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PREPARED STATEMENT

U.S. SECURITIES AND EXCHANGE COMMISSION
ROUNDTABLE ON HEDGE FUNDS

Panel Discussion: "Hedge Fund Strategies and Market Participation"
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My name is James Chanos and I am the President of Kynikos Associates, a New York private investment management company that I founded in 1985.¹ I am honored to have the opportunity to participate in today's panel entitled: "Hedge Fund Strategies and Market Participation." I would like to commend the Commission for undertaking such a thorough review of all the possible issues surrounding hedge funds as a prelude to making its recommendations for any changes to the regulatory structure.

Kynikos Associates specializes in short selling, an investment technique that profits in finding fundamentally overvalued securities that are poised to fall in price. Kynikos Associates employs seven investment professionals and is considered the largest organization of its type in the world, managing over \$1 billion for our clients.

On behalf of our clients, Kynikos Associates manages a portfolio of securities we consider to be overvalued. The portfolio is designed to profit if the securities it

¹ Prior to founding Kynikos Associates, 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.

has sold short fall in value. Kynikos Associates selects portfolio securities by conducting a rigorous financial analysis and focusing on securities issued by companies that appear to have (1) materially overstated earnings; (2) an unsustainable or operationally flawed business plan; and/or (3) engaged in outright fraud. In choosing securities for its portfolios, Kynikos Associates also relies on the many years of experience that our team has accumulated in the equity markets.

Kynikos has sometimes been called a “hedge fund,” but it is not a hedge fund following the classic model first established by A.W.Jones & Co. We operate a short fund. With the proliferation of private investment funds, however, the term “hedge fund” is now used so broadly in some quarters to refer to any private investment fund that I do not believe that it accurately describes Kynikos’ business model accurately.

In almost any market environment, professional short-sellers are a small percentage of those actively engaged in the markets. The bull market of the 1990s drove a number of previously short funds into alternative strategies or out of the market altogether. In today’s less robust market environment, however, a number of new participants have emerged and, with them, heightened public, corporate and regulatory scrutiny of the practice of short selling has ensued, as it does during almost every prolonged market downturn.

Following a brief discussion of the general benefits of short selling, I wish to address, in the strongest manner, my belief, which is borne out by testimony,

experience and empirical analysis, that short selling is beneficial to the markets not only in the technical aspects of providing liquidity or a hedge against long positions, but also as an important bulwark against hyperbole, irrational exuberance, and corporate fraud. As Bernard Baruch said nearly ninety years ago: “To enjoy the advantages of a free market, one must have both buyers and sellers, both bulls and bears. A market without bears would be like a nation without a free press. There would be no one to criticize and restrain the false optimism that always leads to disaster.”²

Who Sells Short?

There are three main categories of market participants who sell short, and they do so for differing reasons.

The first category is exchange specialists, market makers and block traders who will sell short for technical reasons in order to maintain customer liquidity and price stability.

The second category of short sellers are those who are engaging in market neutral arbitrage and are seeking to take advantage of temporary or minute price discrepancies in markets or in similar securities.

² Bernard Baruch, testimony before the Committee on Rules, House of Representatives, January 1917.

While the above activities are common market techniques, they are not what the public generally has in mind when any discussion of short selling arises. The last category of short sellers is the investor expressing his or her view that a specific stock or market index is overvalued and will decrease in price over time. It is this activity that is often associated with hedge funds and is also the frequent target of corporate criticism.

Regulatory Requirements and Economic Costs of Short Selling

First and foremost, it is important to note that short selling, like any market activity, is subject to the full panoply of anti-fraud and anti-manipulation provisions of the securities laws. There is no loophole or gray area of which I am aware in the federal securities laws that makes it illegal to manipulate the price of a stock upward but simultaneously permits the manipulation of the price of a stock downwards. In fact, and contrary to the allegations of some, short selling is one of the most heavily regulated market strategies around.

First, open short interest is disclosed monthly by both the New York Stock Exchange and the NASDAQ Stock Market for every listed company. Any investor can take a look and see how much short interest exists for any particular company. So the charge that short selling is a wholly opaque practice is spurious.

