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September 15, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

RE: File Number S7-30-04; Registration Under the Investment Advisers Act of
Certain Hedge Fund Advisers; Proposed Rule, Rel. No. IA 2266, July 20, 2004

Dear Mr. Katz:

We appreciate the opportunity to submit this letter in response to a request by the Securities and Exchange Commission (“SEC” or “Commission”) for comments on the above-referenced proposed rule. The proposed rule, if adopted, would require advisers to certain private investment pools currently exempt from registration to register with the Commission under the Investment Advisers Act of 1940 (“Advisers Act” or “Act”). The proposed rule, among other things, would amend Rule 203(b)(3) to require investment advisers to count as a separate client for purposes of determining the availability of the private adviser exemption of Section 203(b)(3) of the Act each owner of a “private fund.” A “private fund” is defined in the proposed rule in a manner designed to include most hedge funds. Currently, Rule 203(b)(3)-1 provides a safe harbor by which investors in a private investment fund may be excluded from the count of clients of the adviser, and the fund, instead, may be treated as a single “client” of the private adviser for purposes of determining whether the adviser has fewer than 15 clients and, therefore, is exempt from registration under Section 203(b)(3).

I am offering my comments as the President of Kynikos Associates LP (“Kynikos”), a New York private investment company that I founded in 1985. On behalf of our clients, Kynikos manages a portfolio of securities we consider to be overvalued. The portfolio is designed to profit if the securities it has sold short fall in value. Kynikos selects portfolio securities by conducting a rigorous financial analysis and focusing on securities issued by companies that appear to have an unsustainable or operationally flawed business plan, and/or appear to have materially overstated earnings and/or engaged in outright fraud. In choosing securities for its portfolios, Kynikos also relies on the many years of experience in the equity markets that our team has accumulated.

While the term “hedge fund” was meant to describe a private investment company that is market-neutral, Kynikos Associates falls under the definition used by the

Commission in its proposed rule¹ and which encompasses almost any form of private investment fund that is not registered under the Investment Company Act of 1940.

We support the Commission's goal of providing a mechanism to obtain basic and meaningful information about hedge funds. We also support the Commission's goal of providing hedge fund investors with the kinds of important investor protections that clients of registered investment advisers enjoy. However, we do not believe it is necessary to require hedge funds to register under the Advisers Act in order to achieve these important goals. In this letter, we propose an alternative to the Commission's registration approach. I proposed this alternative in my July 15th testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, a copy of which is attached to this letter.² That testimony was based on a proposal I made when I was privileged to appear before the Commission's Roundtable on Hedge Funds over a year ago on May 15, 2003, a copy of which also is attached to this letter.³

In brief, we propose that the Commission address its interest in protecting hedge fund investors by making the safe harbor client counting provisions of SEC Rules 203(b)(3)-1 and 222-2 (17 C.F.R. §§ 275.203(b)(3)-1, 275.222-2, which implement the private adviser exemption under Section 203(b)(3) of the Act and the preemption provisions of Section 203A of the Act) conditioned upon hedge fund managers' adoption of basic investor safeguards, such as custody, audit, disclosure, compliance and valuation requirements and standards. In addition, we propose that the SEC address its need for information about hedge funds by making the exemptions conditioned upon the SEC's receipt of certain written information by each hedge fund.

We believe this approach offers a reasonable middle ground between what to date have been opposing sides in the debate over hedge fund regulation, and it may offer a way to achieve consensus among the various financial regulators and within the Commission itself – all for the benefit of hedge fund investors and the capital markets. We are concerned that, without such an agreement among all parties, the Commission's legitimate concerns about the lack of information concerning our rapidly-growing industry may be delayed or challenged, or, if the Commission is successful in adopting its rule without change, it will find it overreaches in some respects and fails to address the real issues in others.

¹ 69 Fed. Reg. 45172, 45173-74, 45195.

² *Regulation of the Hedge Fund Industry: Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs*, Cong. 108, Sess. 2 (July 15, 2004) ("Senate Hearing") (written statement of James Chanos).

³ Prepared Statement of James Chanos, Securities and Exchange Commission: Hedge Fund Roundtable, Panel 5 – Hedge Fund Strategies and Market Participation, May 15, 2003. The law firm of Bryan Cave submitted a comment letter on August 16, 2004, containing a proposal for a limited exemption in certain respects similar to the proposal contained in this letter and contained in my previous statements of July 15, 2004 and May 15, 2003, before the Congress and the SEC, respectively. Form D is a notice filing under certain exemptions in the Securities Act of 1933 and rules thereunder. While many hedge funds use Form D, many other Form D filers are not funds; the statutory context is different, and Form D is administered by the Division of Corporation Finance, while the Investment Management Division more appropriately would review information concerning hedge funds. While we believe basic information about hedge funds should be provided to the Commission, we do not believe modification of Form D is the appropriate vehicle for an exemptive filing.

Overview and Need for SEC Oversight

As a member of the hedge fund industry, we believe informed Commission oversight is necessary for investor protection and also for the long-term health of the industry. We no longer are a “cottage” industry. The hedge fund industry today includes an estimated 7,000 funds with assets under management of approximately \$800 billion – and growing. This growth, and the importance of hedge funds to investors and to the capital markets more broadly, appropriately has focused debate on the adequacy of the existing regulatory framework governing hedge funds.

