

Testimony of

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TESTIMONY BEFORE THE  
SENATE COMMITTEE ON THE JUDICIARY  
"HEDGE FUNDS AND INDEPENDENT ANALYSTS: HOW INDEPENDENT ARE THEIR RELATIONSHIPS?"  
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## I. INTRODUCTION

As the largest and most diverse U.S.-based association representing the hedge fund industry, Managed Funds Association ("MFA") is pleased to provide this testimony to the Senate Committee on the Judiciary for the hearing "Hedge Funds and Independent Analysts: How Independent Are Their Relationships"?

The hedge fund industry has experienced significant growth in recent years, with assets under management estimated at \$1.5 trillion. MFA believes this is a direct result of the demand, largely from institutional investors, for investment vehicles that offer a diversity of investment styles and help them meet their future funding obligations and other investment objectives. As former Federal Reserve Chairman Alan Greenspan has noted, hedge funds have "become increasingly valuable in our financial markets." Hedge funds enhance market liquidity and contribute to pricing efficiency and market stability. Hedge funds also foster financial innovation and risk sophistication among the market participants with which they deal. As discussed later in this testimony, hedge funds' ability to deliver these benefits to the financial marketplace depends in large measure on their ability to engage in short sales and related activities.

MFA recognizes that with the growth and evolution of the hedge fund industry have come new responsibilities and challenges. The hedge fund industry and policy makers currently face an important challenge, namely to preserve the benefits offered by hedge funds while addressing legitimate investor protection and market integrity issues presented by the growth in hedge fund investments. MFA is committed to meeting these industry challenges.

Background on MFA. Founded in 1991, MFA is the U.S.-based global membership organization dedicated to serving the needs of the professionals who specialize in the alternative investment industry. MFA's over 1,000 members include professionals in hedge funds, funds of hedge funds and managed futures funds. MFA members manage a substantial portion of the estimated \$1.5 trillion invested in these investment vehicles. Members include representatives of a majority of the 50 largest hedge funds groups in the world. The larger hedge fund managers represented within MFA collectively manage in excess of \$500 billion in assets and pursue a wide range of investment strategies.

As further explained below, MFA's activities include educational outreach to and representation before the U.S. Congress, the Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC"), Federal Reserve Board, U.S. Department of the Treasury, state legislatures, and international regulatory agencies. MFA also participates in a number of private sector initiatives, including development of industry sound practices, participation in Treasury-sponsored advisory committees, and work with the major dealers in improving credit derivative market practices.

## II. OVERVIEW OF HEDGE FUNDS AND THEIR STRATEGIES

**Definition of hedge fund.** The term "hedge fund" is not a defined term under the federal securities laws, but it is used generally to connote a private investment fund that is not required to register as an investment company under the Investment Company Act of 1940 (the "Investment Company Act"). It is thus a term that is susceptible of meaning different things to different people. In general, and for purposes of this testimony, MFA considers a "hedge fund" to be a privately offered investment company that is administered by a professional investment manager that seeks attractive absolute return, typically through investments and trading in publicly traded securities and other interests. In this regard, hedge funds are similar to venture capital, private equity, leveraged buyout, oil and gas, and real estate funds, although MFA does not intend to capture them within its definition of "hedge fund."

**Size.** Because of the non-public nature of hedge funds, there is no universally accepted estimate on the size of the hedge fund universe. MFA believes it consists of 5,000 to 7,000 funds with total assets of approximately \$1.5 trillion. A small number of these hedge funds are part of large organizations with aggregate invested assets of over \$1 billion and performance records extending 10 years or more. At the other end of the marketplace, there are thousands of small firms managing hedge fund assets under \$50 million each, many of them relative newcomers to the industry.

**Investment profiles.** As noted above, hedge funds are more easily defined in relation to what they are not. They are investment companies that are not publicly offered. The hedge fund universe is characterized by a wide variety of strategies, with different risk characteristics and different return expectations. Many hedge funds managers engage in "absolute return" strategies, meaning that their returns do not depend on, nor are they benchmarked against, the long-term return of the markets or the assets in which they invest. In other words, hedge funds seek to achieve positive returns based on the skill or strategy of the manager rather than to meet or exceed the performance of the underlying market or asset class. Many hedge fund strategies employ "enhanced active management," in which managers combine traditional active management with techniques such as short selling and leverage. Some hedge fund strategies may not be based on traditional techniques at all, such as risk arbitrage, convertible hedging, and distressed debt.

