U.S. COMMODITY FUTURES TRADING COMMISSION

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CPO AND COMMODITY POOL ROUNDTABLE

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9:06 a.m.

Commodity Futures Trading Commission
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P R O C E E D I N G S

[9:06 a.m.]

ACTING CHAIRMAN BROWN-HRUSKA:

This is an open meeting of the Commission. Good morning and welcome to the CFTC's Commodity Pool Operator and Commodity Pool Industry Roundtable. On behalf of myself and the other Commissioners, I want to thank all of our distinguished panelists and guests for participating in today's roundtable. I look forward to hearing what our panelists have to say.

Over the last three years under the CFTC, the CPO and commodity pool industry has become quite large. Today, there are approximately 1,800 CFTC-registered CPOs who sponsor, operate and advise 3,500 commodity pools. These commodity pools hold over $600 billion in net assets. While this is small in comparison to the almost $9 trillion in mutual funds, it is a significant

amount of money, even in Washington.

While not well-known to the general public, CPOs and the commodity pool industry are becoming an important part of the financial services industry. Many of our large commodity pools are actually known to investors as hedge funds. The primary investors in commodity pools and hedge funds today are public pension funds, major university endowments, large institutions and high net worth individuals. Only a small portion of assets under management, something like $8 billion and less than 60 funds are offered to the retail investing public.

Over the last few years, hedge funds or, in the vernacular of the futures industry, commodity pools, have generated an increasing amount of interest and fascination on the part of the investing public and regulators. To read the press, at times, it seems that this industry operates under more secrecy than the National Security Agency, but with the abandonment of a bull or a bear, as is often the case, in a china shop.

Certainly, much of the commodity pool industry has operated outside the investment sphere of the average investor because of the net worth and income restrictions that are on these private entities. Others limit information to their own participants in order to protect investment strategies.

As a regulator of commodity pools and futures markets, it is actually the case that we know a great deal about this industry. As will be discussed later, we know a great deal about who is operating in this industry, when trading in the futures markets; we know a great deal about the positions they take, specifically with a great deal of precision. Through registration and auditing by the National Futures Association, we know a great deal about how these funds invest their money, value their assets and deal with their customers.

I hope that through this roundtable, we can clear up some of the mystery and misconceptions that have come to exist with respect to the commodity pool industry and hedge funds and

increase our knowledge of the industry as well. I believe that the pool industry is an important part of the futures industry and even the economy generally. As a source of speculative funds, pools contribute to the liquidity of the markets and help eliminate pricing inefficiencies.

Today, we'll be looking at the size, the shape, the growth, our regulatory program and other issues facing the CPO commodity pool industry. We have an excellent roster of panelists and a very full agenda in front of us, so I'm very much looking forward to moving at a rapid pace, but I believe we'll keep you engaged the entire time.

Before turning to the other commissioners for some opening remarks, I'd like to specifically note for your information that we are having ongoing discussions between the Commodity Futures Trading Commission and Securities and Exchange Commission regarding an exemption for CFTC registrants from the new SEC's hedge fund registration advisor rule. I firmly believe that CFTC registrants, who sponsor, operate, or advise

identified commodity pools should be exempted from the SEC's new rule. Avoiding duplicative and unnecessary regulation is a priority of the administration and of Congress, and it's just common sense that the two agencies should not spend taxpayer money doing the same thing.

In October of last year, the CFTC requested that the SEC provide a broad exemption for CPOs and CTAs who are already registered with the CFTC. While the SEC did not provide the requested exemption at that time, I've advised Chairman Donaldson that this is something which is very important to the CFTC. The senior staff of the SEC and the CFTC have met two times this year on the issue, most recently on March 23rd, and have made what appears to be significant progress on an approach to provide an exemption. We're looking at a primarily engaged test and other options.

Additional meetings are scheduled for later this month, and I'm optimistic that the CFTC and the SEC will be able to announce an agreement later this spring if not earlier, and I'm pleased

to note that we have some commissioners coming over today after their very important open meeting that they're having this morning on the National Market System, so we're expecting Commissioners Atkins and Glassman to come and join us, and I also think Raul Campos is coming as well. So we're very pleased that they're going to join us, and I think there are some SEC staffers here as well.

In any case, I'd like to now turn it over to my colleagues for some remarks. Commissioner Lukken.

COMMISSIONER LUKKEN: Good morning, Madam Chairman. I appreciate the opportunity to provide some comments this morning about the commodity pool roundtable. It's good to see some familiar faces out there, some new faces as well. I welcome you.

Obviously, commodity pools play a vital role in our futures markets by contributing important liquidity and pricing information to the marketplace. In our weekly surveillance meetings, we are routinely reminded of commodity pool participation in our futures markets through our

large trader reporting system. In these meetings, the CFTC economic staff utilizes this important source of data to monitor and report on the positions of large traders, many of which are commodity pools. John Fenton, our head of surveillance, will brief us later on that system.

In addition, the CFTC has long recognized the market significance of these types of investment vehicles and has thus required the registration of certain commodity pools since the CFTC was founded some 30 years ago. Two years ago, the CFTC revisited these registration requirements to ensure that these policies are properly tailored to the public risks and the market risks associated with commodity pools and their operators. I believe this was the right course of action now and then.

Last year, the Securities and Exchange Commission, as was noted, decided to register certain hedge fund advisors, many of which are already registered with our agency. Today's proceeding will not only illuminate the trends and

regulatory issues in this industry but will also help us to identify areas in which the CFTC registration requirements overlap with that of the SEC and how our agencies might cooperate so as to lessen the duplicative burden on this industry. I look forward to the upcoming dialogue between our agencies and thank the participants in advance for their testimony.

Thank you, Madam Chairman.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you, Walt. Excellent remarks.

Commissioner Hatfield.

COMMISSIONER HATFIELD: I want to thank our acting chairman for holding this important roundtable and to thank our guests for being here today. The timing of this discussion is propitious. With the stock market struggling and the demand for commodities continuing to rise to meet global expansion, especially in China, the growth in influence of commodity pools and hedge funds in the commodity markets and our economy generally is one of the hottest topics in financial

news.

As the number of these funds multiplies, so, naturally, do the number of investors, but perhaps more importantly, the profile and expectations of the hedge fund investor are changing as well. A Morgan Stanley study revealed on Monday, for example, that the largest inflows to the funds were no longer wealthy individuals but institutions such as pension funds.

Warren Buffett has referred to financial derivatives as financial weapons of mass destruction, and the New York Times recently quoted a $5 billion hedge fund owner as saying, quote, it is completely obvious that this will end badly for the firms, for investors, everyone, unquote, yet Federal Reserve Chairman Alan Greenspan often says hedging through the use of derivatives has benefitted the economy by spreading the risk among a greater number of institutions, and he has usually proven prescient.

Perhaps this is a conundrum. Today, we are lucky to have some of the brightest and most

successful people involved in the managed funds industry to address a number of these issues, including the growth of the industry, and I'm looking forward to hearing each of your thoughts as we move forward.

Thank you, Madam Chairman.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you.

Commissioner Dunn.

COMMISSIONER DUNN: Thank you, Madam Chairman. I want to thank you for having this meeting. It comes at a very good time.

I don't think there is a day that goes by when our News Clips don’t have some type of story in one of the financial papers about hedge funds, whether it's a bubble? Whether it's going to pop? What's driving it? What will happen in the future? So I am pleased to be here today, and I'm looking forward to hearing from so many members of the managed fund industry on the operation and oversight of commodity pools and their operators.

As this segment of the financial services industry has evolved, we have heard calls for

various changes in the current regulatory oversight of such entities, in particular those deemed to be hedge funds. I look forward to your comments on this and other key issues facing the industry. This is an excellent opportunity for us to get a good understanding of how you operate.

Commission roundtables provide the Commission with valuable industry input. They give participants an opportunity to raise and discuss issues in a public forum. This is of great benefit to the Commission but, more importantly, to the investing public at large. This is a type of transparency that I think the public would like to see more.

I would like to thank the Commission staff for putting together an excellent agenda, and I would like to extend a special welcome to our guests panelists. Thank you all for taking your time to be here. I look forward to hearing from each of you today and throughout the year.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you very much. I appreciate these remarks very much,

and you can see that we have a very strong Commission here that is very knowledgeable about the issues, and we are very much looking forward to learning more. This is a great sight to look out at this distinguished group. We are delighted you are here. And at this time, I will turn it over to our general counsel, Patrick McCarty.

MR. MCCARTY: Good morning, Acting Chairman Brown-Hruska and Commissioners. My name is Patrick J. McCarty, and I'm the general counsel of the CFTC. I will be moderating the first panel.

We have four distinguished panelists, whom I'd like to briefly introduce. You will find the panelists' complete biographies in the briefing books as well as on our Website. Starting on my far left is Professor Myron Scholes. Professor Scholes is the chairman of Oak Hill Platinum Partners, which is a CFTC-registered CPO. He's been a member of the board of directors of the Chicago Mercantile Exchange since 2000, and Professor Scholes is the co-originator of the Black-Scholes Option Pricing Model, for which he

was awarded the Nobel Prize in economic sciences in 1997.

Next to Professor Scholes is Mr. George Crapple. Mr. Crapple has been the co-CEO and co-chairman of Millburn Ridgefield Corporation since 1983. Millburn Ridgefield is a CFTC-registered CPO. Mr. Crapple is also a member of the board of directors of the Futures Industry Association and the CFTC Global Markets Advisory Committee.

Next to Mr. Crapple is Adam Cooper. Mr. Cooper has been the senior managing director and general counsel of Citadel Investment Group since 1999. Citadel is a CFTC-registered CPO. Mr. Cooper is currently the chairman of the Managed Funds Association.

And our last but certainly not least panelist is Mr. Jack Gaine, the president of the Managed Funds Association. Mr. Gaine has been with the MFA in various capacities since 1993 and the president since 1997. Mr. Gaine was my predecessor here at the CFTC, where he was the second general

counsel, a post he held from 1977 to 1981.

As moderator for the first panel, I'd like to set the scene with four or five slides from my CPO commodity pool industry PowerPoint presentation. The first chart that you'll see here provides a little perspective on commodity pools and the broader pooled investment vehicle industry. As you may know, the mutual fund industry dwarfs the commodity pool industry. This chart shows that pooled investment vehicles hold approximately $9.5 trillion. Mutual funds hold roughly $8.5 trillion of that. An additional 10 percent is held by the hedge fund and commodity pool industry, $850 billion.

The second chart that I'd like to point to is the one showing the significant growth in the industry since 1992. This chart shows that the number of CPOs increased almost 600 from 1992 to a total of almost 1,900. There was a significantly greater increase, however, I would point out, in the number of commodity pools, going from approximately 800 in 1992 to 3,500 in 2004; in

other words, approximately a 400 percent increase.

The next chart is a breakout of the 3,200 commodity pools that filed financial statements for the year ended 12/31/03. These commodity pools held approximately $614 billion in net assets. As you can see, the 300 large commodity pools, those with over $500 million in assets, held approximately 65 percent of those assets. On the other hand, you can also see that the small funds, those with less than $50 million in assets, are 50 percent of our total number of pools.

My next chart just shows the difference between our fund area, and the mutual fund area. It shows that 98 percent of the 3,500 pools are actually private placements. As noted by the Chairman in her opening remarks, only 57 are public commodity pools, which are offered and registered at the SEC.

My final chart would be the institutional investor list, which shows that 18 of the top 25 hedge fund complexes are registered with the CFTC as CPOs, and 63 of 100 are.

And with that, I think I've set the scene, and Mr. Gaine, you were the general counsel here from 1977 to 1981. Can you give us a little perspective on the CPO and commodity pool industry when you left the Commission?

MR. GAINE: Yes. First of all, I'd like to, Pat, thank you for your role in putting this together, and Chairman Brown-Hruska and other Commissioners, this is a very, very timely event, and a very, very impressive by and large list of panelists, and I thank you again.

Well, I can set the scene. The Commission was formed April 21, 1975, as you know. I became general counsel on August 1, 1977, and we had, needless to say, a lot of issues and a lot of problems, and I recall maybe on the 2nd or 3rd of August, someone coming up and saying, Jack, what about the CPO/CTA rules, to which Jack responded what's a CPO or a CTA? So, in the meantime, I've come to know fully well what a CPO and CTA is, and it was a--I'll run through some data quickly which will give you some idea of the shape and size it of

the time.

First, let me tell you I'm the president of the Managed Funds Association. We're headquartered in Washington, and we're the leading trade association representing the interests of the alternative investment management industry, including hedge funds, futures funds, and funds of funds, and we operate through lobbying and education.

Our history somewhat parallels the growth of the alternative investment industry in that we were founded in 1991 as the Managed Futures Association with 300 members, and the industry at that point stood at about $15 billion in assets under management. In 1997, we became the Managed Funds Association, as the interconnection, which is part of my theme that in order to understand the alternative investment industry, you have to go back to the roots, which is in this building and its predecessors of managed futures, and in 1997, we became the Managed Funds Association.

Today, we have nearly 900 members, and our

industry, the entire alternative investment industry has over $1 trillion in assets under management, including $132 billion in managed futures. These are remarkable. I don't know if there are any other economic engines growing quite at that level, but they have been remarkable.

I have been actively involved in the industry since 1997, and I say that you can't really understand today's managed funds industry without understanding the roots in managed futures, with pioneers who began as talented futures traders, many of whom were associated with Commodities Corporation, including Paul Tudor Jones, Bruce Covner, Louis Moore Bacon, who founded Tudor, Taxon, and Moore.

Today, the largest commodities trading advisors like Millburn and Campbell and John W. Henry, some of them date back to 1971. John Henry is back to 1982, and whether they're managed futures funds or hedge funds, they share similar goals, pursuing noncorrelated strategies and absolute returns through their use of leverage,

short selling, futures, options, swaps and derivatives. The value of these funds as a key portfolio diversification tool as an alternative to the traditional long-only products is clear as proven by the agency growth.

The managed futures industry sort of got started in 1949. Richard Donsheen set up the first futures fund, and at the same year, A.W. Jones set up the first hedge fund. Commodities Corporation was founded in 1969. This was founded by a gentleman named Helmut Weimar, who was from MIT, and some of his colleagues, and it was advised by the economist Paul Samuelson.

They were kind of a think tank of futures trading, and as I said earlier, they were affiliated with a number of the great futures traders, who eventually ended up being the founders some of the great what we call hedge funds today. Paul Tudor Jones and John Henry and other CTAs did extremely well in the eighties, particularly after the 1987 crash. In 1990, there was $7 billion under management in futures funds, under hedge

funds and $10.5 billion in managed futures, and at that time, the hedge funds were Julian Robertson and Soros, but the managed futures business actually dwarfed the hedge fund business at that point.

In 1995, there were $22.8 billion in managed futures versus $76 billion in hedge funds. There was a big switch. That was the big switchover. And then, in 1996, NISMEA was passed, which added 3(c)(7) to the Investment Company Act, which I think was a tremendous engine for the great growth of getting up to the amounts that we are today, up to $1 trillion.

We had a few blips along the way: the Hunt silver crisis, Long Term Capital, the industry, this absolute return necessary component of institutional and high net worth investors has driven this bus and has overcome some of the obstacles that have arisen.

After 9/11, we became subject to the PATRIOT Act and its anti-money laundering provisions, and we're working on that, and as you

have all pointed out about the growth of the industry, and the SEC rulemaking of last year, which is going to require managers of many hedge funds to register as investment advisors.

I just want to close on noting that this alternative investment industry exists because of the wisdom and foresight of this agency and its creation in 1975. It promotes financial innovation; it promotes flexibility; particularly in a sophisticated investor base such as these hedge funds and futures funds, and for that, the economy at large and the public should be very grateful, and I thank you very much.

MR. MCCARTY: Jack, that was great.

Our next panelist is Adam Cooper. Adam, would you please share with us your perspectives on the more recent growth?

MR. COOPER: Thank you very much, Pat, and first, I'd like very much also to thank Chairman Brown-Hruska, Commissioners Dunn, Hatfield, and Lukken for putting together this critically important roundtable. More importantly, I'd like

to thank you all for the courage to air these issues openly, the interest in learning. Really, the industry has evolved because of the openness of regulators and market participants to learn and to speak and debate openly.

As part of our panel's industry overview, I'd like to pick up really where Jack left off. I'd like to discuss this morning what I'll call the institutionalization of the CPO industry. That is, the process of maturation, of evolution, and of development that's taken place in our industry, into the firms in the industry over the last decade.

When we speak of an industry becoming more institutionalized, we really can be talking about many different things. Institutionalization can refer to the experience of a firm or to the experience of an entire industry. It can be defined as the growth in institutional investors among a firm's client base or within an industry, and it can also refer to the growth in the number of entrepreneurial firms that are making the

transition to acting like more structured financial institutions. In addition, institutionalization can refer to the move by more traditional investment management firms to offering innovative alternative investment products in order to attract assets and to retain talent.

While all of these definitions roughly fall under the umbrella of the maturation of our industry, I think there's one constant I'd like to keep in mind as the organizing principle as I go through my remarks in the next few minutes, and that is a focus at an industry or a firm level on infrastructure and the buildout of infrastructure, that is, the ability to maintain operational integrity; it's a system of policies and control procedures designed to facility safety and soundness and risk management, and that's what I mean by institutionalization.

No matter how you define it, there's no denying that the CPO industry has become more institutionalized in recent years, but why has this occurred? Much of this dynamic can be attributed

to the growth in demand for alternative products, particularly among institutional investors.

As you've heard, the managed futures industry has grown from having $310 million in assets in 1980 to over $131 billion in 2004. As for hedge funds, in 1970, there were roughly 150 hedge funds with a combined billion-plus under management. At the end of 2004, there were roughly 6,000, and by some measures, many more hedge funds, with nearly or slightly over $1 trillion in management.

Institutional investors are comprising a growing portion of the net inflows into the industry. Alternative investments have become a permanent fixture within institutional portfolios, including the portfolios of pension funds, endowments and foundations. Institutional investor demand has steadily increased over the last decade because these products have been proven to help institutions diversify their portfolios and meet their critically important future funding needs.

This recent trend is certainly expected to

continue. It's been reported that more than a third of U.S. institutional investors expect to make a significant increase in their allocations to hedge funds in the next three years. One consulting firm has forecast that U.S. institutional investor capital in hedge funds will increase to over $300 billion by 2008 from an estimated $66 billion at the end of 2003. Worldwide, institutions are likely to account for over 50 percent of annual net inflows into the hedge fund industry by 2008. That is from less than 10 percent in 2001.

As alternative investments have become a more significant part of institutional portfolios, institutional investors have placed greater demands on the industry. Like any sophisticated investor assessing an investment opportunity, the foundations, endowments, pension funds and other institutional investors assess many dynamics; of course, portfolio allocation is one of them, but they understand very well how an investment in alternatives will not only diversify their

portfolio, but also, they seek to ensure that their investments move into a stable system like any investor does, that is, that the safety and soundness, the certainty and the stability and the risk management infrastructures of the managers that they invest with is critical to the decision, and the firms with the strongest infrastructure, that is, the firms deploying the most institutional business model, receive the bulk of the allocation, and those that do not evidence these characteristics tend not to grow.

These investors are seeking more and more information about how CPOs are investing, how they are valuing their investments and how they are managing risk. They want to ensure that there's a separation of the trading and the risk management functions at the fund. They track the use of leverage. They try to ascertain whether the firm has the right technology, the right infrastructure in place to meet investment objectives. Many want to know how positions are tracked, what percentage of the fund's assets will be invested in OTC

instruments, what prime brokers are used, just to name a few examples.

Risk measurement and management technology have also become more sophisticated over the years. Larger hedge funds have built their own risk management platforms. Smaller firms are relying on prime brokers and other external providers that offer funds needed risk management and compliance services. The growth in risk expertise in the industry is also facilitated by the many managers, traders, and research analysts entering the industry from major banks and financial institutions, bringing with them an institutional perspective on risk.

In sum, the growth of our industry has led to institutionalization on several levels. This evolution has led to greater expectations of sophistication and greater expectations of professionalism. One final sterling example, if I may, of the institutionalization, and that is the maturity of our industry is the presence of a meaningful trade

organization. MFA, as a provider of educational and other services and advice to the industry has never been more important than it is today, and this is a trend that we expect also to continue to increase.

There's a cause and effect relationship to this dynamic. An important example of the development of this dynamic, of the symbiotic relationship, if you will, between the maturity of an industry and the meaningful voice of a trade association is the development of sound practices. MFA updated and reissued Sound Practices for Hedge Fund Managers in 2003. This guide was originally created in response to a recommendation by the PWG in financial markets, and the PWG recommended in 1999 that hedge funds establish a set of sound practices for their risk management and internal controls.

Since the publication of these original sound practices in 2000, it's been widely recognized by members of our industry as well as by the industry service providers as being a highly useful resource. MFA will be publishing and

updating an expanded version of Sound Practices for the Hedge Fund Industry in just a few months. The products by these sound practices will include valuation practices, risk management responsibilities, to investors, and disaster recovery to name just a few. These topics really tell the story of our marketplace: sustainability in a competitive environment demands sound practices, and as the industry evolves and matures, the importance of these issues will be increased.

Thank you this morning for the opportunity.

MR. MCCARTY: Thank you, Adam. The maturity of the industry and commodity pool operators and hedge funds becoming more like their larger brethren, banks, broker-dealers, and FCMs is quite exciting and interesting.

I'd like to move on now to our next panelist, George Crapple. George, Millburn Ridgefield has been in the CPO and commodity pool business since the early seventies, and would you please tell us a little bit about the trend

following strategy which Millburn employs and a little bit about your experience running some of the publicly-offered commodity pools which you have?

MR. CRAPPLE: Sure, thanks, Pat.

As Pat mentioned, we are one of the CPOs with the greatest longevity, predating even the coining of the term commodity pool operator. We're also a CTA and a registered investment advisor, and as Pat mentioned, I'm co-chairman and co-CEO. I should mention I'm also on the board and executive committee of the MFA, and I'm a past chairman of the Managed Funds Association.

In 1971, when Millburn started systematic futures trading, I was a young lawyer at Sidley and Austin in Chicago. In 1976, our founder, Malcolm Weiner, wanted to roll his few futures managed accounts into a pool as a more efficient way to trade, but he couldn't find any lawyers in New York who knew about futures. That situation has changed.

By that time, I had set up some of the

early public commodity pools for Sidley clients: Heinald Commodities and Cotty Commodities. Malcolm urged me to go east, but I thought up give a partnership in a major law firm to be a commodities speculator? By early 1983, I had seen the light. We set up our first pool, Nestor Partners, in February of 1977, with $5 million, and it's still going strong 28 years later with approximately $200 million.

Millburn is currently managing about $1.5 billion in currency and futures funds, hedge funds, funds of hedge funds, and currency overlay. About $900 million of our assets under management is in currency and futures funds. In our activities as CPO of futures pools, we direct all trading as opposed to subcontracting to other CTAs. We're currently a CPO of 13 funds, two of which are SEC-registered public funds, one of which is currently being marketed by a syndicate of regional and major broker-dealers, and nine of our funds are domestic limited partnerships, plus two offshore funds, which are all private placements. We also

have six managed accounts from other CPOs.

The portfolios range from currency only to fully diversified to commodity only and from long-term trend following to short-term trading. Our managed futures business is approximately equally divided between high net worth institutional business on the one hand and retail business and SEC-registered publicly offered funds on the other.

We participated in our first publicly-offered fund in 1978. It was sponsored by Heinald Commodities, and we were the CTA. I believe this was the first fund offered by a major Wall Street firm, Blythe Eastman Dillon, and was the first to be Blue Skyed in virtually all the states. The fund raised the then-unheard of sum of $10 million. Since 1980, we have also been in the fund of hedge funds business, initially as a diversification vehicle for our principals, and we operate a domestic and an offshore fund with about $150 million in equity. Both are private placements. In this case, our CPO activities

entail selecting and delegating trading to outside managers.

In 1987, we launched our first equity-oriented hedge fund, and we currently manage three equity-oriented hedge funds with about $200 million in equity. These are also private placements, and we manage them internally.

The principal strategy we utilize in the currency and futures markets is systematic, intermediate to long-term trend following. A trading system is basically an idea for making buy and sell decisions in a financial instrument or commodity which is reduced to a mathematical formula which is then back-tested historical data and evaluated. The premise is that if a system would have performed well over the environments, cycles, and shocks of the last 10 or 20 years, it has a reasonable probability of performing well in the future.

Every system, when it signals the initiation of a long or short position, also has a reversal price, which is continuously recalculated.

If the position loses enough money to hit the reversal price, it is closed out.

Because losing trades are closed out relatively quickly, and profitable trades may run for months, the average profit on winning trades is greater than the average loss on losing trades, and the strategy can be successful even if more than 50 percent of the trades are unprofitable.

Every year, you can look back and see what kind of system performed best. Looking forward is a lot more difficult. Because we cannot predict what kind of market environment will unfold, we use a spread of eight different systems in each different futures contract traded in an effort to conserve capital in difficult periods and capitalize during trending periods. It's also difficult to predict which markets will be the best performers in the future.

We address this by broad diversification. We trade about 85 markets in six portfolio sectors: currencies, interest rates, stock indices, energy, metals, and agricultural commodities, and we spread

the risk among the markets relatively evenly based upon our assessment of the relative volatility or risk of each market.

After selecting systems and portfolio weightings, the question remains: how large should the portfolio be? This is determined by back-testing the portfolio against historical data to determine the worst historical peak to trough drawdown. That's a daily peak in equity in a hypothetical fund to a subsequent daily low point, whether that's a week or a year later. The tolerated worst case sets the leverage or total risk of the portfolio. This is painting with a very broad brush and leaves out a lot, but I hope it's of some use in understanding how trend followers work.