The hedge fund industry’s vitally important role in the U.S. capital markets has been acknowledged by Federal Reserve Board Chairman Alan Greenspan, the President’s Working Group on Financial Markets, the Chairman of the Commodity Futures Trading Commission, and most recently, by the Commission itself. With that important role comes a responsibility on the part of the hedge fund industry to address the legitimate public policy concerns of the Federal Government. While any new regulation should be considered cautiously and carefully, we, in the industry, have a responsibility not to simply reject the idea of regulation outright. Instead, we should consider the basis upon which the government, or more accurately, the Commission, is proposing new regulation.

Two opposite positions have been expressed in the debate over hedge fund regulation, and, so far, both sides have talked past each other more than to each other. At one end of the spectrum are those who maintain that any additional government scrutiny is unwarranted and undeserving of consideration – a position that does not accurately reflect the economic influence of the hedge fund industry.⁴ At the other end are those who argue that hedge funds and their advisers should be subject to the full panoply of Investment Company Act and Investment Advisers Act regulation.⁵ This position ignores

⁴ This position is reflected in the stated position of a leading industry trade association, the Managed Futures Association. *See* Senate Hearing, *supra* n. 2, Statement of Adam D. Cooper, Chairman, Managed Futures Association. Opponents of the Commission’s proposal have suggested that Commission is without statutory authority to require registration of hedge fund advisers. *See* Comment Letter dated September 8, 2004 from Wilmer Cutler Hale & Dorr. (We note, however, that investors in hedge funds are treated as “clients” of the investment adviser for purposes of the brochure rule and the anti-fraud provisions of the Advisers Act, and that section 203(b)(3) of the Act specifically excludes clients of a registered business development company from the 15-client count that triggers registration, yet provides no similar exclusion for investors in private investment funds.) However, the Commission has the ability to limit or condition the availability of regulatory “safe harbor” exemptions, such as Rules 203(b)(4)-1 and 222-2. While an investment adviser might choose not to comply with the modified safe harbor rule and, if a dispute with the Commission or an investor later arose, argue to a court that it nonetheless should be allowed to ignore the fund’s investors and treat the fund as a single “client” for purposes of the private adviser registration exemption under Section 203(b)(3) of the Act, few advisers would take that risk. The legal defensibility of our proposal (which would modify the safe harbor), as compared to the Commission’s current proposed rule (which would require registration), in the legal challenge to the Commission’s rule that will inevitably follow adoption of a final rule, should be considered by the Commission before reaching a final decision.

⁵ This position has been advocated by the trade association of the registered investment company industry, the Investment Company Institute, and is the basic approach reflected in the current proposal.

the unique characteristics of hedge funds and their investors and would place unnecessary burdens on the industry, undermining the benefits hedge funds provide to the capital markets. It also would divert the resources of the SEC from the inspection of registrants who more directly impact retail investors.⁶

The debate at the Commission's July 14, 2004 open meeting to consider the proposed rule also was polarized, and the lack of consensus was reflected in the 3-2 vote to approve the proposing release and the unusual filing of dissents by two of the Commissioners.⁷

The Need for a Balanced Approach to Address the SEC's Policy Goals

There is a middle ground. The framework we are suggesting falls between these opposing positions. It is designed to address the important public policy goals articulated by the SEC, but in a simpler and less burdensome manner than the SEC's proposed registration requirement.

The Commission's release sets forth a strong argument for the need for a formalized census of hedge funds, their advisers and their basic information. We agree that the SEC should have basic and meaningful information about the activities of hedge funds and their advisers. All hedge fund managers that are not otherwise registered with the SEC or CFTC should provide the SEC, on an initial basis and periodically thereafter, certain basic information to enable the SEC to understand who they are, where they are located, who runs them, what they do, and the amount of assets under management.

The Commission also has stated a reasonable basis as to why industry best practices and certain protections offered under the Advisers Act should be guaranteed to investors in hedge funds. We agree that hedge fund advisers should be required to disclose information about issues important to investors, such as conflicts arising from side-by-side management of hedge funds and other client accounts, hedge fund advisers' relationships with prime brokers, disclosure of financial arrangements with all interested parties, and disclosure of investment allocation policies and valuation standards.

However, the Commission's stated basis for going the next step and requiring a system of registration, routine inspections and examinations is lacking in the same strong

⁶See, for example, the concerns expressed by the U.S. Senate Committee on Banking, Housing, and Urban Affairs on passage of what later became the National Securities Markets Improvement Act of 1996: "The Committee is concerned about the lack of adequate oversight of the growing number of investment advisers and the impact inadequate regulation may have on investors and American consumers. This is particularly troublesome since many investment advisers hold themselves out to the public as 'REGISTERED WITH THE SEC,' a statement that may give investors a false sense of confidence--particularly if the investment adviser has never actually been inspected by the SEC and is in little danger of any imminent inspection." Senate Report 104-293, accompanying passage of S.1815, "The Securities Investment Promotion Act of 1996," (June 26, 1996.)

⁷ See the transcript of the Open Meeting of the Securities and Exchange Commission, July 14, 2004 located at <http://www.sec.gov/news/openmeetings.shtml>. See also 69 Fed. Reg. at 45197-45200.

evidentiary and historic foundation.⁸ The Commission states that hedge fund fraud is on the rise, with nearly 46 enforcement cases being brought over the past five years.⁹ This number is relatively small, however, when viewed against the more than 2,600 enforcement cases brought by the Commission overall during the same period.¹⁰ The Commission also argues that inspection and examination will serve as a prophylactic against fraud.¹¹ The proposing release suggests that if the Commission had such powers over hedge funds, it would have been able to more quickly detect the abuses within the *mutual fund* industry that were first uncovered by New York State Attorney General Elliot Spitzer. However, as Commissioners Atkins and Glassman aptly note in their dissent, "...mutual funds and their advisors *are* registered, and examiners were inspecting the mutual funds involved in the scandals and did not find the abuses."¹²

Moreover, we do not agree with the notion that the SEC, even with an expanded examination staff, could effectively inspect and examine the thousands of additional investment advisers that would result from requiring registration of hedge fund managers, and at the same time fulfill the SEC's responsibilities to examine the many thousands of registered advisers for which it now has responsibility.¹³

Thus, at the heart of our difference with the Commission's proposal is the idea that there is a compelling public policy need for a system of examination and inspection of hedge fund advisers. While we strongly support the SEC's objectives, we respectfully disagree with its proposed approach.

