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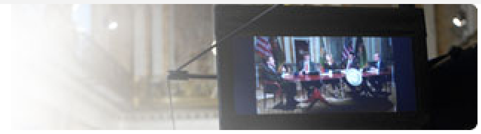

Under Secretary Robert K. Steel Keynote Address to the Managed Funds Association

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Chicago- Thank you, Richard, for that kind introduction.

This year's conference has brought together some of the best minds in alternative asset management, and it is an honor to be here. The Managed Funds Association (MFA) is an important organization, and you are very fortunate to have the strong leadership of Richard Baker. I first met Richard when I was working at Goldman Sachs and then was fortunate to be able to work with him again when I moved to Washington. As a Congressman, he was one of the members we respected most and we always enjoyed working with him as a member of the House Financial Services Committee. He understands all financial services extremely well, particularly asset management, and he will be a great leader for this Association.

We continue to enjoy a great collaborative relationship with Richard and of the rest of MFA's leadership. Your organization has served as a useful source of information for policymakers like me, and your efforts to promote sound business practices are more important today than ever before.

It is always a privilege to be back in Chicago, my home for more than 15 years. I attended business school at the University of Chicago and began my career in financial services here more than 30 years ago. It was here that Secretary Paulson and I first met. We worked together in the Goldman Sachs office on the 60th floor of the Sears Tower. Chicago was then, and continues to be, a global financial center that exemplifies innovation and leads the world in global derivatives trading.

Chicago is significant to finance for other reasons as well. For instance, Chicago is the birthplace of the "Chicago School" of economics, which was developed by renowned economists like George Stigler and Milton Friedman at the University of Chicago. Their influential work emphasized free market economics and market discipline. The "Chicago School" of thought has substantially impacted the field of finance and it continues to be relevant in today's marketplace.

In fact, one observation that can be drawn from our current period is that regulation itself can not insulate us from market volatility. Friedman and his colleagues, who famously cautioned against an over-reliance on regulation, would probably not have been surprised by the irony that during recent market instability, investment partnerships have generally faired better than more directly-regulated financial institutions.

Another influential line of economic thinking – the "efficient market hypothesis" – also owes its roots to the city of Chicago. Research in the 1960s by Professor Eugene Fama, also at the University of Chicago, suggested that market participants cannot "outsmart" the market (1). This idea, which was popularized in the 1973 book *A Random Walk Down Wall Street* by Burton Malkiel, assumes that markets are "informationally efficient," and the availability of that information prevents market participants from successfully outperforming the market with any consistency greater than random chance would allow.

This hypothesis has faced its fair share of criticism over the years (2), and I am confident no one in this room believes it is impossible to outperform the market or you wouldn't be hedge fund managers. Yet, the efficient market hypothesis certainly has some truth to it - it is indeed challenging to outperform the market on a risk-adjusted basis. In fact, today's asset management industry has very clearly distinguished between the delivery of beta and alpha returns. Market-correlated returns are widely available for a very modest charge, however, the ability to produce real alpha is difficult to achieve but very valuable. The clarity of this distinction puts a clear focus on the ambition of alternative investment strategies.

The ideas developed within the "Chicago School" and the "efficient market hypothesis" have helped shape our modern views of market discipline and market integrity; and therefore have important implications for the hedge fund industry, a large portion of which is represented in the room today. In recent years, your industry has grown dramatically in both size and importance. With that growth, comes new responsibilities.

Let me spend my time this afternoon giving some background on our efforts at Treasury with regard to investment partnerships and provide a brief update on our progress. I will then describe some of the specific responsibilities that your industry must accept, followed by some perspective on the role of regulation. Finally, I will conclude with a brief update on current market conditions.

Hedge Funds and Public Policy

It has long been my view that the growing hedge fund industry brings many benefits to our capital markets. Hedge funds improve market liquidity, enhance efficiency, catalyze financial innovation and diversify the investor base within our capital markets.

Yet with the benefits of this success, hedge funds also bring the potential to pose additional risk to the financial system. The size and higher leverage suggest that hedge funds have the potential to trigger broader challenges within the financial system. Moreover, as hedge fund investments have become an increasingly attractive option for some institutional investors, new challenges arise for investor protection.

When Secretary Paulson and I arrived at Treasury in 2006, hedge funds were an increasing area of focus for public policymakers around the world. This attention was heightened in September 2006, when the failure of Amaranth Advisors marked the largest hedge fund wind-down in history. The once $9.2 billion hedge fund, lost more than $6.5 billion by employing a highly leveraged strategy concentrated in the natural gas industry. Although there were no systemic effects from the collapse of Amaranth, the losses were unsettling and the fund's failure renewed many fears both on Main Street and in Congress about the risks hedge funds pose.