Second, alone among market transactions, short selling is subject to the “uptick rule” on both the New York Stock Exchange and the NASDAQ Stock Market. Every short sale transaction must be disclosed as such. The uptick rule requires that a short sale could, in fact, only be made at (zero plus tick) or above (plus tick) the last transaction price. Thus, it is mechanically impossible for short sellers to drive down the price of the stock. It is an open question whether the harm done to price efficiency in the marketplace is warranted by the supposed protection offered to investors against so-called bear raids. An inquiry into the transaction-by-transaction functioning of the uptick rule may in fact disclose that significant numbers of sell orders get trapped behind the gate, thus making it more difficult for investors of all sizes and sophistication levels to sell their securities when they wish.

Third, Regulation T, administered by the Federal Reserve Board, requires that short accounts post at least 50% of the value of all shorted shares as a margin requirement. Of course, margin calls can arise if the price of the shorted stock increases, thus triggering additional collateral deposits in order to meet the strictures of Regulation T.

Collateral requirements on securities loans used by shorts to deliver shorted securities pose a further control on short selling. Short sale proceeds are used to collateralize borrowed securities and they are not available to leverage the portfolio and enable additional short sales. This represents a further control on short selling.

Lastly, many institutional investors such as pension funds, mutual funds, and endowments have been prohibited or are severely restricted in shorting stock by the prudent investor rules under which managers operate such funds.

To this regulatory burden, there are also significant economic costs and market risks. Short-sellers typically must hold their short positions for extended periods—often months—until the market realizes how badly overvalued a particular stock is and the price declines. Holding the short positions is expensive and risky for the short seller. A joint Harvard Business School-University of Michigan Business School working paper in 1999 summarized these factors:

The proceeds from a short sale are not available to the short seller. Instead, the proceeds are escrowed as collateral for the owner of the borrowed shares. Typically, the short-seller receives interest on the proceeds, but the rate received (“the rebate”) is below market rate. The difference is compensation to the lender of the stock. Thus short-sellers cannot directly use the proceeds from short sales to hedge their short positions. ... The tax treatment of short positions contributes to the high cost of short selling. All profits from a short sale are taxed at the short-term capital gains rate, no matter how long the short position is open. Finally, the short-seller is required to reimburse the stock lender for any dividends or other distributions paid to the shareholders of the shorted stock while the short position is open. ... The standard stock-lending practice is that the loan must be repaid on demand. This practice exposes the short-sellers to the risk of being “squeezed.”³

³ Dechow, P., A. Hutton, L. Meulbroek, R. Sloan. “Short Sellers, fundamental analysis and stock returns,” Working Paper. Harvard Business School, University of Michigan Business School. May 1999. Pages 3-4.

The fact that there is a significant regulatory and economic burden to short selling is not to say that it cannot be a profitable transaction. Nevertheless, I would hope that this brief overview of the regulatory and economic forces in play when anyone chooses to short stock, puts to rest the carping of critics who allege that this is a lightly regulated or wholly unregulated endeavor that one would enter into cavalierly.

Short Sellers as Financial Detectives⁴

The public benefit of the “long” side of the market is well understood by almost everyone in 21st Century America: companies raise capital to fund investment, research and job creation; retail and institutional investors seek out equity investments in order to share in the creation of wealth that flows from well-managed, honest companies.

The public benefit from the “short” side of the market is less well understood, but no less valuable. As Edward Chancellor, the noted expert in the history of finance, wrote in 2001, “we need more, not less, shorting activity if, in the future, we are to avoid wasteful bubbles, such as the recent technology, media and telecoms boom.”⁵

⁴ See Alex Berenson, The Number: How the Drive for Quarterly Earnings Corrupted Wall Street and Corporate America. Chapter 9, “Detectives and Archeologists.” Random House. 2003.

Many of the major corporate frauds and bankruptcies of the past quarter century were first exposed by short sellers doing fundamental research: Enron, Tyco, Sunbeam, Boston Chicken, Baldwin United, MicroStrategies, Conseco, ZZZZBest and Crazy Eddie are but a few examples of this phenomenon.