Major hedge fund investment strategy classifications include the following:

- ? Long/short strategies for trading in equities.
- ? Dedicated short sale equity strategies focusing on selling short securities that are deemed to be overvalued.
- ? "Macro" or global directional investment strategies, which take positions in domestic and international currency, interest rate and equity markets based on global economic conditions and opportunities perceived to be presented by them.
- ? "Market-neutral," "relative value," or arbitrage strategies, which take offsetting long and short positions or otherwise hedged positions to reduce market risk and utilize leverage to achieve desired returns.
- ? Event-driven strategies, which seek to profit from anticipated events or special situations, such as mergers, restructurings, distressed securities.
- ? Regional strategies, which concentrate on a particular geographic region (such as emerging markets).
- ? Sectoral strategies, which focus on a particular industry.
- ? Long only, or "buy and hold", equity strategies, similar to traditional equity mutual fund strategies, but which may also include active efforts to become involved in the management of holdings.
- ? Specific asset class strategies (such as currencies, commodities, interest rates).

The significance of this broad array of strategies should not be underestimated, as it reflects the increasing segmentation of the hedge fund industry, and with that the growing segmentation of risk. Today's hedge fund industry is thus actually comprised of many sub-industries, with separate and distinct pockets of risk. Each strategy can prudently withstand different levels of leverage, and each strategy has a different time horizon for investment and varying levels of volatility. The diversity of strategies employed by hedge funds also presents important considerations for policymakers seeking to accurately understand the scope of potential challenges as well as the efficacy of potential remedies.

## III. BENEFICIAL ROLE OF HEDGE FUNDS IN CAPITAL MARKETS

**Diversification for institutional investor.** Much of the growth in hedge funds since the 1980's can be attributed to the increasing recognition by sophisticated investors that hedge funds can help diversify returns and thereby reduce the overall risk of an investment portfolio. The majority of direct investment in hedge funds by institutional investors has come from endowments and foundations. From 2004 to 2005, endowments increased their hedge fund allocations from 7.3% to 8.7% on average.

According to a study by the Bank of New York, "the hedge fund industry is midway through an important transition in its source of capital."

Five years ago, hedge funds derived virtually all of their assets from wealthy individuals. Institutional interest was limited to a small number of endowments and foundations. Over the next five years, institutions (including pension funds) are likely to provide an additional \$250 billion of hedge fund capital, accounting for 35 percent of net new flows in this period.

Corporation and public pension plan investments in hedge funds continue to grow, both through direct investments and through fund-of-hedge-funds vehicles. Former Federal Reserve Chairman Alan Greenspan has noted that these inflows may be attributed to institutional investors seeking alternatives to long-only investment strategies in the wake of the bursting of the equity bubble in 2001.

These institutional investors understand that hedge funds provide attractive mechanisms for portfolio diversification because hedge funds' absolute returns tend to have little or no correlation to those of more traditional stock and bond investments. Many hedge fund categories may therefore outperform stock and bond investments when the latter perform poorly. Investment in hedge funds can thus help diversify risk in many institutional investment portfolios. Drawdowns in individual hedge funds -- largest drop from peak value to trough value -- are often less than in publicly traded indices. Academic research recognizes that hedge fund investments can reduce overall risk of investment portfolios for investors such as endowments and public and private pension plans.

Source of liquidity. As active trading participants in international capital markets, hedge funds add depth and liquidity to markets. This characteristic of hedge funds has been recognized by commentators including former Federal Reserve Chairman Alan Greenspan. He testified before the Senate Banking Committee in 2004, "it's so important that [hedge funds] are left free to supply the extent of liquidity that they are supplying to our financial markets. ... [T]he degree of flexibility in our economy has been instrumental in enabling us to absorb the shocks which have been so extraordinary in recent years. One of the most successful parts of our system is our ability to absorb financial shocks."

Increase in efficiency. By trading on the basis of sophisticated and extensive market research, hedge funds provide markets with price information that translates into pricing efficiency. In targeting temporary price inefficiencies and market dislocations, hedge funds effectively help to minimize market distortions and eliminate these dislocations. The President's Working Group described this function as follows:

Hedge funds and other investors with high tolerance for risk play an important supporting role in the financial system in which various risks have been distributed across a broad spectrum of tradable financial instruments. With financial intermediation increasingly taking place in the capital markets instead of banking markets, prices play a larger role in the allocation of capital and risk. In this world, investors such as hedge funds that undertake a combination of long and short positions across markets help maintain the relative prices of related financial instruments.

Decrease in volatility. The increase in hedge fund growth has coincided with a decrease in overall market volatility. This may be due to the added liquidity that hedge funds provide to the market. This may also result from the fact that hedge funds generally eschew the "momentum trading" that many individual investors engage in. Because hedge fund investors generally have accepted longer redemption horizons, hedge funds have fewer incentives to engage in momentum trading. By contrast, more traditional investors, such as mutual funds, are more likely to buy into rising markets and sell into falling markets as a result of purchases and redemptions by individual retail investors, accentuating market volatility.