At the time, many experts predicted the next round of market instability to be connected to the hedge fund industry. Knowing what we know now – that hedge funds have remained generally stable during the current period of volatility – there is a certain amount of irony to that sentiment.

These fears of the hedge fund industry were even more pronounced overseas. The German government, whose former deputy chancellor compared hedge funds to a "plague of locusts", began advocating for a government-sponsored code of conduct for hedge funds (3). In January 2007, Germany assumed the G-8 Presidency and made hedge fund regulation one of their top priorities.

While we believed hedge funds were an appropriate area of focus for public policy, we had a different perspective than the Germans on the benefits of hedge fund regulation. In February 2007, the President's Working Group on Financial Markets (PWG) – a group chaired by the Secretary of the Treasury that also includes the Chairmen of the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission – responded by issuing principles and guidelines for private pools of capital.

It was the strong view of the President's Working Group that two issues, systemic risk and investor protection, are the key areas where policymakers should and must focus their attention with regard to hedge funds. The principles and guidelines highlight how these risks are best addressed through market discipline, disclosure and transparency and a balanced regulatory approach.

As we made clear at the time, the principles and guidelines were not an endorsement of the status quo. The ten principles provided a clear but flexible approach to address issues presented by the growth and dynamism of these investment vehicles. They represented a uniform view from the Treasury Department and the group of key independent regulators that heightened vigilance is necessary. The PWG designed the principles to endure as financial markets evolved and identified four stakeholders who must contribute to hedge fund vigilance: asset managers, creditors, investors and regulators.

At the time, many people were calling for much more dramatic change. To our encouragement, these principles and guidelines have been extremely well received by policymakers, legislators, regulators, industry leaders and the general public, both in the U.S. and abroad. We feel good that these principles and guidelines provided the appropriate guidance to address public policy issues associated with the rapid growth of investment partnerships, including hedge funds.

Best Practices Committees

But our job was not done yet. Seven months after releasing the principles and guidelines, the PWG followed up by announcing two blue-ribbon, private sector committees - one committee comprised of investors and the other comprised of asset managers. The mission of these private sector committees is to assess and foster a private sector dialogue on issues of significance to the industry and the market.

The asset managers' committee is a diverse group of hedge fund managers, with over $140 billion in assets under management and representing many different strategies. The investors' committee members include public and private pension funds, endowments, foundations, labor organizations and hedge fund consultants.

The first task of these two committees was to develop best practices using the principles and guidelines as a framework. These best practices were released on April 15th of this year. The recommendations were open for public comment for 60 days, and that comment period just ended on June 13th. The committees will now review and, as necessary, revise these best practices and standards, before releasing the final version in the coming months.

The best practices for the asset managers call on hedge funds to adopt standards in critical areas of business, including disclosure, valuation of assets, risk management, business operations, compliance and conflicts of interest. The work done by the MFA on "sound practices" for the industry provides a useful complement to these efforts. Moreover, given the global nature of financial markets, a parallel set of best practices for asset managers were developed by a group in the United Kingdom chaired by Sir Andrew Large.

The best practices for investors include a Fiduciary's Guide and an Investor's Guide. The Fiduciary's Guide provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The Investor's Guide also provides recommendations for executing and administering a hedge fund program once a hedge fund has been added to the investment portfolio. In simple terms, these two guides help fiduciaries decide if hedge funds are appropriate for their portfolio and if so how a hedge fund strategy should be developed.

Both best practices documents recommend innovative and far-reaching practices that exceed existing industry standards. The recommendations complement each other by encouraging both types of market participants to hold the other more accountable. The committees will continue to meet to discuss raising the standards for industry participants, even after the best practices are complete.

The Responsibilities of Hedge Fund Managers

The work of these two hedge fund committees comes at a critical time for the hedge fund industry. Today, global assets under hedge fund management have grown to over $ 2.7 trillion, more than triple the amount managed in 2000 (4). Last year, a high-profile research project completed by the McKinsey Global Institute named hedge funds one of four "new power brokers" that are shaping today's global capital markets. That report concluded that, "Hedge funds' unique investment activities are having a broad and undeniable influence on global financial markets (5)." This validates your industry as critically important actors in modern financial markets.

At Treasury, we have been very clear that we believe hedge funds have many benefits for global capital markets. While being an advocate for the benefits of your industry, it is also important for me to be straightforward about the risks hedge funds pose and the responsibilities you must accept. In essence, congratulations are clearly in order to you and your industry, but with the benefits of that success comes additional responsibilities.