In lieu of registration, we suggest that the Commission retain a modified version of the current safe harbor rule allowing a private investment fund to be counted as a single "client" (rather than counting each investor in the fund as a "client") for purposes of the "fewer than 15 clients" exemption of Section 203(b)(3) of the Investment Advisers Act, but that the SEC modify the rule to impose a series of conditions designed to (1) obtain the basic information about hedge funds and their managers that the Commission needs, and (2) help protect investors from potential abuse by requiring compliance with the most important and effective investor protection requirements applicable to registered investment advisers.

We believe our suggestion, first made at the SEC's Roundtable on Hedge Funds in May of 2003, will reduce the risk of undue reliance by investors on SEC oversight,

⁸ See, e.g., dissent of Commissioners Atkins and Glassman. *Id.*

⁹ 69 Fed. Reg. at 45175.

¹⁰ 69 Fed. Reg. 45197 at n. 12 (dissent of Commissioners Atkins and Glassman). *See also* Statement of Patrick J. McCarty, General Counsel, Commodity Futures Trading Commission, Senate Hearing, *supra* n. 2. McCarty's statistics for both the CFTC and the SEC are 81 enforcement cases against hedge funds out of a total of 3,035 cases filed over the past 5 years or less than 3% of total enforcement cases.

¹¹ 69 Fed. Reg. at 45175, 45178-45179. *See also id.* at 45198.

¹² *Id.* at 45198.

¹³ The Commission argues that the burden to its resources are relatively minimal since nearly half of the estimated 2500 eligible hedge fund advisers are already registered with the Commission. *See* 69 Fed. Reg. at 45190. Of course, that estimate is at odds with the Commission's earlier assessment that it lacks "basic information about hedge fund advisers and the hedge fund industry..." 69 Fed. Reg. 45177.

conserve important SEC resources, and reduce the risk that registration will grow, over time, into a creaky and burdensome form of regulation that robs the capital markets of the innovations, insights, liquidity and efficiencies that the hedge fund industry currently brings.

Our Suggested Approach

Instead of using investment adviser registration as a means to gain regulatory control over hedge fund managers, we recommend that the SEC, by rule, make the safe harbor counting rule enjoyed by hedge fund managers under SEC Rules 203(b)(3)-1 and 222-2 under the Act (17 C.F.R. §§ 275.203(b)(3)-1 & 275.222-2),¹⁴ which implement the client counting rules in Sections 203(b)(3) and 203A of the Advisers Act,¹⁵ contingent upon written receipt by the SEC of basic information about the fund, its operations and its managers, including:

- Name of the Fund, address and telephone number(s);
- Name of Chief Compliance Officer and telephone number of said person; and,
- Total Assets under management at the end of the most recent calendar month preceding notice.

Further, as a condition to relying on the safe harbor of Rules 203(b)(3)-1 and 222-2, the manager of the fund would be required to provide a certification of the investor safeguards discussed below, which are the key investor protections currently provided under the Advisers Act.

Minimum investor qualifications at or above current accredited investor levels (to be established by the SEC; to address the retailization issue). The Federal securities laws and SEC rules have long recognized that sophisticated and high net worth investors are able to bear greater risks than those with less sophistication or modest means. These same concepts should be maintained as part of the hedge fund regime.

Minimum threshold of assets under management (to be established by the SEC). For consistency with the current Federal/State division of authority codified in Section 203A of the Advisers Act as adopted under the National Securities Markets Improvement Act of 1996, the SEC might provide that the conditional exemption would be available only to hedge fund managers who have \$25 million or more under management, and managers who choose this conditional exemption should not be subject to state adviser regulation.

¹⁴ SEC Rule 203(b)(3)-1 under the Act defines “client” of an investment adviser and provides that an adviser may count a legal organization (which would include a hedge fund) as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual investment objectives of its owners.

¹⁵ Section 203(b)(3) excepts from the registration requirements of the Act advisers that have had fewer than 15 clients during the preceding 12 months and do not hold themselves out to the general public as investment advisers or serve as an investment adviser to a registered investment company.

Custody of private investment fund assets in an identified broker-dealer or bank and compliance with SEC interpretations on constructive custody (to address misappropriation of assets, fraud and transparency issues). Effective in April of this year, the Commission's amended custody rule for registered investment advisers requires registered investment adviser client assets be held in custody at a qualified custodian (a bank, trust company or broker-dealer). Imposing a version of this custody requirement on hedge fund advisers as a condition to reliance on the Rule 203(b)(3)-1 safe harbor will make it less likely that investor assets will be misappropriated, and will improve the quality of the annual audit.

Annual audit and delivery of financial statements to investors, with the audit conducted by an accounting firm that would be independent from the hedge fund manager under the SEC's auditor independence rules (to address fraud and transparency issues). A audit requirement will make it more likely that fraud will be detected (thereby deterring fraud as well as detecting it when it occurs) and will provide investors with reasonable assurances that annual financial statements provided by a fund are fair and accurate.

