THE BROOKINGS INSTITUTION

LIVING ON THE HEDGE: A FORUM ON THE PRIVATE INVESTMENT FUND INDUSTRY

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WELCOME

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INTRODUCTORY REMARKS

THE HONORABLE JACK REED (D-RI)
United States Senate

THE EVOLUTION OF THE HEDGE FUND INDUSTRY

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PRESENTATION: WHY TRANSPARENCY MATTERS

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THE EMERGING REGULATORY ENVIRONMENT FACING HEDGE FUNDS

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P R O C E E D I N G S

MR. HUTCHINS: Good morning. Is this working? Can everybody hear me? Okay, great. Good morning. My name is Glenn Hutchins, I am a Trustee of the Brookings Institution, and on behalf of all of my colleagues at Brookings, I'd like to welcome you today.

Today's event is sponsored by the Brookings Initiative on Business and Public Policy, which is led by Martin Baily here in the front row; thank you, Martin. And the Business Initiative focuses on providing research and recommendations on public policies issues affecting the business sector in the United States and the world, which, of course, is the front page news every day these days.

Today's event on hedge funds is part of the Business Initiative's Fixing Finance Paper and Event Series. And if you haven't had a chance to read the work that Martin and his colleagues have produced, I highly recommend it, some of the best stuff out there, and I think we have it available for you up front today, right.

And the series is taking an in depth look on how we can restore the health of the financial sector while preserving its ability to compete and ensure future market stability. We have I think a terrific program for you today, and we're thrilled especially to have Senator Reed with us; Senator, thank you for coming. The program today will start with Senator Reed, and then we'll have a panel on the evolution of the hedge

fund industry, we have some of the leading practitioners in the field here with us today, we appreciate all them coming, thank you, and then a very interesting paper on transparency, which is, obviously, a very hot topic with respect to the hedge fund industry, and a panel on the regulatory proposals for a different kind of regulatory approach to the hedge fund industry, and then Bob Greifeld, the CEO of the NASDAQ stock market, obviously an important part of this whole mix, will be here to talk to us just before – just at the end of the program.

Today – this is a very important topic for at least two reasons, and it's a very interesting day to be here because the hedge fund industry is at a crossroads for two reasons, one is, obviously, last year was a time period in which it was very hard for people to post any decent kind of performance and the result of which there were significant redemptions, and there's a whole question about kind of wither the hedge fund industry today, and so that's – so from a market perspective, that's a very interesting – an issue that's front and center. Secondly, of course, there are a whole bunch of different regulatory proposals and issues about transparency and regulation that are going to be very much in the news over the next couple of months, and I think Brookings having a point of view about that will be very helpful.

But second, the hedge fund industry is clearly an important part of the solution to the problems that we have in our country today. If you listen to Secretary Geitner's remarks a couple of days ago, and he

talked about public private partnerships and capital to come in, and helped begin to stabilize prices in the mortgage market, and particularly with other markets and open – reopened the credit channel, the hedge fund industry is the private part of that public private partnership, and so having this capital and the people who have the ability to price the assets and manage the assets at their purchase is going to be vitally important to getting us out of this mess.

With that said, it's my great pleasure and honor to introduce Senator Reed today. Senator Reed is a person who needs no introduction, but I'm supposed to do it nonetheless. He is a graduate of West Point, 1971, and served in the – as active duty as an Army Ranger and a Paratrooper in the 82nd Airborne Division, Platoon Leader, Company Commander and Battalion Staff Officer. And after that, of course, he went to my old alma mater, Harvard, for both a Kennedy School degree and a law school degree. And not having I think served his country enough, went back into his service, served in the Rhode Island State Senate, and was elected to the United States Senate in 1996.

Among his assignments are, he serves on the Senate House – Banking, Housing and Urban Affairs Committee, banking and housing sounds like two things that are reasonable important these days, and is the Chairman of the Sub-Committee on Securities, Insurance and Investment. So there's no one I think better situated to give us his point of view. Senator, thank you very much for coming, we do appreciate having

you here today.

SENATOR REED: Thank you very much, Glenn, for that kind introduction, and I really appreciate it. I was talking to Glenn previously, and even though he has not offered me a contract with the Boston Celtics, for obvious reasons, I so appreciate very much the introduction; thanks, Glenn. I'm very happy to be here at the Brookings Institution to provide some thoughts on the emerging regulatory environment. As we aggressively pursue a stimulus package today in the United States Congress, we're also committed to substantial reform of the oversight of financial markets. This reform is particularly necessary at this moment.

As we all gather here today, as you gather to discuss the issues of hedge funds and the future of regulation in this area, we are in the midst of a great financial crisis in our markets. The crisis transcends the cratering employment numbers and the contracting credit markets and touches on fundamental confidence, confidence in our economy, our financial institutions, and our regulators.

The early warning signs started with a Bear Stearns hedge fund in 2007. Few would have guessed then that less than a year later that firm would disappear as part of a weekend agreement hashed out between the Federal Reserve and J.P. Morgan Chase, and after that it only got worse.

All of those losses undercut our sense of financial security,

investors feel it, and the volatility of the markets show it. Many of our present challenges can be traced to bad mortgage lending and underwriting, securitization that occurred with little due diligence, and the inability of our financial institutions to manage their risk. These business lapses were amplified by extraordinary leverage. Some of the investment banks were leveraged as high as 34 to one. Leverage at the Bear Stearns hedge funds was reported to go as high as 60 to one in some deals. And as Forbes pointed out in an article, in rocky times, this kind of leverage can sink the ship in no time at all; in fact, that is what appears to have happened.

We also know that complexity in the markets contributed to the problem. The ingenuity of financial engineering in an environment of low interest rates and high leverage outstrip the ability of our markets and our regulators, particularly when the housing bubble burst. These failures have made one thing clear, the markets that once were a source of security for investors and for the American economy have now become a source of anxiety.

While we can point to many problems, we must acknowledge the important role that private pools of capital, such as hedge funds, have played. When others had no capital for funding, it was hedge funds that were providing liquidity in certain markets. It is also clear that many hedge fund managers have been adept at identifying market trends early and accurately. As we discuss the need for more oversight of

hedge funds and talk about the problems in the economy, it is with the awareness on the contribution these funds have made to robust capital markets and capital formation and their continuing role in these very important tasks.

But the problems have not just been with the private sector certainly. Regulators have not provided the necessary and effective oversight, in part, because of an outdated regulatory structure. The securities most of the regulatory structure has created in response to the Great Depression. Our country leaders then had the foresight to see that there was a need to prevent the return of such economic devastation to our country.

But the last two years have taught us hard lessons about the present effectiveness of regulatory oversight. Many of the failed or currently struggling institutions were under direct supervision of our regulatory agencies. For example, the Federal Reserve did not see in advance or act upon insights it gained from overseeing bank holding companies. The SEC did not effectively oversee investment banks, and that program ended in failure. The Office of Thrift Supervision, OTS, failed in its holding company oversight. The examples of AIG, Washington Mutual, and Wachovia provide ample evidence.

But there were other areas of potential systemic risks that were beyond the scrutiny of regulators and demonstrates why we need entity based regulation, as well as product based regulation.

One market that has been of concern to me is the over-the-counter derivatives market, particularly the growing market in credit default swaps. Last July I held a hearing on this topic and invited all the regulators to discuss their authority. The general response was that they had no direct oversight of credit default swaps, but they could manage these risks indirectly by overseeing the regulated entities that trade credit default swaps. They also said they had plenty of information to monitor the markets.

Three months later I heard a different story. Then SEC Chairman Cox was asking for explicit authority from Congress to oversee this market. Regulators suddenly awoke to the need to have visibility into the risks that have accumulated in a market estimated at over $50 trillion in notional value. The latest news is that we are in a regulatory holding patent on establishing clearinghouse for these products. At the very least, I believe that we need a central clearing mechanism with strong risk management systems to reduce counterparty risk and absorb unanticipated shock to the market. And I'm looking forward to seeing movement on this front very soon. This is just one example of an area that has received little oversight and no direct regulation.

Today, it's not just the Congress, but it's the American people who are demanding significant regulatory reform. As President Obama stated in his Inaugural Address, our challenges will not be met easily or in a short span of time, but they will be met, and this commitment applies particularly

to regulatory reform.

I want to just outline for you a few reform ideas I had before talking more directly about hedge funds. Last week the Banking Committee held the first in what will be a series of hearings on reforming the regulatory structure of the United States. At this moment, Congress is considering many ideas on reforming our system to be more proactive in addressing the emerging crisis. The failures of our financial regulators point to the need for significant change. On the Sub-Committee for Securities, Insurance and Investment, which I chair, I hope to start with a thorough review of the Securities and Exchange Commission. I plan to hold a hearing with a range of stakeholders and experts, reviewing the SEC from top to bottom, to see where we need to make improvements, including how to deploy additional resources for regulation enforcement.

One area of obvious concern is the proper oversight of credit rating agencies, which in the past year saw unprecedented discrepancies in the accuracies of their ratings. Though the SEC recently issued new rules to address some of these failures, I do not see these rules as going far enough. Congress will be considering the implementation of these new rules and whether further action might be necessary.