Our hope is that you have been engaged in the process so far and taken advantage of the opportunity to submit public comments on the best practices developed by the "Asset Managers' Committee." We are appreciative that the MFA has submitted public comments. The private sector committee will greatly benefit from your perspectives. Your next task as hedge fund managers is to adopt and implement these comprehensive best practices. The best practices emphasize controls and standards in five key areas:

- Strong disclosure practices that provide investors what they need in order to make informed decisions;
- Robust valuation procedures that call for segregation of responsibilities, thorough written policies and oversight;
- Risk management practices that emphasize measuring, monitoring, and managing risk;
- Sound and controlled trading and business operations and infrastructure; and
- Specific practices, such as written code of ethics, to address conflicts of interest and promote the highest standard of professionalism.

Adopting these practices across all aspects of your business will help mitigate systemic risk and ensure investor protections.

Your industry also has a critical responsibility to maintain market integrity. As significant participants within our marketplace, you must set an example by maintaining the highest ethical standards. Attempting to `beat the market' through fraud, manipulation or rumor mongering is an unacceptable breach of market integrity. That's not beating the market, that's cheating the market.

It is important that regulators have broad authority to investigate and prosecute those who seek to gain an unfair advantage. These measures instill confidence in market participants that the market is operating in a fair and transparent fashion where rules matter. Market participants must know the playing field is level and the rules are fair.

The Role of Regulation

Today, markets remain under considerable stress and there is a debate underway about how to address these challenges. In particular, there has been substantial discussion focused on longer-term regulatory fixes. For more than a year, Secretary Paulson has been leading efforts to modernize our financial regulation. We believe today's marketplace needs a more effective and efficient regulatory structure.

Last year we began work on a *Blueprint for Financial Regulatory Reform*. That document, which was released in March, describes an optimal regulatory structure and short- and intermediate-term recommendations that will help move us toward the ideal structure.

The optimal model recommends three regulators: a regulator focused on market stability across the entire financial sector, a regulator focused on safety and soundness of those institutions supported by a federal guarantee, and a regulator focused on protecting consumers and investors.

The market stability regulator would be given broad powers to protect the stability of the overall financial system. To do this effectively, the market stability regulator should collect information from all market participants including commercial banks, investment banks, insurance companies, hedge funds and commodity pool operators. But rather than focus on the health of a particular individual organization, it will focus on whether a firm's or industry's practices threaten overall financial stability.

At the same time, it is important to recognize that regulation alone can not protect us from market challenges. Markets can and do operate very efficiently, just as the work by Milton Friedman and other Chicago economists over the years has suggested. But efficient markets require that market participants help uphold market discipline and market integrity.

Hedge funds have endured a period where many people were critical and afraid. Today your industry has been validated as a critically important player in global capital markets. With that privilege, comes new responsibility. By accepting these responsibilities, you have the opportunity to enhance the professionalism and integrity of the asset management business.

Conclusion – Update on Markets Conditions

Let me conclude by offering some brief perspective on current market conditions. As the U.S. economy continues to weather these challenging times, we face a trio of head winds – a housing correction, contracting credit conditions and high energy prices.

Capital markets continue to challenge financial institutions, as de-leveraging and re-pricing of risk continues. Secretary Paulson has urged banks to promptly recognize and report losses and raise additional capital. And many global financial institutions have begun this process – reporting losses of over $370 billion and raising additional capital of more than $275 billion. We expect the process of raising of new capital to continue, which demonstrates a long-term display of investor confidence in our financial institutions as well as the economy.

As Americans continue to spend their stimulus checks we have already seen an impact, as reported earlier this month retail sales have increased notably. To date over $71 billion in stimulus payments have been sent out to U.S. families, and $23 billion more will be sent out by the middle of this summer. We are leading several initiatives to increase the availability of affordable mortgages and keep homeowners in their homes. The housing correction is in progress.

We are optimistic that conditions will continue to improve, but not in a straight line. There is still significant de-leveraging occurring in our markets today, and we recognize that this process will take additional time. I am confident that in the long term, our markets, financial institutions and regulatory practices will all help to make our capital markets stronger, enabling them to contribute to sustainable economic growth.

Thank you. I will be happy to take your questions.

(1) See "Efficient Capital Markets: A Review of Theory and Empirical Work;" *Journal of Finance*; May 1970.

(2) For one example, see: Lo, Andrew and Craig MacKinlay; *A Non-Random Walk Down Wall Street*; Princeton University Press (1999).

(3) Mallaby, Sebastian; "Hands Off Hedge Funds"; *Foreign Affairs* Jan/Feb 2007.

(4) HedgeFund.net; First Quarter, 2008

(5)"The New Power Brokers"; McKinsey and Company; October 2007. pg 95.

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