We don't consider managed futures a core investment which should replace stocks or bonds. Its role is diversification, because its correlation to stocks and bonds tends to be about zero. In fact, managed futures tends to be negatively correlated to losing periods for stocks

and bonds and other alternative hedge fund investment strategies. This noncorrelation profile is due to the market sectors traded, many of which are not directly represented in traditional asset classes and indifference to market direction, which can provide profit opportunities for market movements often adverse to traditional investments, such as rising interest rats, falling stock prices, a declining dollar and commodity inflation.

Thank you.

MR. MCCARTY: Thank you, George. Very interesting to hear about the trend following, and we all know that there are other strategies which are employed, but that is one of the very popular approaches of the CTA community.

Our next panelist is Professor Scholes, and I would note, Professor Scholes, you're in a very interesting position: not only do you run a commodity pool operator and a commodity pool, but you're also on the board of directors of the Chicago Mercantile Exchange, the largest futures exchange in the United States. Would you please

tell us a little bit about the recent changes in membership at the CME, membership rules, that I believe would permit commodity pools and CPOs to actually become members and discuss generally something about the importance of commodity pools in terms of volume on futures exchanges.

MR. SCHOLES: All right, thank you very much, Madam Chairman and the other Commissioners for inviting me to participate. I'm actually a retired professor from Stanford University, and as Pat mentioned, went off again. Thank you.

I'm chairman of OHPP, which is a $1.75 billion relative value hedge fund and also on the board of directors of the Chicago Mercantile Exchange since 2000. I observed the transition to a stockholder owned exchange. Obviously, these are my opinions that I'm going to be talking about today.

Before talking about the growth of the hedge funds as members of the CME and providing liquidity, I would like to first talk about the value proposition that I see for hedge funds,

commodity pool operators, and then, be able to relate that to the growth of membership on the Chicago Mercantile Exchange.

I really think that there are, although not limited to hedge funds, there are really four ways to make money in investing: what we call in the academic world and now the practitioner world, one is alpha generation, which is an ability to forecast, say, cash flows better or factors better than other investors in the market and be able to capitalize on these predictions.

The second way to make money is in systematic exposures, and we know a large fraction of the population invests in markets, such as the stock market, which offers positive expected returns, obviously, with risk, but a large fraction of the hedge fund world also or CPO world also tries to think about macro factor predictions, whether stocks are going to outperform bonds or whether commodity prices in general are going to go up or down.

There are two other dimensions of ways of

making money that are not as well understood by either the academic community or, in my view, the practitioner community, and one is risk transfer, and the other is liquidity provision. In the world of risk transfer, which really has its roots here in the Commodity Futures Trading Commission role as well as the community at large, we've always known about the farmer transferring risk to the miller, who stores the wheat, and then, the miller takes the risk until such time as the bakers come and buy the flour to make the cakes and bread that we all eat.

That risk transfer mechanism has been the core of the futures market since basically its inception. The idea that we have known and understood is that the miller has two sources of risk: one is the idiosyncratic risk associated with the unique aspects of the wheat that's being stored and the second risk is the generalized risk associated with price movements in the price level of the wheat being stored.

That generalized risk is generally

transferred through the futures market to the speculators, because the capital needed by the miller to handle those risk levels when the inventory levels are high is just too great, and it's too costly, and so, as a result of that, the miller keeps the idiosyncratic risk and transfers the generalized risk to the marketplace.

That whole risk transfer mechanism has moved away from just the commodity world to the corporate world and the banking world and the financial world since the 1980s. And now, corporations are realizing that having equity as a risk cushion is expensive relative to risk transfer mechanisms that can be employed by using structured products and the like engineered by investment banks who, like the miller, now transfer their risks to the hedge fund community and are willing to pay for that risk transfer, or ideally, the corporations, banks, and others, are paying for the risk transfer services.

I distinguish risk transfer from liquidity provision in the sense that we know that less

liquid assets tend to generate premiums, and as a result of holding less liquid assets, you expect to earn a premium from holding these assets. But risk transfer and liquidity provision are sometimes used interchangeably.

The interesting part is that risk transfer and liquidity provision is that the price of risk transfer and liquidity does not remain constant. It changes. It changes as a result of shocks in the economy, because to understand when to be a speculator, when to provide risk transfer and liquidity services, you have to have a model, you have to understand a valuation model, that and how to calibrate your model.

That requires a very talented team of individuals, and for that team to be able to do this at the time of shocks it is not going to stand in the middle of the freeway and be run over by a truck. But what they do is they withdraw capital at that time until they have a chance to understand how to recalibrate their models. So having a team in place at the time of shocks such

as in a hedge fund allows that team to redeploy capital sooner than rebuilding a whole team.

So basically, my view is that one of the advantages of having, major advantages of having hedge funds or others providing risk transfer and liquidity is that they have the teams in place to be able to intermediate and continue to create a functioning capital market at a time of unanticipated events.

So I don't think any of these businesses, the alpha business, the beta, or systematic exposure business or risk transfer liquidity business necessarily is a zero sum game. I definitely think that as we know in the futures markets that hedgers are willing to pay speculators, and as the demand for hedging among corporations increases, we will see their willingness increased to pay for liquidity provision and risk transfer.

I think that we have seen a great growth in hedge funds as being a leader in understanding and learning how to manage risk. This is being

transferred as well to the rest of our society, to corporations, insurance companies and other banks and institutions, and in risk management, we have the areas that I think are growth areas and are changing dramatically, everything from capital allocation, how you allocate capital to strategies, other panelists have directed their attention to some of these issues, but risk management is really not risk minimization. Risk management is optimization: how do we allocate our capital among various opportunities for the risk that we are taking?

But not only do we have to worry about our local risk that we have, but we have to worry about stress and what the effect of stress risk is on our allocations. These are the what of what we have to do. And the how to do this is you need a feedback system, a mechanism to understand how you made money, how you lost money, learning about your models and how they're performing; the degree of transparency within the firm and to investors and how one runs the organization is an important

consideration.

The structure of the firm, how we pay people: the CPO industry, in my view, is moving away, as others have said on the panel, from the hunter organization, where you have hunters trying to just earn money to being a farm, where we try to build an organization and create a surviving organization, and that's important.

Next area is capital structure. When you're in a hedge fund, it's different from a mutual fund in the sense that it's a levered business. So we're talking about debt and equity of your structure and how to manage that, and then, also, dealing with the regulations and changing regulations around the world.

If we look at the CME, the CME provides services to clients and customers, and the idea of liquidity or the provision of risk transfer services of the exchange also needs liquidity or liquidity provision. As the exchanges move from a pit or trader in a pit oriented entity to an electronic entity, the pools of liquidity providers

or speculators change; it evolves. It's not static.

So those pool providers, through electronics, could be anywhere in the world. They could be through hedge funds; they could be others around the world. So the exchange realizes to provide liquidity and to keep markets efficient and low cost was necessary to engage these liquidity pools, and as a result of that, tried to encourage hedge funds to be inactive members and provide liquidity, especially in the markets such as the eurodollar markets or the S&P trading markets.

So I think the trends are to see a dynamic flow of capital, because the growth of risk transfer and liquidity provision which is crucial to our economy and to the world, especially at a time in a global environment where we are more prone to having shocks, more prone to having unanticipated events, to having growth of our teams of liquidity and risk transfer providers in place leads for us to have a much better facility to withstand these shocks and to be able to keep our

markets well-functioning and providing a better source of capital and risk transfer for corporations and for other financial intermediaries.

So I am excited about the future, and I think that for the evolution and changes that we are going to see in the years ahead, it's going to be a continually exciting time.

Thank you.

MR. MCCARTY: Thank you, Dr. Scholes.

We have about five and a half minutes for questions. Chairman?

ACTING CHAIRMAN BROWN-HRUSKA: Well, thank you very much, Pat, and thank you very much, panelists, for the interesting presentation.
I think it should be comforting to many outside who are looking at hedge funds and thinking about maybe diversifying or utilizing commodities in their portfolio to know, for example, as George Crapple mentioned that these funds have been
operating in a legitimate and important fashion, contributing to that market sector for a long time

and that the CFTC has had a presence in regulating
and in supervising, in some sense, that activity
from the perspective of ensuring operational
integrity. And so, I'm pleased to hear these
remarks.

My question that I'd like to ask--and
then, I'll give the other Commissioners a chance --
reflecting on Professor Scholes' remarks that hedge funds
have these liquidity provision and risk transfer
strategies that are now being utilized and have
been utilized, for many years really. These strategies have led to a
condition where funds bring that
liquidity to the markets to actually absorb shocks in our economic
system. And I believe Commissioner Hatfield
mentioned that Alan Greenspan has also noted this. In effect
derivatives markets and speculative interests in
the form of hedge funds have provided important
liquidity; they have actually made our economy run
smoother and brought more stability.

So, as a follow-on, as

a college professor myself, and teaching alternative investments and derivatives and private equity, my question for you, Dr. Scholes, is related to something we've always thought, but I haven't really checked the recent evidence. But the hedge funds and their activities, do you believe that they make markets more efficient? Do we see improvements in market quality generally as a result of this speculative interest and these types of activities that funds engage in?

MR. SCHOLES: My view is that to make markets efficient, you need intermediaries. It doesn't become efficient entirely on its own. As a result of actions that are taken by individuals in the marketplace, either corporations, pension funds, insurance companies, individuals, they create an imbalance in the market by their activities.

That means you need intermediaries to enter into the market to smooth out the demands or the supply that's presented by entities until other entities can step in. As a result of

intermediaries entering the market, the markets are made more efficient. The intermediaries have to expect to earn a profit by their activity, and as a result, those who want the services of the intermediary such as hedge funds should expect that they pay for the talent and the teams that are established that are necessary to do this service.

As the world becomes more complicated because it's more global, the value of the team is enhanced, because you need more skills to be able to undertake these functions, and that means the talent is accumulated in these, say, hedge funds or commodity pool operators to provide this intermediation service.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you.

Commissioner Lukken.

COMMISSIONER LUKKEN: I just had a question for the panel and anybody who wants to jump in, but somebody had mentioned AML requirements that are now being put on the hedge fund industry. A lot of the SEC registration requirements, as well as what we're doing in the

area, all these things are adding to the burdens of hedge funds, and, you know, part of I think what we want to do is to encourage hedge funds to trade on open, transparent markets to provide liquidity, as we mentioned, and that contributes to the efficient functioning of our markets.

But is there any chance that the regulatory issues that I just mentioned may force hedge funds offshore, where it becomes much more opaque, much more beyond our jurisdiction? How easily could this happen? I mean, is this something we should worry about as regulators to make sure that what we do is tailored to the risks involved? And how best can we accomplish that without scaring these investment vehicles offshore?

MR. GAINE: If I might just take a quick response to that, in developing the AML regulations, we've enjoyed a very healthy, good relationship with Treasury and the other functional regulators. The regulations are not yet final. It's Treasury's desire, I think, to minimize disruption that would put the U.S. funds at a

disadvantage, but I think as general proposition, I know Chairman Greenspan has referred to back in the 1998-1999 days that direct regulation might indeed result in exactly what you're talking.

I'm not in a position to quantify that. Maybe somebody else on the panel would be. But I think it should always be a consideration of the regulator, but it's funny, on the AML issue, I got no pushback, really, from the membership. This was something they almost embraced; you know, it's the right thing to do. But I think on other regulatory more economic-oriented things, I think it's a very important consideration for any agency before they adopt any rule.

ACTING CHAIRMAN BROWN-HRUSKA: Any other comments or additions?

I think that's important. I'd just point out that by AML, we mean anti-money laundering. I don't know if we clarified that, but I think--I agree with you. I think we have seen a lot of positive response, but I think anecdotally, our biggest concern as regulators is that we

do not inadvertently, in trying to expand our understanding and our reach in the fund industry, create burdensome and duplicative regulatory requirements that would actually cause funds to leave the U.S.-regulated environment and move offshore. If that were to happen we'd lose the fundamental regulatory control that we have, to protect investors that we have at this time.

MR. GAINE: You have kind of the reverse of that in the SEC's investment advisor rule that if you have 15 or more U.S. persons, then, even if you're located offshore--it's the other side of this coin--then, you must register with the SEC. There is a tremendous amount of pushback by U.K. FSA-regulated and other foreign hedge fund managers to the point where they're suggesting if they have 19 U.S. investors, they're going down below 15, et cetera, et cetera, so these consequences have to be weighed and brought into bear in the judgments.

ACTING CHAIRMAN BROWN-HRUSKA: Commissioner Hatfield?

MR. SCHOLES: One of the issues you have with the dynamics of the business, it's hard to regulate. It has to be careful in regulation, because if things were static, it's easier. But institutions are always easier to regulate than functions, and basically, if the functions are, as you know, for all these are, say, the major one, liquidity provision and risk transfer, and the dynamics of liquidity provision and risk transfers are changing, and they're global and, as a result, it's harder to--you have to be careful on what one regulates, because you can inhibit change, which is something we want in our society, because that's what we expect to occur all the time, and that's very important to foster.

MR. MCCARTY: We've run over our time, but I think we probably have room for two very quick questions.

COMMISSIONER HATFIELD: Much has been made in the media about the, quote, secretive world of hedge funds and specifically the proprietary trading models and positions that are taken by the

various funds. Do any of the panel members care to comment on the importance of the issue of proprietary trading models?

MR. COOPER: Proprietary trading models are the life blood of each individual manager's systems. I think we heard George speak eloquently about the systems employed by Millburn Ridgefield. It's really not, I think, by the way, the phrase secretive world; it's really quite an unfair characterization. The actual composition of the particular portfolios is really not the issue. It's not reverse engineering; it's not understanding what each position is and how it moves. It's really the broader impact on the system that we've heard Dr. Scholes speak about that we've been speaking about this morning.

So I think like any investor, like any investment bank, like any institutional investor, the precise composition of the portfolio is really not the issue.

MR. SCHOLES: I think part of it is some models are secret, but a large part of the business

is not really that secret; I mean, a lot is pretty open as to what's done. The issue is that it's very important to bring together the quantitative and qualitative aspects of what is being done, so it's hard to replicate the team aspect, as I said. Some is secret, but some is not.

MR. CRAPPLE: I'll just make a very brief comment: if you're a large trader in any market, whether it's stocks or derivatives, it's not in your interest that everybody in the market knows exactly when you're coming. So there's a certain amount of if you want to call it secretiveness that is necessary to survive.

MR. MCCARTY: That would be the Indian poker approach to things and showing everybody your book. I guess the only other comment I would make is that to the extent that many hedge fund managers rely upon SEC exemptions from registration, at least in the past, one of the major restrictions to claim the exemption was to not hold yourself out to the public as being in the business or make public offerings, and so, for that reason, there is

something of a statutory/regulatory gag order about advertising your business. So I'd just make that observation.

COMMISSIONER DUNN: The panel paints a picture of a very dynamic, evolving, vibrant business, and for me, it was great to see this evolution, the development of it. But I want to reflect, how has the Commodity Futures Trading Commission evolved during this same period as a regulator during the same period, and what advice would you have during the upcoming year?

MR. GAINE: If I might just briefly, I think they have evolved, as I suggested, in a very, very decent way. But they early on made the distinction between the retail public use of futures markets, producing a white book which, when I was here, was about three-eighths of an inch, it's now about four inches thick, versus the institutional marketplaces. They have adopted Rules 4.5, 4.7, other exemptions that recognize the institutional nature, by and large, of this industry that's in front of you. And continuing on

that vein where you do not have customer protection, Dan Roth will probably address NFA and customer complaints and how minuscule they are. I think it's that being at the root of your decision making and philosophy has been critical in the growth to date and will continue to be very important that the people in these markets don't need the protections such as the retail people do.

MR. SCHOLES: I think that the idea of fostering innovation and change as opposed to form, you know, substance over form, and a lot of regulation which you've avoided takes an act of form, and so, I commend you in that regard.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you.

On that note, I think we'll take a brief break, and we'll come back in about 10 minutes and get started again.

[Recess.]

ACTING CHAIRMAN BROWN-HRUSKA: Thank you. I enjoyed that first panel. I think we're looking forward to the next panel, and with that, I'll turn it over to my partner in fighting crime, Dan Roth

of the National Futures Association.

MR. ROTH: Thank you, Madam Chair, and I'd like to echo the comments of the first panel in thanking the Commission for putting this roundtable together, and in particular, thanking the staff, because I know the enormous amount of work that goes into putting something likes this together, so thank you for all of the staff's efforts, and in particular, I'd like to thank the staff for allowing me to moderate such a distinguished panel that we have here for the second panel.

I would, for the members of the audience, I commend that you read the biographies, the extensive biographies of each of the panelists, and given our limitations on time, I won't go through their full biographies, but I would like to introduce for the audience our panelists, who include, and I'm not sure, I guess at the far left hand side, we have Mark Silber, who is Vice President of Renaissance Technologies. Sitting next to Mark is Cindy Fornelli. Cindy was formerly deputy director of the Division of Investment

Management at the SEC. She's now at the Bank of America, where she is in charge of securities regulation and conflicts management. Next to Cindy is Jim O'Hara, who I'm very proud that Jim O'Hara started his futures career at National Futures Association, and he's very proud that he's moved on.

[Laughter.]

MR. ROTH: And Jim is now director of operational due diligence at Lighthouse Partners. Next to Jim is Armando Belly, who is general counsel for Soros Management, Soros Fund Management. Armando confessed to me prior to the panel that the first time he became involved in futures, he was dealing with the Commodity Exchange Authority, and so, no one should be deceived by his boyish looks. And finally, next to me is John Torell from Tudor Investment.

So I'd like to thank all of them for agreeing to participate. What we thought we would do for you today, we thought it might be helpful if we spent the bulk of our time really just having a

conversation, a conversation among ourselves to talk about the regulation of CPOs and of funds from the vantage point of those who are regulated, and in particular, sort of to find out from them first hand what it is, if anything, that drives them nuts about the regulatory process, and in particular, I think the issue of dealing with multiple regulators.

I'm just sure that there's someone out there who enjoys being regulated by multiple regulators, but I've been at NFA for 22 years, and I haven't met him yet. But maybe today's the day he'll turn up. But I think we'd like to talk among ourselves and for kind of an informal discussion about the challenges of dealing with multiple regulators. I'd like to find out from the panelists from their point of view to what extent are they currently subject to multiple regulators, to what extent did they see similarities or differences in the approaches of the different regulators that they deal with, and what do they want from their regulators to try to improve the

efficiency of the regulatory process and to ease in any way we can their burdens?

So we'd really like just to have a conversation, and on those general topics, I would invite my panelists, as we did in our--I wish you'd listened to the teleconference. The teleconference we did last week was great, and what we did then and what we hope to do now is to have it very informal where I would invite the panelists to jump in at any point they'd like and not certainly wait to be recognized.

The only monologue we're going to subject you to is mine, and that's because I'm the moderator, and I get to do a monologue.

[Laughter.]

MR. ROTH: But I thought it might be helpful a little bit to give you a little bit of an overview not so much for the Commission, because you're intimately aware of our regulatory programs at NFA but for the members of the audience, give just a very brief overview of the regulatory programs for CPOs and at NFA.

Pat did a very nice job of sort of surveying the overall landscape as far as the number of CPOs and the number of funds. Let me just mention that of the 1,800 or so registered CPOs, at any given time, there are approximately 900 CPO members of NFA that are actively involved in managing funds. Pat already went over the significant overlap between our CPO registrants and CPO members of NFA and the hedge fund community, so I won't go over that point again.

But let me point out that there are basically three basic component parts of our regulatory program for commodity pool operators and their funds. And the first is the examination process. NFA does an examination, an on-site examination of every CPO member, active CPO member within two years of their first becoming a member of NFA, and then, we basically have a three-year audit cycle after that.

On the three-year audit cycle, I should mention that we try not to be particularly rigid about that three-year audit cycle. You know, there

are certain members that we may characterize as high-risk firms, and I'll guarantee you that we may very well be out to the firms that we judge to be high risk based on a number of different factors sooner than every three years, and if that means that certain firms that we characterize as low risk based on our past experience with them may slide a little bit past the three-year cycle, we've learned to live with that.

We do about 300 CPO audits per year. Our examinations cover every aspect, really, of our members' operations, including their sales practices, their trading activities, additions and withdrawals and transfers among funds and certainly their reporting to their customers. With respect to that reporting to customers, our financial testing attempts to trace all material balances to outside sources, and I should emphasize that that includes not only their futures investments but their nonfutures investments as well. Our focus is obviously on futures, but we do not ignore their nonfutures investments and particularly in the area

of financial testing.

With respect to illiquid assets that our members may be invested in, we certainly as part of our examination will review our members' written procedures for valuation of those illiquid investments. We will do testing to ensure that those written policies are, in fact, followed. We will do confirmations wherever possible, and I should point out that we have a number of cases where our enforcement action was based on activity by the members that didn't involve futures at all. And in those cases, we've brought enforcement actions where we deemed necessary. We've made referrals to the SEC and the CFTC, and in several instances, one or both agencies have taken their own actions.

A second component of our program is disclosure document review. In 1997, the Commission delegated to NFA the responsibility for performing the initial review of all of the disclosure documents. We do examine 100 percent of the disclosure documents that are filed with NFA.

In 2004, there were about 900 different disclosure documents that were reviewed for compliance with all aspects of the CFTC's and NFA's rules, including disclosure of risks and conflicts of interest and fees and expenses.

And finally, our third component of our regulatory program involves analysis of financial statements that are filed with NFA. Generally speaking, CPO members are required to file a certified financial for each pool that they operate. We analyze 100 percent of those statements. Last year, there were 3,600 financial statements analyzed by NFA. We want to make sure they adequately represent the financial status of the firm and make sure that the firm's investments are consistent with its disclosure documents.

I'm sorry I've taken a few minutes to go over that, and I recognize that--I wanted people to understand the basic components of the regulatory program that's in place for CPOs, while at the same time recognizing that in a lot of ways, those details about our audit cycle and so forth in a

certain sense aren't that important, because the purpose of regulation is not to do audits, and the purpose of regulation is not to review disclosure documents or to analyze financial statements; as we all recognize, the purpose of regulation is to protect customers, to foster public confidence in the markets, to do that in a way that is efficient and to do that in a way which fosters competition and innovation and growth.

And I would just leave you with two basic statistics that Mr. Gaine invited me to leave you with in his comments: number one, overall, for the entire futures industry, as I mentioned in our testimony a couple of weeks ago, since 1982, volume on the U.S. exchanges is up by over 1,200 percent over the last 22 years. During that same period of time, customer complaints filed with the CFTC and NFA, customer complaints by that period of time have gone down by over 70 percent, and I think that's a significant statistic and a significant accomplishment.

Focusing in on the CPO side of the ledger,

you know, Pat went over, I thought, in some vivid detail the tremendous growth that has occurred in the CPO/CTA side of that business, and I would point out to you that CPO CTA members now constitute over 55 percent of NFA's membership, and they account for 2 percent of the customer complaints that are filed with the CFTC and with NFA.

So I don't know exactly what that means. I know one thing it doesn't mean: it doesn't mean that the regulatory programs are now done, and we don't have to continue to modify them. The industry continues to evolve, and the regulators will have to continue to evolve with it. But it says something good, says something good about the current regulatory program.

So with that, I think one of the big challenges we are facing as regulators is the phenomenon of trying to coordinate our activities and trying to lessen burdens that may result from members having to deal with multiple regulators.

And if I could, I would kind of like to

just sort of go across our panel and get a sense from each member of the panel the nature of your business and how many regulators are you dealing with, and from your perspective as one of the regulated, for the regulators that do you deal with, you know, what do you see as the similarities and the differences in the regulatory approach of the various regulators that you deal with?

And in no particularly scientific way, why don't we just go down and start, if we could, with Mark at the far end?

MR. SILBER: We are a hedge fund who originally came out of the futures world and has evolved into what is more traditional hedge fund business. We've been regulated by the CFTC and now monitored by the NFA for about 15 years, and we're under SEC jurisdiction for the past 10, and the main point I would like to make is in the way of a compliment.

I believe that the regulatory oversight as provided particularly by the CFTC over the past 10 years has evolved into one that more accurately

reflects some of the points that Pat brought out and that Commissioner Dunn referred to. The investor base that we cater to, the hedge fund world in general caters to is the more sophisticated, nonpublic investor base. Pat's statistics showed it was a very small minority of the actual dollars under management were the public funds, and I believe that the regulatory process, the core principles and the NFA's audit process, recognizes that to a large extent, and that is, I believe, more in the past five years than it has in the past.

And I think that is a tremendous accomplishment, because it allows those of us in the industry to continue seeking to make the absolute returns that the investors look for with adequate protection without unduly inhibiting our ability to be flexible and innovative. I don't think the role here is to discuss everything, but we've always viewed the futures industry as a part of the greater hedge fund industry, albeit one with a more unique marketplace, perhaps.

The audit process has not always recognized that. I think the CFTC has come around to reflect that, and I think that is very favorable for the industry.

MR. ROTH: Mark, if I could, I'm sorry to interrupt, but we're going to be doing that all day, or at least for 40 minutes.

MR. SILBER: I'm used to it.

MR. ROTH: Can I just ask other members of the panel, one of the points that has come out is the fairly limited extent of retail participation in commodity pools and the limited number of public pools. For any members of the panel, could you just address whether retail participation is something that you seek, something that you market for? Do you have retail participation in your particular operation?

MR. TORELL: Hi, my name is John Torell, and I'm with Tudor Investment Corp., and we have approximately $12 billion of client assets under management.

We do not market our funds to retail

customers at all. We have very strict levels that have been set for us to ensure that the participants who--some are institutions; a lot are fund of funds capital and the individuals who we market to are high net worth, sophisticated investors who pass specific tests.

I did want to, just on the first question you had, Dan, Tudor, as a hedge fund, actually, our origins came as a commodity pool. Our original trading vehicle that still exists is a commodity pool, and we have been registered with the CFTC since our origins in the early 1980s. And to us, as a market participant, it has been very important to us to have a regulator who understands our markets, who is there to protect the integrity of the markets, and we feel as a participant that the CFTC in conjunction with the NFA's role has done a very effective job.