With regard to the institutional supervision of financial institutions, appropriate reform means treating similar institutions in similar ways. Our current regulatory system does not always do this. As a result, regulatory arbitrage continues to be a source of concern in our markets.

Reducing the many bank related charters, at least at the federal level, will ensure that we'll reduce the gaps in regulatory arbitrate that have contributed to our economic problems. And just as we attempt to remove regulatory arbitrage domestically, it is critical that we remove opportunities for international regulatory arbitrage. We need to be particularly conscience in the realm of accounting standards. We need to be very deliberate in converging accounting standards to international financial reporting standards, IFRS. Any convergence must be to a high common standard and should not mix – leadingly suggest a global uniformity that we have not yet achieved.

As I noted in the beginning of my remarks, throughout this crisis we have faced challenges posed by new financial products and unregulated markets. These are in some cases emerging markets, but also at times markets that have been deliberately left untouched, such as the over-the-counter credit derivatives.

We must provide our regulators with visibility into those areas that pose systemic risk to our economy. These risks include products that currently are not regulated, such as OTC credit derivatives, markets lacking transparency, such as dark pools, and institutions that do not have formal structured oversight, such as hedge funds.

Hedge funds currently lack a comprehensive form of required prudential oversight. At the moment, the SEC relies upon a voluntary registration system. As you all are aware, I'm sure, the SEC attempted to mandate

hedge fund advisor registration by rule, but that rule was struck down by a Federal District Court in 2006, after being in effect for about seven months. The SEC declined to appeal, unwilling to press the issue.

Because of this decision, some hedge fund advisors withdrew their registration, but about 1,800 still remained registered with the SEC. Consequently, oversight remains voluntary and does not provide the SEC with the necessary tools.

From the beginning, this registration program was envisioned as light touch. It provided a little more visibility into the hedge fund world, but not a comprehensive view. Such indirect, voluntary, light touch regulation was the recurring theme with the Bush Administration, but in the present crisis, these themes are no longer as compelling.

Because of the problems brought on by excessive leverage, poorly understood complex financial products, and failures in risk management, many are concerned about whether regulatory gaps are leading to build-ups in risk that can prompt systemic failures. As the group of – report notes, the current approach to hedge funds oversight, based largely on market discipline and indirect oversight through regulated entities, is not adequate. The G-30 report also concludes that hedge funds posing risks that are, in their words, potentially systemically significant, should have established standards set by a prudential regulator, and these standards would include appropriate standards of capital, liquidity, and risk management.

This conclusion represents a growing consensus that I share. However, how these standards are set and how they are monitored remains to be determined. In fact, that is part of why all of you are here, to discuss issues such as these. And I personally, and my colleagues, look forward to receiving your advice as we address a range of questions.

For example, which federal agency or agencies should have oversight over hedge funds? What kind of information should we review or the regulators should review? For example, would they look at real time position information or concentration risk with counterparties or industries or asset classes or any number of any other items of information? What size hedge funds should require oversight? And what extent of oversight should be applied based on that size? I recognize that the ability to redeploy capital in innovative ways is important to our economy, absolutely critical to our economy. And if the losses can be effectively absorbed by private parties, they do not pose a systemic problem of risk.

In addition, to what extent should leverage be reviewed, and in some cases constrained? How can the regulators best measure this and how can they measure the embedded leverage that certain financial products contain? What is the nature of the risk in various business models and strategies that these funds use?

Again, I recognize the proprietary information is sensitive,

however, financial institutions provide such information to regulators regularly, and this information is kept confidential.

Should structures of corporate governance be reviewed to ensure that the interest of investors are taking into consideration? How might feeder fund activities be evaluated, particularly in reviewing the due diligence that such funds conduct on behalf of investors? Finally, how can hedge funds improve transparency on the information they provide to potential and current investors regarding their investment strategies? There is some indication that information disclosed in private placement and offering memorandums which are provided to potential investors have been found in some cases to be incomplete, inaccurate, or outdated.

Once we answer these questions, and they are a daunting set of questions, we need to ensure that the regulators have the right resources and authority to prevent systemic problems. But I see as one of the values of this conference today providing us with critical insights on these questions and many, many more.

Let me make a few final points. Many may reject the idea in whole based upon the presumption that sophisticated investors are involved, but we can see that many of the investors have found themselves more exposed than they probably ever anticipated.

I understand that markets should rest on individual decisions. However, when those decisions collectively endanger the broader economy, we must consider whether this concept of the

sophisticated investor is sufficient justification for avoiding oversight and regulation. Also we have to be very cognizant that implementing hedge fund oversight in the United States alone will leave huge gaps. We have to ensure that we harmonize these changes with other regulatory authority. We have to create a successful international system to oversee systemic risk.

The G-30 report acknowledgement of the need for prudential supervision of systematically important private pools of capital represents an encouraging international appreciation of the dimension of this problem and the approach of a solution.

The implementation, however, will need to be carefully managed by our regulators to prevent regulatory arbitrage and flight of capital to lightly regulated jurisdictions.

With all that said, we are all here today committed and interested and determined to shape a vibrant American economy. We understand the need for innovative financial institutions such as hedge funds that provide liquidity and much needed capital. All of you are part of contributing to effective and efficient reform and the restoration of confidence in our financial markets, and I look forward to the results of this session today and continue to work with you in the future. Thank you very, very much. I'll take some questions. Yes, sir. Brookings always has microphones, they're very efficient.

MR. CHIN: Cho Chin free-lance correspondent. Thank you

for your comment and pointing out the way. I have two question; first one is this. Sure, we need reform, but reform take time. In the meantime, shall we wake up the Federal Reserve, SEC, and other regulatory agents do their job on the book? And second, it's important, you point out, have to be – to harmonize that regulation in the nation – international arena; which – should be the foreign to do this harmonization? Thank you.

SENATOR REED: Well, first, I think you're absolutely right, I think we just can't wait for the very deliberate and even fairly quick congressional response. The regulators have to step up the action. I was very encouraged by Chairwoman Mary Shapiro's initial decisions to unbundled some of the enforcement activities, to make changes, to become much more aggressive, not just for the sake of being aggressive, but to begin to restore that confidence in the market that the rules are being enforced. I think with respect to the Federal Reserve, I hope they also get the message that they have a huge responsibility. I think with respect to international harmonization, you are echoing my comments exactly, where this can't be done in a vacuum. The proper forum, there's going to be multiple forums. The first major convocation of world leaders will be in London in April, a G-20 meeting. I know our foreign counterparts are going to come loaded for bear with their proposals for systemic international reform. President Obama and his colleagues will have to do so also. That will probably be the first time there will be a high level discussion of these issues of, in the international context of what do we do

and who does the regulating.

But I've sensed that the international regulators are beginning to get the message that a hasty movement towards weak rules for the sake of international conformity means a mistake.

Just yesterday I met with Sir David Tweedie and his colleagues in the International Accounting Standards, and they're I think, and to their credit, working on a very deliberate pathway to 2011, to international accounting standards based upon high standards and based upon collaboration of all the major trading economies in the world. So I agree with you, I mean the enforcement has to begin with what we have on the books now, and it is considerable, and I'm encouraged by what Chairwoman Shapiro has done. Yes, Bill.

MR. GALE: Thanks, Bill Gale, Economic Studies here. I have a question, if I could switch the attention away from hedge funds for a second, for – about housing, the other part that Glenn mentioned, issues that you cover. What I don't see is how we solve the foreclosure issue, which is essentially a retail issue, you know, a mortgage by mortgage issue, how we solve that with a wholesale approach. So I was wondering if you could comment about not just the general structure of a housing solution, but how it actually gets implemented.

SENATOR REED: Thanks, Bill. I think there's – I was talking with Glenn about, you know, the real economy versus the other economy. The real economy in Rhode Island is very simple, do you have

a job and do you think you'll keep it, and is your health worth something. If those two factors – those two tests on that, then people – my constituents, and I think I can speak for most of my colleagues, think they're doing pretty well. So the issue of not just employment, which is one of the major – of the stimulus package, but stabilizing housing prices, hopefully appreciating housing prices, is critical to the recovery of this country and the world. The practical issues, I think you're exactly right, you can talk generically about funding and supporting banks indirectly, et cetera. I think what you've got to do is, you have to make – you have to get people to modify mortgages, people meaning you have to have financial institutions that hold mortgages willing to write down principal.

There was a very detailed report just done by Goldman a few days ago talking about the housing and the likelihood if we don't take prompt action, that the markets will overshoot, that, in fact, you'll have a much larger loss than is necessary, which will make us even more weak in our economy even further; we have to avoid that, how do you do it? Well, a couple of proposals.

First, I think the Treasury has to announce a standardized modification program, given the parameters, the degree of write down, the techniques you can use. Then I think they have to get an agreement among all the entities, financial entities that are holding mortgages, that they would participate in this program, perhaps as a condition to further federal support or as a condition to deposit insurance, as a condition – we

can find a condition. Then there's another issue out there, that's the securitization of these mortgages. We have been working on and working with colleagues with respect to Remick legislation which would require the trustees to adopt this standardized program as a means of maintaining their benefits under the Remick Statute, and that we think would allow them to efficiently make changes in their trust agreement so that they could, in fact, begin to modify mortgages.