#### IV. BENEFICIAL ROLE OF SHORT SELLING IN CAPITAL MARKETS

In periods of bear markets, as has been true from time to time recently, the topic of short selling becomes controversial, particularly among those who have an interest in seeing market prices rise. Critics of short selling practices often claim that short-sellers unfairly collude to drive down stock prices, but academic research has not linked market declines to any single trading strategy or concluded that short selling drives prices to levels they would not otherwise reach on the basis of issuer fundamentals or other, exogenous factors.

The fact is that short sellers, by expressing negative views on particular stocks, tend to dampen what may be irrationally positive market perceptions. They contribute to liquidity and to price formation, which are fundamental to

market efficiency and to free-market pricing of assets. Those whose investments lose value when prices decline are counterbalanced by those who can buy at the reduced prices and whose buying pressure tends to restore market equilibrium. By targeting companies whose financial positions -- or whose accounting -- is shaky, short sellers identify and stigmatize the bad actors, many of whom, like the former Chairman of Enron Corporation, complain about the "shorts" as the engine of their downfall, a myth his criminal trial exploded:

The trial underscores that neither defendant fully accepted what happened at the company. Mr. Lay testified that the collapse was largely caused by short sellers, critical articles in The Wall Street Journal, and a resulting panic in the marketplace.

But short selling, negative press and market concerns are issues that scores of companies deal with every year, without collapsing. Indeed, to some degree, Mr. Lay's argument was a bit like blaming a match for igniting a basement filled with gasoline. In this case, the accelerant was the poor condition of Enron's financial structure. As Edward Chancellor 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."

MFA believes that there is no demonstrated need to further restrict short-selling or to tilt the playing field further toward the long side by implementing additional restrictions on short-sellers. Many hedge funds engage in investment strategies that involve short-selling, such as long/short strategies -- buying some securities "long" and selling other securities "short", but these strategies are by no means confined to hedge funds. Many other market participants engage in them as well. Consequently, if a re-examination of short-selling were to be undertaken, MFA believes that it should be undertaken by the Division of Market Regulation of the SEC, the Federal Reserve, the Commodity Futures Trading Commission and the Treasury, in consultation with representatives of the industries that would be impacted by increased regulation.

MFA believes that short selling is not only a legitimate investment activity, but one that plays an important role in improving market efficiency and price discovery. By allowing market participants to place short positions on particular securities that they believe to be over-valued, the existing regulatory scheme allows investors not only to protect their own investment portfolios, but also to reduce market volatility and help bring asset valuations back into line. As noted above, short-selling serves as an important counter balance to "bubble" markets and the long biases of other market participants. In several recent cases, hedge funds have acted indirectly as "whistle-blowers" by engaging in short-selling, the validity of which was later borne out by discoveries of fraud or other misconduct by the issuers concerned.

The research done by academic economists tends to confirm that short selling contributes to the health of the markets and that the companies that complain most bitterly about short selling are often the companies most in need of governmental investigation and possibly prosecution:

The evidence on subsequent stock returns suggests that in public battles between short sellers and firms, short sellers usually are vindicated by subsequent events. The evidence suggests that short sellers play an important role in detecting not just overpricing, but also fraud. Policy makers might want to consider making the institutional and legal environment less hostile to short sellers.

The prospect of additional regulation of short selling raises fundamental market issues that go far beyond those related to the trading activities of hedge funds. It potentially affects the efficiency and volatility of U.S. equity markets and the position of U.S. market participants in the world financial system. The adoption of additional short selling rules could constitute a rash and harmful overreaction to isolated incidents of alleged impropriety that would be better addressed under the existing anti-fraud provisions of the U.S. securities laws.

#### V. RECENT ALLEGATIONS OF ABUSES INVOLVING SHORT SALES AND THIRD-PARTY INFORMATION

Whether investment managers are investing on the long or short side, they have a fiduciary duty to their investors to consider all reasonably available information that might bear on the advisability of their decisions. Fortunately, we live in a time that a recent SEC chairman referred to as the "age of information," and information relevant to investment decisions is in fact available to investors from many sources, including sell-side and independent research, the financial press, "bloggers" and reports filed by public companies with the SEC. Another SEC commissioner many years ago compared the information available at any given time to pieces of a "mosaic" that would support an investment point of view if the individual pieces could be correctly assembled. For this effort to succeed, there must obviously be a robust supply of information from many sources, including those that express views that are at odds with prevailing sentiment.