Quarterly unaudited financial reports to investors (to address transparency issue). This will provide investors with regular information about the value of their assets; the annual audit will provide an important check and make it less likely that fund managers will provide false or misleading information in the quarterly reports.

Clear disclosure of financial arrangements with interested parties such as the investment manager, custodian, prime broker, portfolio brokers, placement agents and other service providers, both in terms of description and with some periodic historic quantification of amounts paid to each category and benefits received (to address conflict-of-interest, transparency and fraud issues). This requirement will help assure that investors know to whom their money is being paid and the relationships involved.

Clear disclosure of investment allocation policies (to address conflict-of-interest, transparency and fraud issues). Investors should be told how an adviser with multiple funds and multiple clients determines how to allocate investment opportunities that arise.

Adoption of written supervisory and compliance policies and procedures and code of ethics. This is consistent with the Commission's recent emphasis on compliance policies and procedures and codes of ethics for registered investment advisers and investment companies and will help assure that appropriate controls are in place to safeguard investors and assure compliance with applicable laws.¹⁶

Clear, objective and transparent valuation standards, that are clearly disclosed, not stale, and subject to audit, for use in calculating current unit values for

¹⁶ See 17 C.F.R. § 275.206(4)-7; see also *In the Matter of Robert T Littell and Wilfred Meckel*, IA Rel. 2203 (Dec. 15, 2003) ("failure to supervise" enforcement decision citing failure of unregistered adviser to hedge fund to have supervisory program in place).

investor reports, admissions and withdrawals and calculations of performance and volatility information (to address valuation, transparency and fraud issues.) This element is critical to addressing the concerns raised in the Proposed Rule¹⁷ about hedge fund misvaluations. A hedge fund manager would be required to certify to its valuation standards, which should be clear, objective, and transparent, and clearly disclosed to investors and subject to audit by the fund's independent auditors.

Because the above proposal does not contemplate registration under the Investment Advisers Act, it should be made clear that a hedge fund manager's election of the new contingent exemption would *not* constitute registration under the Act for the purposes of ERISA. Thus, pension fund assets would continue to be managed primarily by registered investment advisers.

Coordination with Other Agencies

The Commission correctly notes that it is the only agency that has direct statutory responsibility to safeguard the nation's securities markets and the investors therein.¹⁸ However, the Proposed Rule makes only a slight attempt¹⁹ to analyze the information about hedge funds that exists – or will soon exist – at other Federal agencies. While it is true that other agencies, principally the Commodity Futures Trading Commission (“CFTC”), uses its information for purposes different than that of the SEC, that does not mean that the data collected by the CFTC is not of use to the SEC in achieving its objectives under the Investment Advisers Act. Moreover, the Department of the Treasury, through its Financial Crimes Enforcement Network, has proposed regulations that would bring hedge funds into compliance with the requirements of the USA Patriot Act. These regulations²⁰ would require hedge funds to provide significant amounts of information to FinCEN, including much of the information that would be required to be provided to the SEC under its proposed rule.

We believe it will serve the interests of investors, as well as the industry, if the Commission can work with other Federal agencies to determine what information can be obtained from these other sources and develop appropriate mechanisms for regular sharing of that information. We recommend that, within 180 days of the final adoption of the Proposed Rule in any form, the SEC and CFTC enter into a Memorandum of Understanding with respect to regular information exchange on hedge funds. We also recommend that the SEC and Department of Treasury enter into a similar Memorandum of Understanding no more than 180 days after final approval of the Treasury's proposed rules under the USA Patriot Act.

¹⁷ 69 Fed. Reg. at 45179

¹⁸ *Id.* at 45177.

¹⁹ *Id.* at 45181.

²⁰ Department of the Treasury. Financial Crimes Enforcement Network; Anti-Money Laundering Program for Unregistered Investment Companies. RIN 1506-AA26. 67 Fed. Reg. 60617 (Sept. 26, 2002) (unregistered investment companies); RIN 1506-AA28, 68 Fed. 23646 May 5, 2003) (AML programs for investment advisers).

Exemptions for Private Equity and Venture Capital Funds

The Commission has stated that it designed its proposed rule to exempt certain types of funds – most notably private equity funds and venture capital funds – from registration.²¹ While the characteristics of these funds, in the aggregate, are somewhat different from hedge funds, many of the underlying concerns expressed by the Commission as a basis for registering hedge funds also apply to these types of fund as well. Specifically, the Commission’s concerns over valuations – expressed at length in the proposing release²² – are particularly on point for both private equity and venture capital funds, the securities of which tend to be illiquid and, therefore, their value is determined by less than transparent methodologies.

We also question basing a continuing exemption from registration solely upon a “redeemability” requirement.²³ Many hedge funds already adopt lock-up requirements on investors that are close to the two-year threshold for continued exemption from registration. For many hedge fund managers, it would not be difficult to obtain the consent of investors who have already agreed to one-year or eighteen month lock-ups to extend that period to two years. It is also not clear why the Commission feels compelled to make this distinction between unregistered advisers in the first place. However, if the Commission is intent upon continuing the exemption for some private funds, it should do so based upon the investment characteristics²⁴ of the fund in addition to lock-up periods and require a certification from the exempt fund managers that it complies with the contours of the exemption.

Conclusion

Too little regulation or too much regulation of hedge funds can be damaging to the capital markets and to investors. Striking the right balance is the challenge we all face. These suggested conditions to a continued safe harbor exemption from registration impose significant new disclosure and investor protection requirements that should address the major concerns identified in the SEC’s proposed rulemaking.

