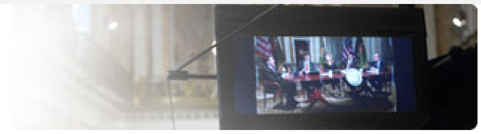

Testimony of Treasury Under Secretary for Domestic Finance Robert K. Steel Before the U.S. House of Representatives Committee on Financial Services

7/11/2007

HP-486

Washington- Chairman Frank, Ranking Member Bachus, and Members of the Committee, good morning; it is a privilege to be with you today. Thank you for holding this hearing and inviting the Treasury Department to present our perspective on the important topic of "Hedge Funds and Systemic Risk."

Chairman Frank, Ranking Member Bachus, and Members of the Committee, good morning; it is a privilege to be with you today. Thank you for holding this hearing and inviting the Treasury Department to present our perspective on the important topic of "Hedge Funds and Systemic Risk."

Today, I am representing both the Treasury Department and Secretary Paulson in his capacity as Chairman of the President's Working Group on Financial Markets (PWG). Fostering preparedness for financial crises is part of the core mission of the Treasury Department. Under Secretary Paulson's leadership, the PWG - which also includes the chairmen of the Federal Reserve Board, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) - issued a call to action along with the Office of the Comptroller of the Currency and the Federal Reserve Bank of New York, directing all market participants to undertake efforts that mitigate the likelihood and impact of a systemic risk event in the private pools of capital industry.

Private pools of capital, which include hedge funds, private equity and venture capital funds, exemplify the competitiveness and innovation that make our capital markets the strongest in the world. These investment vehicles bring many benefits to our markets including liquidity, price discovery and risk dispersion. However, the growing size and scope of private pools of capital merit appropriate attention, particularly given possible challenges posed by private pools in areas of investor protection and the potential for systemic risk.

To address these concerns, Treasury strongly believes that a collaborative policy effort is required. For that reason, the PWG, as an interagency working group, is well-positioned to provide the leadership to frame the issues and confront the challenges. Over the years, the PWG has periodically evaluated private pools of capital. However, before describing the motive and goals of the PWG principles and guidelines for private pools of capital released earlier this year, I would like to add some context that framed the group's thinking. This Committee has asked for Treasury's remarks on hedge funds and I will focus on that part of the private pools of capital industry.

Hedge Funds: Benefits and Challenges

It is useful to describe the marketplace developments that have occurred since the PWG's 1999 report on hedge funds. In recent years, hedge funds have experienced tremendous growth and dramatic change. Many of these changes have been well-documented:

- In the last five years, the number of hedge funds has more than doubled, growing to over 9,000 funds today.
- Since 1999, hedge fund assets have grown by more than 400 percent, totaling approximately $1.4 trillion.
- They are also generating an increasing share of trading volume. Some experts estimate they may represent up to 50 percent of trading in our markets today.
- The number and nature of investment strategies that these managers deploy have also continued to grow, and today there are over 20 different categories of investment strategies.

Hedge funds broadly encompass pooled investment vehicles that are privately organized, administered by a professional manager and generally not directly available to the retail public. As policymakers, we do not view hedge funds as an asset class or as an industry. Instead, we see them as a business model that asset managers use to manage capital. The objective of this business model is to attract and grow capital and generate returns through a defined investment strategy.

Hedge funds were birthed here in the United States, and this country remains their largest home. A thriving, competitive hedge fund industry brings many benefits to U.S. capital markets. Hedge funds are significant providers of liquidity in our marketplace, making our markets attractive to investors. They bring information to markets, enhance market efficiency and are a crucial ingredient in the price discovery process. Targeting price inefficiencies and wide bid/ask spreads as part of their investment strategy, hedge funds produce the public good of better price discovery and more efficient markets.

Hedge funds help to segment and disperse risk and also help foster innovation in developing new risk-management tools and techniques. For example, hedge funds are often willing counterparties on derivatives transactions with financial institutions seeking to distribute the risks inherent in their normal business activities. Furthermore, hedge funds are also beneficial to investors, as they potentially offer diversification benefits. With their ability to engage in absolute value return strategies, hedge funds provide investors the opportunity to profit in down markets.

While hedge funds can provide benefits to investors and the overall marketplace, they present some challenges as well. The scale, complexity and dynamic nature of these business models and their investment strategies emphasize why we believe heightened vigilance is necessary. Managers are now relying more heavily on the use of leverage, transaction volumes are increasing, and the impact of hedge funds on markets continues to grow.