We are registered globally with a number of different regulators, the FSA in UK, in Singapore and Australia and used to be in Tokyo, and we are very encouraged by, Madam Commissioner,

your comments that the CFTC is involved with the SEC to see if there is an exemption available to participants like ourselves who have a primary regulator in the markets in this jurisdiction, so we very much encourage your efforts, and we're very happy to hear that as a market participant.

MR. ROTH: Mark, again, I may have interrupted you before you got to the issues. What regulators do you guys deal with in the course of your day-to-day operations?

MR. SILBER: CFTC, NFA, and the SEC in our role as a registered investment advisor. And, you know, as you pointed out, I'm not one of those people who enjoys the dual registration.

MR. ROTH: We have not found that individual yet.

MS. FORNELLI: It's outside counsel. That's who it is.

[Laughter.]

MR. ROTH: Well, Cindy, what about you at the Bank of America?

MS. FORNELLI: Well, at the Bank of

America, we're regulated by, I think, every governmental agency known to man, both domestically and--

MR. ROTH: Congratulations.

[Laughter.]

MS. FORNELLI: Thank you; internationally. So we've got the CFTC, the SEC, the banking regulators, the FSA, and so, we see it all now. Obviously, in different portions of our business, but we do see the whole gamut, and one of the things that I was struck by, and I think Professor Scholes kind of touched on it when he was talking about risk assessment or risk management that risk management shouldn't be viewed as necessarily risk reduction but risk optimization. And I don't know that the SEC would it that way, and I'll be interested to hear what Mr. Fishkin has to say later on about that particular issue, because I think one of the differences that you do see, at least between the banking regulators on the one hand and the Securities and Exchange Commission on the other hand is this notion of whether or not the

regulator should be a cooperative regulator, or if it is actually there to, you know, try to catch you doing something wrong.

And I don't think the SEC views itself necessarily as a catch-you agency, but I certainly think the industry probably views the SEC in that sense. And so, you do see some of those differences, and I think that that is probably one of the concerns that hedge fund managers and that CPOs have is that, you know, what is the SEC regulatory regime going to be like, and what will the exams be like, and will it be much different?

MR. ROTH: Armando, are your experiences with multiple regulators more in the domestic setting or more in the international setting?

MR. BELLY: In the international setting. We're registered as a commodity pool operator here in the United States, but historically, we have also been registered with the FSA. We have a company, Soros Funds, Limited, which has been registered as a broker-dealer and as an investment advisor in London.

Actually, it hasn't caused much of a problem, because the two businesses are very separate, the business in the UK and the business in the United States, and also, I think the philosophy behind the regulators, the CFTC and the FSA, are quite similar, in that they're risk-based. Our flagship fund or actually our only hedge fund, the Quantum Endowment Fund, it hasn't been open for new investments since 2000, and all of its investors are 4.7-qualified investors, essentially, very sophisticated entities and people. And as a result, we qualify under 4.7, and the type of scrutiny we get is measured with respect to any type of audit or review by the SEC, CFTC, or NFA.

The Financial Services Authority in the UK, they have basically, my understanding is, a five-step analysis to measure risk in terms of how you regulate an entity, with five being the highest and one being the lowest. And currently, fortunately, I think we're one, the lowest, so we don't get much scrutiny there other than the periodic audits, which are quite thorough, like the

NFA audit.

I think we have a concern or I have a concern about the SEC. We are a relatively new registrant with the CFTC, having registered in 2000, and when we registered, someone from the NFA, the New York office, called us up and said they would like to come down and talk to us, and they did a preaudit, and it was very, very helpful to us. Their attitude was we want to help you get through this process. We know you want to get through the process and meet all of our requirements and the CFTC requirements.

We found the same attitude in the UK. In the UK, they assign a particular person within the FSA to be your point person, and you have the obligation of letting them know if you have changes or something comes up that's important, and they also work with you to make sure you meet all of your requirements.

We're starting now to look at what it means to be SEC-regulated, and we've heard stories that, in fact, it is not as friendly; it's more--it

can be adversarial. I hope that changes, and I understand when they adopted the rule that Commissioner Campos suggested that they start looking at a risk-based approach similar to what the CFTC has and the FSA, and if we do have to register, I hope they go forward with that, and I think they could learn a lot from looking at how you regulate hedge funds and how the FSA regulates hedge funds if, in fact, we have to have dual regulation.

MR. ROTH: I'd like to come back to that in a minute, but Jim, from your firm's point of view, what are your interactions with multiple regulators, and to what extent is it a problem? To what extent is it--

MR. O'HARA: Lighthouse Partners, we come from a different, probably, viewpoint than the other panelists here. We're a fund of funds, so we're also an investor. We allocate--we currently have $4 billion under management. We allocate out to in excess of 100 different investment managers, and as an investor with a fiduciary responsibility

to the people who give us money, you know, we like to see the regulatory oversights of the different managers whom we give money to. Roughly 50 percent of our managers are NFA members, CFTC-registered, and less than 20 percent are now SEC registered.

With that said, you know, we are also NFA members, trade and advisor commodity pool operator, and we are SEC-registered, and I can see on the flip side, you know, to have the dual regulation, we actually have the Federal Reserve come out and audit us as well, and we saw it last year when we had all three entities within a six-month period, and one of the points that, you know, I want to make is that, you know, we seem to be duplicating resources here instead of sharing resources and eliminating some of this same audit procedures coming out every three, six months. That's one of the things I'd like the panel to talk about.

MR. ROTH: And I think we ought to get back to that in a little bit.

Mark, can I go back to you for a moment? You mentioned the various regulators that you deal

with. I think Cindy had sort of mentioned that there's a perception that maybe of a difference in the regulatory approach; maybe not so much at the SEC but among those that are regulated. I think someone else made reference to the same sort of possible difference. From your perspective, I mean, do you see a difference in regulatory approach, or do you think they're more similar?

MR. SILBER: I think that it may be more maturity of approach than anything else. The CFTC, in my experience, has been involved with hedge fund-type investors my entire experience with them, 15 years, while the approach that we've seen with the SEC has been coming more from a mutual fund, protect the investing public point of view.

While obviously, that's an important role, I'm not quite sure that they've gotten down to the point where they adapt to the appropriate level of review, at least it seems like that at times.

MR. ROTH: And John, I think you had mentioned, if I recall, was your experience with multiple regulators more on the international level

than at the domestic?

MR. TORELL: Yes, we're registered with the FSA as well as CFTC, and I would concur with Armando that both, in our view, both the CFTC and the FSA take a risk-based approach to regulating. They, both from our, as participants, are what I would call pro-market participant. You know, they are not there to find a problem; they're there to protect the markets from fraud and to preserve the integrity of the markets they regulate.

And so, you know, with the CFTC, for example, over the 11 years I've been at Tudor, we feel very comfortable calling the CFTC if we have an issue or we think we have an issue without a lawyer present. We think we can call and say we need to discuss something, and then, we're going to have a receptive professional person or persons on the other end of the line. That's very important to us. And conversely, we've seen where there might be events in the markets that are things that the CFTC wants to educate themselves about, and they've called us not to say is Tudor involved but,

you know, can you help us understand the strategy of what these participants might be doing?

The point is that there's a very healthy, proactive two-way street with the market participants at least from our perspective and the CFTC, and I would say that that's the same as it relates to the FSA. And because we're not registered currently with the SEC, you know, I can't share with you, you know, their approach to audits or interaction.

MR. ROTH: Well, we'll come back in a couple of years, and maybe you can--

MS. FORNELLI: Dan, I might address that just for a moment.

I think that the SEC under the leadership of Chairman Donaldson is wanting to go more towards the risk-based model and is trying to develop that, and it's certainly something that ties into some of the concerns that have been raised even within the Commission about the SEC's resources as they moved forward with their registration rule. Obviously, registering hedge fund managers is going to

increase the number of registrants that the SEC has under its jurisdiction and has to examine, and so, those two things, I think, kind of work together to move toward a more risk-based approach to examinations.

But, of course, when you're moving models, there's always, I think, going to be a period of transition and perhaps some growing pains. And one of the things that I might throw out is that, you know, the CFTC and the SEC and perhaps the MFA work together to have educational programs and educational panels so that everybody is comfortable with everybody's knowledge level, because that's one of the things that I hear frequently is a concern that is the SEC examination staff, do they fully understand how hedge funds operate and what their role is in the market and what their complexities are?

And these are very complex products that are out there. And so, perhaps, in this new era of cooperation, everybody could get together and have some educational opportunities there.

MR. ROTH: We could then all sing Kumbaya at the end of the--

[Laughter.]

ACTING CHAIRMAN BROWN-HRUSKA: Just real quick, I just want to ask the panelists, that was just Cindy Fornelli who remarked, and Cindy, I just wanted to identify you to the reporters and others. We've gotten a request from outside from members of the press who are listening, and they're saying who are these people who are talking? So if you could identify yourselves--

[Laughter.]

ACTING CHAIRMAN BROWN-HRUSKA: --that would be great, and Cindy, I just wanted you to clarify for us, you were at the SEC at one point.

MS. FORNELLI: As of six months ago, I left, and now, I'm at Bank of America. So I was, for better or for worse, you know, you're pointing out here--

[Laughter.]

MS. FORNELLI: --Madam Chairman, whether it's good or bad.

ACTING CHAIRMAN BROWN-HRUSKA: Well, you've been the most critical of our sister agency, so I wanted people to know where that criticism was coming from.

[Laughter.]

MS. FORNELLI: I hold the SEC very fondly in my heart, and I think registration was the right way to go. But I was there at the SEC during the study, during the roundtable that the SEC held, to which, you know, Patrick was a participant as were others even on this panel and so, you know, was there during the report writing and the rulemaking process and do think it was the right way to go.

But I also appreciate that there are a lot of people in the industry who are concerned about both the SEC's capacity to do the examinations and also the duplicative regulation and how it's going to overlap with the CFTC and other regulators. So I don't mean to be critical but just realistic, and I think that we need to get these things flushed out and put them on the table and discuss what people's concerns are and try to find constructive

ways to address those concerns.

MR. SILBER: I just wanted to add I agree with Cindy. I think the SEC's approach, in theory, is appropriate. But I was very encouraged when the Chairman mentioned that there are ongoing discussions for the information sharing and joint registration as opposed to parallel registration. That would be very helpful for the industry for the SEC to take advantage of some of the things that the CFTC and the NFA have learned from regulating people for a much longer period of time, and that can ease the burden, I think, on both sides for more effective registration as opposed to ongoing, you know, audits.

MR. ROTH: On behalf of NFA, obviously, we do the bulk of the CPO audits, and if there's any way we can be of assistance to the SEC and as far as exchanging ideas or letting them learn from our experience, we'd be obviously happy to do that.

Cindy, you just mentioned maybe there would be a possibility of some kind of public forums to talk with the SEC so that the SEC can

sort of hear from some of the shared experiences of others who have had a regulatory presence in that area. Mark, I know you're active at MFA, and I'm sure there's an ongoing dialogue between the CFTC and the SEC, but I think you've had discussions as well at your level, haven't you? I thought MFA had already had some dialogue with the SEC.

MS. FORNELLI: I think that's definitely true, and in fact, I don't think I'm giving any secrets away. Jack told me that they just met with the SEC staff a few weeks ago and that they have ongoing discussions, so I think that only benefits everybody when there's open dialogue back and forth. But I do wonder if there might not be, you know, an opportunity to have some kind of a more public forum to talk about these issues; I know the SEC has training programs where they train staff and bring people from the industry, and perhaps something like that would ease everybody's apprehension.

MR. ROTH: I should also just mention as an aside that, you know, NFA, we have a hiring

class every year where we bring our new auditors in, and we go through a fairly extensive training in house, a portion of which is devoted to CPO/CTA audits, and we have had people from outside NFA ask to attend those training sessions, regulators from other parts of the world, actually sometimes law enforcement people, and they're always welcome, and we'd be certainly happy to extend that sort of an invitation to the SEC as well.

MS. FORNELLI: And one thing I would point out, and I do think we're being a little unfair to the SEC staff in the sense that many hedge funds--

[Laughter.]

MR. ROTH: Cindy, we have security here to escort you--

[Laughter.]

MS. FORNELLI: Thank you. Many hedge fund managers are already voluntarily registered with the SEC, and so, they're currently subject to the SEC examination regime, and so, you know, SEC examination staff have been going in and looking at hedge fund managers over the past several years.

So it's not a totally foreign concept. I think it's part of Commissioner Atkins and Commissioner Glassman's concern was a capacity concern, a resources concern, but as we've all noted, too, this is an evolving industry and a very sophisticated industry, and so, you know, ongoing education is always wanted.

MR. ROTH: So ongoing educational efforts for all of the regulators, not just the SEC but for all of us so that we can benefit from each others' experiences is one thing.

Let me just ask: what else does this panel of industry participants want from the regulators, either to ease the process of dealing with multiple regulators or on any other regulatory issue? Jim, you had mentioned some scheduling issues that you were less than thrilled with the timing of the various audits that you were experiencing.

MR. O'HARA: If I can address it, I think there needs to be some type of sharing of resources, whether it be a database of activity

that, you know, we are going to cooperate in this dual regulatory environment that we need to share so that we're not coming in; the regulators aren't coming in at the same time; they're not auditing the same funds; that they can coordinate their efforts and, I think Cynthia had alluded to it, that the SEC is now going to go to more of a risk-based auditing approach similar to what the FSA and the NFA currently do, and it's more important now that they're not going to be getting out to see firms every two to three years; that, you know, these efforts are coordinated between the different regulatory agencies that, you know, you don't have two audits in one given year on the same fund, and then, you go another three years without anybody coming in; that there's some type of database, and, you know, to the extent that there's issues or problems with different managers, certainly, sharing of work papers.

I know that the CFTC coordinates their efforts with the NFA to review work papers; that there should be, you know, to the extent that

there's a major issue, some type of sharing of information to that extent, but I know the NFA currently, having worked there for 12 years, coordinates with the NASD, the FSA; they have a joint audit committee where they share information with, you know, for FCM members, so more of that, working the SEC into that type of environment would be great.

MR. ROTH: Armando or John, as you look forward, you may each be subject to SEC registration within the next year. What is it we can do as regulators to sort of ease your burdens? I know, Armando, you made reference to the educational audit that NFA did with your firm and that we do with a lot of new firms, but what types of things would you be looking for from the regulators? What can we do to ease this process?

MR. BELLY: Well, we've been going through, of course, what it means to be registered with the SEC. And it seems to us that the regime that they have is geared toward mutual funds. It doesn't really appear to be tailored to the

business that we have. And what I would hope is that they in terms of their shift to a more risk-oriented approach also take a look at the requirements, of what they expect of a hedge fund registrant in terms of the difference in business of the hedge fund and the different types of shareholders that hedge funds have.

Most, I think, of the large hedge funds, for example, simply don't attract retail-type investors. They're all very, very wealthy people who invest, and they obviously don't need the protection that a mutual fund investor would have. So the first thing, I would call upon the SEC to figure out what the requirements they would impose on a hedge fund; for example, the custody rules, they don't really seem to be designed to deal with hedge fund rules. They have rules dealing with proxy voting.

It seems like they want to have one set of rules for everybody that one can't really apply.

MR. TORELL: I would echo both Jim and Armando's comments. I think that one of the things

that could be very helpful from the NFA and CFTC's perspective in terms of educating the SEC, while it's true that the SEC, you know, audits hedge funds, many of those out there are the traditional long-short hedge funds, and a lot of the organizations like some of ours here, we do have long-short funds, but we also do have vehicles that trade in futures and currencies and are leveraged vehicles.

And I think the CFTC and the NFA are very experienced in understanding that you can have two CTAs who have identical portfolios, but they use different--they have different amounts of equity. And they get that, and they understand that, and they can understand how those participants can be, you know, very safe and effective in the markets that they trade in.

I think we'd like to, once the SEC comes into our world, we'd like to make sure they have the same understanding of leverage as the CFTC and NFA do. So I think education, as Jim pointed out, and coordination of information would be very

helpful for us.

MR. ROTH: I'm not sure that members of the audience can see that we have over here right in front of Pat McCarty basically an NBA shot clock, and according to the--and it seems to indicate that the buzzer is going to go off here in a second, and certainly, we'd welcome any questions from the Commissioners. But before we turn to questions from the Commissioners, can I just ask if there's anything else that anybody on this panel really just wants to--I was going to use the phrase get off your chest, but anything else that you think needs to be conveyed to the regulators that is sort of irksome about the regulatory process that you think we could address, general complaints?

Anybody got a beef? And if you're just being polite, God bless your heart. So with that, Madam Chairman, we would certainly be glad to answer any questions.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you. You know, I can explain to you why the conference

call that you had without us present was so vibrant in its complaints and discussion and why they're so quiet now. I mean, I think I understand, being the regulator.

I'm going to go ahead and just pass to Walt and see if he has any questions for this panel.

COMMISSIONER LUKKEN: I guess a lot of what the discussion has been is about the approaches between what the NFA, and the CFTC and the SEC have done recently in their registration requirements. I guess I'm interested in sort of getting behind the approaches and really what the risks are to the public that each of those entities are looking for.

I think pretty clearly, we know what we're looking for and recently visited our registration requirements a couple of years ago. I think for us, it's more of an institutional, market integrity risk that we're concerned with in this area; you know, looking at accounting practices, looking at the different things that we do when we require

these hedge funds to register.

My question is, because a lot of our registration requirements also have an otherwise regulated exemption, so if somebody else is doing what we want them to do, they can get out of it, because someone else is looking at the same risks that we're looking for as regulators. And so, what I'd like the panel maybe to address is are we looking at the same risks as the SEC and maybe Cindy can address some of this, but are we sort of comparing apples to apples, and should we expect the SEC to just, you know, have an exemption for an entity that is CFTC-registered? Are we looking at the same risks to the public, the same market risks that they are? And if so, you know, we oftentimes mention FSA at the UK, I mean, we have all sorts of Part 30 rules that recognize other regulators, and we allow them to do their job when we know that they are being properly regulated.

And so, my question to the panel and maybe Cindy in particular, are we comparing apples to apples in the risks that are involved with these

two registration requirements?

MS. FORNELLI: Well, I think you raise a very good point in that the SEC's perspective, and, you know, normally, when I was at the SEC, I always had to give the disclaimer that I'm only speaking for myself and not the Commission. That is probably more true now than ever; the Commission probably doesn't want me speaking for them at this point.

But I think the theory behind the SEC's registration efforts were that the other regulators that look at hedge funds are more concerned about market impact and market structure and market integrity and that the SEC as a securities regulator is really the only entity that is looking at investor protection issues, and so, with the advent of more and more retail investors having access, not directly but indirectly, perhaps, through pensions and funds of funds having access to hedge funds that now is the appropriate time for the SEC to step in and worry about those investor protection issues.

And I think that the investor protection angle is probably why the exams are different, and the regulatory regime is different and perhaps not as cooperative. I think it is cooperative. I mean, I don't want to make it sound as if it's so adversarial but--

MR. ROTH: If I could just comment, I think it's certainly right that there is a somewhat different focus of the regulatory perspectives between the two agencies, but it always irks me a little bit when it is somehow portrayed that the focus of the regulatory efforts on the futures side, you weren't suggesting this, Cindy, ignore customer protection issues, because that couldn't be further from the truth.

I mean, there's a huge effort that NFA makes along with the Commission toward customer protection issues. It's a huge portion of every audit that we do, and we're very proud of the fact that there have been so few customer complaints in this area, and it's largely because it hasn't been a particularly retail product, and I recognize

that. But I wouldn't want anybody to walk away from the panel with the idea that the regulatory approach on the futures side does not pay an awful lot of attention to the protection of individual customers, because that's simply not the case.

MS. FORNELLI: And I think likewise the SEC would be irked if people accused them of not being concerned about market impact issues. I mean, they're meeting now on market structure issues as we speak. I think that it gets to some of the things that Adam Cooper was talking about that the industry is going toward more controls and more risk management, and that's obviously something that the SEC is going to be very focused on and that the registration process focuses on, you know, do you have internal controls? Do you have compliance programs? Do you have policies and procedures that get toward these investor protection type issues?

ACTING CHAIRMAN BROWN-HRUSKA: Okay; let's move on.

Fred, do you have any questions?

COMMISSIONER HATFIELD: Yes, I do.

Dan, in your written submission, you touched on the issue of leverage, and one of the big issues, obviously, in this area is the leveraging of managed funds and hedge funds. To what degree, you know, there's a great deal of discussion about the relationship between the banks and the funds and whether or not somebody's overleveraged. To what degree in our audits are we able to get at and feel comfortable that we know when a fund is overleveraged?

MR. ROTH: I think it's certainly part of not only the examination process at NFA, but it's also something that we would look at in the examination of the financial statements, the certified financial statements that get filed each year. And obviously, leverage is an important part of the futures industry, but if you see, you know, I had mentioned that we have a risk-based system where we will characterize certain firms as sort of higher risk based on a number of components. The degree of leverage that we see at present in those

firms is certainly one of those factors that we would consider.

So it is something that we focus on. It's something that we focus on both in the examination process and in the review of financial statements, and it is a factor that we take into account in determining our audit priorities. So I think it's something that we're very cognizant of and focus on to a significant extent.

ACTING CHAIRMAN BROWN-HRUSKA: Commissioner Dunn, do you have any questions?

COMMISSIONER DUNN: Once again, I find this just absolutely fascinating to listen to this panel of those who are being regulated, and I think the philosophy for most of the Commissioners here in talking with them is that we really do, Cindy, want to be the person who helps you get into compliance, not playing the I got you role.

But that presupposes that we have the correct regulatory regime in place in the first place, and that is incumbent upon you to ensure that we hear from you as we go through promulgating

our regulations, as we go through putting our team together of what it is we need to do to ensure that this industry is well-regulated, and sophisticated investors are also going to scream and cry if they lose a lot of money. And you know that already. But we don't want to hear about it on the front page of one of the financial papers.

ACTING CHAIRMAN BROWN-HRUSKA: And let's turn that over to a practitioner. John, do you have any ideas about--

MR. TORELL: I would agree with those comments. I mean, one of the things Tudor did years and years ago was work with the NFA and CFTC to put together ethics training for the industry. And so, we think it's very important that, as I mentioned earlier to Madam Commissioner that there's a healthy two-way dialogue not only between the CFTC and the market participants like us but also us and the NFA, who are conducting the audits.

And so, I think it's incumbent upon all of the individuals, all of the registered organizations to communicate and work with the

Commission and the NFA, and I think to the extent that you have read a healthy culture of working together and don't have the got you mentality, it's much more conducive to doing that.

And I would go back to the statistics that Dan mentioned earlier that complaints are going down, while participation and the market growths are increasing drastically. And I think that's one validation that it's working well.

ACTING CHAIRMAN BROWN-HRUSKA: Well, thank you. I think that that kind of reflects some of the same sentiments that were stated in the last panel. I think Professor Scholes had kind of raised, and also Adam Cooper, that the desire is to stay in business and to continue to operate, and so, therefore, you have to adopt, you have to provide ethics training, and you have to ensure that investors are well aware of the risks that they face in investing in this alternative asset class.

Okay; let's go ahead and switch. Thanks to all the panelists. Let's go ahead and switch to

the next panel, if we could, and move right along.

Our next panel is on futures market oversight and surveillance risks. I'm pretty excited about this panel. We have Marianne Smythe, who is a partner with Wilmer, Cutler, Pickering, Hale & Door, and Marianne actually helped participate in a hedge fund panel that I did at the Financial Management Association meetings recently. I appreciate that she's doing duty for the Commission again.

And I'm also excited about this because some of our economists are presenting in this panel. We have Michael Haigh, who is an economist who has done some very exciting financial research recently, and his and his co-authors' first draft has just come together, and so, we are very pleased to provide some sort of cutting edge work in this area on the effect of hedge funds on our markets.

So if everyone is comfortable, let's see, is Charles Fishkin here yet?

MR. FISHKIN: Right here.

ACTING CHAIRMAN BROWN-HRUSKA: Okay; good,

Charles, good to see you.

Marianne, you ready to tee it up?

MS. SMYTHE: Thank you; thank you very much for inviting me to do this. I'm very honored to have this opportunity. I would also like to point out how happy I am this morning to look at something that looks like a basketball shot clock. As some of you may know, I both went to and taught at the University of North Carolina at Chapel Hill, and being reminded of basketball this morning is a very good thing.

I will also point out as a Yankee fan that Derek Jeter hit a walk-off, game-winning home run yesterday, so this is a good morning to be here. I appreciate it; I did work myself on the staff both at the SEC and at the CFTC and seriously am honored to be here with a very distinguished panel. And I won't take up much time. I want to just begin.

The surveillance issue is clearly an important issue in the regulation of hedge funds. The meltdown of 1998 is still very much on everyone's mind, and the sharing of information

between and among the various regulators who make up this oversight function is of critical importance. Obviously, the CFTC has taken the lead in the oversight in this area, and it will be interesting to hear today what my other alma mater, the SEC, is doing to assess this area that the previous panel was obviously more polite than I have ever been.

I think the SEC wanted to regulate hedge funds, and then, the SEC wanted to regulate hedge funds, and then, the SEC wanted to regulate hedge funds, and then, there were a variety of pretexts for why they wanted to do it, but in the end, it just wanted to do it, and all else failing, they could blame the market timing crisis on hedge funds, and that's the reason they're regulating hedge funds. You know, the SEC abhors a vacuum and felt that this was something they had to get into.

So that's the only editorial comment I'll make on that subject, on the question of surveillance. So let's start with John Fenton, who is one of your own. I will point out that in this

panel of all these folks, we lawyers are outnumbered. There are only two lawyers. Everybody else here actually knows how to count, and John Fenton is one of those people. He is the deputy director of market surveillance in your own CFTC and is going to talk briefly about the CFTC's market surveillance program.

So John?

MR. FENTON: Thank you very much, Marianne. It's a pleasure to be here today with such a distinguished panel not only on this panel but on the other panels.

As the members of the Commission know, we do surveillance on markets, not on hedge funds or pools, but in the process of doing our surveillance, we learn a lot about fund trading, and we believe we know what we need to know to protect the marketplace.