Thank you for this opportunity to provide these comments and recommendations.

Sincerely,


JAMES CHANOS
President
Kynikos Associates LP

²¹ 69 Fed. Reg. at 45184-85.

²² *Id.* at 45179.

²³ *Id.* at 45184.

²⁴ The description of both private equity funds and venture capital funds at n. 142 and n. 143 of the Proposed Rule (69 Fed. Reg. at 45184) could provide a sample basis for such criteria.

TESTIMONY OF JAMES CHANOS
PRESIDENT
KYNIKOS ASSOCIATES, LP

U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
HEARING ON REGULATION OF THE HEDGE FUND INDUSTRY

JULY 15, 2004

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee. My name is James Chanos and I am the President of Kynikos Associates, a New York private investment management company that I founded in 1985.¹ I am honored to have the opportunity to participate in today's hearing on proposed regulation of the hedge fund industry. I would like to commend the Chairman and this Committee for undertaking a thorough review of all of the issues surrounding any new regulation of the hedge fund industry.

On behalf of our clients, Kynikos Associates manages a portfolio of securities we consider to be overvalued. The portfolio is designed to profit if the securities it has sold short fall in value. Kynikos Associates selects portfolio securities by conducting a rigorous financial analysis and focusing on securities issued by companies that appear to have an unsustainable or operationally flawed business plan, and/or appear to have materially overstated earnings and/or engaged in outright fraud. In choosing securities for its portfolios, Kynikos Associates also relies on the many years of experience in the equity markets that our team has accumulated.

While the term "hedge fund" originally was meant to describe a private investment company that is market-neutral, Kynikos Associates falls under a definition used today that encompasses almost any form of private investment fund that is not registered under the Investment Company Act of 1940.²

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

² For a more lengthy discussion of the definition of "hedge fund" see, for example *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission ("SEC Staff Report"), September, 2003, p.3; see also, *White Paper on Registration of Hedge Fund Advisors under the Investment Advisors Act of 1940*, Managed Funds Association, July 7, 2003; p.4-5 ("MFA White Paper")

No longer a “cottage” industry, the hedge fund industry includes an estimated 6,000 funds with assets under management of approximately \$800 billion – and growing. This growth, and the importance of hedge funds to investors and to the capital markets more broadly, has focused debate on the adequacy of the existing regulatory framework governing hedge funds.

There is little question that hedge funds play a vitally important role in the U.S. capital markets. That role has been acknowledged by Federal Reserve Board Chairman Alan Greenspan, the President’s Working Group on Financial Markets, the Chairman of the Commodity Futures Trading Commission, and most recently, by the Securities and Exchange Commission itself.

With that important role comes a responsibility on the part of the hedge fund industry to the legitimate public policy needs of the Federal Government. While any new regulation should be considered cautiously and carefully, we, in the industry, have a responsibility not to simply reject the idea of regulation outright. Instead, we should consider the basis upon which the government, or more accurately, the Commission, is proposing new regulation.

There are two opposite positions in the debate on hedge fund regulation, and, so far, both sides have talked past each other more than to each other. At one end of the spectrum are those who maintain that any government scrutiny is unwarranted and undeserving of consideration – a position that does not accurately reflect the economic influence of the hedge fund industry. At the other end are those who argue that hedge funds and their advisers should be subject to the full panoply of Investment Company Act and Investment Advisers Act regulation. This position ignores the unique characteristics of hedge funds and their investors and would place unnecessary burdens on the industry, undermining the benefits hedge funds provide to the capital markets. It also would divert the resources of the SEC from the inspection of registrants who more directly impact retail investors.³

There is a middle ground. Today, I would like to offer a framework that falls between these two positions and which is designed to address the important public policy goals articulated by the SEC. Our proposal seeks to achieve these goals in a simpler and

³See, for example, the concerns expressed by the U.S. Senate Committee on Banking, Housing, and Urban Affairs on passage of what later became the National Securities Markets Improvement Act of 1996: “The Committee is concerned about the lack of adequate oversight of the growing number of investment advisers and the impact inadequate regulation may have on investors and American consumers. This is particularly troublesome since many investment advisers hold themselves out to the public as ‘REGISTERED WITH THE SEC,’ a statement that may give investors a false sense of confidence--particularly if the investment adviser has never actually been inspected by the SEC and is in little danger of any imminent inspection.” Senate Report 104-293, accompanying passage of S.1815, “The Securities Investment Promotion Act of 1996,” (June 26, 1996.)

less burdensome manner than envisioned under the SEC proposal, which would require registration of most hedge fund managers.

While the Commission has proposed registration and regulation of hedge fund managers under the Investment Advisers Act, we suggest that the current exemption under Section 203(b)(3) of the Investment Advisers Act for advisers with less than 15 clients be retained, but that the SEC, by rule, impose a series of conditions designed to obtain the information on hedge funds it needs and which will help protect investors from potential abuse.

We believe our suggestion, first made at the SEC's Roundtable on Hedge Funds in May of 2003, will reduce the risk of undue reliance by investors on SEC oversight, conserve important SEC resources, and reduce the risk that registration will grow, over time, into a creaky and burdensome form of regulation that robs the capital markets of the innovations, insights, liquidity and efficiencies that the hedge fund industry currently brings.

The 2003 SEC Staff Report ("SEC Report") described the need for the SEC to "collect basic and meaningful information about the activities of hedge fund advisers and hedge funds, which are becoming increasingly influential participants in the U.S. financial markets."⁴ We agree that the SEC should have this information. All hedge fund managers that are not otherwise registered with the SEC or CFTC should provide the SEC, on an initial basis and periodically thereafter, certain basic information to enable the SEC to understand who they are, where they are, who runs them, what they do, and the amount of assets under management.