The short sellers provide the kind of independent research that is the marketplace's best antidote to the myriad conflicts of interest so amply revealed in the global settlement with ten leading Wall Street investment banking firms. Short sellers ask the tough questions and dig out the discrepancies in the financial statements and other regulatory filings made by publicly traded companies.

Paul Asquith and Lisa Meulbroek, in a Harvard Business School working paper, found a strong correlation between short interest and subsequent negative corporate returns:

“Using data on monthly short interest positions for all New York Stock Exchange and American Stock Exchange stocks from 1976-1993, we detect a strong negative relation between short interest and subsequent returns, both during the time the stocks are heavily shorted and over the following two years. This relationship persists over the entire 18 year period, and the abnormal returns are even more negative for firms which are heavily shorted for more than one month.”⁶

⁵ Edward Chancellor, “A Short History of the Bear.” Guest Analysis, www.theprudentbear.com, October 29, 2001. Page 6.

⁶ Asquith, P. and L. Meulbroek, 1996. An empirical investigation of short interest. Working paper (Harvard University, Boston, MA.)

For an investor seeking warning signs in the market, corporate conflicts with short sellers may be just the canary in the mineshaft that is needed. As the New York Times recently reported:

“If you own shares in a company that declares war on short sellers, there is only one thing to do: sell your stake. That’s the message in a new study by Owen A. Lamont, associate professor of finance at the University of Chicago’s graduate school of business. ... The study, which covers 1977 to 2002, shows not only that the stocks of companies who try to thwart short sellers are generally overpriced, but also that short sellers are often dead right.”⁷

In fact, Professor Lamont’s recent study confirms anecdotal evidence collected by the National Association of Securities Dealers in 1986 as part of former SEC Commissioner Irving Pollack’s report to the NASD entitled Short Sale Regulation of NASDAQ Securities:

“The Pollack Report chose eleven securities for analysis, based upon media articles, complaints from issuers, and indications of unusual trading patterns. ... The Pollack Report found that, with respect to two of the securities studied, rumors of extensive short selling were unfounded – large short positions did not exist. With respect to the nine other securities, six of the issuers suffered significant operational losses and five of the issuers were the subject of adverse regulatory action.”⁸

In testimony presented to Congress in 1989, the SEC’s Associate Director of Enforcement, John Sturc, was even more pointed in dissecting the underlying reasons

⁷ “If Short Sellers Take Heat, Maybe It’s Time to Bail Out,” Gretchen Morgenson, *The New York Times*, January 26, 2003.

⁸ I. Pollack, Short Sale Regulation of NASDAQ Securities (1986); see Prepared Statement of Richard G. Ketchum, Director, Division of Market Regulation and John H. Sturc, Associate Director, Division of Enforcement, Securities and Exchange Commission, Before the House Committee on Government Affairs, Subcommittee on Commerce, Consumer, and Monetary Affairs, December 6, 1989.

that issuers and others complain about short sellers. Mr. Sturc outlined five reasons that the SEC “frequently finds that the complaints of downward manipulation that we receive from issuers or their affiliates do not lead to sustainable evidence of violations of the antifraud provisions of the federal securities laws...” including:

“... negative statements which persons holding short positions are alleged to have disseminated to the marketplace may be true or may represent expressions of investment opinion by professional securities analysts. *...many of the complaints we receive about alleged illegal short selling come from companies and corporate officers who are themselves under investigation by the Commission or others for possible violations of the securities or other laws.*” [emphasis added]⁹

Short sellers also help stabilize falling markets by buying shares to close out their short positions. This results in market support and can reduce volatility and market declines caused by a lack of buyers.