If that is a first step, and there's some discussions that if people go through that process and are still unable to modify, then there's also the other issue here of modification to bankruptcy. But there's some discussion of trying to make this a sequential process so that for many, many mortgages, through direct negotiations between the lenders or the trustee of the securitization trust, the modifications could be made.

It has to depend upon, of course, the ability of a modified mortgage to be supported by the borrower. We don't want to get into the circular effect of modifying a mortgage today to have someone come back a month from now. The other point I'll make, the final point, is that all of this is connected together. If people don't have jobs, we can modify mortgages until we're blue in the face, as my mother used to say, they're still not going to pay it. If we don't get the stimulus package moving, if we don't get jobs out there, then modifications won't work. But if we have jobs, and the mortgage is still out of reach of working people, we won't establish – we won't put a floor into our economy.

So I think these are practical steps I hope we can move, and I hope that's the next phase of the administration's approach. Yes, sir. By the way, these are all my own brain ideas, so if you like it, fine, but don't blame anybody else.

MR. MALLABY: I'm Sebastian Mallaby from the Counsel and Firm Relations. Taking you back to hedge funds for just a second, on this question of leverage and the right limit on hedge funds, I think most people would say that the right limit depends on what kind of hedge fund. If it's a very volatile strategy, too much leverage is dangerous; if it's not a very volatile strategy, you can borrow a bit more and still be safe.

So since the strategies are hard to understand, they vary, they even change within hedge funds very rapidly, most people I think who have gone down this path are thinking how do you create a standard imposed by the government, have failed to come up with a standard. Could you imagine at the end of all this debate, when you're asking the right question, you and your colleagues, you look at the details, you see that perhaps it's difficult to come up with a good standard; could it be better in the end to have no standard?

SENATOR REED: I think what we will do in practice is, ask these questions, and I think you're absolutely right. Most of my speech contained, I hope, good questions, but hard answers, and unresolved answers at the moment.

I think what we will do then is, we will provide legislative

guidance, direction, and then allow, as we should, flexibility of regulators to make judgments, that's the normal process, and it's not perfect, but it seems to work better.

And your point is exactly right, so much of leverage depends upon what is the business plan, you know, what risk are they investing in all these things. And for us in Congress to define, you know, completely across the board, I think is not the right approach. It'll choke off innovation. But I think regulators have to be sensitive to this issue. They have to – and they have to have, and maybe it'll be just, at some point, as many cases is, it's a judgmental issue, which it might be disputed, but someone will make a judgment whether this approach and this much leverage would pose a risk.

The other issue I think is one which goes to the size of the enterprise, that's probably an easier way to get at this whole set of issues, because, you know, if you have a million dollar fund which is leverage of, you know, two to one, and they goof, I don't think that's going to bring down the economy.

If you have a billion dollar fund that has leverage of 20 to one, you might have some systemic problem. And I think as we do this, I hope we appreciate, there are some things that give a stronger indication of systemic risk, others that are less indicative, but we want to I think give – have a framework where all of this is considered, because you could have, again, the size could be disguised because the amount of leverage

is so extraordinary that the measured size is much less than, frankly, what you – what is actively taking place in the market place.

MR. HUTCHINS: Jim.

MR. CHANOS: Hi, Jim Chanos from the Coalition of Private Investment Companies. And thank you for appearing this morning, Senator. A question and observation. In the move toward more regulation, and I think everyone assumes that more regulation is coming, just under what forum, what – how much examination is going to be given to smarter regulation?

I mean let's face it, Madoff was a regulated entity. Most of the world's financial train wreck occurred within the confines of regulated entities, and yet this was going on right under the noses of regulators, many of whom sat on the trading desks of the institutions in question.

How is Congress going to exercise its oversight to these various existing and new regulatory bodies to make sure that we've got the right people doing this, asking the right questions? I really worry about the false sense of security that regulation will give our citizens, you know, come the next train wreck.

SENATOR REED: No, I think, Jim, that's a significant concern, and it should be. My sense, looking back, and we have much more precise vision backwards and forwards sometimes, is that, you know, the structure of regulation can be improved, but there was a structure of regulation. I don't think the enforcement was vigorous. In

fact, I think the regulators signal the market place that the enforcement would be very lax.

Now, the policy of SEC to negotiate proposed penalties with the commissioners before they imposed them on entities was a strong signal I think to enforces to say don't bother us. That was changed immediately by Chairman Shapiro. That's an example of more vigorous regulation.

I think the resource question is important, not just how much money you have, but how you're deploying it. And I think in the issue of smarter regulation, which is key, one of the things that Bill Donaldson did, which I thought was very impressive and very far thinking, was to create within the SEC a risk assessment office that would begin to step back from the – going through the books, and you know, and look very closely at systemic problems that could be arising. I think that type of, you know, risk assessment, SEC at the Fed, it has to be an important part of the smart regulation going forward.

And it was disappointing to me when Chairman Cox took over that sort of – that function was let to atrophy tremendously. So the notion of just more rules and more people checking boxes is not going to work. You've got to have a sophisticated insight. In fact, you know, frankly, and what we've seen in the NATO situation, you've got to have access to whistle blowers that is not an invitation for disgruntled people to make claims, but there's an effective system to get a response to

legitimate concerns that are raised.

So there's a lot of things we can do. But I don't want to leave here with the impression that we're going to solve the problem by passing a law and then just, you know, and forgetting about it. It's oversight by everyone.

SPEAKER: Some of us think if Madoff had been publicly traded, the short – might have figured him out a long time ago.

SPEAKER: I'm going to do here and then go over there and then come back to Darryl West.

MR. COLARINA: Senator, thank you. Rob Colorina, Agent, American Chamber, also in private equity. I think our CFR person, I recall this connotation of some hedge funds being characterized as firefighters in some terms; do you think your committee has sort of warmed up to the notion of, and this is more of a PR aspect, or is there a – should the industry, the hedge fund industry, do more in terms of PR or better understanding of what it does to mainstream? Because it would seem that there's a bit of a disconnect between what they do and mainstream.

SENATOR REED: Yeah, I mean, frankly, I think we all have to do a lot more PR today. The American public is just, they're scared, and so if, you know, if the connection is made to Wall Street, I think their first reaction is, well, this is going to be just some type of unusual and probably – they don't do what I do, and I'm working, they're not, et cetera.

And that applies, frankly, to us, too. I mean we, you know,

the whole regulatory process I think has to be presented as not a – as a way that helps people, it protects investors, et cetera. So I would encourage everyone to go out and make the best case for your contribution to the economy in a positive way, and we have to do the same thing. Let me go over here and then I'll get Darryl. Yes, ma'am.

MS. O'LEARY: Hi, Senator, Lizzy O'Leary, Bloomberg News. Speaking of PR, looking at Secretary Geitner's plan or framework and the public private investment, do you see a disconnect at all between the fact that hedge funds, private pools of capital are, for all intents and purposes, going to be the savior here, going to be the private part of that fund, and yet we're talking about administration, where I remember being on the road with the President, and he was mocking Joe, the hedge fund manager, during the campaign; is there some disconnect between having an administration that wants to increase regulation, who, when he was a senator, sponsored an amendment that would look at – or a bill that would look at anti-money laundering provisions and an industry that's probably going to be the only leg left to buy these assets.

SENATOR REED: No; I think the real critical issue here, frankly, and it is – runs through everything we're – that the Treasury has to do, is if you're pricing these assets appropriately, you know, commensurate with the risk, then this is a kind of business transaction that will advance the economy.

I think what we want to avoid is a situation in which we are

not pricing risk adequately, that we are essentially subsidizing private entities who are coming in, be it the financial institutions or hedge funds, at the expense of the tax payers. The real challenge here is not, you know, we don't want private help, we need everybody's help in this effort. And the ultimate goal here, which I think the President is very clear about, is that the private economy, after there is a significant infusion of government resources, begins to grow on its own or grow without these resources.

So I think the issue is not this, well, isn't this – this is a dichotomy and isn't this, you know, strange, et cetera, I think the practical issue is, if you can engage, and, in fact, we must engage, all of our private resources at this point, and the hope is that eventually the private markets will become robust again so that government involvement can decrease significantly, and the key element of that engagement is making sure that we're not subsidizing private investors at the expense of tax payers, that is a very difficult technical challenge, but that's – maybe I'm just kind of a – sort of a plotting personality, but that's, you know, rather than these sort of huge symbolic message type things, if we get that right, then we'll get the economy right, and I think we'll harness private investors, hedge funds, private equity funds in an appropriate way that, you know, they will make a profit, but it will be a profit based upon their risk and it will be in line with the risk they're taking. Let me do Darryl West, because he's – the last question, because he used to be a constituent, but – and he still

technically may be registered in Rhode Island, so I – he was – so I have to be --

MR. WEST: Well, actually I've moved my voter registration to D.C. now.

SENATOR REED: The next question, please.

MR. WEST: Barney Frank has introduced legislation in the House to substantially expand the role and mission of the Federal Reserve, to look not just at financial institutions, but also cover a variety of non-financial institutions, and I was just wondering if you have any thoughts about the effectiveness of that, and if you have any concerns about the Fed taking on a mission that's pretty far removed from its traditional mission.