The SEC Report also stated that the SEC should "require hedge fund advisers to disclose information about issues important to investors, such as conflicts arising from side-by-side management of hedge funds and other client accounts and hedge fund advisers' relationships with prime brokers."⁵ We fully support such disclosures to investors – and more, including disclosure of financial arrangements with all interested parties, and disclosure of investment allocation policies and valuation standards.

Further, the SEC Report recommended that the minimum investment requirement for direct investments in certain hedge funds be raised.⁶ If, in the future, the SEC decides to move forward with this recommendation, we would support it as well. Hedge funds are a unique investment vehicle. They never were intended as an alternative to other forms of more regulated investment vehicles for investors who cannot afford to bear the risk.

The SEC yesterday proposed that most hedge fund managers must register with the SEC as investment advisers in order to subject them to regular SEC inspections and

⁴ SEC Staff Report at xi-xii.

⁵ Id. at xii.

⁶ Id.

examinations.⁷ While we strongly support the SEC's objectives, we respectfully disagree with its proposed approach. We challenge the notion that the SEC, even with an expanded examination staff, could effectively inspect and examine the thousands of additional investment advisers that would result from requiring registration of hedge fund managers, and at the same time fulfill the SEC's responsibilities to examine the many thousands of registered advisers for which it now has responsibility. We propose what we believe is a better means to achieving the SEC's goals. In brief:

Instead of using investment adviser registration as a means to gain regulatory control over hedge fund managers, we recommend that the SEC, by rule, make the exemption enjoyed by hedge fund managers under Section 203(b)(3) of the Investment Advisers Act of 1940⁸ and SEC rules 203(b)(3)-1 and 222-2 under the Act (17 C.F.R. §§ 275.203(b)(3)-1 & 275.222-2)⁹ contingent upon written receipt by the SEC of basic information about the fund, its operations and its managers, including:

- Name of the Fund, address and telephone number(s);
- Name of Chief Compliance Officer and telephone number of said person; and,
- Total Assets under management at the end of the most recent calendar month preceding notice.

Further, the manager of the fund would be required to provide a certification of the following:

- Minimum investor qualifications at or above current accredited investor levels (to be established by the SEC; to address the retailization issue);
- Minimum threshold of assets under management (to be established by the SEC);
- Custody of private investment fund assets in an identified broker-dealer or bank and compliance with SEC interpretations on constructive custody (to address misappropriation of assets, fraud and transparency issues);
- Annual audit and delivery of financial statements to investors, with the audit conducted by an accounting firm that would be independent from the hedge fund manager under the SEC's auditor independence rules (to address fraud and transparency issues);
- Quarterly unaudited financial reports to investors (to address transparency issue);

⁷Agenda for SEC Open Meeting, July 14, 2004: Registration Under the Investment Advisers Act of Certain Hedge Fund Advisors.

⁸ Section 203(b)(3) exempts from the registration requirements of the Act advisers that have had fewer than 15 clients during the preceding 12 months and do not hold themselves out to the general public as investment advisers or serve as an investment adviser to a registered investment company.

⁹ SEC Rule 203(b)(3)-1 under the Act defines "client" of an investment adviser and provides that an adviser may count a legal organization (which would include a hedge fund) as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual investment objectives of its owners.

- Clear disclosure of financial arrangements with interested parties such as investment manager, custodian, prime broker, portfolio brokers, placement agents and other service providers, both in terms of description and with some periodic historic quantification of amounts paid to each category and benefits received (to address conflict-of-interest, transparency and fraud issues);
- Clear disclosure of investment allocation policies (to address conflict-of-interest, transparency and fraud issues);
- Adoption of written supervisory procedures; and
- Clear, objective and transparent valuation standards, that are clearly disclosed, not stale, and subject to audit, for use in calculating current unit values for investor reports, admissions and withdrawals and calculations of performance and volatility information (to address valuation, transparency and fraud issues).

We emphasize the importance of this last element, which we believe is critical to addressing the concerns raised by Chairman Donaldson concerning hedge fund mis-valuations – concerns that we share. Among the required certifications in our proposal, a hedge fund manager would be required to certify to its valuation standards, which should be clear, objective, and transparent, and clearly disclosed to investors and subject to audit by the fund’s independent auditors.

As part of its rulemaking, we believe the SEC should provide that no certification would be needed if the fund manager or fund is currently registered with the Commodity Futures Trading Commission under the Commodity Exchange Act as either a Commodity Pool Operator or a Commodity Trading Adviser. Within 180 days from the promulgation of final rules to this effect, the SEC and CFTC should sign a memorandum of understanding to allow the sharing of information between the agencies on hedge funds.

For consistency with the current Federal/State division of authority adopted under the National Securities Markets Improvement Act of 1996, hedge fund managers who have \$25 million or more under management who choose this qualified exemption should not be subject to state adviser registration.

Because the above proposal does not contemplate registration under the Investment Advisers Act, it should be made clear that a hedge fund manager’s election of the new contingent exemption would *not* constitute registration under the Act for the purposes of ERISA. Thus, pension fund assets would continue to be managed primarily by registered investment advisers.

Lastly, we believe that mandatory registration may create a false sense of security amongst investors that could cause them to lessen their own due diligence in favor of SEC regulation. Our proposal avoids this unintended consequence.