MS. SMYTHE: I was just going to say, so, what is it that you do?

MR. FENTON: So the purpose of market surveillance is to detect and prevent

manipulations. A manipulation is an intentional act that causes prices not to reflect the real forces of supply and demand. An example of that would be a squeeze or a corner. So in order to anticipate this kind of a situation, we need to know positions in the marketplace, and the heart of our surveillance program is our large trader reporting system, which I'm going to talk about in some detail in a minute.

MS. SMYTHE: And I'm not going to let you talk in a lot of detail, because you've got about five minutes to describe that.

MR. FENTON: So we have positions, and the calculus we do is we analyze positions as compared to potential deliverable supply to evaluate whether traders have positions of market power. We're looking at price relationships to see if we detect any distortion of prices.

We report to the Commission on a weekly basis, and we inform the Commission of any market problems or activities of interest during the week, and we stand ready to be provided guidance by the

Commission on actions they think are important to take.

MS. SMYTHE: So I'm sure the Commissioners know this, but I don't know this. Are you clairvoyant, or how is it that you actually know what's going on out there? What are your means for conducting this surveillance?

MR. FENTON: Well, we have large trader reports. We get these reports every day in the morning. They are as of the close of business prior day. So I can look at my computer at 9:00 in the morning, and any market that I want to look at, I can see who has the positions in the market.

MS. SMYTHE: The reports are generated by the markets themselves?

MR. FENTON: The reports are provided to us by the Futures Commission Merchants, the brokers of the world.

MS. SMYTHE: Now, I come from the SEC, too. Why would an FCM who wants to manipulate the market tell you the truth?

MR. FENTON: They're required to.

[Laughter.]

MR. FENTON: And it would be very easy for us to detect that they weren't properly reporting. We have audit checks that check large trader reporting versus other streams of data that we're getting, so we do a careful analysis to see that we are getting the reports from the futures commission merchants who are in compliance with the regulations.

The positions, we get all the large positions in the market. It varies by market. Some markets are as low as 25 contracts; some are as high as 3,000, depending on the size of the market. We get all the largest positions, and generally, we get about 70 to 90 percent of coverage.

We basically wring a lot of uses out of the data we get. Obviously, in surveillance, we use it to detect possible impending manipulations. We publish commitments of trader reports on a weekly basis, which people find quite useful. In the last couple of years, our Division of Clearing

and Intermediary Oversight have very creatively used large trader data to do financial risk assessment evaluations. And finally, we use them for special research projects, and Michael Haigh will talk about that kind of use today.

Generally, we classify traders as commercials or noncommercials. Commercials are traders that are engaged in business activity which they use futures markets to hedge; noncommercials are generally speculators, and that includes the kind of people we're talking about today, the funds. They're a subset of noncommercials. This is very small print here, but it's a reproduction of commitment to trader data that we put out in the beginning of February. It's for natural gas, and it breaks out trades between reportable and nonreportable and then between commercials and noncommercials, and you can see that we're getting around 89 percent of the long side and 94 percent of the short side, so we're getting pretty much the whole market.

MS. SMYTHE: Let me just interrupt again,

because this, to me, as an SEC alum, is fascinating. You're actually able through these reports to surveill the market on more or less a real time basis, you think?

MR. FENTON: Very much so.

MS. SMYTHE: Because at the SEC, I used to say we put on great funerals; that is, we could frequently tell somewhat after the fact what had gone wrong, but we weren't in much of a position--

MR. FENTON: Well, we have the information to evaluate the situation. It's always complex analysis that needs to be gone through, but we have the basic information we need from funds but from all traders. This is not particularly about funds; it's any trader in the market that has a position of a sufficient size.

The next table just breaks out the data that we have that we publish for noncommercial traders and then a subset of this data that we don't publish but we can internally do, and we do track managed money traders, and there, you can see that in natural gas, these traders have large

spread positions, and their net exposure in the market is relatively small. I'm not necessarily saying that that is representative of positions in other markets, but it's interesting.

Finally, our experience with fund trading is that generally, positions of individual traders are not unusually large or extremely large. The net aggregate position of the group as a whole tends to change in the direction of price. As a group on a net basis, they tend to be trend followers. They generally don't carry positions into the spot month, and for that reason and probably others, they have not been a problem with regard to manipulation.

MS. SMYTHE: When you describe the impact on the markets and the impact on the relationship to manipulation, are you talking about the traditional futures markets, that is, the old pork bellies and winter wheat, or are you talking about the financial markets?

MR. FENTON: Actually, I'm talking about both.

MS. SMYTHE: So you actually surveill for buildup of positions in the equity markets, for example?

MR. FENTON: Any futures markets, so it would be equity index futures, it would be single stock futures now, but it would not be directly in the equity market.

MS. SMYTHE: Okay; that's very helpful.

Well, the Office of the Chief Economist, Dr. Haigh, who is a senior financial economist, again, with the CFTC, I believe, will have a report now to describe which describes the impact of so-called managed money traders on one particular market. And could I just ask you, Michael, before you begin, did you use his data to do this? So you actually--the chief economist and the market traders actually spoke to each other. Well, that is something that didn't often happen in my other alma mater. That's encouraging.

MR. HAIGH: Well, I'd just like to thank Madam Chairman, the Commissioners, and Pat McCarty for inviting me to present our research. I guess I

have about seven minutes to talk about two months worth of research, so without further ado: John briefly described the commitment of trader reporting data that's made available to the general public, and a lot of academic studies have used this data to evaluate the role of managed money trading in the marketplace. They use an aggregate form of the commitment of trader data in both the noncommercial and the commercial category.

Periodically, the CFTC has disaggregated that data and looked at individual groups within the commercial and noncommercial categories. 1994 was the last study of that, and what I propose to do today is briefly give an overview of our extension to that study, building on the work by focusing on the natural gas and crude oil markets, and I hope to dig a little deeper into understanding issues surrounding liquidity provision, interactions between different groups of traders and the impact on prices.

The first thing that we analyzed in a very general form was the share of open interest that

managed money traders in the marketplace in natural gas and crude oil in a similar way that was done in the 1994 study, and not surprisingly, the share of open interest has increased in both of those markets, and I'll give you some examples there that I won't go through verbally. You have those also in your tables in the booklet.

We find managed money's share in open interest has increased, but there are other large categories of hedges that also have very large shares of open interest in these markets. The managed money share in open interest in the options on futures is much smaller.

We also analyze the trading characteristics of all the different groups; for instance, the managed money and dealer category on merchandises, et cetera, and we wanted to ask how many participants are there in each group? How actively do they trade, who happens to hold onto their positions the most?

We find that managed money do have a large number of unique traders, but they do not have a

disproportionate presence on any given day relative to any other category, the large hedgers, for instance. And in fact, managed money tend to be less active on a daily basis than some of the large hedging categories.

Perhaps the most interesting thing that we were interested in looking at was the relationship between managed money positions and other categories' positions and to get at the issue of liquidity position. And here, you've got a--

MS. SMYTHE: That looks like an electrocardiogram, I swear it does.

[Laughter.]

MR. HAIGH: It does. It is not that. It is a graph showing changes in positions of managed money over a one-year time period, and I should say the time period that we look at here is August 2003 to August 2004 daily data.

But what you see here, and this picture is worth 1,000 words, is the very strong negative correlation between managed money positions and the largest hedging category position, the dealers in

natural gas. And in fact, this correlation is somewhere in the range of about -0.9, and it's not often that you find such strong correlations in finance.

So this, in itself, leads us on to the question about liquidity provision, and we can see something already. Now, the correlation between these two participants doesn't imply causality, and that's something that we get into, and I don't have time to describe in a lot of details, but we apply a methodology known as directed acyclic graphs which allow us to take large amounts of data and categories of participants and prices and understand complicated short run relationships and causal patterns in a visually pleasing way. This method is quite unique in finance and economics, and it's even more unique given that we're applying it to our disaggregated data here.

But just very, very briefly, what we can see here is information flow from other areas seems to come to managed money. You can see the arrows pointing towards it. The prices seem to go through

the dealer-merchant category and then go into the managed money category. That isn't to say that there isn't a direct link between price activity and managed money positions; it's just the directed acyclic graph gives a little more information as to the transmission of that information. In fact, we do see a strong influence of prices on managed money, which I'll discuss in just a second, but this gives a little more information about a truer story of what's going on.

The directed acyclic graph analysis also allows us to look at individual relationships amongst categories; for instance, changes in managed money positions and changes in prices. And what we find in the crude oil market, for instance, is a negative relationship between changes in positions and prices. It's a dampening effect on the price level.

Now, to me, that combined with the graph of the managed money positions in the hedging category, the flow of information going from dealers to managed money and this negative

relationship confirms to me the liquidity provision argument.

MS. SMYTHE: Confirms what?

MR. HAIGH: The liquidity provision argument, that managed money's trading activity is providing liquidity to the market. In a sense, and Chairman Brown-Hruska even alluded to the fact that in a sense, they absorb shocks, and that's essentially what we find here.

MS. SMYTHE: And you did this research completely empirically; that is, you weren't setting out to find this result. You were openly searching to see--

MR. HAIGH: The data spoke for itself, essentially, is what you're asking.

MS. SMYTHE: As a lawyer, I have a certain apprehension about economists.

[Laughter.]

MS. SMYTHE: First of all, I can only understand every other word that you say.

[Laughter.]

MS. SMYTHE: But beyond that, I have this

sense that economists sometimes will pursue a thesis that they have already identified. I take it this was a genuine open study, hey, here's the data, here's--and so, if Charles down at the other end were to look at the same data, he would likely come to the same conclusion.

MR. HAIGH: I would really hope so.

MS. SMYTHE: Okay.

MR. HAIGH: Yes; it's very comforting to know that the results that come out of here without imposing any restrictions on our models, trying to force an idea, they came out the way I'm presenting it today.

MS. SMYTHE: Why would the hedge fund--excuse me, you have a euphemistic--what do you call them?

MR. HAIGH: Managed money.

MS. SMYTHE: Why would they be on the other side? Why would they be liquidity providers? Why wouldn't they be wanting to--

MR. HAIGH: I'm not saying that they are responding to movements of other categories per se.

They obviously have their own information that allows them to trade. They're not just waiting for orders to come from other markets. But the other participants are demanding liquidity, and see same kind of signals, presumably, that the managed money does, that they are hedging, and they are hedging in understanding the same general price direction that managed money does.

Moving on, what I just presented was a very short-term relationship between these different categories of participants and the prices. We also undertook a simulations which looked at how a change in any particular participant category's position or a change in the price affected the other participants or the prices. We shocked our model, if you like, in mathematical terms.

What we found was a shock in managed money positions had very little effect on price changes in both markets. Most of the variation in the managed money positions came from variations in the large hedging categories. What I don't have on

here is a bullet point that talks about the impact of prices on managed money in the longer term. We find that there is a ripple-through effect from prices to managed money as time goes by.

So in summary, we do find managed money have a number of unique participants. They seem to be less active than the other categories, the other large hedging categories. The managed money positions are negatively correlated with other positions. Our results seem to suggest that managed money are providing liquidity to hedges and not the other way around and not. They are not demanding it. They're providing it. And we see a negative relationship between their trading patterns and price changes in the short run, but in the longer run, prices do seem to have an impact on managed money trading activity.

I'll just finish by saying this is ongoing research. We do intend to extend the data set and to apply this to different markets to test for its robustness.

ACTING CHAIRMAN BROWN-HRUSKA: I want to

just jump in here. So, basically, your last result, if I understand it, kind of contradicts the proposition that I've been reading a lot about in the press, and analysts have suggested, that hedge funds are causing the high prices we see in crude oil and natural gas, for example.

MR. HAIGH: Well, from our analysis, we find that they do have a negative relationship with the volatility. So that would contradict it in that manner, and I think Bob Levin from NYMEX is going to talk about his research, and this was completely independent. In fact, we didn't even know that we were working on similar subjects but using different methods, but I think they came out with the same kind of conclusion.

ACTING CHAIRMAN BROWN-HRUSKA: Thanks.

MS. SMYTHE: And so, with that, with your permission, we will now segue to Mr. Levin and the research he's done.

MR. LEVIN: Thank you very much. I'd like to compliment as well as thank the Commission for convening this dispassionate evaluation of this

subject. We think that's very important. I think the title of this panel reflects that approach, because this is what is needed right now. In some respects, it may not address some of the things that people do read about in some of the popular press, because that's more passionate and certainly not dispassionate. I mean, oversight and surveillance by its very nature I think as John alluded to focuses on individual participants, and unless we have a reason to think participants were colluding, and that would be illegal right away if it were not reported to us.

That's how they're evaluated at NYMEX. Now, I'm not going to report on our surveillance and oversight per se. I am going to pick up where Mike just left off, but I just wanted to mention that when you look at participants individually, the hue and cry that's been out there has been to look at this as a group, and generally, we don't feel an obligation to respond to all the hue and cries that are raised with respect to our marketplace not out of disrespect but because

notwithstanding some of the allusions earlier which we agree with that there is a net benefit from participating in our market, factually speaking, in our market, winnings do equal losings, and to short of take a shorthand, that means about half your participants are losing at any given time, and there's always a hue and cry from them, and frankly, the winners are not always the most cheerful personalities either.

[Laughter.]

MS. SMYTHE: That's okay.

MR. LEVIN: So with all of that, we don't always answer the hue and cry. But we did, and I'm going to talk about some of the results of that, so I have to depart strictly from the title of the panel.

We did look at participation in our market. We looked at trading volume, and we looked at open interest, the two ways that we collect that information. I need to comment on the data somewhat, because when we look at it, we do it independently from the CFTC, and we can't guarantee

that we are categorizing everyone the same as the CFTC. We have our views on what kind of a participant they are, so we do look at them and make those decisions ourselves.

In addition, for reasons we don't need to get into the details of, largely for regulatory purposes, open interest has always been a requirement to look after. But trading volume at an individual level, we need to audit that but not look at it so actively, and that data is very difficult for us at this stage come across, and it takes a lot of work, and so, before we do that, we have to be certain that we think that we have the resources, and it's worth the effort. And here, we definitely think it is and was.

Let me first start: Chairman, to address your question, which I'm not going to give a statistical result, but because you worded it in terms of prices. Our contracts, the crude oil and the natural gas, are delivery contracts. And as such, if you do not want to go to delivery, you need to liquidate your position in the market, and

we think that has an unambiguous implication on price determination. If you're even willing to accept that someone's participation in the market, say, to buy a product, is going to make the price go up, unless they go to delivery, which hedge funds do not by their very definition, so unless they're going to delivery, they're going to have to liquidate that position.

So if you believe when they bought those contracts, they made the price rise, you have to accept, in our view, that when they sell those contracts, they make the price go back down. In fact, since they're selling exactly as much as they're buying, by definition of avoiding delivery, we believe their overall impact on price is neutral.

That, as Mike pointed out, however, leaves the possibility they could have impacts on volatility; that's what we looked at, and I'm going to briefly go over our results, and I'm glad to discuss them in greater detail if questions leave time or if there's interest to do so.

We looked from January to August last year, both at open interest and at trading levels in our market, and in our calculation, I also wanted to mention that if a company does go to delivery or has that means, we think they're a merchant or a trader, depending on whether it's a gas or an oil respectively, just the names I like the use, and as such, we don't characterize it as a hedge fund. They're literally in the physical side of the business.

In the crude oil market, we saw that trading volumes between January and August last year, overall, hedge funds were less than 3 percent of the participation in our market. On the open interest side, and we combined these numbers--I'm sorry, we saw them as 13.5 percent, okay? So they were larger as open interest than they were as trading. On the natural gas side, we saw 9 percent trading but 20 percent in terms of their open interest.

If we add another category that we happen to have for open interest, because as I said, we do

collect that for regulatory purposes, the crude oil number goes up from 13.5 to close to 20 percent in open interest, and it goes up in natural gas from about 20 to 25 percent.

Based on these data, we decided that if we're going to look at volatility, we're going to look at natural gas. And the reason for that is that the relatively small participation in crude oil, less than 3 percent of trading, and even numbers that are--when you put in all sides and open interest, are a fifth that we thought that if we're going to see any results, we'll probably see them in the natural gas market, and as I said, there is a certain labor intensiveness to collecting this information.

When we did that, what we noticed was that we decided to take the data for a longer period, from January to the first part of November, and for hedge funds alone, we saw that the same result that Mike just alluded to, that there's a negative impact on volatility. When we looked at hedge fund participation alone, we saw that we had a

confidence level of about 91 percent. We don't actually draw that conclusion; we kind of draw the reverse of it, and we can't refute that, but getting away from the statistical technospeak, we'll just say that we had a better than 90 percent level that that result, we could be comfortable with, that it was a negative effect on volatility.

We also then combined looking at hedge fund participation in the market with changes in inventories that are reported by the Energy Information Administration on a weekly basis. The reason for this is that we think that's a very important fundamental factor and the information that comes in on a common basis.

When we did that, the confidence level went down to 85 percent for the hedge fund effect. It was still negative. We had a very strong effect in terms of the inventories. They are a strong explanatory variable there. We also noted that when we looked at hedge funds alone, even though it was a negative effect, it was a very small impact. There was a lot of variation around that. But when

we looked at inventories, they had a fairly robust coefficient along with having a robust effect.

In addition to that, we examined, and I think Mike alluded to kind of a more detailed test than we performed. Ours was a Grainger causality test--that's a formal statistical test that looks at lags and impacts between variables, and we looked at it from January through August. And once again, when we looked at the effect, what we noticed was that volatility going up drew hedge fund activity in, but the reverse did not hold. The confidence levels for that, respectively, volatility going up and bringing hedge funds in was 91 percent over that period; the reverse of it showed that not holding was an 86 percent level.

So our conclusions from all of this, which were not ones that we knew what we were going to get when we performed this; in fact, we didn't even know when we started that we were going to look at inventories; that when someone came up with it as a very clever idea, and it definitely improves the explanation of what goes on in the market.

But it did validate our experience of what happens in the market that these are liquidity providers, and to answer the question from the panel chair earlier, and I think it was answered on the first panel today by Dr. Scholes, they provide liquidity because they get paid to do it. There's a premium that goes with that, and that's what draws them to this marketplace.

So I look forward to any questions or any comments. Thank you.

MS. SMYTHE: I think that's really a very, very interesting companion piece to Michael's in describing or attempting to describe the activities of hedge funds or managed money funds.

What we'll discuss next, what Ron Geffner will discuss, is the relationship of this kind of trading activity or trading activity generally and notions of bad behavior; that is, not wanting to be negative about the hedge fund community, there nonetheless has been a lot of press that's suggested that, you know, you scrape away all of the detritus, you look, and what do you find? You

find a hedge fund having somehow, quote, caused the problem.

Again, I'm old, and I'm cynical, so I have my own views about why that might have been the case, that it might have been the kind of public relations drumbeat this past year, but Ron, what have you found? What has your analysis of that been?

MR. GEFFNER: I must admit, by way of background, I used to be at the SEC as well in the Enforcement Division focusing on prosecuting money managers, so it seemed to come out late in Cindy's conversation, so I thought I'd tell you a little earlier in the day.

[Laughter.]

MR. GEFFNER: By way of also disclaimer, my firm represents several hundred hedge funds, so I do make a living based on representing the people who are vilified in the press. I would tell you that they are demonized in the press because it sells papers. You asked a somewhat quick question, you said why has the press been reporting about it?

It sells papers. I can't even control myself. I pass a newsstand, and there's a magazine or some print about a hedge fund; good or bad, I'm going to want to pick it up and read it. And it seems that my neighbors do the same thing.

The basic conclusion I'm going to provide to you is that regardless of additional regulation, I don't think it will change the risk of investments in hedge funds. You're never going to stop fraud from occurring. That's one thing I learned. And I don't think that additional registration, possibly even the registration requirements that are coming into effect are going to turn over much more fraud in the hedge fund marketplace.

MS. SMYTHE: Ron, we lost that fight, so why don't we just go on to the next discussion, which is what, if any, basis is there to a concern that unregulated by the SEC, paren, investment advisors, aka hedge funds, have been a substantial source of misbehavior?

MR. GEFFNER: If you look at the

statistics, at the very best, for those people who are in support of the regulation that went into effect, there may be 110 actions that were brought against hedge fund managers in the last five years. If you look at a population of over 6,000 funds, we're not talking about a high percentage here at the end of the day.

And if you look at the dissenting opinions provided by Commissioner Glassman and Atkins, and they dissect some of those cases, it's quite clear in my mind that some of those cases are really not hedge fund fraud. They either use the word hedge funds; they were already registered in some capacity, so I don't see that having a material effect.

I understand, to continue going, there's a tough balance in your shoes. You're sitting here trying to protect the investors on the one hand; on the other hand, you're trying not to stifle the growth of an industry. I also recognize in the last 10 years, we've seen a dramatic growth in the hedge fund industry and the complexity of their

products that are now being launched by those managers, and it is making it a little bit harder to understand the marketplace.

But my experience has been with regard to fraud, based on my time at the SEC and based on some of the other things I've been involved with as a professional is fraud tends to be found out by virtue of either victims or an informant. You mentioned the market timing case earlier on. That came from somebody who had been an informant to Spitzer's office.

With regard to a comparative analysis, too, between the hedge fund marketplace and mutual funds, who they seem to be balanced against one another when we're distinguishing regulations, there's an inherent and material difference between the investors that invest in the mutual funds, which we've heard other panelists talk about and that of hedge funds, but I would tell you that something people haven't told you or haven't at least discussed yet, I would suggest that hedge fund managers are at higher risk of being sued by a

victim or an investor than they are by a regulatory body, which would mean you'll have a more active population of people investing in the hedge fund products than you do mutual funds. I myself am allocated into mutual funds in my retirement assets. I can't tell you that I have the time to look into the portfolio or really understand how it's being run, but if I were going to give a significant chunk of my money to a private investment vehicle that might be a hedge fund, I'm probably going to be more actively involved in following its returns and try to figure out how the organization is being impacted.

The same concept that you hear about how there's a retailization of the marketplace, and we have pension plans and ERISA assets and large funds of funds we're investing; well, guess what? They actually have lawyers and fellow economists here who have gotten me somewhat lost in this field already from sitting on the panel next to them that are doing their diligence, that are negotiating with the fund managers that are doing everything

they can to not only protect their investors but, quite frankly, to protect their own jobs. So they make a living doing this.

So I would put forth the thesis that the hedge fund investors don't really need protection and factor in the fact that based on all of the information we're seeing, there seems to be a larger push by institutional investment as opposed to high net worth individuals or family offices. So that dynamic is actually improving where you're going to have a more active investor marketplace than we ever had in the past.

If it were me, and we want to talk about areas of risk for fraud that have not been touched upon, I would look to the distribution of hedge funds themselves. One of the issues that I combat regularly in the marketplace is people who raise money for hedge funds contacting our clients and suggesting that they don't need to be properly licensed in order to raise money. And that's an area of misconception in the marketplace, and unfortunately, not enough enforcement action is

being brought and not just--predominantly, I would say more from the NASD, from my perspective.

The other thing that I'm actually a little concerned about that was also brought upon earlier in the panel was hedge fund and the big bubble, will it burst? Well, first, I would tell you that I don't think there's a hedge fund bubble. Hedge funds themselves are not an asset class last I understood the product. And all hedge funds are not created equally. The risk of investing in a hedge fund is dependent on the hedge fund itself. It depends on the investment strategy that's utilized by the manager; it depends on the infrastructure that the manager has and a whole host of other issues.

And going back to when we talked about regulation, I realize I lost the fight. I'm not suggesting that I have a problem currently with regulation as it is. I'm just trying to foster ideas so that regulations don't continue to grow in the direction that they're going. I think we have enough out there.

But Adam Cooper suggests that we're seeing institutionalization; it's fostered the development of an infrastructure. But I would suggest to you that many of these managers, the bigger managers that we now have today came from smaller managers and that the development of an infrastructure is a natural process, and by some of these things that are being suggested, I'm concerned that there is a barrier of entry that is going to increase, and I would tell you that as we counsel clients who are approaching registration requirements, there is a material concern in their minds and not based on reality but based on exaggerations by the media as to the costs and the risks. The fear of God is being put into these people, and it's causing some people to not launch products today, or it's causing other people who are running small products to merge in with bigger managers.

And looking at what Greenspan and other people have said in the marketplace, that's actually a bad thing. We're reducing competition for the future. And I can tell you that there are

many clients of ours now who run a quarter of a billion, a half a billion or $1 billion that started out with $5 million, $10 million, $20 million just several years ago providing a valuable service to the marketplace.

The other point I want to address is something else that I've been reading about, and I haven't been reading about it with regard to the CFTC, but it's more of a point that we're reading about the staff of the SEC.

The staff of the SEC seems to be frowning upon the concept of outsourcing compliance. I actually think that at some level shows a little bit of ignorance as to the industry, and I'll tell you why, because the vast majority of the marketplace is comprised of managers with assets of less than $50 million. Those managers, they're not going to go out to spend $100,000, $200,000 to hire somebody who's competent to do compliance.

So you're telling them, well, if you outsource it, we're going to view you as having a higher risk, and we're going to be scrutinizing it

a little bit more greatly, or alternatively, if you're earning less than $50 million, most likely, I feel like the man's making me stop talking now.

[Laughter.]

MR. GEFFNER: If you're earning under $50 million, what you're going to find is most likely, the shop is comprised of one to two professionals. So at the end of the day, if we're trying to eradicate the concept of fraud, and you're telling them they shouldn't outsource compliance, and that's their defense when investors ask them “Well, listen, you're only a two-person shop, I'd rather you outsource compliance.” “So No, you know what? I'm going to stop myself from stealing.” And last I looked, that didn't happen to people who were actually committing a fraud. They never really seemed to stop themselves.

So the concept is in certain cases, outsourcing is actually a good thing for compliance versus forcing everybody to internalize it for fear that there are going to be other negative ramifications for doing so.