SENATOR REED: The Federal Reserve has become sort of the first stop on everybody's list of systemic regulator for many reasons; their central position in the government, their regulation already of bank holding companies. I think we have to ask, as I posed in my comments, the question of not the agency, but agencies.

We very well might want to divide certain responsibilities. We might want to have consumer investors – protection of consumers and investors in the SEC rather than everything up in the Federal Reserve. I think what you have to look at is along those lines, what do you want to accomplish and who's best situated to accomplish it.

But this notion of the systemic reg, the one that's going to

step back and look at everything, insurance companies, bank holding companies, you know, the range again, I think the pressure will be towards the Federal Reserve. But I think we have to step back and ask ourselves very, very deliberately, does the culture of the Federal Reserve and the other missions of the Federal Reserve complicate their approach to this? What changes do they have to make institutionally so that they can be an effective systemic regulator?

I mean one of the ways that the Fed regulated was by giving speeches. Well, that wasn't the most effective way to regulate a lot of activities in the economy, but that's what they did. They thought if they gave a speech about, you know, behaviors, then those behaviors would change, that doesn't usually happen. So I think that, you know, as we go through here, they might, almost by default, become the systemic regulator, but the Federal Reserve that exists today I don't think is going to be entirely up to the challenges of that regulation. So there's going to have to be institutional changes, they're going to have to look closely at the culture, how they regulate, you know, how they relate to regulated entities.

And I think the other issue here, too, and I don't have any profound wisdom on this, is that they still have the central role of the banking, of the central bank, of monetary policy; in that way, does that distract them or somehow complicate the decision-making about regulation.

So it very well may be at the end of the day, as Chairman Frank is suggesting, that's the systemic regulator. But I think it's going to have to be a changed institution to do the job effectively. And so we have to look beyond just the label, okay, you've got these responsibilities, they have to show us, at least to show me, how they're going to do it, how they're going to separate some of these critical functions, how they're going to avoid a conflict between an impulse on a monetary policy which will contradict the regulatory impulse which might be necessary. So I look forward to a very rigorous debate about this issue. I want to thank Glenn for his kind introduction and thank you all.

MR. BAILY: So we're going to take about a couple of minutes while we just bring people up and mic them up, so we'll have about a three minute hiatus.

(Pause)

MR. BAILY: Okay. I will – we'll get started if I can get everybody back in their seats with their seatbelts fastened and tables upright. Okay. I'm Martin Baily here at Brookings, and I'm going to moderate our first panel, which is on the evolution of the asset management industry.

Now, given what's happened in the last year, I mean which is not extinction, but it's certainly been a pretty tough year for this industry, but we have an excellent panel to review these issues, and let me waste no time, but introduce the panel.

Alphabetically, I guess, Jim Angel is an Associate Professor at the McDonough School of Business at Georgetown University. He's an expert on financial markets and their operations in the United States. Doug Elliot is from Brookings, and I'm delighted to welcome him. He joined Brookings fairly recently. He's a former investment banker, most recently with J.P. Morgan. He's also someone who started his own think tank, quite successfully, a few years back, and we're delighted to have him here at Brookings. And finally, Bill Ackman, who is the Founder and CEO of Pershing Square Capital Management. So welcome and thank you for joining us. So I've got Jim Angel starting us off, so if you could go ahead.

MR. ANGEL: Why, thank you. Pardon me, I've got a bit of a cold in my throat, so I hope you'll bear with me. As I see it, the first panel is how did we get here, and the second panel later this morning is, where are we going. So I just thought I'd speak for a few moments about how we got to where we are in the evolution of the hedge fund industry.

You know, the hedge fund industry, as you well know, didn't just start yesterday. Indeed, when you go back in our financial history, there have been many hedge fund-like entities. But in terms of the current crisis, the – it bothers me when I hear people say words like unprecedented. If you look in our financial history, and I actually teach a course in financial crisis at Georgetown, we have had dozens of meltdowns, panics, crises, and to a certain extent, this is very similar to

previous panics like we've seen in the 19th and 20th centuries. However, there is one thing that is different this time, and the main difference is, this time, one of the main failures is in our shadow banking system. In the late 20th century, we developed an elegant system to connect borrowers directly with savers and bypass the banks. So even though we built a regulatory apparatus that was designed to keep the banks from failing, we did not build a regulatory apparatus to keep the capital markets from failing.

Now, our elaborate securitization process had a weak link. That weak link was that those trillions of dollars in securitized assets had to be graded by the rating agencies. And once we discovered the rating agencies could not do as good a job rating structured products as they could corporations, that market has frozen.

So it's as if a third of our lending capacity has disappeared overnight. And indeed, you know, for this reason, you know, only the securitized markets, but also our state and local governments are also finding it very difficult to access the capital markets, and that is why it has been so difficult to restart our markets. You know, it's not as easy as propping up a bank, how do you prop up a capital market? Now, personally I believe that we need a federal bond insurance corporation to supplement the federal deposit insurance corporation, to take over where the private bond insurers fail, but, you know, that's probably a debate for another time. So anyway, what's different this time is our capital markets

that have failed more so than our banks.

MR. BAILY: Okay, all right. So our next speaker is Doug Elliott.

MR. ELLIOTT: Okay. Thank you, Martin, and thank all of you for coming here. Martin asked me to join this panel I think principally so that I could talk about the evolution of the hedge fund industry from the vantage point of an investment banker, which I was for about two decades, principally at J.P. Morgan before I joined here in January.

And it's an interesting perspective, because when I first personally encountered the hedge fund industry 17 years ago, it was very different than it is today. At that point, it was kind of the novelty act of the financial markets. They were rare and they were usually centered around a strong personality of a brilliant trader.

They were viewed as risky. J.P. Morgan viewed them as good customers, but there was no question that the balance of power was, the hedge funds needed the banks more than the banks needed the hedge funds. And so that showed up in terms of the cost of borrowing the collateral requirements, et cetera. When I returned to Morgan about three years ago for a second stint, the world of hedge funds was very different. And I should just acknowledge up front that there are a vast array of different types of hedge funds, as was referenced earlier. So anything I say is going to gross over generalization, but in order to be able to say anything, let me do that.

And I'm going to focus here on the large hedge funds, which have been most active in moving the market in various ways.

So when I returned to Morgan, I found a world in which the hedge funds were dominant players in many aspects of the financial industry. And consequently, what you had is, there were many more hedge funds, and the aggregate size of the hedge funds was much bigger than it had been before.

So at this point, J.P. Morgan and the other investment banks were almost desperate for the business of the hedge funds. And, of course, this was also a time when leverage was readily available and banks were all looking for ways to deploy their money to actually earn some reasonable rate of return. So at that point, it was much easier for hedge funds to get quite large amounts of leverage and not to have to pay terribly much for it. As a result of the large resources that they had developed and all of the natural advantages the hedge funds have, including, in general, a very high level of innovation, you reach the point where a number of functions that historically had been commercial banking or investment functions, including the securitization that Jim was talking about, had moved basically to the hedge fund industry.

I can remember very vividly my boss recalling a conversation that he had with the CEO of a major hedge fund, who patiently explained to him how the hedge fund industry was going to take over all of the profitable aspects of commercial and investment banking, essentially

leaving us to gather retail deposits and loan them to the hedge funds.

So I do understand the impulse that has developed to bring hedge funds more into the regulatory environment. I will leave discussion of that largely for the later panel who know more about it than I do. But I will make one prediction, and this touches on something Senator Reed was talking about. I do believe that, at a minimum, hedge funds will come to be regulated, the large ones, certain large ones, as systemically important financial institutions. And this concept, as Senator Reed was talking about, is simply a concept that the group of 30 and some others have proposed that says that any kind of institution that's of sufficient size with sufficient inner connections with the rest of the financial system, that it presents a systemic risk, and would, by the way, implicitly probably be guaranteed by the government for that very reason, would have additional requirements.

Now, it's not likely that the requirements will be identical for all systemically important financial institutions because they differ a great deal. But for hedge funds, I would think at a minimum for those hedge funds, there will be much enhanced reporting requirements, and there may well be at least rudimentary capital requirements, as well, to deal with the leverage issue.

Now, the other thing that Martin suggested I talk about a little bit, it's also been touched on earlier today, is looking at the financial stability plan that's been suggested by the administration. In particular, it's

been suggested that there be a public private partnership to buy the toxic assets off the books of the banks. I think you're probably all familiar with the broad outlines, which aren't much more than what I just said at this point, but the idea is that one of the critical elements of finding a way to deal with the toxic assets, where there's government involvement, is, you have to figure out what the value in today's terms is of those assets.

And I'll throw out a range just to have something to talk about for examples. But there are many toxic assets our there that – where the value could legitimately be anywhere between say 30 and 60. It depends on that 30 and 60 cents on the dollar.

So it depends on what you think the foreclosure situation will be in the future, what you think recovery rates will be, and it also depends on what you think in this environment the right return is that an investor should be demanding. Should they be getting 25 percent because these things are starting to look a lot like text stocks, should they be getting 15, should they be getting something lower?