Innovations in financial products, such as complex derivatives and other structured products, are expanding the ways in which market participants, such as hedge funds, can apply leverage. A concentration of market positions and high leverage may lead to market disruptions and illiquidity if traders simultaneously unwind their positions. Consistent with the growing complexity and often illiquid nature of these innovative products is the difficulty in valuing these securities. In addition, the infrastructure for processing, clearing, and settling trades in these complex products has often lagged product development and volume growth. Industry efforts, such as those of the Counterparty Risk Management Policy Group II, have strengthened clearance and settlement practices.

The PWG's February 2007 Principles and Guidelines

In an effort to preserve the benefits hedge funds provide, while addressing the challenges presented by these market developments, the PWG released principles and guidelines for private pools of capital in February. It had been almost eight years since the PWG last spoke about hedge funds. In 1999, the PWG released a report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." That well-received report contained a series of recommendations. Those proposals served as a foundation for many of the successful practices of today.

A great deal has changed since 1999 and the PWG believed it was the appropriate time to update and broaden its approach. Last autumn, the Treasury Department conducted a series of educational meetings with participants representing the entire spectrum of the hedge fund industry. Representatives from the pension and investment management communities, the accounting, auditing and legal professions, asset consulting firms, fund administrators, commercial banks and investment banks were interviewed in order to review current practices. As a result of these efforts, along with other meetings conducted by and within the agencies comprising the PWG, we concluded that it would be beneficial to offer some fresh perspective regarding private pools of capital, such as hedge funds.

In developing its principles and guidelines, the PWG desired to create a forward-looking, principles-based framework that recognizes the financial landscape will continue to evolve. As a result, the principles are comprehensive in scope yet flexible.

The PWG's Call to Action

This framework is consistent with the overarching, non-partisan mission of the PWG to maintain investor confidence and enhance the integrity, efficiency, orderliness and competitiveness of U.S. financial markets.

The focus is on two key goals: mitigating the potential for systemic risk in financial markets and protecting investors. As the PWG has said in the past, we believe the issues presented by the size and scope of hedge funds are best addressed through a combination of market discipline and a balanced regulatory approach. We have not given a green light for the participants in the asset management industry to continue with business as usual. Instead, the PWG agreement highlights two areas in which there is a need for heightened vigilance within the current regulatory structure.

Systemic Risk

Systemic risk is the potential that a single event, such as a financial institution's loss or failure, may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected. We must remain open to the possibility that significant losses by a highly leveraged hedge fund could present challenges to the broader financial system. Our principles and guidelines highlight how this potential risk is best mitigated within the current regulatory framework by market discipline that is developed and applied by creditors, counterparties and investors.

The principles and guidelines make a number of suggestions for improved vigilance in market discipline:

- The principles and guidelines recommend that key counterparties and lenders commit resources and maintain appropriate policies and protocols to define, implement, and continually enhance best risk-management practices.
- The guidelines encourage lenders to private pools of capital, including hedge funds, to frequently measure their exposures, taking into account collateral to mitigate both current and potential future exposures.
- Counterparties and lenders should seek to obtain from the pool both quantitative data and qualitative information on the private pool's net asset value, performance, market and credit risk exposure, and liquidity.
- Managers of these firms providing credit and capital should institute protocols so they are kept informed of large exposures. They must appreciate the implications of these exposures and possess a commitment to ensure that sound risk management practices are developed and implemented.
- Institutional investors in hedge funds have a responsibility to evaluate prudently the strategies and risk management capabilities of hedge funds and ensure that funds' risk profiles are compatible with their own appetites for risk.
- Hedge fund managers must institute and monitor high quality valuation, risk management and information systems.
- Counterparties, lenders and managers must strengthen their processing, clearing and settlement arrangements, especially for over-the-counter (OTC) derivatives.

Investor Protection

Unlike the 1999 report, this year's PWG release also addressed concerns about investor protection. The potential for complexity, illiquidity and opacity of their investment strategies should not by definition suggest that hedge funds are either appropriate or inappropriate. Hedge funds can be a suitable investment vehicle for sophisticated investors. Given certain characteristics of these investments, the SEC has proposed more stringent limits on direct investment in hedge funds.