MS. SMYTHE: Well, that's all a helpful and interesting perspective, I think, on the real world of money managers and what they're confronting as they address the new regulatory landscape. I think what this panel's focus is on, however, is more the question of the market impact and the market surveillance, market oversight of hedge fund manager activity.

I think what you've suggested, Ron, is that there's very little information out there to suggest that private fund managers, which there is obviously no such thing as a hedge fund, so private fund managers, meaning managers who manage funds that don't have to register as investment companies under the Investment Company Act, that they haven't accounted for a substantial amount or an important amount of investor harm. There seems to be a greater concern for the impact that they might have than the data would suggest that they do have.

Absolutely not either last nor least but simply the furthest left from me on the table,

although I'm usually the furthest left on any panel that I know, but for this panel, I'm on the, I guess, far right, is Charles Fishkin, the director of the risk assessment office of the SEC. I think one of the truly creative innovations of the current Chairman of the SEC is to recognize that agency's need to think proactively, to be out in front of the risks that are in the marketplace and to actually formalize the SEC's process of risk assessment.

Charles, I was wondering, and I can't see you, but I know you're there: in listening to this discussion of the behavior of hedge fund, I guess I'll call them hedge fund participants in the marketplace, do you have a reaction as it relates to the SEC's own analysis of these issues? That is, first of all, has the SEC done similar studies? If not, is it going to? Or does it think there's no need to? Where is the SEC on this kind of activity that is the actual surveillance of participants in the marketplace?

MR. FISHKIN: Thanks, Marianne. I think

you have very excellently and admirably stated the mission of our new office at the SEC. I want to just say at the outset thank you all for inviting me here. I've very much been enjoying my new job here in Washington, including the opportunity to share our own thoughts about very exciting things happening at the SEC and in the field of risk management generally.

I need, of course, to state the very obvious disclaimer that my views here are my own, and they are not those of our Chairman, our excellent Commissioners, or any of the other very able members of our staff. I also want to note for those who are listening and who may not be able to see where I am sitting that I have intentionally chosen the farthest seat from the exit, and I will represent to you that I'll stay here throughout the term of the conference and look forward to talking with all of you irrespective of your views of the SEC or hedge fund regulation.

I think it's important to put in context the earlier remarks, and what I really want to do

is in the very few minutes is instead of sort of talking about what I originally was going to talk about, I wanted just to respond to the various themes. There are very excellent and very rich themes that have come up, and I think they're important to elaborate on.

The first really as it relates to the very nature of risk, and this is a theme that pervades hedge funds; it pervades our philosophy about regulation; it pervades sort of all of the activities that cut across the corporate and financial landscape that you touch, that all of you in the room really have a role in participating in.

We want to emphasize that risk is not something that is bad. What is absolutely essential is that individuals and organizations understand the risks that face them and that they take the risks that they intentionally want to take and, I would add, are best able to take. And accordingly, those risks that they don't want or want less of, that they take active steps to mitigate, manage, reduce, or transfer. This is

really the essence of risk management, and it connects very well with the themes that Professor Scholes talked earlier about about the optimization of risk, and I want to add that the work, the extremely elegant and innovative work that he's done in finance really has laid an outstanding foundation for the theoretical concepts that we're thinking about here, so I want to say that I'm extremely honored to be in the same room with him.

I want to emphasize, too, that my view is the regulatory differences that have been talked about or alluded to I think are vastly overstated, and I think the concepts and the philosophy and the approaches of the various participants in the regulatory process are far more similar than they are different and far more interested in doing the right thing and the right prudential thing for the marketplace.

My next theme is about dialogue, and I cannot emphasize further the importance of dialogue around all the issues that we're dealing with and particularly hedge funds with the industry itself,

and I am extremely struck looking around the room here by how many of the people who are participating in the conference have actually come to the SEC and have had a chance to talk with us; we very much value these dialogues. These help us very much appreciate the role that hedge funds play in the capital markets in terms of liquidity and innovation.

We fully recognize the complexity of the different strategies and legal entities. We further recognize that there are very significant differences between hedge funds and other investment vehicles. We realize also that there are very critical differences, and those similarities and differences very much inform our approach to regulation.

The next theme I want to emphasize is collaboration and the importance of collaboration between the SEC, the CFTC, the FSA and a wide range of other regulators. We are in active discussions with these organizations. I can tell you that a very large sector and component of my time in

leading the Office of Risk Assessment has been involved in dialogue with other regulators, and we look forward to much more of it.

Now, there are two more themes I want to emphasize, and I think I've got enough time. The first is the importance of risk management generally at financial market participants and at corporations and the wide range of entities that we see and we touch at the SEC. The most important, we want firms, participants to have strong, robust risk management programs. The best mitigant against problems, the best deterrent to fraud. The best way to avoid any of the difficulties that we've observed in the last several years in the marketplace relating to fines, enforcement actions, catastrophic loss is for organizations to have their own strong risk management and compliance programs.

These kinds of investments, while at times seemingly expensive, are over the long-term the cheapest form of franchise protection and the best form of insurance to enhancing long-term

shareholder value.

MS. SMYTHE: Could I butt in just for a second--

MR. FISHKIN: Please do.

MS. SMYTHE: --on that point? Since I absolutely agree with what you just said, I was wondering how that applies to the SEC's own risk management, that is, one of the issues that I think generated a powerful push inside the agency to require the registration of hedge fund managers was supposedly to enable the SEC to have more of an oversight capability with respect to them.

I was just wondering, in managing the risk to the SEC as an organization of seeming, frankly, of catching the car and getting what it sought, what is the SEC doing to assess the risk to it of now having that responsibility? Is it stepping up its oversight of the trading, the equity trading of private funds? Excuse me, Chairman Hruska, if I'm stepping out of line here, but is that okay to ask? Okay.

ACTING CHAIRMAN BROWN-HRUSKA: Yes.

MS. SMYTHE: I'm just--I couldn't agree with you more that the first place an organization needs to look to be a happy and healthy place is to its own ability to assess its own risks, and I'm just wondering what we're doing at the SEC to oversee this hedge fund community that we've now decided we must oversee.

MR. FISHKIN: It's a great question, and we're doing a tremendous amount.

MS. SMYTHE: You've got 47 seconds.

[Laughter.]

MR. FISHKIN: No, go ahead. I think that what we're doing at the SEC is what the best-managed organizations are trying to do, which is allocate our people, our capital, our time, our budget, which we've been fortunate to receive, to areas that we think are the most prominent risks and prominent risks that affect the critical areas of the SEC's mission: capital formation, investor protection, and market integrity, and we have begun, and it's a process that does take time, to think of all of the activities that we do through

the lens of risk. And we've tried to identify where we think the most prominent risks are and then adjust accordingly.

Now, there's a lot of detail around that, but we introduced quite a few internal processes, infrastructure, investment in technology, additional staff, experienced people to really take into effect this change in thinking, and I want to emphasize that our actions relating to hedge fund registration really reflect our own risk-based thinking, that this is a very large and significant participant in the capital market with huge amounts of activity and influence that we just do not know enough about.

ACTING CHAIRMAN BROWN-HRUSKA: I think we'll go ahead and--did you have another remark? I'm sorry.

MR. FISHKIN: No, I'll stop here. I'll stop here and look forward to questions and comments throughout the day, and I will also--actually, there is one more remark I need to make as a resident of Massachusetts: we're looking

forward to a very interesting, vigorous and active baseball season.

[Laughter.]

MR. FISHKIN: And if you wait long enough, great things do ultimately happen to the right people.

MS. SMYTHE: Once in a century.

ACTING CHAIRMAN BROWN-HRUSKA: Yes, I would turn to Jack Gaine over here of the Managed Funds Association, as a Massachusetts baseball fan that I've known for many years, and you can collaborate, as you suggested; it's something that should be done more by the SEC with the industry, and I invite you to do so.

Well, I'm actually going to adjourn for lunch, and the Commissioners will have the ability to ask questions of these fine participants either in writing or informally during lunch. Thank you very much.

[Whereupon, at 12:13 p.m., the meeting recessed, to reconvene at 1:08 p.m., this same day.]

A F T E R N O O N   S E S S I O N

[1:08 p.m.]

ACTING CHAIRMAN BROWN-HRUSKA: We're going to go ahead and get started, so if you could take your seats. I wanted to get started, and as I welcome you back to our roundtable on CPOs and commodity pools, and I think we had a very vibrant discussion this morning, and very fascinating. I think that again, we've shown that there's a lot of interest in hedge funds and what their activities are, and this roundtable is really designed to showcase what hedge funds are up to and to clarify, I think, what their impacts are on the marketplace, because we hear a lot of scuttlebutt; we see a lot in the press that they are having a negative or quality-harming impact on the markets, and I think what I've heard so far is that that is, in fact, not the case if you look at the evidence. And so, I'm very much looking forward to the next panel.

Before we get started, let me just turn it over to my fellow Commissioner, Fred Hatfield. He has an important--we have a wonderful, an honored

guest here today, and I think Fred is the right man to do the introduction.

COMMISSIONER HATFIELD: Yes, I would just like to acknowledge my former boss, Senator John Breaux, is here, who is a participant in the managed fund industry as well as the investment banking business, and we're very honored to have him here. I must say it is very odd to have him there and me here.

[Laughter.]

COMMISSIONER HATFIELD: I'm tempted to have him come up here and ask him some questions, but maybe that's pushing the role reversal a little too far.

[Laughter.]

COMMISSIONER HATFIELD: Senator, it's great to have you.

ACTING CHAIRMAN BROWN-HRUSKA: And we really benefit from your input as well. We're looking forward to that. If you want to ask any questions, we'll certainly invite you to do so. One thing that we know that you're renowned for is

straight talk and common sense thinking, so we really really invite that and appreciate that.

Let's go ahead and get started. This panel, we're focusing on valuation and other assorted issues, and we're very pleased to have Leon Metzger to lead the panel. Thank you very much, Leon.

MR. METZGER: Thank you and good afternoon, Madam Acting Chairman and Commissioners. I applaud the Commission for holding today's roundtable and hope that we the participants enhance your knowledge of the fund industry.

A hedge fund guy, a candidate for a Ph.D. in finance, and a Talmud scholar were traveling together in a car when the talk turned to valuations. The fund guy asserted that the subject of valuations was not a quantitative field but a qualitative one. The doctoral student disagreed, because he felt that fair value is simply discounted cash flow. The fund guy responded that he thought that fair value was the exit price. To which the rabbi said, that's what the Talmud says.

The fund guy clarified his remarks: the exit price is the one under normal market conditions and is not the distress price if the owner is not in a distress position. To which the rabbi said the Talmud also says that. The fund guy turned to the student and asked so, how would you value a commodity? To which the rabbi explained yes, where is the discounted cash flow in a car?

I share this anecdote with you not to inform you that about 1,800 years ago, the wise men of the Talmud debated how to calculate fair value but to illustrate the difference between pricing, which, indeed, is a quantitative field and valuation, which is a selection from a range of prices, which is a qualitative decision.

While the topic of valuations, at first glance, seems to be an easy concept to grasp, in truth, it is a complex subject. During this hour, we intend to explore this issue as well as others that larger commodity pools organized as hedge funds face.

Our panelists today starting from my left

are Robert Plaze, associate director for regulation in the Division of Investment Management of the United States Securities and Exchange Commission; Stu Porter, partner and portfolio manager of Sowood Commodity Partners Funds, who formerly managed Harvard Management Company's commodity portfolio; George Hall, founder, president and chief investment officer of Clinton Group; and Joel Press, senior partner of the Global Hedge Fund Practice of Ernst & Young CPAs.

I'm Leon Metzger, vice-chairman of Paloma Partners Management Company. The views the panelists and I express are our own and do not necessarily represent those of the organizations with which we are affiliated or those of our colleagues.

The first question goes to Joel: please frame our discussion and tell us what is fair value, and why is that concept important?

MR. PRESS: Thank you.

Perhaps the cornerstone of the hedge fund industry, commodity industry, is valuation. Listed

securities today are pretty simple to value. It's CUSIP numbers; prices are out there. Derivatives, complex instruments, distressed securities, unbelievably difficult instruments to deal with. Generally accepted accounting principles define fair value as the price at which an asset or a liability can be exchanged in a current transaction between knowledgeable and unrelated willing parties. That takes into incredible subjectivity what that means and lots of latitude by each organization.

A valuation of a hedge fund determines the net worth on the financial statement; each individual partner's value, performance; it goes into what goes into the risk computations, leverage, collateral; everything that touches the cornerstone of the hedge fund industry is the integrity of valuation.

Generally accepted accounting principles say if you were formed after May of 2000, fair value has to be the listed price if it's out there. You cannot take a blockage discount. The SEC and

broker-dealers allow for discounts; GAAP does not. So there are differences in how you interpret the GAAP versus the SEC enforcements for broker-dealers. For hedge funds, we still haven't seen any regulations with regard to that, although we're supposed to GAAP. CFTC follows GAAP.

We are now limited in the ability to take that, but when it comes to derivatives, it is based upon fair value: how you determine fair value, where it comes from; very complex, counterparties, risk models; all of that is very subjective, and each organization is responsible to their own policies of enforcing that.

MR. METZGER: George, generally, private equity funds value their investments at cost until sale, while hedge funds price at fair value. Now that hedge funds are investing in private equity, should hedge funds mark private equity at cost or at fair value?

MR. HALL: Well, in the private equity model, there are securities that are so far to the illiquid end of the spectrum that it's almost

impossible to come up with a fair value on a regular basis. That being said, that's why historically, they value them at cost until they're sold. That works okay in the private equity market, because generally, the money is raised at the same time from all the investors, so they're on an equal platform, and they all get their money back at the same time after the assets are liquidated.

Valuation becomes imperative when there are sales or redemptions of shares, and the hedge fund industry varies from hedge fund to hedge fund. Investors can come into the fund at different time periods, which is effectively a purchase of the securities that are in the fund, and at the same time, certain hedge funds, investors can redeem, which is really like selling their shares or sharing their positions in the underlying assets. So hedge funds that have sales and redemptions need to focus on fair value.

The other issue about valuation starts from the transaction, the sales and redemptions, is

hedge funds tend to show monthly returns and use this, and investors rely upon this in evaluating hedge funds in terms of their volatility, in terms of their performance. So I think the most important thing is that fair valuation has to be used whenever there are different time periods at which people are buying and selling the assets and whenever the manager is using this information, the pricing information to show volatility and performance records.

So hedge funds that are involved in private equity, I think there are a couple solutions: they're either going to have to find a way to come up with a fair value, or they'll have to come up with some disclosure to deal with the fact that it would be difficult to get fair values on a regular basis.

MR. METZGER: Stu, one of the valuation principles of the International Association of Financial Engineers is greater independence in performing valuations, both processes and sources, is preferred to lesser. Under what circumstances

can traders mark the portfolio?

MR. PORTER: Well, first of all, I'm going to speak to independence. Independence in valuation is essential to credibility in the industry, I believe. In many cases, third parties keep books and records for the hedge funds. For publicly-traded or listed securities, valuation is really not a debatable issue to a large extent, but on illiquid securities and complex derivatives, the issue becomes somewhat more tricky.

The question arises: should an independent source who has limited knowledge about the instrument being valued value the instrument, or should a source who lacks independence but is very sophisticated about the instrument value that instrument?

In my judgment, independence again is crucial, and in the case of the complex illiquid securities which I think we're talking about here, documented valuation from third-party sources provides an answer for that potential risk and that question. We at our fund use third-party sources

to document and to provide mark to markets for those securities.

MR. METZGER: George, if a fund has a proprietary model to value an over the counter financial instrument, and an independent third party, say, Bloomberg, has its own model, which model should the fund use?

MR. HALL: Well, first, let me say models would really only be used in the case of a fair value as opposed to a market value, and as Joel pointed out, the fair value is the price at which we could expect in a current sale, not a distressed sale, willing buyer, willing seller. I think a rule of thumb is a seven-day liquidation period.

So in that situation, the ultimate goal, regardless of what model you use, is to come up with the fair value of the security which would be transacted on. So the difference between a proprietary model and a model by a third party, really there, are so many assumptions that go into these models; there are different thought processes behind the model.

So the real key is can the model, whether it's your own model, or whether it's a model from Bloomberg or a third party, can that model be used to create a market price? For example, if you're routing derivatives such as swaps, regardless of what model you use, if you take a market price, and you use that to calculate an implied volatility in the case of an option, for example, that can be extrapolated so that you can come up with effective market prices for other securities.

The issue of marking to model really comes up when people have a concern that the model says a security is worth 95, as an example, when the market is saying it's only worth 90. It really doesn't matter what the model says, whether it's your own model or Bloomberg. The fact is the price should be 90, so the marking to model is clearly inappropriate by any standard.

So the most important thing is that the model, the output of the model is calibrated to give you market prices, not what you would consider intrinsic value or what the price should be.

MR. METZGER: Joel, last week, the SEC issued in Staff Accounting Bulletin No. 107 guidance that allows companies to use different valuation methods and techniques to estimate the fair value of stock options. Under what conditions is it acceptable for two or more funds that hold the identical instrument to use different valuations?

MR. PRESS: Very often, in a complex instrument, as George just mentioned, there are different pricing sources that people rely on, let alone their own models. People only use bids; some will use means; some will use average, and in large block positions, those differentials can be significant to the P&L of an organization depending on its assets and its P&L.

And again, materiality, from the SEC's point of view, CFTC's point of view, and GAAP point of view are not always the same. There's balance sheet materiality and P&L materiality. There are different ways you can go about it: training pricing sources, some is through phone calls;

others through traders' confirmation; others by independent groups; and then, there's blockage discounts, which for fair value, is not unusual.

But blockage doesn't mean you reduce the price. Sometimes, you can have a position that's worth more than what people would think is the quoted value, because that position becomes very valuable, and in a secondary offering could be worth more than market.

Everyone looks at discounts to blockage on the negative side. It doesn't always work that way. And very often, that price can be more, like in an arbitrage or a takeover situation, like in a Kmart and Sears. So getting to fair value even sometimes for listed securities can be a very complex subject, and sometimes, you have to look into the future to take a look at what the trading sequencing is of a complex situation.

MR. METZGER: If the SEC examines a fund manager and sees valuations that seem to be wrong, to what extent will the SEC intervene?

MR. PLAZE: That depends. If there is an

error, we might just simply point it out. If it was a repeated error, we would likely raise questions about the methodology that's being used or the processes used by the hedge fund manager. And if the valuation error has had an effect on ins and outs from the fund or on the performance fee paid to the fee advisor, we would want to see some remedy in that situation. And these points will likely be made in a deficiency letter.

Where things get serious is where we see a misvaluation as part of a fraud to cover up losses or to meet the advisor's high water mark and capture performance fees, in which case you'd likely see a referral to our Enforcement Division.

MR. METZGER: Joel, what's the level of competency across the accounting profession to opine on the value of financial instruments held by hedge funds and other financial institutions?

MR. PRESS: For those that work in the industry, the competency is incredibly high. All of the firms that specialize in the hedge fund business, commodity business have unique practices

with unique training programs, unique applications, work with educators, and run internal training.

Where it gets a little bit different is accountants are supposed to have an expertise for every industry they audit. In gathering that expertise, big firms have more resources; most of the big firms, we have our own derivatives group, we have our own modeling group, all part of our audit process. When you get out into smaller firms, it's very hard to do that. They have to have access to pricing sources. Big firms have direct feeds; small firms can't afford that.

So how they go about getting that information, gathering it, utilizing it and then applying it to an industry that requires significant knowledge is an issue for the smaller firms, and even big firms that don't have major practices, it takes a great deal of skill to understand this industry.

MR. METZGER: In May 2003, the Treasury and IRS announced that they were considering a safe harbor which would allow certain taxpayers to use

those values of securities and commodities reported on certified audited financial statements on their tax returns. Joel, are CPAs the guarantors of valuations?

MR. PRESS: If you look at our lawsuits, someone might say so.

Absolutely not. Auditors are not responsible for valuations. That is the job of management, and that is even further complicated by the fact that the documents of hedge funds and commodity pools define the process for the valuations for different kinds of instruments.

George mentioned the private equity side. We're seeing hedge funds get into that significantly. It's much more complex than that, because most of those documents say that if an investor comes in, and we have these private equity type investments, once you're in it, you don't get out. You don't need valuation, because you're stuck for the life. Even if you leave the liquid part of the fund, you stay in that fund in what we call a side pocket.

So although GAAP says to give a clean opinion, we have to value it, and management goes through complex valuation processes to demonstrate to the auditors, that's management's valuation. But the investor doesn't get that valuation. They have to wait until that investment is sold or disposed of in some way to get the fair value, because that's when they know what it's really worth. That's something very unique to hedge funds.

Private equity firms, when you're in, you're in; you only get out when you're out, and the investments are done. It's pretty simple. Hedge funds, it's a little more complex, but auditors are not the arbitrator or the final determination of valuation. We review the process, the consistency, and we look for fair presentation.

MR. METZGER: Bob, if a fund of hedge funds receives audited financial statements and a Schedule K1 prepared by an independent CPA, does either a registered fund of hedge funds or an unregistered one have a responsibility to do more

than compiling the numbers?

MR. PLAZE: Leon, I think Joel just answered the question almost for me. Of course, it's unclear, it's always been unclear to us exactly what audited by a CPA means in terms of reliance on valuations. CPAs obviously don't verify those numbers; they are primarily a management responsibility.

And so, under our statute, the Investment Company Act, where this comes up frequently, directors have a statutory obligation to determine that the values are fair, and we think that means more than simply blindly taking prices from or values from the hedge fund manager who has potential conflict with regard to those prices and its compensation.

We want them to do more; we want them to ask questions; hopefully, they would ask these questions before they made the investment in terms of the processes that are used, the independence, Mr. Porter, which you spoke about as so important in terms of the sources of pricing, and to take

steps to protect their investors.

Many folks who came while we were doing our investigation of hedge funds over the two-year period indicated to us how important institutional investors and hedge funds such as funds of funds have been to creating greater transparency and greater accountability in this market, and so, we're very much interested in the hedge fund of funds pressing hedge funds, understanding, having a better understanding of their policies and procedures.

MR. METZGER: Stu, how should an investor balance the goal of investing with the highest returning funds against the desire to insist on valuation best practices?

MR. PORTER: Well, I think the question might assume that you can't have both. I don't think these objectives are opposite in terms of investment manager performance or in terms of investor diligence. I would suggest that a fund that strictly adheres to best practices in valuation and the rest of their business models

allows the investment manager to spend more time on the investing process.

I believe in the long run, the discipline of best practices in valuation can only benefit both the investor, the investment manager and the industry itself. In my brief experience, our fund has been in existence for roughly just under a year, but my prior employment was at Harvard Management Company. I truly believe that part of the investment returns and the success that were a function of the discipline process that we had in terms of valuation, discipline process that we had in terms of marking to market and the strong back office and middle office that was built there and supported the investor.

MR. METZGER: George, should monthly and annual valuations be equally robust?

MR. HALL: Well, that goes a little bit back to the first question that I answered.

I think the most important thing is the valuations need to be as robust as possible when people are trading on that price. Secondarily,

they should be robust when managers are advertising a track record that uses particular periods as the data for that track record, whether it's monthly or quarterly or annually.

That being said, if the fund is only traded on, and the track record is only advertised annually, then, annually is probably much more important; monthly is much less important or quarterly is much less important. So it's really a function of what those valuations are being used for. That being said, it's very difficult to value a lot of these securities, and one of the advantages of hedge funds is they provide liquidity to the market and they buy investments that are not as easy as just simple New York Stock Exchange securities.

And the valuation you're trying to get to is what someone will pay for it. And a lot of times, it may take several hours for a dealer or someone who might buy something to evaluate it and to figure out what they actually would pay for it. So it's a little bit difficult to expect that

people will spend three hours on a daily basis on one particular security just to figure out what it's worth.

So there's really a balance and some judgment that needs to go into how robust these valuations are, but the economics and the track record is really the most important factors.

MR. METZGER: Joel, to what extent do administrators rubber stamp the manager's valuations?

MR. PRESS: That's a terrible question.

[Laughter.]

MR. PRESS: Nobody rubber stamps anything that I'm aware of, and I probably, in all of this room, have the longest experience with hedge funds, 37 years. The first one was 1968, so I go back a way and watched this industry grow and watched the administrator industry grow. Administrators have a contractual relationship with a hedge fund. They perform certain functions that are defined by that contract.

But the simple securities, again, the

listed securities, CUSIP numbers, commodities that are listed, and it's different when you take in physical commodities, it's a pretty simple process. They have direct market fees; they do a great job. Once you get into the complex instruments, it's different. Then, it's also contractual. There's something called administration lite or NAV lite where they do an NAV based upon information that's 100 percent provided by the manager.

But again, the manager is responsible as a fiduciary in accordance with the offering document and partnership agreement to do fair pricing. And remember, their own capital, which is very different in this industry than the mutual fund industry, is the capital of the principal is as much at risk as anything else in the investment, so what happens to them as general partners and so forth happens to the investors.

So there's clear, direct connection, and also, besides compensation, all the people who are involved have the same interest. So there's so many checks and balances that occur in the hedge

fund, administrators can only do so much, and especially on the complex instruments, as George and Stuart mentioned, it's incredibly difficult, and again, unless they build an infrastructure, they're not capable of pricing those securities, and there are very few administrators that have that kind of infrastructure.

And again, if it's daily NAV, as George said, you don't have enough time to do the complex instruments, because it does take a long time. If it's monthly and quarterly, you have more time to do it. But year end with the auditors is a much longer process, and it works much more smoothly, but there's a lot more time to it.

MR. METZGER: Joel mentioned earlier, referred to the AICPA's bifurcated guidance about blockage. In recent years, the SEC has opposed a fund's employing subjective large block discounts but has endorsed the discounts for restricted securities. If this is still the case, how do you reconcile the seemingly contradictory approaches?