So there is a wide range of values that someone could honestly defend. So the thought was, if the government is involved in that process, private industry, in this case it would be the banks, has very strong economic incentives and arguably significantly more information, and they may be able to negotiate an excessively good deal on the price. Even if the government is capable of negotiating the best deal, the public may not believe that they've been able to do that, so why not bring the

private sector in? Is there a way to harness hedge fund managers and others who have equal access to the information, equal financial incentive with the banks, and have what a market does, willing buyers, willing sellers, they negotiate?

I think that is probably the driving force behind the suggestion of a public private partnership. My own view, which is expressed in the paper you've seen outside, is that there are a whole host of complications and negatives to this approach that I think more than outweigh that advantage of bringing in the pricing element.

But this is the way it looks like things are going to go forward, and there's going to be opportunities for hedge funds to participate in that. I wish I were smart enough to give you some great advice about how to do that, I'm not, but I do have one thing I would suggest. To the extent that hedge funds are looking at this, be very attuned to how things will appear to the public and to Congress as you're thinking about what to do, because I can tell you, coming from the financial markets, there's a whole mindset that's appropriate for dealing in the markets that leads to behaviors, which to someone who's not familiar with the markets, can seem callous or worse.

So I think this will be one of the interesting things. I mean, first, I think it's going to be very difficult to make this happen, because the understanding I have is that most of the private investors who are looking at buying these things want to buy them at 30 or 35, in my example,

they're not looking to buy them at 50 and 60.

The banks, for the most part, are looking to sell at 50, 55, 60. And by the way, it's not as simple as the banks are just wrong or they're unwilling to take the hit. Some of them may genuinely feel it's worth 35 and they're just trying to avoid a massive write down.

There are others who really feel if they can just ride out this present crisis, that, in fact, a long term holder will make a nice return that justifies thinking of these as worth 50 or 60. So there's going to be a pretty big gap in valuation between those two. The federal government, in some way, is going to have to incentivize private investors to be able – to be willing to bid more, or they're going to have to bully the banks into accepting less, and there's a limit to how far they can go in that bullying. So in terms of incentivizing private investors, there's already been discussion of the government providing cheap financing basically, and there's likely to be two aspects of the cheap financing, one is simply the government borrows more cheaply than anybody else, they could certainly pass that cost savings along.

But the more important thing is, often when people talk about financing in this context, they actually mean non-recourse financing, which means that you buy some of these toxic assets for say 45, and then you go to the government, you borrow say 30 against that 45 value, and if the value of the securities falls below 30, you just come back to the fed or whoever gave you the money and say, you know, I'm really disappointed

by this, but here, have the securities and we'll call it even. I won't pay you your 30 back, but you get to keep the collateral, which may or may not be worth 30 or more in the future.

So I do think personally there will be some form of guarantee or non-recourse financing. And figuring out what the conditions are under which that's provided, that is, how much lending there is for each dollar of collateral held in these assets and what the pricing is for that is going to be a very significant economic factor. I could talk a lot longer about this, but I will spare you.

MR. BAILY: Thank you. Our next speaker is Bill Ackman; Bill.

MR. ACKMAN: Thank you. So I'm going to focus very much on hedge funds. If we're going to talk about the evolution of hedge funds, let's start with what a hedge fund is. And a hedge fund, in my view, is just a compensation structure, it's a partnership or a corporation where the manager is compensated typically with 20 percent of the profits and receives, in addition, a base management fee. It's the best compensation structure in the investment management business. As such, it tends to attract, you know, assuming people are economic actors, it tends to, you would think, attract better managers. And it's not a recent phenomenon.

People I think don't recognize that Ben Graham, one of the fathers of value investing, was a hedge fund manager. He received a percentage of the profits, he went long, he went short, he did arbitrage.

One of his great students was Warren Buffet. Warren Buffet was a hedge fund manager. He started a hedge fund in Omaha, he raised a few million bucks from neighbors, he got paid 25 percent of the profits over a six percent return. He abandoned that business in 1969, when he rolled his hedge fund into a public company called Bercher Hathoway, and wonderful things have happened since that time.

In terms of the evolution of the industry, not a lot has changed from, in my view, 1920 – 1950. The compensation structure is fairly similar. The biggest change I would say in the last ten – 15 years is a bit more of the institutionalization of the industry and the fact that capital which was traditionally almost entirely high net worth individuals adjusting hedge funds is now more – other, you know, so called fund to funds or feeder institutions, pension funds, insurance companies, charitable institutions, a lot of union funds invest in hedge funds.

The result of the influx of capital – the capital came from, frankly, better performance, and better performance particularly during poor periods of time in the stock market. Most other managers, whether they're private equity managers or they're long only managers or account managers, are – they take only a, if you will, a bullish view on the stock market. They pick the best stocks they can find, but they stay, for the most part, fully invested. A big difference with hedge funds versus typical, you know, other kinds of investors is, hedge funds go long and short, they work to protect capital in down markets by shorting stocks, they'll keep

large cash positions if they feel that's appropriate, and they also will use leverage if they feel that's appropriate, as well.

Although, again, you know, some managers operate with large amounts of leverage, some managers operate with no leverage at all, and it really depends on the style of the manager.

One of the things I think is – you have to ask if we're focused on making some changes to regulation for the hedge fund industry, you know, what's gone wrong, and the answer, I think the biggest mistakes that hedge funds have made is, they've not done a good job, frankly, in public relations.

You know, if you look at – 2008 is a good example. I would say hedge funds is an asset – if you call it an asset class, out performed almost every other and perhaps every other asset class, whether it's long only institutional management, or commodity investing, and, you know, the average hedge fund was down something like 18 or 20 percent last year, which is not a great number for hedge funds, but it's a lot better than what the stock market did. And I think, you know, if you think about the problems we've had in our capital markets, the problems have come with the most regulated institutions and principally with the most regulated, most highly rated institutions.

So you'd say where would the problems be in the capital markets, well, let's focus on the unregulated, unrated institutions, that's where the problems would be, maybe an observer in advance would think

that, and therefore, you'd focus on hedge funds, but the reality is, there's been no bail out of hedge fund that's required tax payer money, and there's been – well, money has been lost, you know, that's the nature of the bargain that the people made who invested with hedge funds.

Let's look at the most regulated institution in America, or the two most regulated institutions are Fannie and Freddie. In fact, in addition to SEC oversight, in addition to, you know, Federal Reserve, you know, watching what they're doing, Fannie and Freddie had a dedicated regulator with 600 odd employees entirely focused on regulating two companies who had a very simple business model, and the regulation clearly failed. And those two institutions, by the way, had the highest rating of all – by all three rating agencies, they were all Triple A – Fannie and Freddie were all Triple A rated, and now, you know, they're effectively conservatorships.

So you have to ask yourself, is, you know, what's the problem. And I think the – what people don't realize is that when you have a good housekeeping seal of approval, a Triple A rating, when you're regulated by many regulators, investors lose the discipline of doing their own due diligence, and that leads to major problems.

It gives the institution a free pass to take enormous risks. And that's why, you know, I think if we're going to regulate hedge funds, we want to be very careful about the way we regulate them, because the – it's not clear to me that regulation is helpful.

You know, the further away an individual's money is from the person who manages it, the more intermediaries between them and the manager, you know, I think the greater risk. And one of the beauties of the hedge fund industry is, it's very much old fashioned capitalism, where an investor sits down with the person who's going to manage his money, makes a decision as to whether they want to bet with this particular person, and the discipline is that if the performance is poor, they take their money back. And, you know, the hedge fund industry I think has not – more recently a lot of people are complaining about managers are throwing up gates, not letting people take their money out, that's going to lead to changes in the contract between the manager and the investor, but the changes are going to be driven by the private sector, by negotiation between commercial parties, and I think we end up with a much better solution than simply – and I think if you – if hedge funds had credit ratings, and if hedge funds were highly regulated, they would have required government bail outs, because they would have taken much greater risks because they would have raised a lot more money from people that didn't have the ability to assess their capabilities.

So I think that we should be careful about what we do. And now, why are hedge funds important, and the answer, I think you can see that really beginning around September of this past year, the first real regulation of hedge funds took place when Chairman Cox put in a rule making it illegal to be a short seller in America, and that's really the first

time hedge funds have been regulated. You know, the only short sellers of individual investors are really – really been hedge funds. What was the impact of that overnight regulation? Well, the impact was a manager who commits to his investors, they're going to keep a balance between long investments and short investments, and now learns that it's illegal to be short, well, in order to keep their balance, they're going to have to sell stocks, so they sell their long investments, which pushes the market down.

The other thing is does is, now, short sellers are being blamed for, you know, bank stock price declines, and when short sellers could no longer sell and bank stock prices continued to go down, the long investors got concerned that, in fact, maybe these institutions aren't worth what we thought they were, and they began to sell.

The short squeeze created by short sellers not being permitted to short sell put a lot of pressure on hedge fund managers, particular those that kept balanced books, that used leverage. That forced – that hurt their performance, that caused their investors to call for their capital at the end of the year, which, in turn, put more pressure on hedge funds to sell stocks, which, in turn, put more pressure on the markets, which impaired hedge fund performance, and that contributed to why last year was one of, you know, the worst years for hedge funds on record. Well, you know, it's hard to feel sorry for wealthy hedge fund managers, which is why I think they make a very appealing target for the press and perhaps Congress. But you really shouldn't focus so much on the

manager.