An Example of Research Based Short Selling: Enron¹⁰

It may be useful for the Commission to understand some of the mechanics of research based or informationally motivated short selling. I have received a fair amount of attention for Kynikos’ early negative views of the Enron Corporation and

⁹ Prepared Statement of Richard G. Ketchum, Director, Division of Market Regulation and John H. Sturc, Associate Director, Division of Enforcement, Securities and Exchange Commission, Before the House Committee on Government Affairs, Subcommittee on Commerce, Consumer, and Monetary Affairs, December 6, 1989. Pages 434-435

¹⁰ This section of testimony is drawn largely from testimony that I presented before the Committee on Energy and Commerce, United States House of Representatives, “Lessons Learned From Enron’s Collapse: Auditing the Accounting Industry;” February 6, 2002.

it may be useful to provide the Commission and public with one example of why and how a short seller develops his investment view.

My involvement with Enron began normally enough. In October of 2000, a friend asked me if I had seen an interesting article in The Texas Wall Street Journal, which is a regional edition, about accounting practices at large energy trading firms. The article, written by Jonathan Weil, pointed out that many of these firms, including Enron, employed the so-called “gain-on-sale” accounting method for their long-term energy trades. Basically, “gain-on-sale” accounting allows a company to estimate the future profitability of a trade made today and book a profit today based on the present value of those estimated future profits.

Our interest in Enron and other energy trading companies was piqued because our experience with companies that have used this accounting method has been that management's temptation to be overly aggressive in making assumptions about the future was too great for them to ignore. In effect, “earnings” could be created out of thin air if management was willing to push the envelope by using highly favorable assumptions. However, if these future assumptions did not come to pass, previously booked “earnings” would have to be adjusted downward. If this happened, as it often did, companies wholly reliant on “gain-on-sale” accounting would simply do new and bigger deals--with a larger immediate “earnings” impact--to offset those downward revisions. Once a company got on such an accounting treadmill, it was hard for it to get off.

The first Enron document my firm analyzed was its 1999 Form 10-K filing, which it had filed with the SEC. What immediately struck us was that despite using the “gain-on-sale” model, Enron's return on capital, a widely used measure of profitability, was a paltry 7 percent before taxes. That is, for every dollar in outside capital that Enron employed, it earned about seven cents. This is important for two reasons; first, we viewed Enron as a trading company that was akin to an “energy hedge fund.” For this type of firm, a 7 percent return on capital seemed abysmally low, particularly given its market dominance and accounting methods. Second, it was our view that Enron's cost of capital was likely in excess of 7 percent and probably closer to 9 percent, which meant from an economic point of view, that Enron wasn't really earning any money at all, despite reporting “profits” to its shareholders. This mismatch of Enron's cost of capital and its return on investment became the cornerstone for our bearish view on Enron and we began shorting Enron common stock in November of 2000 for our clients.

We were also troubled by Enron's cryptic disclosure regarding various “related party transactions” described in its 1999 Form 10-K, as well as the quarterly Form 10-Qs it filed with the SEC in 2000 for its March, June and September quarters. We read the footnotes in Enron's financial statements about these transactions over and over again and we could not decipher what impact they had on Enron's overall financial condition. It did seem strange to us, however, that Enron had organized these entities for the apparent purpose of trading with their parent company, and that they were run by an Enron executive. Another disturbing factor in our review of

Enron's situation was what we perceived to be the large amount of insider selling of Enron stock by Enron's senior executives. While not damning by itself, such selling in conjunction with our other financial concerns added to our conviction.

Finally, we were puzzled by Enron's and its supporters' boasts in late 2000 regarding the company's initiative in the telecommunications field, particularly in the trading of broadband capacity. Enron waxed eloquent about a huge, untapped market in such capacity and told analysts that the present value of Enron's opportunity in that market could be \$20 to \$30 per share of Enron stock. These statements were troubling to us, because our portfolio already contained a number of short ideas in the telecommunications and broadband area based on the snowballing glut of capacity that was developing in that industry. By late 2000, the stocks of companies in this industry had fallen precipitously, yet Enron and its executives seemed oblivious to this fact. And, despite the obvious bear market in pricing for telecommunications capacity and services, Enron still saw huge upside in the valuation of its own assets in this very same market, an ominous portent.