Where available information leads some investors to take significant short positions in a public company's common stock, it sometimes occurs that the public company - particularly in the last few years - will allege that the short seller has been assisted by third parties in seeking to profit from the short position. For example, companies frequently allege that an investor has established a short position in a company's stock while feeding reports to the financial press that criticize the company's accounting or financial conduct. The allegations often extend to the feeding of such reports to bloggers and analysts, the posting of such reports on Internet message boards and to the investor's making direct contact with the SEC asking that it initiate an investigation (or direct contact with law enforcement authorities or even congressional committees).

Allegations of this kind are, of course, not new. A columnist in a well-known financial newspaper was sued with his publisher in the late 1970s for allegedly writing negative articles about a stock in order to enhance the value of certain investors' short positions in that stock. As so often happens, the plaintiffs' case fell apart for lack of evidence, leading the court a few years later to assess a total of \$76,000 in attorneys' fees against the plaintiffs for continuing the litigation in bad faith.

As discussed above, short sellers often turn out to be right in their allegations about public companies. MFA believes it would be a serious policy mistake to inhibit short sellers from continuing to perform the essential contrarian function described above and that it would raise serious constitutional issues to attempt to restrict short sellers' communications with third parties, including those referred above.

On the other hand, if an investor knows its allegations about a company are untrue, existing law and the SEC's rules provide a means for dealing with this conduct. As we have seen from the reverse situation of the "pump and dump" schemes -- which involve the dissemination of untrue or misleading favorable information about a company -- the SEC has ample authority under Exchange Act Rule 10b-5 and Securities Act Section 17(a) to take action against those responsible. Of course, unlike the "pump and dump" schemes, it is usually difficult to identify the source of negative information except by requiring the recipient of the information to reveal his or her sources - a step that often threatens to undermine constitutional and other important societal values.

If the investor's negative allegations turn out to be true (or if it develops at least that investor did not know the allegations to be false), the existence of a remedy is less clear. On the other hand, it is obvious that there may be little need for a remedy in such cases -- indeed, the short seller may deserve the market's thanks.

At the same time, persons who receive adverse information have their own responsibility to treat it with a degree of healthy skepticism. We assume that the SEC staff routinely asks "tippers" whether they have a short position or other source of bias, and we believe that responsible members of the press and securities analysts should do no less. In fact, we believe the financial press has been increasingly diligent over the past few years in identifying possible sources of bias of persons whom they quote as having positive or negative views on a stock.

In this connection, sell-side analysts, i.e., research analysts employed by member firms of the New York Stock Exchange or the NASD, are subject to those organizations' rules aimed at revealing conflicts of interest and otherwise enhancing the integrity of analyst research. Independent analysts are not subject to the same rules. The views expressed or reported by independent analysts are nonetheless part of the relevant mosaic, and users of independent research must make allowances for the fact that independent research is not subject to the same internal and external scrutiny and standards as research produced by securities firms.

It has been alleged, for example, that some independent analysts have delayed the release of a negative report to permit an investor to complete the accumulation of its short position. Depending on the nature of that analyst's relationship with his clients, such a delay may well raise questions such as whether the analyst has violated its duty to its clients in violation of the federal securities laws. If the analyst were employed by a member firm of the NYSE or NASD, of course, he or she would likely also face criticism by those organizations based at least on a departure from "just and equitable principles of trade."

We should not overlook allegations that plaintiffs who are about to bring a securities fraud class action against a public company sometimes "tip" an investor about the imminent filing of the action, giving the investors an opportunity to short the stock. In these situations, there may be no violation of Rule 10b-5 because the plaintiff and the short seller have violated no previously-recognized duties in making the "tip" and in shorting the stock. It has been

suggested that state law remedies may apply, but this is not at all clear. It may be more productive to focus on whether these situations raise questions about plaintiff's counsel's ethical violations, whether such conduct should be taken into consideration for purposes of a later motion for sanctions against plaintiff's counsel and whether such conduct should disqualify a plaintiff as "typical" for purposes of representing a class.

These allegations all raise serious ethical and legal questions. MFA unequivocally condemns the intentional spreading of false or misleading information. At the same time, there will be many cases where the facts and the law are not clear, and MFA believes -- as have so many during the preceding two centuries and more -- that the remedy in such cases should be "more speech." We urge that the Congress and the regulators follow this principle in dealing with those isolated situations where the applicability of current law and regulation may not be clear.