MR. PLAZE: Well, it is currently the case

that we do follow the AICPA guidance in this respect. We see a difference and not an inconsistency. Block discounts involve valuing a security and then reducing the value based on assumed sale of the block, whether in fact there is a current, present intent to sell the block or not. One can also theoretically have a block premium if, in fact, there's a controlled value on that stock, even though there is no present intent to sell at a premium the block, and pretty soon, you start moving away from current value, which is, again, we've all agreed the cornerstone of valuation of securities.

On the other hand, restricted securities are obviously worth less than freely-traded securities regardless of the intent to sell or sell as a block or not, and therefore, it's appropriate to treat them or to reduce the value of that security.

MR. PRESS: I just have to--the AICPA does not permit block discounts any longer. If something, if it's a million shares you have in a

position, and it sells 1,000 shares a day, and there's a quoted price, you're required to use the quoted price.

MR. METZGER: Joel, doesn't the AICPA guide to audits of investment companies say if you existed before May 2001--

MR. PRESS: Before May 2001, it's a strange role. So, if you are old, Stu's firm can't; Clinton can. The logic to that is a little bit strange; if you got in business before, it makes sense you can do it, new people can't. But the bottom line is this industry will explode and continue to expand. Under the current rules, new hedge funds forming cannot have any form of blockage up or down, even if the manager thinks it's prudent.

And managers will, for partners coming in and out, mark it to the right value that they think they can get out of that blocked position, and then have a financial statement that could have a difference, because they want to have a clean opinion. There are differences that need to be

worked out, and I think from a business point of view, getting the accounting profession to move into this is going to take some time.

MR. METZGER: Joel, you will agree that if a fund advisor has a fund that existed back in 1987 and launches a new fund in 2005, and both funds have the same position, that the large block position, that according to the AICPA audit guide, the fund that existed in 1987 theoretically could take a large block discount.

MR. PRESS: That is correct, but I would tell you in both cases, the investor would be treated identical, because that's what the documents would require as a fiduciary for fair value, so that's where the financials and what actually happens to the investors can actually be quite different, and the documents, actually, will explain that.

MR. METZGER: Let's move a little away from valuations, and Stu, tell us should a disaster recovery plan for a fund cover back and middle office, too, or just the traders?

MR. PORTER: Well, ideally, it should cover back and middle office. The fact is that some of the smaller, emerging funds just won't have resources to have a disaster recovery plan that will cover back and middle offices. And in our estimation, a business continuity plan should be in place to minimize the immediate systemic risks of a wide disruption by assuring payment and settlements can be made, data can and is backed up and can be recovered; alternative communication systems can be used, and most importantly, risk can be managed and measured and delivered to the investors at that time.

The nature of the disaster could have significant effect on the volatilities and the correlations of the positions in the portfolio. Therefore, you know, we deem it as extremely important that the middle office, the back office, et cetera, have the ability to continue business as usual should a disaster occur.

MR. METZGER: George, will the cost of regulatory compliance act as a significant barrier

to entry for new funds?

MR. HALL: It appears to me that it will be a barrier to entry. The most obvious question about compliance or regulation is the hedge funds being required to become registered investment advisors. That entails having a compliance officer, who should be a relatively experienced attorney; having incredible amounts of books and records that have to be kept; not only keeping emails but being able to sort them and produce them in many different ways; business continuity, having a separate office that you can move to in case of a crisis, so it's really quite a bit of an expense.

Now, that may be dealt with through outsourcing of some of this. There are software companies that are being developed to handle emails more efficiently, to handle books and records, personal accounts, personal trading accounts of employees. So, you know, there may be ways that the barriers to entry will decrease, but I think overall, it will be somewhat of a barrier.

MR. METZGER: Bob, the SEC carved out an

exception from advisor registration if the funds under management in general will not allow investors to redeem their capital for at least two years. What percentage of managers must opt out of registration by taking advantage of this exception before the SEC modifies the two-year lockup rule?

MR. PLAZE: I obviously can't speak for the Commissioners, and that is a hypothetical or maybe even a leading question. But I think where we are now is let's see what happens. There's a lot of talk about extending lockups. It's unclear whether many or most hedge funds are, in fact, going to do this or are going to be able to do this simply to avoid the Advisors Act.

But certainly, it will be difficult for new managers, and who's going to want to be locked at the hip with somebody for two or three years that has an unproven track record? And it's also going to be difficult for managers to sell to institutional funds such as funds of funds with a long lockup because of their needs of liquidity. So I think those of us at least on the staff of the

Commission are in a wait and see mode in this area.

MR. METZGER: Besides looking at risk-adjusted return, what else should prospective investors consider when they select a fund?

MR. PORTER: Well, I mean, as I kind of commented earlier, I think business organization and best practices within the organization go hand-in-hand with understanding investment returns. So it's important that investors look at all aspects of the investment organization's operations. Those include but are not limited to a code of ethics that's strictly adhered to; a business continuity plan that's in place; a valuation policy that stresses independence; an ability to accurately and meaningfully measure risk and describe it to their investors in a meaningful way; a strong back office and middle office, as I mentioned earlier, that both meets the needs of the managers, the regulators and the investment process; and for the investment manager to fail to meet--to invest the time up front for those issues can only in the long run, in my estimation detract

from his or her ability to spend time on what they should be doing, and that's spend time on the investments.

So having that process, having that infrastructure in place, I think, is essential in the long run, maybe not in the short run but essential in the long run to having successful investment returns in the long run.

MR. METZGER: George, the National Bureau of Economic Research recently published a working paper entitled systemic risk in hedge funds in which the authors tentatively suggest that the hedge fund industry may be heading into a challenging period of lower expected returns and that systemic risk is on the rise. Is the one in 20 or more model of compensating managers too high in a period of single digit returns?

MR. HALL: Well, first, let me say I've read that report, and I think that report provides a lot of good information and analysis of risk and so forth.

That being said, it also, I think, starts

out with a little bit of a negative bias towards hedge funds to begin with, so in that context, I'll comment, I mean, the fund that they have created, the theoretical fund that they use in the paper is called Capital Decimation Partners, so I think you can see where they were going with that, and they talked about what unscrupulous managers tend to do.

That being said, I think returns probably will on average be reduced over time. We have to consider that we're in a very low interest rate environment, so if it's high single digit returns, it's still a pretty decent spread over risk free rates. But I do think overall returns will come down.

And in some sense, that's a positive, because that points to market efficiency. Hedge funds take advantage of market inefficiency, so if we get to the point where there's less return to be made in a hedge fund, then, we're talking about more efficient markets.

In terms of the fees, I think managers should be paid for what they do, and the fees in

hedge funds appear to be high, because it's a percentage of capital, but hedge funds leverage that capital; they put short positions against their assets; the assets are much greater than the capital itself. So if you look at the fees that they get as a function of the assets and what they really do, the fees are not really that high. It really is going to come down to can they perform in a manner which makes it worth paying those fees?

In terms of systemic risk, the paper talks about Long Term Capital, which is a favorite example. However, and I think there's been a lot of research on this, the failure in Long Term Capital was that the financial institutions may have been a little bit lax in their guidelines for credit and monitoring, and they probably gave Long Term Capital too much credit, and I think it really is a failure on the financial institution side. So, you know, well, I think my time's up, so I'll stop there.

MR. METZGER: Joel, how much soft dollar use do you see at funds, and what is the average

level of disclosure?

MR. PRESS: Soft dollars is an integral part of the securities industry. It's been that way forever, actually. Most people don't recognize that, but it's been around for 50 years in some form or another. Hedge funds very carefully define their process with soft dollars. Most hedge funds, especially the big ones, and you can define bigger as somewhere between $50 million, $100 million or larger, have soft dollars within 28(e), the safe harbor for research related.

Small hedge funds, entrepreneurs that start out, soft dollars are critical for them to be able to survive, to pay their overhead and so forth, and use commissions as disclosed in their documents to pay for other costs, whether it's rent or whatever it might be. Perfectly legitimate within the context of that organization and within the context of what they define as best execution. So soft dollars is an integral part of this industry.

And with regard to disclosure, as it

becomes material, generally accepted accounting principles, and soft dollars are a form of a barter system. So for things within 28(e), GAAP says you don't have to break anything out. If it's outside of 28(e), outside of the research, then, if it's material, then, you're actually supposed to adjust the commissions for the actual product being bought and record that into the financials.

There's not much of it, because in general, it's not that material on the smaller hedge funds and on the larger hedge funds, it's almost never material where that ever occurs, and as I said, most of that is within 28(e) for the bigger hedge funds.

MR. METZGER: Joel, would it be easy to estimate what the benefit is?

MR. PRESS: No, impossible to estimate what the benefit is.

MR. METZGER: Stu, are funds of funds effective at managing asset allocation and risk?

MR. PORTER: This is going to be a short answer, because I don't have a tremendous amount of

experience with funds of funds. But I certainly believe that some funds of funds add significant amounts of value. They add value to the investor who lacks the experience or the resources to A, build a diversified portfolio of alternative investments; B, provide detailed due diligence on everything from sources of returns to business operations; and finally, selected funds of funds provide access to premier organizations that the investor might not otherwise be able to invest in. But my experience in this area is somewhat limited.

MR. METZGER: Bob, what concerns does the SEC have about side letters?

MR. PLAZE: The primary issue is lack of disclosure to the nonrecipients of the side letters as to the impact, the rights that accrue to a particular investor that has a side letter might affect them.

We brought a case two years ago against a hedge fund advisor who was liquidating the hedge fund and had letters to two investors allowing them to redeem their shares early, leaving the rest of

the investors holding the bag, so to speak, and subject to market value. It's full disclosure to all investors of material information about side letters. That's what our concern is.

MR. METZGER: Stu, should a personal securities trading policy allow personal investments, and if so, what should be restricted?

MR. PORTER: We might have an extreme view on this, but I firmly believe that all funds should have a personal securities trading policy. Having such a policy reduces the likelihood that employees of the fund become subject to conflicts of interest, and if a fund does have a policy, it should consider restricting employees' investments to products that are unlikely to have potential conflicts. They include open-ended mutual funds, index funds, Treasury, agency, or municipal bonds.

I think they also should consider disallowing transactions in individual securities or instruments that may obviously or at some point present a conflict. You know, and from the investor's point of view, it's my strong belief

that as an investment manager, your job is to manage money for your investors. It's not to spend time on selecting specific securities for your own personal account. Any time that is spent on doing that actually detracts from the time that you would spend managing money for your investors.

MR. METZGER: George, on the front page of today's Business Day section of the New York Times, Reva Atlas wrote an article about hedge funds actively buying second lien loans. What are some of the other emerging strategies that may become popular in the short-term?

MR. HALL: Well, I think from a general sense, hedge funds are going to flow to wherever there's a need for liquidity and wherever they feel that they have some sort of advantage, either on information or analytical ability or whenever there's not enough capital in a particular market to absorb the volatility in that market.

So I think it was mentioned on the previous panel, there was a lot of talk about energy or energy-related products, so clearly,

hedge funds are gravitating towards those products. That can be directional plays on energy sources as well as trading power interstate as well as doing arbitrage between various energy sources.

Insurance companies are also, as the article mentions this morning, getting into more lending. They're starting to gravitate into insurance and reinsurance, and pretty much anywhere where there's an opportunity for capital to be employed at above average expected returns, hedge funds will gravitate there.

MR. METZGER: Bob, one of the results of hedge fund advisor registrations is the requirement of hiring a chief compliance officer. How acceptable is it if the CCO's bonus derives from the overall profitability of the fund?

MR. PLAZE: First of all, the hedge fund registration requirement is that the hedge fund manager must designate somebody as a chief compliance officer. It could be and in many situations will likely be a current employee rather than a separate hire. Large organizations, George,

like yours, probably already have had compliance people on staff for some time.

We believe that it would be unwise, simply a business control matter, to compensate an employee based upon overall profitability. You're creating conflicts within an organization as somebody who's going to have to say no sometimes to profitable opportunities because they're unlawful. That being said, there's nothing in the rule that prohibits it.

MR. PRESS: Just a comment on this: it's interesting: hedge funds reward people, particularly senior people, based upon their performance and also based potentially about their own performance, and a percentage of the 20 percent or the management fee or both or, in certain cases, separate. So if you're a senior person, and all the other senior persons all have a piece of so-called the action, and a CCO who's a very senior person doesn't, and then, they're on a discretionary bonus, or they're on no bonus, this is an area that again we either need better

guidance, because if we are going to hire a senior person, that senior person is going to want to be a participant in the piece like all the senior people. That's sharing in the P&L. I don't think that's necessarily bad. But we have to make sure we have clarity on that issue.

MR. HALL: Maybe I'll jump in, too, and mention that I think it's the rule, certainly it is how we practice it, is that the chief compliance officer actually reports directly to the board of directors as opposed to the CEO or the head of the legal department, and compensation is determined by the board, which should have a separate set of goals from the traders and the management of the company.

MR. PLAZE: That seems like an optimal arrangement.

MR. METZGER: George, you just told us about some of the emerging strategies. Some say that they see a convergence between Wall Street and hedge funds where each is entering the other's terrain. Do you agree with this assessment, and if

so, in which areas do you see this convergence, and in what ways will this trend continue?

MR. HALL: Well, Wall Street historically has been a service provider to various investors. They've provided liquidity; they provide back office support and so forth, so I think they're continuing to support the hedge fund industry through their prime brokerage operations, their money raising operations and their fund of funds operations.

Wall Street firms historically also have proprietary trading desks that they get more commitment to at times when opportunity is good, and then, sometimes, their commitment to proprietary trading decreases. That's where hedge funds are really picking up the slack in terms of proprietary capital that's invested.

I think the convergence seems to be that there's also quite a bit of convergence going on between private equity and real estate and the hedge fund business. I think hedge funds are really entering into all those spaces, and over the

long run, alternative investments will really be the umbrella for all those products. That being said, hedge funds are involved in lending, in bridge loans, in some of the typical things that banks and Wall Street firms have done in the past, so there is a bit of a convergence among these areas.

MR. METZGER: Joel, why domicile a fund offshore, and which countries are popular, and why?

MR. PRESS: The offshore market really developed because of U.S. tax laws. Going way back, non-American investors didn't want to come into America, get their name known, information about them. Offshore domiciles became the way to do that. Offshore hedge funds are really mutual funds in an offshore environment, registered either in Bermuda, Cayman, the Bahamas or even Dublin. Each of those locations are major places for hedge funds.

If you want to sell to European investors, especially with the EC, you need a Dublin listing. So you have to be listed in Dublin. Whether you

form in Dublin or not is another matter. Most hedge funds today form either in Cayman or in Bermuda. Both have regulatory bodies similar to the SEC. They have money laundering laws. They have significantly in the last five years increased their enforcement.

Cayman, for example, has a local auditor-required signoff, so that the auditors are required, for that country, when they are formed in that country, they have to sign those reports. Those countries now have very elaborate laws that have to be followed for registration and so forth. U.S. tax exempts mostly go in the offshore environment, because again, for tax reasons. Those entities are non-passthrough vehicles. In America, if you are a tax exempt, and you trade with leverage, and a hedge fund could trade with leverage on the domestic fund, then, you have to pay tax on a corporate level.

If you go offshore, you're buying a mutual fund type of investment; there's no passthrough. So the offshore funds that have grown dramatically

because of our current tax laws and will continue to be where the tax exempts and foreign investors are. U.S. wealthy people traded mostly in America, and that's what's called onshore funds.

MR. METZGER: Bob, what types of information sharing arrangements regarding U.S.-based private fund advisors does the SEC have with other countries, and what are the benefits of such arrangements to investors and the SEC? Would the SEC be willing to share such information with the CFTC if the CFTC does not have a similar arrangement?

MR. PLAZE: We have approximately 30 enforcement MOUs in operation with other countries. These MOUs amount to a commitment on the part of both parties to provide investigative assistance, including compelling information on behalf of each other. If we have an Enforcement case, the FSA can actually take testimony for us in London and provide that testimony for us.

The information can include bank brokerage and trading records as well as different types of

testimony from potential defendants as well as third parties. In addition to the formal MOUs dealing with enforcement, we also have two MOUs for investigation or examinations with the FSA in the UK as well as Hong Kong securities authorities. They permit us to do joint exams and share exam information, and of course, those two journalists are important in terms of the hedge fund industry.

The benefits, I think they help protect U.S. investors from fraud that begins in another country but that affects U.S. investors, and we would be pleased to have discussions with CFTC staff with similar information sharing arrangements.

ACTING CHAIRMAN BROWN-HRUSKA: In fact, I would suggest you already are. I think we've certainly brought joint cases before; we've shared information; I think we're even working on one right now in this very space together with the SEC, and it wouldn't have been possible, I think, without a significant sharing of information. And I think that's something that Dan Roth this morning

alluded to as well is that they, in the process of
doing their audit and compliance function on
registered CPOs, in fact do from time to time
uncover activity that raises concern, and they have
in many cases referred those cases to either the
SEC or the CFTC, whichever is appropriate based on
the type of activity that's taken place.

So we're very proud, I think, of our
cooperative enforcement efforts with the Securities
and Exchange Commission and globally. I appreciate
very much your remarks and your panel; thank you
very much, Leon, an excellent panel. I'll just
sort of kick off the questioning, because I was
very interested. I have to give my caveat
that I have been a college professor before and
had students--basically, in a business school, you
have two types of students; you'll have
students who are specializing accounting and
auditing, for example, and my experience has
been they're not terribly interested
in or they hadn't historically been exposed to the
kinds of valuation techniques that were necessary

to value, for example, some of these complex derivatives and instruments that are of great interest to hedge funds.

And it's sort of as a segue into another point that you all raised in this discussion; you talked about compensation structures and, in fact, noting that the compensation, whether or not auditors and compliance officers would be able to have a performance based compensation; in other words, something that is tied into the P&L. I just wondered if we could flesh that out, because what I have heard from my colleagues at the business school is they're having a very hard time, bringing in and satisfying the new demand for compliance officers or for, you know, the type of person that we as regulators are creating a demand for by requiring so much information and so much verification and back-testing of our models and double checks and balances on the valuation techniques. I just wonder are we creating a monster here where business

schools aren't going to be able to fill this need, and there's going to be a squeeze of funds looking for talented people.

Joel, I see you shaking your head. That must mean you have an opinion.

MR. PRESS: The monster is created. The industry is desperately seeking chief compliance officers. It's mostly coming from the legal firms. The legal firms are losing associates at an incredible rate never before seen. It's a new position. It will even itself out over time. The first couple of years, like with anything new, like with the regulation; two years, from now, we will be talking a lot of other things other than regulation and so forth; there will be other great topics, but right now, the chief compliance officer is a big issue, where to find them. They are more and more expensive.

You know, we laugh at the SEC with all due respect when they said it was $25,000 for a chief compliance officer per annum; we thought they meant per month maybe, and that's even low.

So, yes, we have an issue. It will even itself out. We have another year until the registration is actually taking place, but the legal profession, the broker-dealer side, are providing the people, and it's driving pricing up, and it's just--somewhere along the line, it will even itself out, but that is the problem today.

MR. HALL: Can I add something on that? One of the issues with the compliance officer is that it's been said that they would actually have personal liability for compliance violations, and Bob, maybe you could--

MR. PLAZE: No. What we have said and what I have said is that a chief compliance officer gets involved in a fraud or gets involved in illegal conduct, they're going to be liable like any other individual in an organization.

However, the compliance officer is not a guarantor of the organization. If he does his job and avoids getting personally involved in a fraud, he's going to be just fine. And the cases we've brought against chief compliance officers, the one

best known is the chief compliance officer with the Strong Funds. The chief compliance officer actually got involved in not necessarily the fraud but the coverup of the fraud.

So I think there are lessons to be learned about the cases that we've brought, and moreover, the cases that we haven't brought because of the chief compliance officers.

MR. HALL: I have to say that my compliance officer is very relieved to hear you say that, because I think that there is the impression there that the compliance officer is effectively the guarantor that, you know, as many as several hundred people could be doing something, whether it's mistakenly or on purpose, and that the compliance officer would have responsibility for that. So I think, certainly, I appreciate your comments, and I think we could use a little more guidance on that.

MR. PRESS: I think there's another problem, also, that the industry sort of ignores. We always look at the big funds. They have chief

compliance officers. But this is a group of entrepreneurs. They can't necessarily afford chief compliance officers. So they clearly will be outsourcing.

The SEC has not made it clear that outsourcing the compliance function works and how well they'll look at that, how that will operate, because you still technically have to designate someone inside the shop as the chief compliance officer. So if I'm a single hedge fund, I'm running $100 million, I don't need anybody else on equities, long, short, whatever I'm doing, I can do it all on my own; I'm the chief compliance officer? I know nothing about compliance. I can outsource it maybe; it's expensive. Can I afford it? This industry is affected by those kinds of costs. We have not seen the effect of those with the smaller funds yet. They're scrambling to try and figure out their direction.

MR. PLAZE: What I'm impressed upon by the registered advisors, not the hedge fund advisors that are coming in the next year, is how they have

adapted to these rules and how they have outsourced, how they have designated people currently employed. We're not talking about necessarily a full-time compliance officer if you're not a large organization. About half of the advisors registered with us have five or fewer employees. They are a lot smaller than your typical hedge fund organization with many fewer assets, many fewer resources, and they have adapted to the requirement in various, creative ways to deal with their own scale and their own set of issues.

What's very important is not to impose upon a small organization all the conflicts and all the complexities and all the legal issues that arise in a large organization and say, well, how is this small organization going to apply that? In fact, the small organizations don't have the scope of problems.

ACTING CHAIRMAN BROWN-HRUSKA: I think that's good. I think that's an important observation, because I think from our perspective

as public servants, we concern ourselves with the
impact of regulation and of our requirements on
these small entities, and we are also cognizant of
the fact that ultimately, somebody has to pay this
bill, and I guess it's got to be the investor
I mean, it doesn't just materialize out of thin air,
so I assume that ultimately, that could play a role in the
returns decline as well, other than, you know, in addition
to this influx of more money chasing the
inefficiencies that we see here.

MR. PRESS: Actually, many hedge funds,
the investment manager of the hedge fund itself
pays the cost, because that comes out of the
management fee. And we really haven't seen an
increase in management fees in the past three or
four years. Only a few hedge funds charge all
direct expenses, so it depends on what the direct
expense is, but I would tell you probably more than
90 percent of the hedge funds are eating this cost
themselves.

MR. PLAZE: Are some softing it?

MR. PRESS: I haven't seen that yet, but on the smaller ones, I would think they would have to. It will be interesting to see how the SEC reacts to that when they look at best execution for outsourcing compliance. It's going to be quite interesting.

[Laughter.]

ACTING CHAIRMAN BROWN-HRUSKA: Well, I better turn it over to my colleagues if they have any questions.

COMMISSIONER LUKKEN: I just want to make one comment in regards to the outsourcing issue. I would note that the International Organization of Securities Commissions has recently put out a report on outsourcing. This is a body, an international regulatory body that the SEC and the CFTC both belong to. Our chairman participates in those discussions often. I get to on occasion. But they have put out some guidance in this area.

Hopefully, the SEC and the international folks at the SEC--I know Raul Campos, the Commissioner at the SEC, has worked on this issue

quite a bit, so I think that might provide us some guidance on when outsourcing is allowed, and it might also help relieve some burdens, I think, on the small funds so that we can continue to allow innovation to happen.

For time's sake, I'm going to just limit my one comment there and pass it to my other Commissioners for questions.

COMMISSIONER HATFIELD: I'd like to follow up the mentioning of side letters, and it's my understanding these letters are issued and, to some extent, allow certain investors out of the funds earlier than other investors, and I've heard them referred to as, quote, the ticking time bomb of hedge funds. I'd like to get Mr. Hall's comments A, does he use side letters, and do you see them as a danger to your investors or to the industry.

MR. HALL: Well, we have some side letters as well as we have within various funds, we have separate share classes. So there is some uniqueness among the investors and what they get. It depends on the nature of the side letters. If

the side letter allows, you know, certain large investors that could put the company in jeopardy to get out very quickly or put the fund in jeopardy, then, that potentially could be problematic. By the same token, if there's a side letter, a liquidity side letter that's a small amount of capital that can be withdrawn, and if there's some mechanism to make sure that it's withdrawn at the fair value so there's a fair valuation done, then, it may not be problematic. So it's really a function of what the nature of the side letter vis-a-vis the nature of the fund.

COMMISSIONER HATFIELD: Thank you.

COMMISSIONER DUNN: Joel, I was fascinated with your discussion of fair value.

MR. PRESS: Good or bad?

COMMISSIONER DUNN: Well, I've got about two pages of notes, and that may be a long follow-up conversation between us.

MR. PRESS: My pleasure.

COMMISSIONER DUNN: But I'm wondering, for those entities that have multi regulators, do the

regulators all have the same concept of fair value?

MR. PRESS: Not in my experience, not at all. Usually, one regulator will yield to another if it's the sort of which group sort of dominates, whether it's the broker-dealer side of the SEC, investment advisor, and so forth. But everyone has a different way. You know, broker-dealers have capital rules and are supposed to follow GAAP, and then, there's exceptions to GAAP within the capital rules.

So the regulators, I don't see a consistency. I think they're getting there, and in the complex instruments, it's even more difficult, because A, we need people to understand those complex instruments, how they operate, how they got to their valuation and then as a regulator make sure they feel it's fair and appropriate, was done properly at that month and then how it was applied and on a consistent basis.

I think the regulators will get there. I'm hoping that information within each regulator in each department, banking, insurance share,

because all of them have different skill sets working with the different complex instruments, and it would be great if we could see--and it may be happening, and we're not seeing it in the industry--this information being used in a fair manner so that we get a consistency of application of what the regulator is looking at.

I can tell you the organizations are pretty consistent on how they apply it, but each time the different groups come in; you get different kinds of questions. It makes it a little bit more difficult. You're justifying it from very different angles.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you very much. We certainly enjoyed this panel immensely, and we're looking forward to talking with you all later.