Too little regulation or too much regulation of hedge funds can be damaging to the capital markets and investors. Striking the right balance is the challenge we all face. These suggested conditions to exemption impose significant new disclosure and investor protection requirements that should address the major concerns identified in the SEC proposed rulemaking.

Chairman Shelby, these hearings can play the pivotal role in this debate. During consideration of the Investment Advisors Act in 1940, Banking Committee Chairman Robert Wagner, noted that an impasse had developed between an unregulated industry – the investment advisors – and the Commission. He stated, however, that “at the conclusion of the hearings...representatives of the investment advisor organizations and the Securities and Exchange Commission, at the suggestion of the subcommittee, conferred with a view to drafting proposals which would have the support of the [industry] and the Commission...”¹⁰ Sixty-four years ago, the Commission and the industry met that challenge from Congress. I believe that we can achieve the same today.

¹⁰ Senator Robert Wagner, Congressional Record, p. 10076; August 8, 1940.

JAMES CHANOS
President, Kynikos Associates

PREPARED STATEMENT

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

Panel Discussion: "Hedge Fund Strategies and Market Participation"
Thursday, May 15, 2003

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

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

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

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

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

Following a brief discussion of the general benefits of short selling, I wish to address, in the strongest manner, my belief, which is borne out by testimony, experience and empirical analysis, that short selling is beneficial to the markets not only in the technical aspects of providing liquidity or a hedge against long positions, but also as an important bulwark against hyperbole,

irrational exuberance, and corporate fraud. As Bernard Baruch said nearly ninety years ago: "To enjoy the advantages of a free market, one must have both buyers and sellers, both bulls and bears. A market without bears would be like a nation without a free press. There would be no one to criticize and restrain the false optimism that always leads to disaster."²

Who Sells Short?

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

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

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

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

Regulatory Requirements and Economic Costs of Short Selling

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

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

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

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

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

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

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

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

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

Short Sellers as Financial Detectives⁴

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

The public benefit from the "short" side of the market is less well understood, but no less

valuable. As Edward Chancellor, the noted expert in the history of finance, wrote in 2001, "we need more, not less, shorting activity if, in the future, we are to avoid wasteful bubbles, such as the recent technology, media and telecoms boom."⁵

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

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

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

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

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

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

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

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

In testimony presented to Congress in 1989, the SEC's Associate Director of Enforcement, John

Sturc, was even more pointed in dissecting the underlying reasons that issuers and others complain about short sellers. Mr. Sturc outlined five reasons that the SEC "frequently finds that the complaints of downward manipulation that we receive from issuers or their affiliates do not lead to sustainable evidence of violations of the antifraud provisions of the federal securities laws" including:

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

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

An Example of Research Based Short Selling: Enron¹⁰

It may be useful for the Commission to understand some of the mechanics of research based or informationally motivated short selling. I have received a fair amount of attention for Kynikos' early negative views of the Enron Corporation and it may be useful to provide the Commission and public with one example of why and how a short seller develops his investment view.

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

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

The first Enron document my firm analyzed was its 1999 Form 10-K filing, which it had filed with the SEC. What immediately struck us was that despite using the "gain-on-sale" model, Enron's return on capital, a widely used measure of profitability, was a paltry 7 percent before taxes. That is, for every dollar in outside capital that Enron employed, it earned about seven cents. This is important for two reasons; first, we viewed Enron as a trading company that was

akin to an "energy hedge fund." For this type of firm, a 7 percent return on capital seemed abysmally low, particularly given its market dominance and accounting methods. Second, it was our view that Enron's cost of capital was likely in excess of 7 percent and probably closer to 9 percent, which meant from an economic point of view, that Enron wasn't really earning any money at all, despite reporting "profits" to its shareholders. This mismatch of Enron's cost of capital and its return on investment became the cornerstone for our bearish view on Enron and we began shorting Enron common stock in November of 2000 for our clients.

We were also troubled by Enron's cryptic disclosure regarding various "related party transactions" described in its 1999 Form 10-K, as well as the quarterly Form 10-Qs it filed with the SEC in 2000 for its March, June and September quarters. We read the footnotes in Enron's financial statements about these transactions over and over again and we could not decipher what impact they had on Enron's overall financial condition. It did seem strange to us, however, that Enron had organized these entities for the apparent purpose of trading with their parent company, and that they were run by an Enron executive. Another disturbing factor in our review of Enron's situation was what we perceived to be the large amount of insider selling of Enron stock by Enron's senior executives. While not damning by itself, such selling in conjunction with our other financial concerns added to our conviction.

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

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

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

In the summer of 2001, energy and power prices, specifically natural gas and electricity, began to drop. Rumors surfaced routinely on Wall Street that Enron had been caught "long" in the power

market and that it was being forced to move aggressively to reduce its exposure in a declining market. It is an axiom in securities trading that no matter how well "hedged" a firm claims to be, trading operations always seem to do better in bull markets and to struggle in bear markets. We believe that the power market had entered a bear phase at just the wrong moment for Enron.

Also in the summer of 2001, stories began circulating in the marketplace about Enron's affiliated partnerships and how Enron's stock price itself was important to Enron's financial well-being. In effect, traders were saying that Enron's dropping stock price could create a cash-flow squeeze at the company because of certain provisions and agreements that it had entered into with affiliated partnerships. These stories gained some credibility as Enron disclosed more information about these partnerships in its June 2001 Form 10-Q, which it filed in August of 2001.

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

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

Is There a Need for Regulatory Change?

