of these assets are permitted to accept instructions from the manager to transfer cash or other assets to the manager. This hole in current Advisers Act custody requirements can allow SEC-registered

Anti-Money Laundering

We also believe private investment companies should be required to implement customer identification and anti-money laundering programs, and file suspicious activity reports and currency transaction reports, just as securities broker-dealers, banks, and open-end investment companies are required to do.[33] Currently, neither registered investment advisers nor registered closed-end investment companies are subject to customer identification or other formal anti-money laundering rules.

We believe the legislation offers this Committee and the Congress an opportunity to set its priorities for private fund regulation, through greater specificity in its delegation of rulemaking authority to the SEC, and through the establishment of specific timetables for proposing and completing the rulemaking in particular areas.[34]

V. Conclusion

Private investment companies have operated remarkably well in the absence of direct government oversight and subject to the due diligence of sophisticated, high-net-worth investors.

---

advisers to abscond with money or other assets and falsify documentation of ownership of certain categories of assets, and makes it difficult for auditors, investors and counterparties to verify the financial condition of advisory accounts and private investment funds. Requiring independence between the function of managing a private investment fund and controlling its assets, by requiring that *all assets* be titled in the name of a custodian bank or broker-dealer for the benefit of the private fund and requiring *all cash flows* to move through the independent custodian would be an important control. Similarly, requiring an independent check on the records of ownership of the interests in the private investment fund, as well as imposing standards for the qualification of private investment fund auditors ─ neither of which currently is required by the Advisers Act ─ would also greatly reduce opportunities for mischief. Detailed formal requirements on the means by which private investment fund assets enter and exit the custodian's control are needed to assure that the fund's assets really exist and cannot easily be stolen. CPIC has filed a comment letter with the SEC in connection with its pending rulemaking, in which we advocate a further strengthening of the custody rules.

[33] This requirement is consistent with the AMC Best Practices.

[34] In this regard, it is not clear whether the six-month deadline for rulemaking in section 7 of the Committee draft would apply to all rules relating to disclosures (to investors, counterparties, creditors) unless they were also filed in "reports" with the SEC.

CPIC nonetheless supports the call for enhanced oversight, with the SEC as the primary functional regulator. But, simply imposing new regulation without properly tailoring it to address the relevant risks would add to the burdens of hard-working, but already overstretched agency staffs. Moreover, simply requiring registration under the Advisers Act could degrade investor due diligence by causing undue reliance upon SEC regulation under statutes that are insufficiently robust to address the unique characteristics of private funds. We have testified in the past that we believe that the twin goals of improved investor protection and enhanced systemic oversight could be better achieved with a stand-alone statute, tailored for private investment funds. However, we believe the Committee draft can accomplish these goals, if it includes the key provisions and enhancements discussed above.

We appreciate the work this Committee is doing in crafting legislation in this area, and we stand ready to work with you in the days ahead. Thank you for giving CPIC the opportunity to testify on this important subject.