## VI. SEC REGULATION OF SHORT SELLING

The SEC has observed on many occasions that short selling can contribute to market liquidity and pricing efficiency: Short selling provides the market with two important benefits: market liquidity and pricing efficiency. Substantial market liquidity is provided through short selling by market professionals, such as market makers, block positioners, and specialists, who facilitate the operation of the markets by offsetting temporary imbalances in the supply and demand for securities. To the extent that short sales are effected in the market by securities professionals, such short sale activities, in effect, add to the trading supply of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of supply.

Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise. Both the purchaser and the short seller hope to profit by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.

To be sure, the Commission also has recognized that short selling can cause market operational problems and can be used as a tool for manipulation. The market operational problems can result from failures to deliver securities in settlement of trades (short sales or long sales). Manipulation can occur when short sales are made with the purpose of driving down the market price of a security, rather than for the purpose of profiting by covering their shorts when the market at large recognizes what the short sellers believed they were first to see, that the security is mispriced and should be trading at lower levels.

In recognition of the need to guard against improper uses of short selling, the SEC has comprehensive rules addressing short selling. The SEC adopted Regulation SHO in 2004 to limit failures to deliver on short sale trades. Before a broker-dealer executes a short sale for a customer or for its own account, Regulation SHO requires a broker-dealer to locate a source of securities that can be borrowed to deliver to the purchaser at the time of settlement. In recognition that not all trades will settle in a timely manner, however, Regulation SHO also requires broker-dealers to go into the market and buy sufficient securities to close out a persistent fail to deliver position in so-called "threshold securities."

Manipulation of security prices is illegal, and is one of the primary concerns of the SEC and the self-regulatory organizations ("SRO") because of its pernicious effect on market integrity and the investing public. Accordingly, the SEC and the SROs have a wide array of laws and rules to deter and detect manipulation. Market manipulation can also be prosecuted criminally.

One kind of short selling, namely, so-called "naked short selling," is the focus a much issuer and media attention. As the SEC staff has noted, this term can have many meanings, and it is important to know which activity is the focus of discussion. The term typically is used to have any of the following meanings:

- (1) selling stock short without having located stock for delivery at settlement. This activity would generally violate Regulation SHO, which places the "locate" obligation on broker-dealers.
- (2) selling stock short and failing to deliver shares at the time of settlement. This activity doesn't necessarily violate any rules, because there are legitimate reasons why a seller may not have the stock available on settlement day.

(3) selling stock short and failing to deliver at settlement with the purpose of driving down the security's price. This manipulative activity is not addressed by Regulation SHO, but generally would violate various securities laws, including the general antifraud and anti-manipulation provisions.

The SEC and the self-regulatory organizations ("SROs") are actively examining broker-dealers and others for compliance with Regulation SHO. In addition, they have said that they are continually on the alert for instances where the third type of naked short selling, namely, manipulation, is occurring. Hedge funds, like all short sellers, and the broker-dealers that execute their trades are fully subject to this panoply of regulation, and can be prosecuted if they engage in violations.

As briefly outlined above, short selling is subject to a comprehensive regulatory scheme, and compliance with those regulations is very much in the forefront of the regulators' agenda. One of the main purposes of the SEC's adoption of Regulation SHO was to create a uniform set of requirements for short sales. As part of that process, the SROs were required to rescind their overlapping (and occasionally disparate) rules. MFA believes it would be a mistake to reintroduce differences and disparities in short sale regulation, either on the federal or the state level.

## VII. CONCLUSION

The hedge fund industry has experienced significant growth in recent years. Much of this growth can be attributed to institutional investors seeking to diversify their returns and thereby reduce the overall risk of their investment portfolios. This growth has enabled hedge funds to serve as source of liquidity in global capital markets, increasing efficiency and decreasing risks.

Short selling is not un-American, particularly when it is on the basis of information obtained from a variety of sources and some of which contradicts the conventional wisdom. Information released by public companies does not reflect all that is known -- or should be known -- about such companies. Short selling helps to correct mispricing of stocks and in that way it contributes importantly to the honesty and fairness of our markets. It does so in particular by:

- ? Identifying overvalued securities and causing their prices to return to more appropriate levels.

- ? Identifying companies whose public disclosures and accounting are false or misleading.

- ? Providing liquidity to the markets and assists in price formation and price discovery.

- ? Providing handsome returns to the investors -- often pension funds and other aggregators of wealth who represent the savings of many thousands of U.S. individuals.

- ? Offering a means by which those who have formed negative views on the competence or integrity of incumbent management can act on those views, often to the displeasure of companies like Enron Corporation and some of the other companies complaining the most vociferously about short sellers.

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We thank the Committee for the opportunity to allow MFA to share its views with you on this important topic.