You know, the people that get hurt when a hedge fund manager's business model gets disrupted by regulation are the Carnegie Halls, the major hospitals, you know, the Harvard Universities, the Yale Universities, you know, the investors are, you know, the pension plans, the union pension plans, you know, the firemen, those are the ultimate people that hedge fund managers manage a lot of capital for.

And the other thing – person – group that gets hurt is really the country at large. And we've heard, you know, Geitner's plan for saving, you know, dealing with distressed assets, well, he wants to go to the most opportunistic pool of capital in the world, and the most opportunistic pool of capital in the world are hedge fund managers. The problem is, hedge fund managers have been impaired by actions taken in the last few months, and you know, the buyers – the short sellers who would buy when stocks crashed, well, you know, they weren't – they were absent because of changes in the rules. My overarching point here is, I think hedge funds perform a very valuable function for the capital markets, it's a very opportunistic capital, they tend to be the first buyers.

You know, the rest of the world will come on board when they see a trend of consequence in the stock market and they feel everything is fine. But the people willing to take risk are going to be the ones who are compensated for taking that kind of risk, and so that's my defense of hedge funds, if you will.

And then just one last thought, we are a registered investment advisor, we voluntarily registered under the Advisor's Act, and I think it has been very little consequence to us and hasn't harmed our business, if anything, I think it's helpful. I don't think we need a new regulation scheme for hedge funds. I don't think it's unduly burdensome for hedge funds to live within the current Advisor's Act.

My concern about the Grassley/Levin proposal to regulate hedge funds is, part of that legislation is the requirement that managers will provide a list of the names and addresses of every one of their investors. You know, I think one of the great rights of an American is the right to privacy. And can you imagine what – first of all, I don't think anyone would invest in a hedge fund if they were subject to having their name be in the newspaper as being an investor in a hedge fund, i.e., I'm a wealthy person, I'm in a hedge fund.

Why don't we just have J.P. Morgan provide a list of the top 100 depositors and where they live? I mean I think it's – so I think that we have to think about what the, you know, what's the benefit to the capital markets to get a list of – other than, you know, kind of pornography, if you will, what the benefits are to get a list of wealthy people. I mean it does – there's a interest in that, but I don't think it achieves anything in terms of protecting the capital market.

So I'm all in favor of regulation for hedge funds, but in a manner that doesn't destroy an industry that's going to be important to

bailing us out of our current issues.

SPEAKER: Thank you. I'd like to sort of go back to the panel, and I'm going to ask one question, and partly to respond to Bill's defense of hedge funds, which was terrific to hear. Let me pose a question this way; hedge funds are not homogeneous, there may be good hedge funds and bad hedge funds, there may be hedge funds that earn returns because they have managers that are excellent, have skills that other people don't have, that are able to take money and invest it in ways that yield above normal returns.

But there may also be hedge fund managers that, and this goes to the paper that Peyton is going to present shortly, are not so skillful, they either copy what other people are doing, or they take very large risks which maybe provide payoffs over five or ten year horizons, but at the expense of going broke periodically.

So to what extent has the hedge fund business model been – is it still intact given what we've gone through? It's not just I think – it's not just hedge funds as one entity, it's do we need any kind of regulation that separates out the good hedge funds from the bad hedge funds, or since you, yourself, mentioned that a lot of the people that are now investing in hedge funds are not just, you know, individuals who are making judgments, but these may be, you know, widows and orphans that depend on pensions and so on, so do you think that same model is going to be sustained going forward or do we need some regulation to kind of

wean out the people that are going – create trouble down the road. And I'm going to start at the other end and get some responses both to my question and to the other panelists' comments. Let me start with Jim – yes, I was confusing.

MR. ANGEL: Yeah, I think the point, pardon me, I think the point to remember is that, yes, the hedge funds are very diverse, and in any discussion of where they're coming from and where they're going, we need to take that diversity into account, that some of the hedge funds are plain old asset managers, some of them are acting like financial intermediaries, using leverage to manage assets.

Others are fundamentally acting as market makers or arbitragers. So you have a wide variety in diversity in business models here. But in addition to what Bill said, that a hedge fund is a compensation scheme, another thing that defines hedge funds is their flexibility. And personally I believe that the traditional long only manager is a dinosaur for a very simple reason, that if you are a chef and you only have one ingredient, you're going to have a very boring output. If you are a mechanic and you only have one tool, there's not a lot you can do. We now have many new investment tools, you know, not only long only investing in short selling, but we also have a number of derivative products and other things, and we have a generation of managers who are skilled in using these things. So it makes no sense whatsoever to restrain a money manager from using all the tools available to them.

So personally I believe that as we go forward, all money management firms will begin to look like hedge funds in terms of the diversity of their product choices and the tools they use. So, you know, that's a little bit about the evolution and where we're going.

Now, as far as the regulation goes, I think we need to take this diversity into account, and we need to focus on regulating not so much the institution, but the function. If you have a large entity, whether you call it a hedge fund, or an insurance company, or a bank, or a broker, or a whatever that's acting like an insurance company, you know, the regulation needs to be thinking about it as, okay, what kind of systemic risk do we have, what kind of consumer protection issues do we have, what kind of solvency issues do we have, you know. These are the kind of things that need to be addressed regardless of what label we put on the institution.

SPEAKER: Yeah, I rather like Mr. Ackman's description of what the essence of a hedge fund is, and that is that your basic – I would throw in a couple other elements. It's basically taking money from wealthy people and other sophisticated investors and channeling it to funds managers who are in a kind of partnership arrangement with you. And where you're looking – you're looking to take advantage of their skills. And there are a lot of different ways to make money in the financial market, so there are many, many, many different types of hedge funds.

If you look at that as sort of the central point of a hedge fund,

I think, yes, there's still very much a role for them. It does seem like it makes sense for them to be more lightly regulated than say a mutual fund. At the same time, I do expect there will need to be somewhat greater regulation, partly for those that have become so important that they're systemically significant, and partly because I do think there are legitimate complaints about the level of performance information being provided.

And it's true that you could probably deal with that via the ordinary sort of fraud laws, but it would be helpful I think to have some way of a greater standardization that somehow still worked with the diversity of the different approaches that exist. And again, I don't know the exact way to do that, but I do think something in that direction.

MR. BAILY: So, Bill, do you think we need to separate out the good from the bad or we should just let the market do that process?

MR. ACKMAN: I mean do you think it makes sense for Congress to pass a law that will differentiate the good stocks from the bad ones?

MR. BAILY: No.

MR. ACKMAN: I mean I think, you know, the market is much better at differentiating among a good investment manager versus an inferior one. And to the extent that there is strategies that are bad strategies, capital withdrawn from those funds, it'll be reallocated to funds that have better strategies, and that's a great, you know, market disciplining manner.

To the extent someone is using a game, like they're long – I read the paper, you know, long – 500, and you know, buying, you know, selling – out of the money to enhance the strategy, you know, good due diligence should fair out non, you know, so called alpha generating kinds of strategies, and capital will be reallocated in a way that makes sense. I think what we should be concerned about from a, you know, what's good for America, what we don't want to have happen is a hedge fund blows up and it takes down the banking system. And how can that happen? The only real way for that to happen is leverage.

Where there's – a regulated institution is providing a large amount of leverage to a hedge fund, the hedge fund takes enormous risk and loses not only its partner's capital, but the capital from a financial institution, and I think that's where the focus on regulation should take place, is on leverage, but I'm not sure that it needs to happen by regulating the hedge fund, simply just regulate the prime brokers that provide the leverage and you can, you know, figure out, you know, where the, you know, where the systemic risk issues are.

So I don't think it's that complicated. I think, you know, to the extent that a manager should, you know, should be subject to the SEC coming in and checking the books, I'm completely open to that, we are registered a registered advisor, and I think, you know, as long as that information is kept confidential, it's not in the public domain, I don't think there's any real good reason why a manager couldn't sign up for that kind

of regulatory regime. But beyond that, I'm not sure what we need.

SPEAKER: Well, let me press you on a couple points. If you do issue a public stock, there's a lot of disclosure requirements around that. Any company has to make a disclosure or an offering or something like that. So there's a lot of information that has to be provided in a public stock.

So one question is, should the hedge fund be required, should there be a set of information that it's required to offer about how it's going to invest the money or what are some of the risks involved in that money?

And the second point would be, should anybody be allowed to invest in hedge funds? I mean should we have the school teachers in Wisconsin investing in hedge funds or should there be some restrictions on who can invest in a hedge fund or not?

SPEAKER: Okay. So two answers; first of all, there are requirements on what you need to disclose if you want to raise money from investors, and we put out a, you know, a hedge fund manager puts out a very thorough offering memorandum with a list of – extensive list of risks, a description of the strategy, a description of the manager. One of the other big market disciplining forces of hedge funds, unlike other kinds of investment vehicles, is the hedge fund manager typically is the largest investor in hedge fund, you know, herself or himself, you know, again, common sense, if you are going to risk your capital with somebody, you

want to risk your capital with someone who has no money invested or you want to risk your capital with someone who has money invested.

I would propose the following. I would say a hedge fund manager should be given a choice. If they're going to be – if they're going to operate in the private domain and they don't want to make public filings, then they should only be able to raise money from private – not in public offerings, the way that things exist today.