Let's go ahead and bring up the next panel, please, current and future issues. Well, this is a very familiar looking bunch of individuals. We're so glad to have you here today. One of our favorite outside attorneys, Ken Raisler,

from Sullivan and Cromwell, today, he's here managing a panel on hedge funds. I think sometimes, he's here talking about the futures industry. Ken has significant experience in our industry. He, too, is an alumni of the CFTC, Commodity Futures Trading Commission. He was the general counsel some years back, and he continues to provide good advice to us as we go through reauthorization, and Ken, thank you very much for doing this. Looking forward to the panel.

MR. RAISLER: Thank you, Mr. Chairman. Thank you for that kind introduction, and Madam Chair and Commissioners, we are delighted to be here and to participate in such an important event, which I think this panel and the panels that preceded will highlight how important these issues are to the financial services industry generally, and hopefully, we're providing some insight to this Commission.

Let me begin by introducing our panel. To my immediate left is David McCarthy. David is the founder of Martello Investment Management, which is

a specialist fund of funds and advisory firm concentrating on a variety of absolute return fund strategies and other variety of fund strategies. He has prior experience as an investment manager for Global Asset Management and is a well-known figure in this industry.

Immediately to his left is David Mordecai. David is a founder of Risk Economics Limited, a firm specializing in the development and implementation of structured credit arbitrage, financial engineering and asset liability management solutions and also is a founding partner of S3 Asset Funding, providing collateralized term financing. He has a long history in the derivatives and structured product businesses and the hedge fund world, previously having worked at Clinton Group, where George Hall from the last panel runs that organization and also a founding editor in chief of the Journal of Risk Finance. He has included in his materials a paper or a link to an abstract of a paper that he has prepared on doctoral research on the limits of arbitrage based

on evidence from statistical analysis of hedge funds leverage and performance, and for those of you who are interested in terms such as heteroscedasticity and multicollinearity, thank you, I appreciate that, David, I recommend that paper to you highly, and I'm still working through a few of those formulas there but--

ACTING CHAIRMAN BROWN-HRUSKA: That's the nicest thing you've ever said, Ken, thank you very much.

MR. RAISLER: I have to get to the end of that.

For purposes of the panel and those who are--with no offense to either of our Davids here, I will refer to David McCarthy as David and David Mordecai as Dr. Mordecai; no disrespect or respect collaterally to either of them but for our simplicity purposes.

Immediately next to the two Davids is Bo Collins, who is a founder and managing partner of an organization called MotherRock, LP. As many of us know, Bo as a long history in the futures

industry, having served as the president of the NYMEX for a number of years and prior to that having worked at El Paso Merchant Energy. And as a new entrant to the hedge fund business, I think he brings an interesting perspective to the discussion we're going to have this afternoon.

Immediately next to Bo is Danforth Townley, who is a member of Davis, Polk & Wardwell's corporate department; is an expert in the Investment Company Act and Investment Advisors Act, advising hedge funds and investment advisory clients on a variety of issues under those legislative enactments and brings a wealth of legal experience for us.

And immediately at the end on the far left, again, no political intent there at all, is Charles Gradante, who is managing principal of the Hennessee Group. Charles, as many of you know, has been an active participant in the debate around hedge fund regulation, participating in a number of hearings on Capitol Hill and providing some very useful and profound insight in that undertaking.

He also has included in his materials, I think, a very provocative paper that hits on a number of issues, some of which have been discussed in part today. One topic that he discussed at some length that we will not discuss, because it was brought up on other panels, was the issue of the myths and misinformation in the press around hedge funds. He does a nice job in his paper of kind of taking those one-by-one and responding to them, and I recommend that paper to you.

Our panel here is current and future issues, so we're basically batting cleanup. We can sort of say anything we want, cover any topics we want, and hopefully, bring some insight to the discussion and perhaps some wrapup to prior comments that have been raised.

Let me begin with Dr. Mordecai and ask basically, I think we've heard today, and we've heard in the press mostly every day, there's a high degree of interest in commodity investments, in commodity pools, in hedge fund investments, and the question really is from your point of view, do you

think this is a reaction to perhaps poor or not stellar equity performance and just basically an alternative investment or do you think that perhaps there is a paradigm shift to alternative investments from the standpoint of the institutional community seeing this as a new asset class which has to be part of their portfolio?

MR. MORDECAI: Speaking as someone who is more of a financial economist with some 20 years of experience in the finance industry, I personally think it's a bit of both. I agree with the earlier statements that it's not so much that hedge funds are an asset class as they are a flexible management scheme for dealing with nontraditional assets to generate absolute returns, returns that hopefully are statistically uncorrelated with the traditional asset classes.

I think hence, if you're going to have situations where institutions are trying to manage their investment returns against their liabilities, and in fact may become, because of the differences, how markets have different conditions and states

that they come in and out of, they may be limited in being able to bridge al of those states with their current strategies.

To go out and find managers that can produce or financial product companies that can produce for them returns, real returns in those environments where they cannot manage their own returns to meet that mark, that high water mark they have of their own, whether it be mortality related for an insurance company or pension mortality related, there's certainly this what we've seen now is an adoption of technology that has continued to develop in order to better serve their customer base.

In a sense, they say hey, this is a product that helps me better serve my customer base. I better get it in here. And so, you're going to see inflows at times when you start to see your traditional asset classes suffering, your relative benchmark managers not necessarily--sure, they're doing relative to benchmark, but relative to benchmark is -20, and they're four above. It

doesn't help them bring home the bacon, so to speak, for their constituents.

So the answer is you will observe inflows or greater inflows at times when traditional markets are suffering, but I think you're seeing something more seminal than that.

You know, to quote Robert Merton in his seminal paper on financial intermediation, he talks about this continual evolution of financial intermediation into higher and higher levels. I think we're observing that in the long run.

MR. RAISLER: Bo, when you decided to leave the NYMEX and sort of go out into the real world, if you will, you had a lot of different options available to you as to where you thought that the best opportunities were and decided to go into the hedge fund space, and without making it a detailed war story, could you sort of correlate that thought process and how you came to set up a hedge fund with your view of what the market's needs were and where the opportunities were?

MR. COLLINS: I basically have a view that

the market is going through a massive paradigm
shift from a standpoint of general investment. And
what I mean by that is that I think traditional
forms of capital formation, certainly in public
equities, are going through their own very
difficult set of challenges, and if you compare
that as a capital formation mechanism with the
capital formation mechanism of a private
partnership that offers a number of advantages, one
of which is that it has a very efficient tax
structure in terms of flow-through to the investor.

The other is that the business is becoming
more institutionalized, so it's very, very rare
that you have a conversation with an investor or a
potential investor that they don't genuinely
understand your business nearly as well as you do.
As a result, standards are being put in place, very
common ways of looking at the business and
mechanisms for measuring it are in place.

And so, what we have is the
institutionalization of a new capital formation
process. My personal view was that the investment

flows were going to continue substantially into that arena, and it was a good opportunity for me to exercise my skill around that capital.

MR. RAISLER: David, can you give your thoughts on the potential growth of alternative investments and particular commodity pools? We heard this morning from the first panel some statistics on that growth, and one of the things we're going to talk about is sort of whether there are constraints on that growth. But if you can give your projection of where you see the market going both for pools and perhaps more generally for hedge funds.

MR. MCCARTHY: Well, it's obviously difficult to kind of make those kinds of projections, and I think in the end, I probably won't in the end, but I will talk about it in a slightly narrower sense.

You know, certainly, and we've heard this today, and we've heard the talk about innovation, you know, there's clearly been a lot of innovation in the hedge fund area; the scope of the hedge

funds, the scope of the investment activity is much broader than it was 10 years ago, certainly.

We heard a comment today earlier about is there an investment bubble in hedge funds? It probably isn't, but it's not exactly clear. Let me just review some information and try to make one or two observations on it. One of the leading CTA indices, for example, grew from $35 billion in 2000, the end of 2000 to about $105 billion today. That's a 200 percent increase. The 14 managers that are represented in the S&P managed futures index have grown from $5 billion to $20 billion over the same four-year period, a 250 percent increase.

If you look at the open interest of a variety of futures contracts, you see an increase but not nearly to the extent of the assets going to the managers. The 10-year Treasury note on the CBOT, for example, the open interest has grown over that period about 40 percent; crude oil, 35 percent; soybeans, 49 percent; gold has grown by 161 percent.

And not surprisingly, you see the percentage of the open interest held by the noncommercials increasing as well. The noncommercial percentage of the 10-year Treasury has gone from 15 to 28 percent over that period of time; crude oil from 22 to 30 percent, soybeans from 27 to 34 percent; gold from 33 percent to 45 percent. So it's not surprising that with the inflow of money, you're seeing the speculative interest in some of these contracts going up as a higher percentage.

Is there a limit to that? It's not clear. But there clearly is some limit in terms of instruments, like some of the physical commodities. You know, an interesting exercise is to do something like the following: if you assumed, and I think this understates, but if you assume that the managed futures industry is about $105 billion, and let's assume that 65 percent of that money is represented by trend followers, and George Crapper this morning talked about typical trend following approach to the market.

These are very homogeneous managers. We, for example, follow and monitor about 40 of these trend followers. The average paired correlation of these trend followers, the 40 we follow, is about 0.55. That's a huge paired correlation. Because, you know, in significant down markets, they are all in the same trade.

You can make some simplifying assumptions about how they trade, how much they risk on individual positions and come to the following theoretical demand for positions for open interest. Now, this is simplifying assumptions and theoretical, but in 10-year Treasuries, under these simplifying assumptions, you can say, well, I can come up with a theoretical demand for open interest of 620,000 contracts. Well, that's 32 percent of open interest and 100 percent of the most recent daily volume; crude oil, a theoretical demand of 122,000 contracts; 15 percent of open interest, 57 percent of daily volume.

Those are probably doable propositions. Soybeans, a theoretical demand of 200,000 contracts

at 66 percent of open interest and 300 percent of daily volume; gold, a theoretical demand of 488,000 contracts; that's 179 percent of open interest and 550 percent of daily volume.

Now, clearly, you know, and what you see over time in this growth of the managed futures industry, you see a shift of what the managers are allocating their risk capital to from the physical commodities to currencies and fixed-income where the capacity exists in those markets. But to the extent that investors, for example, are making an investment in this space in order to take care of the diversification in commodities, they're certainly getting less diversification today than they were five or 10 years ago.

So it's clear to me that the currency and fixed-income markets are sufficiently liquid to accommodate significant increases in the size of this industry, but it is also the case, I think, in specific markets where the increase in size that we have seen and are likely to have seen in the future will have an impact on those markets.

MR. RAISLER: Danforth, do you have any thoughts about the impact on this community in terms of the implications for its growth in terms of restricting performance or having business implications of any kind?

MR. TOWNLEY: You know, I think from a regulatory point of view, from looking at it from a legal perspective, how you can form these entities and the capacity to raise capital, I mean, it's really pretty striking to see how much capital can be raised so quickly for a new hedge fund operation with a manager that has either a very strong track record or sort of historical relationships that indicate that he would be a good person to place money with.

And so, we see many stories about, you know, numbers in the range of $2.5 billion, $3 billion being raised literally overnight practically, you know, in no more than a space of really a couple of months or weeks or months. So I don't see any real capacity constraints from that aspect of the marketplace.

MR. RAISLER: Charles, in your paper, you put forward a theory around short selling that indicates that there may--through the limitations on short selling and restrictions on borrowing--be constraints on the growth of some hedge fund strategies.

MR. GRADANTE: To put it in perspective, many in the traditional money management arena believe that the alternative investment world, particularly hedge funds, are going to outrun their business. Their projection is that they will be at $4 trillion by 2010; that's not our projection, but that's what's been reported by certain authorities. And so, that has generated a lot of commotion in the industry.

Factually, most of the asset growth in the hedge fund industry, if not all of it, has come from investment pools that do not hedge. Consequently, as money moves from nonhedge strategies to hedge strategies, the demand to borrow bonds and stocks to support the hedging activities increases and eventually may reach a

point where it becomes uneconomical.

Right now, the hedge fund industry is pegged at about $1 trillion in assets. We see a ratio of about 43 percent for every dollar on the long side on the short side. Net-net, when money moves from traditional money management to hedge funds, it's a zero sum game on the long side of the portfolio.

What increases is the need to borrow on the short side. So that ends up being the achilles heel, if you want to use that word, for the hedge fund industry, the ability to borrow on the short side. It's not the long side that's a problem.

So this phenomenon may create some sort of a glass ceiling on the growth of the industry. Hedge funds will either reduce historical hedge ratios and become more net long, whether they're bond players or equity players, or they'll have to limit capacity, or they may even create new ways to hedge using derivatives of some sort, but that alternative is not the most desirable.

So clearly, the cash market borrow is the

bottleneck to the growth of the hedge fund industry, and today, we're hearing from managers more frequently than we did several years ago that they have negative short rebates, that it's more difficult to borrow equities and bonds, and not just the illiquid stuff, but we're talking across the board. GM did a convert a year ago, and the ability to borrow against that convert last year, a year and a half ago, was, you know, difficult.

So the short side is really going to limit the industry. We don't think the industry can go to $4 trillion without having a systemic change in the way it does business on the short side. The stock loan, bond loan departments on Wall Street are not prepared for this kind of growth.

MR. RAISLER: It is sort of staggering to talk about a $4 trillion limit for the business, since this has just recently crossed $1 trillion, but I guess we come back for our next session of this, we'll be talking in those, probably, numbers.

David, from your perspective, do you think there's going to be performance impact from some of

this growth and constraints? And there was some discussion earlier about, you know, sort of high single digits and the impact of that, but do you see that growing out of these kinds of limitations that are otherwise perhaps embedded in the marketplace?

MR. MCCARTHY: Well, listen, it's difficult to say. At the end of the day, a lot of, especially in the managed futures space, the CTA type of space, you know, if we got a very good trend in the dollar, if we got a good trend in fixed-income, you know, that could cure a lot of ills. But clearly, in the last year or so, returns have come down.

But let me shift a little bit to talk about, kind of, CPOs a little bit, and one thing that I do see happening. To the extent that a CPO is the same as a fund of funds in this discussion, the business model of a fund of funds is very simple. You know, the cost structure of a fund of funds is a function of the number of managers you allocate to, the number of clients you have and the

number of products you offer. The interesting one, I think, is the number of managers you allocate to.

Insofar as the--because of the significant increase of assets in this space, a number of managers are closing to new investment. So for a fund of funds and a CPO to increase its size, they end up having to allocate to more managers in the fund than would have been the case, because they cannot linearly increase the allocations to the managers in the space. And there's absolutely no question in my mind that most CPOs today, most funds of funds hold in their fund more managers today than they did five or 10 years ago.

This has put pressure on the funds of funds to expand their staffs. They have more managers they have to follow, more managers they have to evaluate, do kind of portfolio reviews with, or in some cases, it's led the fund of funds to limit their own growth, but frankly, we see very little of that in the industry.

What performance impact it will have is unclear. Perhaps it will make the historical track

record of the fund of funds a little suspect as the allocations shift to more managers in the fund; perhaps it will lead to more homogeneous CPO fund of fund returns as the individual portfolios become less distinctive, and I think you perhaps are seeing some evidence of that today.

MR. RAISLER: Yes, that's a very interesting comment and seemingly, at least, I think at some level seemingly has some truth to it.

Bo, from your perspective, and there was some discussion particularly in the context of the study that both the CFTC looked at and the NYMEX looked at around natural gas, but even more broadly, what do you see the impact of this growth of hedge fund and pool trading to be on the markets and market efficiency, specifically around volatility trending and the like, and from a trader's perspective, how do you see that growth impacting performance?

MR. COLLINS: The great thing about following the fund business, if you will, from a macro view is the flows of capital do precisely

what they're supposed to do. So in a given marketplace, the application of an immense amount of capital almost by definition dampens volatility as well as dampens returns.

And you can see that if you look at a lot of the hedge fund indices that are posted and have historical track records. I think there's commonly 15 or 20 buckets. And you can see that strategies that were new a decade ago had these remarkable risk-reward returns, and they stayed in place over time, and as capital has been ever more applied to those strategies, the returns have decreased as well as the volatility in their respective marketplaces.

So what I think is going to be very interesting is over time, the popular press and the public will recognize that the hedge fund or alternative class, if you will, is nothing more than a conduit for the application of capital into unique markets. That kind of removes, if you will, the argument that it has a bubble type of effect.

What you're more likely to see in the

sense of a bubble is a particular investment strategy or a particular investment theme become overwhelmed with capital, especially in the application of leverage. So it wouldn't be uncommon or surprising to see, for instance, a convertible arb strategy, which has had very compressed returns recently, have some sort of shock, if you will, or a shakeout relative to managers who are applying excessive leverage to that strategy in an effort to ramp up their returns.

It's all very corrective. The market will behave as it should behave, and when the return becomes too cheap, and there is a shock, it will go back to normalized level as capital withdraws from that strategy.

So what should be interesting to follow as the hedge fund industry grows is you're going to see massive application of capital and relatively quick flows into inefficient asset classes or asset spaces, hopefully one of which will be energy, if you believe that the activity in that will come in

the form of investment infrastructure as well as financial participation in the markets.

MR. RAISLER: On the last panel, George Hall was asked to comment on the convergence of the alternative asset investments of hedge funds and commodity pools with that of the banks and the broker-dealer community, and I'd like to build a little bit on that subject and, Danforth, ask you about what do you see as the conflicts and business ramifications that potentially buy from these multiple organizations involved in the space when one of those organizations provides service to the other?

MR. TOWNLEY: Yes, it's interesting that now, as opposed to perhaps historically, when you had, say, large banks, large broker-dealers with small hedge fund clients. We are now see very large pools of capital in hedge funds. And so, for example, I mean, it's not uncommon to have an $8 billion hedge fund that basically has the latitude to deploy that capital sort of in any area that it sees fit.

And so, we're seeing hedge funds basically get into the arena where they're also converging into private equity type investments or even public investments like, you know, well-known investments such as those in Kmart by large hedge fund managers.

Now, I think what that--obviously, it's also the case that banks and broker-dealers provide a lot of services to hedge funds and regard them as their very significant clients through their prime brokerage activities, and financial institutions also run their own hedge fund platforms, because they want to offer product, and they want to be able to have some understanding of the product that they're offering, and they often create their own hedge funds or have affiliates who run the hedge funds to offer to their clients.

So it's a little bit unclear to me where all of it is heading to, because it's really a new world that is coming into place, but from a regulatory point of view, there are substantially different regulatory regimes that apply to, say, a

bank or broker-dealer running its own business or being involved in this proprietary trading as opposed to a hedge fund that is formed and doing largely the same activity.

MR. RAISLER: It does seem to me to be an area that will, over time, get, I think, more scrutiny because of that disparity in regulatory treatment, not just domestically but also internationally.

Dr. Mordecai, we also discussed this morning and this afternoon the blurring of the distinctions between these various asset, alternative asset investments. We don't really know what the definition of hedge fund really is. The Chairman spoke earlier about trying to distinguish between the hedge fund paradigm to some extent and the CPO world by a definition of primarily engaged in something, and we'll have to see how that sorts out.

But do you see the blurring, and what's the impact of the blurring between hedge funds, commodity pools, private equity, venture capital?

And to pick up on Bo's point sort of the notion that equity capital is being deployed by the investment opportunities that are most illiquid?

MR. MORDECAI: I was in a forum once where the definition of hedge fund was given as 2 in 20, but I think even that has blurred over time.

Well, as we look at the emergence of multistrategy, multimanager hedge funds with growing capital bases, growing head count and offices and, you know, the fact that we can already see alternative managers as a specialized type of financial intermediary, one large hedge fund recently received a financial institutions rating from one of the large rating agencies where they acknowledged the fact that this is a financial institution of sorts.

We can look at and take leads from large multinational industrial companies that as they grew in size and ended up with more and more capital and had an efficiency in capital formation, that they then began to look at how to allocate capital as a multiproduct firm because of

synergies, because of economies of scope, economies of scale, in terms of deploying capital and technology to related although somewhat different regions, and I think that's a natural case for hedge funds.

As banks need more and more risk-bearing capacity, hedge funds are providers of risk-bearing capacity. Hedge funds are also providers to the consumers of returns, as I mentioned earlier, statistically uncorrelated state-dependent returns that are different from what you might get from a mutual fund.

It's a natural thing to see this convergence and what you call here a blurring of distinctions. The interesting thing is going to be how is that managed in terms of hedge funds retaining the flexibility that they have, which provides some of their uniqueness relative to some of the other players and hence keep that unique role, preserve the unique role they have?

MR. RAISLER: Thanks, Danforth.

Picking up on that, I mean, one of the

things that's sort of interesting is the SEC in developing a rulemaking requiring registration of hedge fund advisors made a specific point that they were not intending to regulate either private equity or venture capital; yet, I think we've heard on the panel before us that hedge funds are, in fact, investing in private equity and certainly are not swearing off of venture capital. And so, how do those distinctions work from a regulatory standpoint, and to what extent is there the potential that this kind of regulation could stifle some of the innovation that the marketplace otherwise has grown--

MR. TOWNLEY: I think fundamentally, even with the recent increase in regulation, I don't feel as though it's going to stifle innovation and creativity at this level, although I do agree with others who have said it is going to raise some barriers to entry into the industry. And when we talk about the interests of institutional investors such as pension plans looking for, you know, also a similarly institutionalized advisor that they are

going to look for the infrastructure and the backbone systems of strong risk management and other systems, and it may therefore, given the compliance burdens that go along with this under the new registration regime, I think it does shift--increases the burden to those people who just want to set up a new hedge fund and start going into business. And so, I think that aspect of it is something that bears paying close attention to.

In terms of, I mean, certainly, some of the issues that get wrestled with a lot are new structures and new ways of deploying capital, you know, arise all the time and very frequently, and there are new strategies whether they're involving derivatives or other kinds of instruments that simply can't be captured by regulation that's, you know, in some cases, 40 years old or in other cases, you know, just a few years old.

And so, I think that certainly is a big challenge. I think it requires sort of an active dialogue certainly among practitioners but also

with regulators to try to see where reasonable judgments, you know, can be assessed as to how to comply with those regulatory issues.

MR. RAISLER: Yes, it seems to me from the discussions today that the distinctions have got to be blurred if, in fact, what the paradigm, if you will, of a hedge fund is investing in illiquid assets. That means that they'll go wherever those assets are, and in doing so, clearly take advantage of investment opportunity. Yet, the regulatory structure is quite a bit more rigid than that, at least in the U.S., and I think that the questions for the regulators is how to balance that. I think that really is going to be a challenge for them.

MR. TOWNLEY: And it's extremely complex in the way that we heard a little bit earlier about trying to comply with GAAP financial standards and having that, then, become an element of being a compliant advisory under the SEC's rules on being a registered investment advisor. Suddenly, you're caught between trying to determine what's the right fair value if you're trying to determine what's

fair for your investors in terms of, you know, your relationship with investors that are coming in and coming out and trying to come up with the fair value for the net asset value of the fund, and having an accountant say, you know, no, actually, you know, you can or cannot do that depending on certain GAAP principles provides a tension that can be extreme.

MR. RAISLER: Yes, and I think that the--I guess you're right; it's not just a regulatory issue. It has a lot of other ramifications, tax, potentially, as well can play a role.

Picking up on that, Danforth, if you go crossborder, you just magnify those issues and concerns, and I guess one of the comments that has come through today is that there is a real issue of coordination globally on regulation for efficiency purposes, and there are few hedge funds of any size that aren't taking advantage of operating in multiple jurisdictions. From your professional experience, what are the ramifications of that, and what are the difficulties of that?

MR. TOWNLEY: I think one of the ramifications is just the extraterritorial effect of whatever regulations get adopted here in the U.S. Those are yet to play out, I think, especially with regard to the registration of investment advisors by the SEC, because literally, under the terms of that, there may be a manager in London who has all of his operations solely in London and has approached investors just in London, but if one of them is a fund of funds that indirectly has admitted U.S. investors, suddenly, he becomes potentially subject to being required to register with the U.S. Securities and Exchange Commission, and the reaction of those managers has just been utter disbelief, I think, that they could be subject to that kind of extraterritorial reach.

And I think some of the reaction is likely to be that they will then determine if they're going to try to comply with this is to basically force a redemption of investors that may be U.S. persons or may indirectly have U.S. persons, and so, it may restrict, you know, the available

opportunities for U.S. investors in ways that, you know, that one would not have intended to do but may in fact be the result of some of the new regulatory hurdles.

MR. RAISLER: Bo, you know, if your vision is correct, and I think it certainly is, that these are great investment opportunities at times where, you know, people are looking for investment opportunities, is there any reason why this marketplace shouldn't migrate toward more retail participation, people looking for the opportunities in that area, and what are the implications of such a trend if it does, in fact, catch on in that way?

MR. COLLINS: There's certainly, you can make a case that there would be an opportunity for the right retail product to be sold to allow individuals to invest in these types of partnerships. In a tertiary sort of manner, that's already happening vis-a-vis pension funds or college endowments and even, in some special cases, fund of funds.

I personally am uncertain if we are really

mature enough in the industry to encourage that type or form of participation, simply because the vehicles typically that would be considered alternative investments are deploying strategies that are fairly advanced and fairly exotic, and inevitably, you have a problem with one of them.

And so, it would be a shame to end up in a situation that is similar, I think, to the SEC mutual fund paradigm that the introduction of retail investment requires such immense legislation and protection to that individual investor that it by definition threatens the very strategy of the fund itself. so I'm not sure that that would be constructive on the whole since it seems to be that the current institutional appetite to apply capital into these types of products is greater than the ability for the industry to adequately supply it.

MR. RAISLER: Charles, there was discussion, I think Ron Geffner in an earlier panel about the fraud in the hedge fund and CPO space, and it was discussed as well from the CFTC's perspective. To what extent do you consider this a

concern, and to what extent can the problem be reduced from your perspective?

MR. GRADANTE: Well, here's where I get in trouble with some of my colleagues. We looked at 30 SEC fraud cases, and most frauds were found by our estimation to be potentially curtailed by gatekeepers in the industry if improved best practices were employed.