Beginning in January 2001, we spoke with a number of analysts at various Wall Street firms to discuss Enron and its valuation. We were struck by how many of them conceded that there was no way to analyze Enron, but that investing in Enron was instead a "trust me" story. One analyst, while admitting that Enron was a "black box" regarding profits, said that, as long as Enron delivered, who was he to argue.

In the spring of 2001, we heard reports, later confirmed by Enron, that a number of senior executives were departing from the company. Further, the insider selling of Enron stock continued unabated. Finally, our analysis of Enron's 2000 Form 10-K and March 2001 Form 10-Q filings continued to show low returns on capital as well as a number of one-time gains that boosted Enron's earnings. These filings also reflected Enron's continuing participation in various "related party transactions" that we found difficult to understand despite the more detailed disclosure Enron had provided. These observations strengthened our conviction that the market was still over-pricing Enron's stock.

In the summer of 2001, energy and power prices, specifically natural gas and electricity, began to drop. Rumors surfaced routinely on Wall Street that Enron had been caught "long" in the power market and that it was being forced to move aggressively to reduce its exposure in a declining market. It is an axiom in securities trading that no matter how well "hedged" a firm claims to be, trading operations always seem to do better in bull markets and to struggle in bear markets. We believe that the power market had entered a bear phase at just the wrong moment for Enron.

Also in the summer of 2001, stories began circulating in the marketplace about Enron's affiliated partnerships and how Enron's stock price itself was important to Enron's financial well-being. In effect, traders were saying that Enron's dropping stock price could create a cash-flow squeeze at the company because of certain provisions and agreements that it had entered into with affiliated partnerships. These

stories gained some credibility as Enron disclosed more information about these partnerships in its June 2001 Form 10-Q, which it filed in August of 2001.

To us, however, the most important story in August of 2001 was the abrupt resignation of Enron's CEO, Jeff Skilling, for “personal reasons.” In our experience, there is no louder alarm bell in a controversial company than the unexplained, sudden departure of a chief executive officer no matter what “official” reason is given. Because we viewed Skilling as the architect of the present Enron, his abrupt departure was the most ominous development yet. Kynikos Associates increased its portfolio's short position in Enron shares following this disclosure.

The effort we devoted to looking behind the numbers at Enron, and the actions we ultimately took based upon our research and analysis, show how we deliver value to our investors and, ultimately, to the market as a whole. Short sellers are the professional skeptics who look past the hype to gauge the true value of a stock. Let me now turn to the question of whether, in light of the important work they do, short sellers should be subject to greater, or perhaps less, regulation.

Is There a Need for Regulatory Change?

It is important to separate the questions regarding additional regulation of hedge funds, on the one hand, and the possibility of additional regulation of short selling, on the other. Unfortunately, the two are often linked, even though there is little evidence that there is a relationship between the two that warrants changes in public policy.¹¹

A. Short Selling

As I have outlined above, short selling is already a heavily regulated strategy with significant legal and economic constraints. Strong capital markets in the U.S. require a robust short side; restrictions on short selling impede the market's efficiency and decrease the amount of independent research necessary to mitigate against irrational exuberance and outright fraud. Short selling represents only a very small fraction of market activity. It is very costly and full of risk for the short seller to execute and maintain a position, waiting for the rest of the market to realize the stock is overvalued.

¹¹ See, for example, Edward Chancellor, "A Short History of the Bear." Guest Analysis, www.theprudentbear.com, October 29, 2001.

There are already tight regulatory requirements and economic costs that restrict short selling. Imposing further barriers and restrictions upon short sellers may shrink an already small number of professional short investors and further limit their incentive and ability to serve as the counterbalance to hype and irrational optimism that frequently drive stock valuations to unsustainable heights, resulting in the misallocation of capital in our markets.

Any manipulation of stock prices, whether upward or downward, should be prosecuted to the full extent of the law, and I firmly believe that the enforcement agencies – federal, state and SRO – must have the tools necessary to accomplish that objective. But I believe that the record – as evidenced by the NASD’s Pollock Report in 1985, the SEC’s testimony in 1989 and Professor Lamont’s study in 2002 – demonstrates that the allegations about illegal short manipulation activity are frequently spurious. One can even go back to the Senate investigation that led to the enactment of the Securities Act of 1933. It started out as an investigation of alleged “bear raids” and short manipulation in the 1929 market crash, but found instead issuer and investment banker hype, conflicts of interest and inadequate disclosure. The investigation vindicated short selling as an important market activity and led instead to the enactment of the federal securities laws, regulating issuers and investment bankers.