But I also think – it seems a little unfair to me that if, you know, if you are not an investor that meets the accredited investor test, you're not a wealthy person under the definition, you're limited to investing in stocks directly, mutual funds, or long only managers, and – which meant that last year you lost about half of your capital if you invested with –

SPEAKER: Don't remind me.

SPEAKER: -- with those. Okay. But – so why is it that only the wealthy are permitted to invest with managers that use hedge strategies? I mean that doesn't seem like a particularly American kind of notion. And there isn't necessarily a correlation with being rich and being sophisticated about picking your investments, right, so the definition that the SEC has used for determining who can invest in a hedge fund is not based on your ability to assess the risks, but whether you have a net worth of a million or a million and a half or more, whether you made a certain amount of money in the past, or whether you inherited a lot of

money, right, those are the determinations as to whether you can invest in a hedge fund. Those, to me, don't seem like the right answers.

So a couple thoughts on that is, one, perhaps there could be a test that one could take to qualify them to invest in more complicated vehicles, right. You know, you want to drive, you've got to get a license, right, okay. It's not a crazy notion, as opposed to other net worth tests, that's one thought.

The other thought is, I think the best – one of the best ways to solve some of the problems with hedge funds, which is I think going to be better for the manager and better for the investors is, if hedge funds were allowed to be – the actual fund vehicles could be publicly traded. So today you can have a closed in vehicle that's a mutual fund, but you can't have a closed in vehicle that's a hedge fund that trades on the New York Stock Exchange. What would be the benefits of that? Well, number one, you'd have clearer SEC oversight, you'd have the Jim Chanoses of the world looking for the bad hedge funds, shorting them, you'd see the short interest grow, you'd think about whether you want to stay in that hedge fund or not, they would be available to the entire universe of investors, they would give the manager permanent capital until such time as the partners threw him out for poor performance, and the investors daily liquidity.

They could withdraw whenever they wanted by simply selling the stock in the market place. And today we do not have a regulatory regime

in the United States that allows you to have a publicly traded hedge fund. And it would provide much more – if Madoff, you know, Jim made this point earlier, I don't remember –

SPEAKER: I'm glad we got to him, okay.

SPEAKER: But if you think about Madoff, Madoff could not have happened, in my view, for 30 years if Madoff was a publicly traded vehicle, because enough of the Markopolises of the world out there would be – the performance would be out there in the public domain, and some smart investor would short the stock, and then either inform the SEC or put out a public analysis of why this is a – strategy, and Mr. Madoff would be forced to defend himself. And it's because Mr. Madoff operated in the shadows, and by the way, he was not a hedge fund manager, he was a managed account manager, he was able to get away with one of the great, you know, frauds of all time.

So I'm all in favor of providing access to, you know, it's much riskier to buy an internet stock. We allowed the investing public to invest in very, very high risk ventures in the public stock market, okay, but they're not allowed to invest in hedged investment strategies unless they have a net worth above a certain level; it doesn't make any sense at all.

If you're a private individual with a $25,000 net worth, you're permitted to take your entire net worth and speculate on short term stock options, right, but you're not allowed to invest in a hedge fund manager with a 20 year gray track record, that doesn't seem right to me.

MR. BAILY: Well, I'm going to throw this open, but I can't resist just asking you one more question, and that is, a friend of mine lost a lot of money on LTCM when it went down, and his comment to me was, I discovered that hedge funds don't hedge, so is that wrong or – they weren't hedging, they were betting, right?

SPEAKER: The problem with LTCM is, they used 100 to one leverage. And if you've got a hedge strategy with 100 to one leverage, you're guaranteed you'll lose your money, you know, when you hit a pot hole, you know, that's basically how it works. And we've all hit – all of us in business have hit pot holes along the way, but leverage is really the problem.

The answer is, some hedge fund strategies are hedged and some are not, and they tell you whether they are or they're not. And I would rather rely on an individual's judgment, do I want to be with a manager that's levered and betting on the stock market going up, do I want to be on a guy who's long and short, he's not going to make me as much when the market goes up, but he's not going to lose my fortune when the market goes down. Just public disclosure, transparency, access to a broader rate of the public, and the market will discipline the good managers from the bad managers, and we have a very successful system.

MR. BAILY: Okay. Let me throw this open. Could you please identify yourselves, and there are some mics coming around. Okay, do you want to start here?

MR. CHIN: Yeah, Chow Chin Freedom Correspondence. Mr. William Ackman, you said the hedge fund industry lack the public relation; would your hedge fund do some public relation from now on, and then if you do, what's the content of your public relation? And you touch the word, privacy, and now – we heard transparency a lot, so how do you get the balance between privacy and transparency?

And also, to everybody on – about there, if I exam further my perception is – the function of hedge fund is somewhat like a bank. Thank you.

MR. ACKMAN: Okay. I'll see if I can remember all of that. On privacy versus transparency, my point on privacy is, I think an individual and his or her net worth and where they invest should be a private thing. So if someone wants to invest in a mutual fund, it wouldn't seem to be fair that if Fidelity had to post a list of everyone who was in the Magellan fund. And the same way, I don't think it's appropriate that there should be a list of everyone who's invested in Jim Chanos' hedge fund. So that was my point on privacy. On transparency, I think that transparency is a good thing to a limit, and I'll give an example on that. Some strategy – if you think about what a hedge fund manager does, if they invest in relatively few situations, that's really their intellectual property. And to the extent they have to disclose the day after they make an investment what that investment is, and it can be expropriated by everyone else in the market place, we'll take away that manager's benefit.

So right now we have the transparency that's required for managers in the U.S. is a 13 and a half – 13G – a 13D system, where there's a reasonable period of time where a manager can accumulate a position before they're required to report it publicly.

There was a proposal for hedge funds to have to disclose their short positions in the same fashion, and the theory behind it was, well, we're going to find out who's piling in and taking down the banks and we're going – we think hedge funds are operating in a collusive manner to drive down the stocks of, you know, pick a – or pick a financial institution. And there was a point in time where the SEC was going to put out on their web site a list of which stocks, and I keep picking on Jim because he's the famous short seller, but which stocks Jim Chanos was short, and all that would serve to do, by the way, is guarantee that those stocks were declined, because if you were an investor and you said –

SPEAKER: Not always.

MR. ACKMAN: -- wouldn't guarantee always, but actually I think it would. And exactly the kind of collusive behavior that people are concerned about is, what do you do – what do people do with 13 – when Warren Buffet files a 13F, discloses he just bought ten million shares of a stock, the stock tends to go up because the Warren Buffet followers buy the stock because they think Warren Buffet is a smart guy.

Well, the Jim Chanos followers on the short side see Jim Chanos is short of stock, well, they don't need to be collusive at all, they

just need to go to the SEC web site and figure out which stocks he's short, they're going to short them, as well, and then the managers who are along those stocks are going to say, hey, Jim's had a good check, or being a short seller, why do I want to be a long – a stock that Jim has such a big short position, I'm going to sell, and that, in turn, is just going to drive stocks down. So you want to be careful that transparency doesn't actually create the problem you're trying to address. So where we are now I think with short selling disclosure in the U.S. is a reasonable place, which is, the SEC is actually collecting data from managers on which stocks are short on a relatively – every two weeks I have to file a form, here are the stocks that I'm short, it goes into a file cabinet at the SEC, no one ever looks at it, but my point is, that's a much better system, and what I would do if I were Chairman of the SEC is, I would actually go look in the file cabinet, and I would say, look, there's big short positions building in company XYZ, and it's not really a bet on – it's not, you know, you're shorting – not because you think the business is, you know, there are two kinds of shorts, there's shorts because you think that business is going to do poorly and there's shorts because you think the business is fraudulent.

And what I would do is, I would look for the big short positions and I might contact some of the managers and say, hey, why are you short company XYZ, and if Jim tells you it's a fraud, then I would put the enforcement people on it, you know, kind of right away. So I think there's some – there's value in transparency, we've got to think very hard

before we put something out in the public domain versus put something in a file cabinet at the SEC because the implications from a systemic point of view can be very, very negative. I think you had three questions, I don't remember, on public relations, and then I'll leave it to someone else.

The reason why the hedge fund industry is so easily attacked by the press is, we are limited by law in terms of the kind of public, what's called advertising, we're not allowed to advertise.

And the SEC's definition of advertising, your lawyers will tell you, is very, very broad. So if you speak at the Brookings Institute, and you say the wrong thing, someone might say, ah, you were recruiting investors for your hedge fund, and a lot of hedge fund managers, as a result, won't speak publicly, won't write an article, won't do an op-ed, because the risk reward of getting a slap on your wrist from the SEC versus providing – doing PR, if you will, is, you know, is just not an interactive risk reward, and that forces the industry into the shadows. And it's all – it's part of this whole thing about you can't raise money except from high net worth investors on a, you know, a word of mouth basis. And I think – it's not clear to me that that's the right way to protect the markets and to protect investors.

MR. BAILY: Is there anything you guys want to add on this discussion or should we take some more questions?