However, some concerns exist about indirect exposure of less sophisticated investors to hedge funds through their pension fund investments. Investment fiduciaries, such as pension funds managers, have a responsibility to perform due diligence to ensure that their investment decisions on behalf of their beneficiaries and clients are prudent and conform to established sound practices consistent with their responsibilities.

The guidelines encourage hedge fund managers to provide accurate and timely, historical and ongoing information necessary for investors to perform due diligence, enabling them to make informed investment decisions. Investors are encouraged to evaluate the investment objective, strategy, risks, fees, liquidity, performance history, and other relevant characteristics of a hedge fund. Investors should also evaluate the fund's manager and personnel, including background, experience, and disciplinary history.

The philosophy underlying these investor protection principles and guidelines is to encourage and recommend transparency and disclosure by funds and managers to fiduciaries and investors, as well as continued encouragement by regulators to strengthen market and counterparty discipline.

However, this need for transparency and disclosure should not go so far as to materially discourage innovation in the marketplace. There needs to be some balance regarding disclosure. For example, we need to respect sensitive proprietary information, and individual positions should not necessarily be expected to be disclosed.

Regulators also have an important role to play in addressing concerns of investor protection. The existing regulatory framework provides broad authority, which should be utilized to address these issues. For example, the SEC and the CFTC have broad anti-fraud and anti-manipulation authority.

Next Steps

So far, these principles and guidelines have been well-received by policymakers, regulators, industry leaders and the general public, both in the United States and abroad. It is noteworthy that the two largest and most important markets, the United States and the United Kingdom, share a similar regulatory philosophy. The goals put forth by these principles align with the approach used by the Financial Services Authority in the United Kingdom. The European Union countries also adopted a common hedge fund position earlier this year that closely reflects our approach.

The PWG has stressed that this agreement is not an endorsement of the status quo. All industry participants need to accept responsibilities to mitigate risks; therefore, the principles and guidelines speak directly to the four key groups of market participants: regulators and supervisors, counterparties and creditors, managers of private pools of capital, and pool investors.

Our next step is to ensure that all four groups of participants adopt and use these principles and guidelines. We are encouraged by the initial response, as much progress is already underway.

Regulators and supervisors are already involved in a range of important initiatives. Supervisors are engaged in ongoing reviews of creditors' and counterparties' practices. They are working with the large financial firms that serve as counterparties to hedge funds. These efforts are aimed at improving the sophistication of stress–testing practice, counterparty credit risk management in OTC derivatives, structured credit, and hedge funds, and the post–trade processing infrastructure in the OTC derivatives markets.

Regulators are also looking carefully at liquidity risk management practices and the management of the bridge exposures institutions run in leveraged lending, leveraged buyout and merger and acquisition financing, and credit activities more generally.

Just two weeks ago, Secretary Paulson announced that the PWG will encourage the development and adoption of industry best practices for asset managers and investors in hedge funds. The PWG is facilitating the establishment of two separate, yet complementary private sector groups, one for hedge fund managers and the other comprised of hedge fund investors. These two groups will develop best practices for their respective groups that address investor protection, enhance market discipline and mitigate systemic risk.

The PWG is looking to highly respected leaders in these industries to create these guidelines because when leaders adopt best practices, others in the industry feel pressure to do the same. The intense competition in this market pushes the rest of the market to follow the standards of excellence set by those at the top.

The investors group will develop detailed guidelines for best practices for hedge fund investors, including practices regarding information, due diligence, and investment appropriateness. Specifically, we expect to see them address many issues including risk assessment and management, conflicts-of-interest, valuation, performance reporting, operations and controls, leverage, reporting and administration to name a few.

The hedge fund managers group will define best practices for managers regarding information, valuation and risk management systems. Specifically, we expect to see them address many issues including reporting, conflicts-of-interest, valuation, trading practices, risk management, codes of ethics, settlement, recordkeeping, regulatory filings, compliance and business continuity and disaster recovery to name a few.

Conclusion

Hedge funds bring many benefits to our markets, but they also pose potential challenges. Our principles and guidelines seek to preserve the benefits that these hedge funds provide, while highlighting how risks posed by such funds are best addressed by increased vigilance within the existing regulatory environment.

All participants must be accountable to help ensure the integrity of our capital markets. While substantial progress has already been made, there is still much work to be done by all participants. We look forward to the development and implementation of coherent best practices for investors and hedge fund managers.

Thank you. I look forward to your questions.