In a more modern context, the Commission testified before Congress in 1989 (again addressing allegations of short selling and market manipulation) that it “frequently” found the negative statements of short sellers to be true; and, that it also found that “many of the companies from whom we receive complaints about alleged illegal short selling are themselves under investigation for possible violations of the securities or other laws at the time they make the complaints.”¹²

Obviously, we will willingly comply with any new law or regulation that is enacted. But it is my hope that a careful examination of any allegations of regulatory gaps will reveal that the facts do not support the case for new regulatory action.

In fact, the Commission itself contemplated *relaxing* restrictions on short selling at a number of points in the 1990s, most recently issuing a concept release in 1999 on the topic. I believe that the facts underlying those releases are much the same today as they were then. Thus, if as part of this inquiry into hedge funds the Commission will also examine short selling, I hope that it will give as much consideration to *removing* antiquated and inefficient regulations as it does to imposing new regulations.

¹² Oral Testimony of John H. Sturc, Associate Director, Division of Enforcement, Securities and Exchange Commission before the Committee on Government Operations, Subcommittee on Commerce, Consumer, and Monetary Affairs, U.S. House of Representatives, December 6, 1989.

B. Hedge Funds

Chairman Donaldson in his April 10, 2003 testimony on hedge funds to the Senate Committee on Banking, Finance and Urban Affairs identified a number of the important issues to be considered in reviewing and considering changes to private investment fund regulation. I applaud Chairman Donaldson and other Commissioners for holding these roundtable discussions in order to get the insights of a variety of academics, investment managers and other observers of the investment management industry in order establish a policy and factual basis for any possible future activity.

In his April 10th testimony, the Chairman identified “retailization” of hedge funds as a problem.¹³ From a business perspective, I know that I am not comfortable soliciting funds from individuals who simply meet the minimum criteria of the Regulation D/accredited investor/3(c)(1) exemption of either \$200,000 in annual income or \$1 million in net worth. As a business practice, I do not find that I can make a presumption that an individual or business entity that meets those criteria is sufficiently knowledgeable about the risks associated with Kynikos’ investment strategy to make an informed decision. Short selling is an inherently risky proposition. Profits are limited to a maximum of 100% of the proceeds on the date of sale; losses, however, can be infinite, depending on how high the stock price moves after the sale. Private investment companies like Kynikos also set different rules for

¹³ Testimony of William J. Donaldson, Chairman, Securities and Exchange Commission; Senate Banking Committee; April 10, 2003.

withdrawal of funds than do most mutual funds or other traditional money managers. I do not want someone who is not able to tolerate these risks to invest with me. It is simply not good business. Therefore, the prerequisites for investing in our funds are much more stringent than they are for these other managed investment vehicles.

When Regulation D was adopted over twenty years ago, its definitions of accredited investor of \$200,000 of annual income or \$1 million in net worth were considerably higher standards than they are today. In general, the investment strategies of private investment funds involve substantial risk and illiquidity. They are not appropriate for the average investor.

I do not know, as a matter of public policy, what the right level of income or net worth is to make a presumption about market sophistication. I am aware that when Congress enacted an expansion of the 3(c)(7) exemptions in 1997, that it used the criteria of \$5 million in “investible assets” – a more selective barrier – as the presumptive basis for market sophistication. Given the increase in the number of hedge funds over the past decade, perhaps it is appropriate to re-examine the Rule 506 accredited investor/3(c)(1) standard.

In addition to the NASD's recent move to improve broker-dealer suitability standards for sales of hedge funds, additional steps can be taken to keep investors limited to those who can understand and bear the risks associated with private investment funds. One such step would be setting a higher minimum investor

qualification standard than the current “accredited investor” definition. This could include both a higher net worth and a limit to an investment in a fund to a percentage of that net worth (some states, such as California and North Carolina, historically have used a cap on privately placed investments at 10% of the investor’s net worth as a rough benchmark or limit, while others have used a 20% limit).