Administrators, for example, should only accept third party marks, never accept trader marks. Where there was fraud in cases involving administrators, they accepted marks from the manager without doing valid testing of those marks. What's interesting is that administrators performed this function for offshore funds, and I'd like to consider that perhaps this be done onshore, i.e., monthly review of the NAV of the hedge fund, because most frauds have involved valuation deception, and many of them occurred onshore.

And if we're waiting for the annual audit to be done, quite often, it's not very timely. There are already some hedge funds that have

adopted this policy, so I think there is a move in that direction to some degree, but that's something that should be considered.

Secondly, accountants should only accept third party marks, and K1 statements and audits should be mailed directly from the accountant to the limited partner, and in many cases, it goes through the hedge fund manager, where you have document fraud being committed, and I'll cite some cases regarding this.

So valuation fraud invariably involves document fraud with respect to K1s and the annual audit or the lack of testing of valuations on the part of the auditor; in other words, accepting the manager's mark. Lawyers are not going to go without something to do here, and that is they should be performing background checks on managers when they generate offering docs. Some law firms do this, but many do not.

Consequently, there has been fraud where managers or people have started hedge funds and lied about their college degree and their work

experience, and I'll cite some cases here.

In the case SEC v. House Asset Management, the manager made false statements about his background in the offering memorandum. Where was the law firm when they wrote that offering doc? Why not invest $3,000, $4,000, charge the manager, and do the background check and establish what he's saying in his offering doc, what he's purporting to the investors is, in fact, true. In the case SEC v. Manhattan Capital--

MR. RAISLER: Charles, we're going to be pressed for time so--

MR. GRADANTE: Okay; I'll just wrap up here. The manager hid fund losses from the auditor, fund administrator, and the investors by creating phony account statements. And in the case of the SEC v. Edward Strophate of Lipper Convertible, the auditor's apparent acceptance of manager marks for several years led to sizeable losses.

Thank you, Ken.

MR. RAISLER: Yes; I think one of the

things that was spoken about earlier--

MR. GRADANTE: You notice Ken jumped in when I mentioned lawyers.

[Laughter.]

MR. RAISLER: I was a little nervous there. The Managed Funds Association has been working on sound practices for the industry, which are being revised and then updated as the industry matures and as issues arise, and these are the kinds of points that MFA takes into account in developing guidance which we hope the industry abides by and I think largely have been widely adopted by the industry for the industry's overall benefit.

David, talking about the growth in the market, to what extent, and this is a topic, I think, even that Commissioner Hatfield referenced Chairman Greenspan with respect to, is to what extent does this growth increase capital efficiency and provide better pricing efficiency and therefore basically have a positive effect on U.S. and global economies.

MR. MCCARTHY: Well, let me describe kind of an anecdote. I was interested here earlier today, somebody said that they've been in the industry 37 years. I gave my first allocation to a CTA 20 years ago in 1985, and I'm glad there's somebody older than I am in this industry, because it doesn't seem so at times.

But I remember when we set up the account, the FCN, the broker at the time said, you know, they'll do the business for $35 round turn commissions, you know, and that was actually probably a commercial rate at the time. Now, you can come in off the street and get $5 to $7 round turn.

There's no doubt in my mind that a more sophisticated group of investors have improved the kind of pricing efficiency of that part of the market and that those same benefits have accrued to the commercial participants as well. And let me talk about how that kind of works its way through. You know, there are a number of strategies--today, in fact, there was a manager this morning at one of

the panels who has a very high frequency turnover of their trading. If you look at a typical trend follower such as Millburn, for example; I don't know Millburn's specific case, but most trend followers would trade 2,000 contracts per round turn per $1 million of investment.

There are a number of high frequency strategies that trade 8,000 contracts per million dollars of investment. Well, if you reduce the transaction cost, the commission cost in those contracts by $10 even, you know, that's an 800 basis points return that drops through to the bottom line; so something that might not have been feasible at an 8 percent annualized return is now feasible at a 16 percent annualized return.

You know, as money is attracted into that sector, it only follows that those markets would become more efficient, because more money is trying to pick off the inefficiencies, and what's happening is reduction in transaction costs are allowing those inefficiencies to be more directly arbitraged by the underlying managers.

It's possible, though, that a result of that in the end, specifically, I think, because of the amount of money that's come into this space now is that we might have seen, you know, an end to that run certainly in the reduction and commission costs. I don't think we're going to see much lower commission costs than we see right now.

Certainly, the advent of electronic trading may further give rise to further improvements in the efficiency of markets. I would also expect that you might see as a result of kind of this end period, you know, some strategy deterioration in terms of the performance of the underlying strategies and then, therefore, redeployment of capital to other greater opportunities in the hedge fund space.

MR. RAISLER: Dr. Mordecai, do you see the growth that we've discussed and perhaps the impact on opportunities that are in the marketplace shrinking having an opportunity on leverage, and in turn, do you see this potential growth or this real growth in leverage raising systemic concerns?

MR. MORDECAI: I'm going to start with a classic economist's answer: it depends. And let's talk about what it depends on, okay? It really depends on how we harmonize as a society both participants and regulators incentives, market discipline, market mechanisms, other incentives.

You know, I think one of the things that's been mentioned several times today by Adam Cooper, by George Crapple, by Myron Scholes and others is that the hedge fund sector, it's a business, and as a business, it's going to go through growth cycles as any other industry. I think, you know, after the Long Term Capital Management crisis, a couple things happened which were interesting. One is that the industry responded with a sound practices study, and also, in similar themes, a number of multilateral and quasigovernment and government agencies responded with similar studies around something called risk-based leverage.

And risk-based leverage is, well, how do we come up with appropriate measures, quantifiable appropriate measures for looking at leverage in the

ways that hedge funds utilize leverage as opposed to the way that, say, a metal bending company might utilize leverage? And in what way is the leverage some of the leverage of a bank or something else?

And, you know, one of the things the sound practices document emphasized is the importance of a hedge fund manager having flexibility in terms of managing leverage and setting the right set of leverage going into a shock, during a shock and after a shock. In addition to that, another colleague from Yale, John Genocopolous, who also is a partner at Ellington, a large fixed-income shop, has done some theoretical work which he's presented recently around looking at having maybe slightly higher margin requirements, slightly lower leverage preshock and then not moving margins up as high during the shock and forcing an involuntary delevering that could actually have a negative effect on prices.

So that's an excellent example of how to harmonize regulation, market practices, incentives with the prudence of managers and their own

instinct for survival, if you will, and let market discipline work well with the other mechanisms. So the question is if we limit managers' flexibility in terms of moving in and out of different markets, you may actually see the opposite result. You may see managers forced into a box increase leverage to try to stay alive and maintain the firm.

If you give them more flexibility to adjust their business models prudently, you may see them actually not increase leverage but actually try to find other opportunities where that leverage and capital can be better employed, because at the end of the day, these firms are risk-bearing capacity firms and generate those uncorrelated returns based on finding useful and appropriate ways to allocate risk-bearing capacity.

MR. RAISLER: And, David, what do you think about systemic risk and the potential systemic--yes, Dr. Mordecai, I'm sorry.

MR. MORDECAI: That's okay; I think my own research, first of all, during the 1997 to 2000 period taking LTCM out of the sample, what we found

was most managers showed a great deal of prudence in terms of reducing leverage going into shocks.

The other thing that it says, though, is that there may also be circumstances for them to be more effective at their jobs. We need to provide them with more stable balance sheets from a liability perspective to maybe take on, prudently take on a little bit more leverage to help them help us stabilize and rationalize prices in those sort of ugly events when they are basically the lenders of last resort.

I think in terms of handling systemic concerns, there were always systemic concerns in any industry and in any marketplace. You know, our economies and our markets are basically delicate ecologies, evolving ecologies, much like a coral reef. And as a result, there are going to be storms, there are going to be tsunamis, there are going to be all of these things that come and go, and we have these different financial institutions, financial intermediaries as actors or agents there all trying to do their individual jobs, and what

you're hoping for is enough coordination and harmonization through market mechanisms combined with regulatory institutions and so forth for that corollary to continue to survive and evolve.

I think there are issues to address, and in my own document, I include a possible policy research agenda drawing from various areas of economics and financial economics and posing some operative questions that can come from history, if you will, as well as current state of affairs and start to look at some ways to move through the landscape.

I think a lot of these things are already being addressed by the more prudent managers, and I think that, you know, we will continue to see a focus on coordination and balance, and that's the right focus. I think beyond that, it's just very important to move with a delicate touch, not to kill the goose in an effort to cure the goose. And so, my sense is there will always be systemic concerns. This is not a world without risk. The question is how do we appropriately manage our way

through the morass of possible concerns that will arise?

MR. RAISLER: Charles, with a promise not to blame the lawyers here, do you have any suggestions about improved systemic risk monitoring by government agencies from your perspective?

MR. GRADANTE: When we look at systemic risk, there are many aspects of it, but the three most prominent are, you know, leverage, off-balance sheet risk, and counterparty risk. And with respect to leverage, prime brokers and commercial banks provide virtually all of the leverage if not, you know, 98 percent of it.

So by polling the few prime brokers and the few commercial banks that provide leverage, you can very quickly assess how much leverage is in the marketplace not only hedge funds but non-hedge funds alike, and that should be a very simple thing to do relative to auditing 3,000 hedge funds.

The second thing is monitoring off balance sheet transactions. Many auditors attempt to report them, but it's not a standard to my

knowledge at that point in time. So off balance sheet transactions should be reported not only to the limited partners but to some regulatory agency, and counterparty risk; there's a lot of counterparty risk out there, and being on Wall Street, talking to managers, everyone speculates what bank is going to start the domino effect.

This needs to be researched by regulatory agencies, and information can be collected fairly easily about this stuff, I mean, relatively easily by having the accountants gather this information from hedge funds and report it in.

MR. RAISLER: Dr. Mordecai?

MR. MORDECAI: That's actually a very interesting point. The consolidation in the banking industry is resulting in fewer and fewer really large banks that are acting as prime brokers; fewer and fewer banks have the operational expertise as well as the balance sheet to serve a greater, a growing group of borrowers, which includes hedge funds.

And then, being given a uniform set of

value at risk or quantifiable or quantitative enterprise risk measures results in one systemic risk that I know the industry is trying to address right now with other alternative forms of financing. Is that what happens when all the enterprise-wide risk managers yell models tell us everybody out of the pool, and you've got three or four guys financing the entire industry?

So, you know, one of the things that needs to be addressed, and the industry is addressing it saying what alternative sources do we have to relieve some of the burden, some of the counterparty burden, some of the settlement risk burden and some of the burden around having identical coordinated risk management radar, you know, coming from the same set of guys who are the sole suppliers of credit to this very important part of the industry which, by the way, needs credit in order to lever returns in order to do their jobs as a risk-bearing capacity--so, you know, that is definitely one key.

MR. RAISLER: Bo, from the perspective of

an energy trading hedge fund, how do you see the evolution of exchanges? And here, I'm talking particularly about futures exchanges as well as OTC trading and also particularly the advent of clearing impacting a firm's ability to trade and particularly impacting the opportunities available to a relatively new firm in terms of credit relationships in the marketplace.

MR. COLLINS: You know, we implemented when I was at NYMEX a program called over the counter clearing. The name of it is clearport clearing. And it really sort of revolutionized the way that energy transactions were conducted, particularly in the over the counter marketplace.

It was introduced at a time that there was a huge demand relative to the merchant energy crisis for an intermediary with a very solid balance sheet. So starting from that point, my observation of the development of that market has been that it has served as a remarkably efficient mechanism for credit in the sense that the industry as a whole is, in effect, mutualizing the

distribution of credit through the advent of a clearinghouse, which, of course, is not new; it's been in effect for quite some time through all the major future exchanges.

So it's leveraging a very traditional process that we have managed very effectively for a very long time, and it's extending it to new products, and more importantly new ways of transacting business. The advantage to that beyond just the distribution of credit is you significantly remove a barrier to entry into the comprehensive ability to trade and conduct transactions at market prices that are reflective not only of the public futures markets but the over the counter markets, which, in many cases are identical instruments.

So that's enabled a firm like MotherRock to take a relatively small amount of capital and apply it as competitively with somebody who has, for instance, a double-A balance sheet. I think that the evolution of over the counter clearing, whether it's in energy or other marketplaces, could

be an extremely effective solution to mitigating, if you will, systemic risk, particularly as it relates to counterparty risk.

ACTING CHAIRMAN BROWN-HRUSKA: Ken, can we wrap it up?

MR. RAISLER: Two last questions; do we have enough time for that? Just let me go--two last questions, first to David in terms of from your perspective, the growth in changes in the CPO business, the hedge fund business, do you think they've been adequately researched and analyzed, and you and I have had this discussion that more work could be done here? Very quickly--

MR. MCCARTHY: Well, first of all, I was heartened by Michael Haigh's presentation this morning on the economic stuff at the CFTC. I think that was a very good presentation, very interesting. I also have to say I was a beneficiary of--when I was doing my own doctoral dissertation through the Freedom of Information Act of a lot of manager, historical manager performance that was housed at the CFTC that I sought under the

Freedom of Information Act and got.

But I think, listen, I think that there is a lot more that can be done. I think the CFTC has a role for that; I think that the research department within the CFTC has a role for that. You know, the problem on doing kind of academic research in this space is the availability of data. I serve on the academic board of a center that tries to look at this. And it's always the data issue, and to the extent that data is available and could be made available to researchers by the CFTC through the economic stuff and the interaction between the outside researchers and the economic staff, however that can be put together through committees, working committees, I think would be a great plus to the industry and to the CFTC itself.

MR. RAISLER: And sort of a related question on, perhaps, building on what David said, either Danforth or Dr. Mordecai, do you see any additional role that the CFTC could play in this space? And we talked as a panel about an idea of should there be, you know, a CFTC advisory

committee built on the CPO/CTA businesses? Are there other areas where the CFTC should be more proactive potentially? Danforth, thoughts on that?

MR. TOWNLEY: I think I would just say, you know, fostering additional and multiple layers of dialogue, you know, between the agencies and the participants is very, very useful, and so, I think to the extent that we can continue to do that both on a formal level such as this and more informal levels, you know, I think that's very, very helpful.

MR. MORDECAI: I would agree. I think Cynthia Fornelli earlier also advocated the concept of forums for dialogue and discourse. It's something that I feel that there is a pressing need for. I think the CFTC and the other regulators in the marketplace should really view themselves as stewards, you know, shepherds or farmers basically trying to cultivate and nurture these markets and guide these markets, and as I mentioned before, there's sort of this delicate touch that's needed, and I think a lot of that delicate touch has to do

with guidance and advisory suggestions, recommendations, you know, clarification of issues as they come up.

And that responsiveness and, you know, back and forth between industry practitioners and regulators, I think would be good.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you very much. It's a good way--

MR. RAISLER: I had to get those last two in there.

ACTING CHAIRMAN BROWN-HRUSKA: Did you promise them in advance?

[Laughter.]

ACTING CHAIRMAN BROWN-HRUSKA: I'm going to start actually with Commissioner Dunn, if he has any questions.

COMMISSIONER DUNN: No questions, because I don't know where to start, I have so many. Just an excellent panel, as have all the panels been, and I really very, very much appreciated being the newest commissioner--not the youngest commissioner. It has given me a great deal of oversight and at

times sounded like the old Indian proverb of the blind man trying to describe an elephant. Everybody was talking about the particular piece they had a hold of, and it's up to us as a Commission to get a picture of the whole critter and understand it and then to take that analogy a little further.

Dr. David, you said we should shepherd the industry, but I don't think we should shepherd. We should certainly provide an environment where that elephant herd can expand and build, but we also have to be able to be on the outlook for that single rogue elephant out there. Because of the enormity of the beast, it could do a great deal of damage in a short time if we're not vigilant, so that's the challenge I see to us.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you.

COMMISSIONER HATFIELD: Yes; I have a question for Dr. Mordecai, and before I do that, I have to commend him despite Mr. Raisler's comments about his terminology and their pronunciation and then their understandability. He did title his

paper, “How Do We Cure(not Kill) the Golden Goose” which I certainly understood and, in light of Mr. Gradante's comments, certainly an apropos title.

But I have a question specifically on “ What is the appropriate role for regulation?” and under transparency, the word for the last two years in the industry, I guess, you have a bullet that says, “Too much versus not enough information.” What do you mean by that?

MR. MORDECAI: I mean that one of the classic conundrums in economics, and it actually has been dealt with quite a bit in the industrial organization literature is around the overinvestment and underinvestment in any function. Sanford Grossman and the late Merten Miller looking at in financial markets the production of usable information, you know, and how much is too much, how much is too little, the role that exchanges play in price discovery in producing that form of information, the role that disclosure regulations play in producing information that is useful, not redundant, information that's actually clear,

signals that are clear.

There are ways in which regulatory actions can actually reduce signal clarity. So if everyone is required to meet some standard, and it's an expensive minimum standard to meet, what you may have actually done is eliminated the ability for people to signal the quality of the services they can provide and, hence, reduce the ability for the consumer to tell who's really good versus who's just kind of okay.

Now, that doesn't mean that standards shouldn't be there; it's just there has to be a lot of thought given into whether this is a positive externality or a negative externality. Is it something that actually promotes social benefit or reduces social benefit? And so, in choosing the right kind of signal, okay, it's a very delicate balance, and so, generating, for example, too much information may be full position disclosure.

Full position disclosure could actually result in managers being predated upon. Franklin Allen from Wharton Financial Institution Center has

done quite a bit of work now on people who have credit relationships with each other and the bigger balance sheet guy being able to use the information he may have on the smaller balance sheet guy's positions to actually drive him out of business.

You know, there are all of these kinds of delicate balances that need to be taken into account: strategic, predatory, and so on and so forth. So the idea of one size, first of all, does not fit all, and then, sends the other idea of whatever information is coming out needs to be sort of appropriate information, and also, you don't want to spend so much in cost that the information actually ends up being more costly than the function you're trying to do.

COMMISSIONER HATFIELD: Very helpful; thank you.

ACTING CHAIRMAN BROWN-HRUSKA: Thank you for that.

Would you be interested in a job at the CFTC?

[Laughter.]

MR. MORDECAI: We'll talk later.

[Laughter.]

ACTING CHAIRMAN BROWN-HRUSKA: I'm aware of some research as well that in the experimental area that's found that more information is--mandatory, required information does not lead to necessarily more information in the markets or more efficient prices, which is sort of counterintuitive to most people, but in fact, it is the case that people will work harder to provide information-- will provide higher quality information if they have natural incentives to do so, and the mandatory requirement often undermines those natural incentives. I always find that so interesting.

MR. MORDECAI: Just move through Times Square at rush hour and just see how hard it is to keep a thought. Yes.

COMMISSIONER LUKKEN: I just wanted to offer similar comments as my colleagues on how wonderful today's panels have been. I'm glad Bo mentioned the over the counter clearing mechanism

that was put in place in 2000. Before that, it was illegal until the Commodity Futures Modernization Act was passed on the recommendation of the President's working group. So I know that hopefully, the marketplace starts to understand that this might be an alternative mechanism for managing counterparty risk, and that market starts to develop.

One question that I had in regards to retail customers, since that's a lot of our focus as regulators, Bo had mentioned that he did not see the retail customers coming into the hedge fund space. I guess let me flip this around: what about the mutual fund maybe morphing more toward the hedge fund space? I sat through this SEC hedge fund roundtable I guess it was last year--it seems 10 years ago--but that seemed, after the end of the discussion there seemed to be almost a belief that hey, let's allow retail customers into this. You saw Commissioners, sort of, the light bulb come on that, hey, why can't retail get a piece of this action, as somebody had stated.

So do you see a movement of maybe changing some of the rules within the mutual fund side of the equation, maybe the uptick rule that disallows short-selling so that some of the advantages and the alternative strategies that hedge funds are allowed to use might be allowed for retail customers?

MR. GRADANTE: There are 15 mutual funds today that operate as a hedge fund. They're slightly restricted in the amount of shorting that they can do, but with minor modifications to the Investment Act that they're regulated by, they can operate as a hedge fund. You have mutual funds that do merger arbitrage; you have BDOs, business development funds, that do venture capital and private equity. So there is a modicum of a spectrum of hedge fund activity already in the mutual fund world; a little bit more restricted, but how about carving out a class of mutual funds and expanding the restrictions or deleting some of the restrictions and offering that to the retail world?

MR. RAISLER: I certainly see this as part of an evolutionary path how, whether it's a separate path as the hedge fund path or a different path. But I certainly, you know, I was at the same hearing, and there clearly was a feeling that these are rather than, I think before the hearing, a lot of people were thinking, well, gee, these are bad investments, these are very high risk investments, these are very inappropriate investments, and instead, it seemed, well, gee, if the institutional marketplace can take advantage of it, what is it that restricts retail from taking advantage?

So I think those are issues that are going to need to be certainly addressed as people look for more investment opportunity and as the literature continues to expand around alternative investments pointing out the manner in which it improves a portfolio's performance. And I know that certainly there are a lot of banks and investment banks looking at retail opportunities for these markets, because they believe that this is something that the consumer wants.

COMMISSIONER LUKKEN: Thank you.

ACTING CHAIRMAN BROWN-HRUSKA: Well thank you very much. I just have written down a couple of notes on those answers. You know, I keep thinking that some of the issues that come up, to me, seem to be new to many folks, but they're not necessarily. I think if you have a futures background, and you've sort of been in these markets for a long time, you really see a lot of the same issues resurfacing.

And, you know, one concern that I've had about regulatory structure and how we go about involving ourselves in this rapidly growing and very innovative market is that we may--again, by our regulatory program-- hinder the development of these markets and hinder their ability to resolve inefficiencies that exist in the marketplace. I think that's one of our goals is to not go backwards but instead to go forwards, and I think we do have a regulatory model at the CFTC that has performed well and has been very responsive to the changing needs of

this--I want to use the words asset class, but I'm reminiscent of some of the panel members who wanted to suggest that it's not an asset class but rather a vehicle to have access to multiple asset classes.

And I also think about single security futures; I don't know if it was you, Charles, or Danforth, who mentioned that there's a limit on the ability to borrow on the short side, and that's going to limit the growth of this industry. And I keep thinking we have a symmetrical, transparent marketplace in securities, in equities, that doesn't suffer that same, artificial constraint, in the futures business. We believe that going short is just as legitimate as going long.

And so, I often wonder why it is that single security futures aren't of more interest to the managed money traders and to the hedge fund industry. Does anybody want to hazard a guess as to why that might be? David, you're shaking your head as if you might have an idea.

MR. MORDECAI: With a deep knowledge of

credit arbitrageurs, guys that work in the credit
arbitrage space, there would be a tremendous--I
don't think the frictions are coming from the
managers. I think there would be tremendous
interest. I think it's more about how that's going
to affect the general landscape and structure of
the industry in terms of who gets profits for
transforming things from over the counter contracts
into exchange rated contracts. I think the
managers would be interested.

ACTING CHAIRMAN BROWN-HRUSKA: I've always
wondered, too, another issue that we're very
sensitive to as a regulatory agency is not trying
to predetermine the competitive outcome, and I worry a
little bit that some of the impetus for change
in our regulatory structure and
some of the enthusiastic support for what
the SEC is trying to do comes from the fact that
many Street firms have often been a little jealous
of the talent pool that has left them and gone to
the hedge fund industry. The capital that maybe the
mutual funds feel that they would

like to have access to, even though they're certainly large enough that they have plenty.

But, I mean, I was just wondering if anyone had a sense that maybe there are competitive underlying competitiveness or competitive motivations for the regulatory program that the SEC is interested in embarking on or that rather than motivations, let's say that there could be competitive outcomes. It could change the competitive landscape in some sense and move business, from the funds to the more organized investment banking community. It's just a thought, but I don't know if any of you have thought about that.

MR. RAISLER: It seems to me that regulation always does that. It's just a question of how much and how profound that change is, but it's always going to affect the dynamics, because it fundamentally is a cost-benefit type analysis, and people will take into account whatever is available to them in making a decision. Questions of onshore-offshore; questions of being private

equity versus hedge fund, definitional questions, these are all, I think, part of an evolutionary path, so I think it is an outcome that we have to be sensitive to.

MR. GRADANTE: The key thing we have to protect is the entrepreneurial spirit, which may be threatened, and hedge funds provide liquidity and pricing surfaces in their activities, and they have become non-bank banks, as George Ball mentioned earlier.

So we have to be concerned about that entrepreneurial spirit being stymied by overregulation.

MR. MORDECAI: Can I make a plug for my school? I mean, Merten Miller, Richard Posner, Ronald Coase, names that are sort of, you know, icons in economics have all talked about regulatory activity as being a key determinant in the competition for economic rents and which way they go, and so, I'd just direct the answer to a deep body of literature that's been around and demonstrated to be quite clear.

ACTING CHAIRMAN BROWN-HRUSKA: Yes.

MR. MCCARTHY: Madam Chair, I'd hark back to something you said in your opening comments. When we talk to and as a fund of funds talk to a large number of managers and talk to them about the regulatory environment and the regulatory issue, there's almost none of them who oppose being regulated.

The idea that they're being regulated simultaneously by two arms of the U.S. Government is--most of them find borderline offensive, you know, not only from the standpoint of the, you know, the inefficiency of that but just conceptually, and I think that to the extent that the CFTC is having those discussions with the SEC, you would get great encouragement from the industry and support to try to resolve that, as I know you're trying to do.

ACTING CHAIRMAN BROWN-HRUSKA: Well, thank you very much. I give you my word we will continue to pursue that enthusiastically, and we will also take the good advice of many panelists that we

should reach out to the public and to others in the industry, talk, collaborate, educate each other and educate interested investors and educate our fellow regulators to the extent possible about what our regulatory program is and how these markets operate, what are the risks associated with the markets.

So in some sense, I sense that this is just the beginning. This is the first in a series of hopefully some future meetings that we can have that can hopefully reach out to the public and provide these types of opportunities and these forums. I appreciate everyone coming, and hopefully, again, we'll see you soon.

[Whereupon, at 3:28 p.m., the meeting concluded.]