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

A. Short Selling

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

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

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

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

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

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

B. Hedge Funds

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

In his April 10th testimony, the Chairman identified "retailization" of hedge funds as a problem.¹³ From a business perspective, I know that I am not comfortable soliciting funds from individuals who simply meet the minimum criteria of the Regulation D/accredited investor/3(c) (1) exemption of either \$200,000 in annual income or \$1 million in net worth. As a business practice, I do not find that I can make a presumption that an individual or business entity that meets those criteria is sufficiently knowledgeable about the risks associated with Kynikos' investment strategy to make an informed decision. Short selling is an inherently risky

proposition. Profits are limited to a maximum of 100% of the proceeds on the date of sale; losses, however, can be infinite, depending on how high the stock price moves after the sale. Private investment companies like Kynikos also set different rules for withdrawal of funds than do most mutual funds or other traditional money managers. I do not want someone who is not able to tolerate these risks to invest with me. It is simply not good business. Therefore, the prerequisites for investing in our funds are much more stringent than they are for these other managed investment vehicles.

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

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

In addition to the NASD's recent move to improve broker-dealer suitability standards for sales of hedge funds, additional steps can be taken to keep investors limited to those who can understand and bear the risks associated with private investment funds. One such step would be setting a higher minimum investor qualification standard than the current "accredited investor" definition. This could include both a higher net worth and a limit to an investment in a fund to a percentage of that net worth (some states, such as California and North Carolina, historically have used a cap on privately placed investments at 10% of the investor's net worth as a rough benchmark or limit, while others have used a 20% limit).

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

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

One simple means to address these issues would be to impose some basic prudential restrictions on hedge funds that wish to rely upon the regulatory exemptions from investment adviser registration--17 C.F.R. §§ 275.203(b)(3)-1 & 275.222-2 (which treat a private investment fund as a single "client" of the manager for purposes of determining whether the manager has 15 or more clients and is thus subject to registration and regulation under the Investment Advisers Act). The

rule could be amended to require a "look through" to count the investors in the fund if the fund does not meet certain basic investor qualification and investor protection requirements such as:

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

Simple, basic standards on each of the above points could be added to Advisers Act Rule 275. 203(b)(3)-1(a)(2)(i) as a condition to reliance on the "single client" treatment of a private investment fund. Those investment managers who operate investment funds that meet these standards would be allowed to treat the fund as a single "client" and thus continue to avoid registration under the Advisers Act. It may be appropriate to exempt family partnerships, family trusts, and gift & estate situations and "knowledgeable employee" funds from these requirements (to mirror exemptions contained in current Investment Company Act §§ 2(a)(51)(A)(ii) & (iii); 17 C.F.R. §§ 270.3c-5, 270.3c-6 on the grounds that these types of closely-held arrangements do not involve marketing to unrelated investors). Investment managers that operate private investment funds that do not meet these standards would be required to look through the investment fund and treat each of its investors as a "client", thus subjecting the investment manager to registration, SEC examination and regulation under the Investment Advisers Act.

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

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

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- 1 Prior to founding Kynikos Associates, I was a securities analyst at Deutsche Bank Capital and Gilford Securities. My first job on Wall Street was as an analyst at the investment banking firm of Blyth Eastman Paine Webber, a position I took in 1980 upon graduating from Yale University with a B.A. in Economics and Political Science.
 - 2 Bernard Baruch, testimony before the Committee on Rules, House of Representatives, January 1917.
 - 3 Dechow, P., A. Hutton, L. Meulbroek, R. Sloan. "Short Sellers, fundamental analysis and stock returns," Working Paper. Harvard Business School, University of Michigan Business School. May 1999. Pages 3-4.
 - 4 See Alex Berenson, *The Number: How the Drive for Quarterly Earnings Corrupted Wall Street and Corporate America*. Chapter 9, "Detectives and Archeologists." Random House. 2003.
 - 5 Edward Chancellor, "A Short History of the Bear." Guest Analysis, www.theprudentbear.com, October 29, 2001. Page 6.
 - 6 Asquith, P. and L. Meulbroek, 1996. An empirical investigation of short interest. Working paper (Harvard University, Boston, MA.)
 - 7 "If Short Sellers Take Heat, Maybe It's Time to Bail Out," Gretchen Morgenson, *The New York Times*, January 26, 2003.
 - 8 I. Pollack, *Short Sale Regulation of NASDAQ Securities* (1986); see Prepared Statement of Richard G. Ketchum, Director, Division of Market Regulation and John H. Sturc, Associate Director, Division of Enforcement, Securities and Exchange Commission, Before the House Committee on Government Affairs, Subcommittee on Commerce, Consumer, and Monetary Affairs, December 6, 1989.
 - 9 Prepared Statement of Richard G. Ketchum, Director, Division of Market Regulation and John H. Sturc, Associate Director, Division of Enforcement, Securities and Exchange Commission, Before the House Committee on Government Affairs, Subcommittee on Commerce, Consumer, and Monetary Affairs, December 6, 1989. Pages 434-435
 - 10 This section of testimony is drawn largely from testimony that I presented before the Committee on Energy and Commerce, United States House of Representatives, "Lessons Learned From Enron's Collapse: Auditing the Accounting Industry," February 6, 2002.
 - 11 See, for example, Edward Chancellor, "A Short History of the Bear." Guest Analysis, www.theprudentbear.com, October 29, 2001.

- 12 Oral Testimony of John H. Sturc, Associate Director, Division of Enforcement, Securities and Exchange Commission before the Committee on Government Operations, Subcommittee on Commerce, Consumer, and Monetary Affairs, U.S. House of Representatives, December 6, 1989.
- 13 Testimony of William J. Donaldson, Chairman, Securities and Exchange Commission; Senate Banking Committee; April 10, 2003.