This change would not necessarily require an amendment to Regulation D’s definition of “accredited investor.” Other regulatory provisions could be amended—for example, the pending rulemaking under Section 18 of the Securities Act of 1933 to preempt state filing requirements for sales to “qualified purchasers,” would define “qualified purchasers” by reference to the Regulation D definition of “accredited investors.” Rel. No. 33-8041, 66 Fed. Reg. 66839 (Dec. 2001). Why not set a somewhat higher investor qualification standard for private placements that seek to rely on preemption to avoid all state filings?

In addition to the “retailization” issue, Chairman Donaldson in his April 10 testimony also noted conflicts of interest, valuation, performance reporting, fraud, misappropriation of assets, and relations with prime brokers and other service providers. Each of these is a significant issue that all managers of a private investment fund should be required to address as a condition to operating in a relatively unregulated format.

One simple means to address these issues would be to impose some basic prudential restrictions on hedge funds that wish to rely upon the regulatory

exemptions from investment adviser registration—17 C.F.R. §§ 275.203(b)(3)-1 & 275.222-2 (which treat a private investment fund as a single “client” of the manager for purposes of determining whether the manager has 15 or more clients and is thus subject to registration and regulation under the Investment Advisers Act). The rule could be amended to require a “look through” to count the investors in the fund if the fund does not meet certain basic investor qualification and investor protection requirements such as:

- Minimum investor qualifications above current accredited investor levels (addresses retailization issue);
- Custody of private investment fund assets in a broker-dealer or bank and compliance with SEC interpretations on constructive custody (addresses misappropriation of assets, fraud and transparency issues);
- Annual audit and delivery of financial statements to investors (addresses fraud and transparency issues);
- Quarterly unaudited financial reports to investors (addresses transparency issue);
- Clear disclosure of financial arrangements with interested parties such as investment manager, custodian, prime broker, portfolio brokers, placement agents and other service providers, both in terms of description and with some periodic historic quantification of amounts paid to each category and benefits received (addresses conflict-of-interest, transparency and fraud issues);
- Clear disclosure of investment allocation policies (addresses conflict-of-interest, transparency and fraud issues); and
- Clear, objective and transparent valuation standards, that are clearly disclosed, not stale, and subject to audit, for use in calculating current unit values for investor reports, admissions and withdrawals and calculations of performance and volatility information (addresses valuation, transparency and fraud issues).

Simple, basic standards on each of the above points could be added to Advisers Act Rule 275. 203(b)(3)-1(a)(2)(i) as a condition to reliance on the “single client” treatment of a private investment fund. Those investment managers who operate investment funds that meet these standards would be allowed to treat the fund

as a single “client” and thus continue to avoid registration under the Advisers Act. It may be appropriate to exempt family partnerships, family trusts, and gift & estate situations and “knowledgeable employee” funds from these requirements (to mirror exemptions contained in current Investment Company Act §§ 2(a)(51)(A)(ii) & (iii); 17 C.F.R. §§ 270.3c-5, 270.3c-6 on the grounds that these types of closely-held arrangements do not involve marketing to unrelated investors). Investment managers that operate private investment funds that do not meet these standards would be required to look through the investment fund and treat each of its investors as a “client”, thus subjecting the investment manager to registration, SEC examination and regulation under the Investment Advisers Act.

While we are not advocates of increase in the general regulation of private investment funds or short selling, we are concerned that the misdeeds of a few could result in a backlash against the industry. Requiring private investment funds to follow a few basic requirements on investor qualifications and investor protection along the lines set forth above as a condition to continuing to operate in a relatively unregulated fund environment could protect both investors and the private investment fund industry from the actions of a few bad actors.

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Again, thank you Chairman Donaldson and all the other members of the Commission for the opportunity to participate in these roundtable discussions. I welcome your examination of these important issues and would be happy to assist the Commission however I can as it moves forward.