SPEAKER: Well, I'd like to emphasize the fact that when we're talking about transparency, we are talking about breaching peoples'

intellectual property rights, and there better be a very good public purpose for doing so. In a world where we're becoming ever more conscience of intellectual property, in a world where we are beating on other countries to respect our copyrights and our patents, we need to be aware that market data is not a free good, that peoples' investment positions are their own personal property, and whenever we breach that property right, we better have a very good public purpose for doing so.

MR. BAILY: Okay. Let's take some more questions; over there.

SPEAKER: Thanks; I'd like to go back to the bigger picture.

MR. BAILY: Could you just identify yourself?

SPEAKER: -- the question is, there seems the – issue of the financial bailout or recovery as we call it now is the variation of the toxic asset, and you just alluded to the point that it can be 30, it can be 60, or in between, or even zero, or maybe 120, who knows, but the point is that it cannot be known at this point, it depends on a future value. So given that in public eyes the private side has little credibility and the public--the government, are quite incompetent, you're kind of guaranteed that the taxpayer's going to lose if you have a partnership of some sort. But at the same time, there's another event lately. It's called backdating. It's a crime. But if you think about it is it possible to use that technique for the government to work with the private side, basically try to see -- we don't decide who gets what now. We put out the funds, but maybe 5 years from now or 10 years

from now, looking back, using this backdating -- backdating is basically CEOs exercising their options and try to use the strike price and go back to look for a lower point when they initially paid into the -- paid in for their shares.

So if you do this -- now, we'll take out the question of making a specific determination valuation at this point and maybe set up agreement of 50-50 between the private and public, and make sure that the public doesn't get, you know, the short side, the short end of the equation. The private would also be willing to join the process.

MR. BAILY: Can you bring it up to a conclusive end to your question?

SPEAKER: That's it. I hope to hear your comments.

MR. BAILY: Okay. Doug, do you want to take that?

MR. ELLIOTT: Sure. I mean, the issue is there's a great deal of uncertainty. Right now it exists with the banks because they -- I mean, there are some other people who own the assets, but we're focused on the banks. You could shift portion of that uncertainty, as you suggest, rather than the total. You could, for example, have the backdating you're describing mean that you'd pay the bank on a contingent basis, perhaps some fixed amount at a contingent. The problem with that is then you've left a lot of uncertainty with the banks. You may not have improved things that much.

You could move all the uncertainty from the banks to a

combination of the public and private and have an agreement between them as to how to go back afterwards and make a revision. You could do that. My guess is it's probably not that attractive to the private sector investors, but that is one thing one could look at.

SPEAKER: Let me see if I can address what you say as well. I think it's a very simple solution to the problem. You want to sell assets and maximize their value, what you do is you provide full transparency in the broadest possible way about details about the assets. You set up a data room online with $50 billion worth of stuff that you want to sell or $10 billion worth of stuff that you want to sell. The government is not the partner of the private sector. The government should be a lender to the private sector. So the government puts up 75 percent financing to anyone, the winning bidder, at a rate of -- pick a rate -- 7 percent. And where the government gets an addition for providing that financing that's not today available in the marketplace, 20 percent of the profits, let's say, that the purchaser ultimately receives.

You hold the -- you take the most similar assets, you put them up for sale. These are a huge amount of private capital sitting on the sidelines looking for opportunities. You've got built-in financing. The high bidder wins in an auction-type context. That's the way you maximize the value of the assets.

Now let's fast forward five years from now. Let's say it turns out it was a bad bet for the private sector. Well, the good thing about this is,

number one, the taxpayer's in a senior position and the private sector's in a first loss position. That's -- so, number one, there's going to be more capital. So if government made available $750 billion, there would be actually $1 trillion available to buy these assets. Number one, it increases the amount of capital available.

Number two, the private sector determines the price in a completely fair and transparent manner.

Number three, the transparency and the auction context make sure that you're getting the highest possible value. And if the private sector fails, the government forecloses back on the asset, puts it up for sale again, and they provide 75 percent financing to the next buyer, okay. And ultimately, that's how you rationalize the assets.

And the best analogy I can give to this is if you look at the RTC. The RTC did a very efficient job in getting rid of assets the government ended up owning as a result of failed banks. And there were some assets that the RTC just couldn't sell. There were no buyers for lands. So what did the RTC do? Well, originally the RTC said you've got to come up with your own financing. The government didn't finance any of the purchases. When it got down to the few scraps of things that couldn't be sold, the government provided seller financing and the government took back a mortgage, 75 cents on the dollar or 80 cents on the dollar mortgage, until they found a buyer for the asset. I just think that's a very, very simple way to deal with the problem. You pick an interest rate -- and by the way, if the government ends

up providing financing and the buyer got a huge windfall, the government's going to get a piece of the profits from their share of the participation. It's a simple as that.

MR. BAILY: Now, that sounds great, to some extent. No, no, I'm not being facetious. It does. I think we should put you in charge of the plan. But --

SPEAKER: I've got a few other ideas if you want to hear them.

MR. BAILY: But when Paulson was Treasury secretary and he brought in all these smart folks from Goldman Sachs, they couldn't seem to be able to work out a plan. Is that just because it was a mistake or they didn't have long enough or it wasn't -- what was the missing ingredient that they needed in order to make that work?

SPEAKER: They didn't follow pure economic rationality and they let politics affect decision making. And, you know, if you want, I'm happy to walk you through some examples, but, I mean, we're doing the same thing now. Geitner's doing the same thing now with the banking system. You know, if you look at Fannie and Freddie. How would that have been restructured in the private sector? So Fannie and Freddie together had $1.8 trillion worth of debt and they had a little sliver of equity and clearly their assets were worth less than their liabilities. So what do you do in a situation like that if there's no government?

What you do is you go into bankruptcy. You sit in front of a

judge, you argue about what the firm is worth, you come up with a value. You figure out what kind of debt this now combined Fannie and Freddie, let's say, can support. Well, they got $1.8 trillion and it turns out the firm is worth $1.4 trillion, or whatever, you figure out a number. You convert enough debt as necessary into equity so you have a solid firm. It re-emerges. It lists on the New York Stock Exchange and it trades publicly.

What the government did instead of that -- I actually laid this plan out and sent it by e-mail to Paulson and went on CNBC and talked about it -- the government said, okay, we're going to wipe out the equity holders. We're not really going to wipe them out. We're going to let the stock continue to trade, but effectively we're going to wipe them out. We're going to wipe out the preferred stockholders. And we're going to stop at the junior debt of Fannie Mae and we're just going to keep feeding -- we're going to feed $100 billion of equity into each institution with taxpayer money. So you've got an insolvent institution with a trillion -- combined $1 trillion 800 billion worth of debt and $200 billion was fed into it. What happened to that money? It went to pay interest to bond holders on bonds that weren't worth par.

Look at the General Motors situation. You've got an insolvent auto company. It can't compete on a global basis with the capital structure and the contracts it has. What do you do in the private sector? You put it into bankruptcy, you convert sufficient debt into equity so you have solvent business that can compete on a global scale, you emerge, and you've got a

profitable business.

What did the government do? They leave all the debt outstanding. They put $14 billion into General Motors. It's enough to pay interest for about 90 days. And then they're going to file for bankruptcy again or they're going to kick the can down the road.

Now, I think it happened for political reasons. I think George Bush did not want General Motors on his resume as a bankruptcy. You know, it was bad enough as it is and he didn't -- (Laughter) you know, the last thing he needed, you know. No disrespect intended, but the last thing he wanted was to be the president where the automakers went bankrupt. That's going to happen in the Obama Administration.

The unfortunate thing about it is that we wasted taxpayer money. That money went to pay interest no bonds that weren't worth anything near par.

So we just need pure economic rationality. We do the same thing with the banking system. We're putting equity into banks, many of which are insolvent. The taxpayers are -- that money is going to pay interest on debts. Most of these banks have a lot of debt. When you bought a bond issued by a particular bank, you were taking a risk and it didn't work out. So what should you do? You should put the bank into, you know, a conservatorship, in effect. You should wipe out the equity. You convert as much debt as necessary to have a solvent institution. They should auction off their bad assets at whatever the price is.

And if that -- if the institution is not -- imagine a bank that has a trillion dollars of assets and $200 billion of debt. I'm not going to name names, okay, or $2 trillion of assets and $400 billion of debt. I mean, you can pick a financial institution. But if you just convert that debt into equity you've got -- you probably -- you have enough capital in the bank where you can absorb the real losses. You auction off the assets with the private sector methodology we talked about.

If what happens after all of that this institution is still insolvent, then if you think it's in the interest of the system you can put equity into the institution. The taxpayer is protected and you have a bank now that's paying zero on deposits, that can make good loans, and it can earn its way out of the problem and you can recover on the debt. So there is a simple, straightforward way to solve the problem in my opinion.

Thank you.

MR. BAILY: Did you have a comment, Jim?

MR. ANGEL: Yes. I'd like to add that the big issue here is that of risk management. Who bears the risk here?

Now, we created our central bank nearly a century ago, our third attempt at a central bank, as a lender of last resort. But in reality what we're talking about is a risk manager of last resort.

Now, our private institutions provide a number of risk management tools, a number of risk managing entities. However, there are some risks that the private sector just does not handle well. You know, for

example, flood insurance. You know, it's very hard to diversify floods or earthquake risk. So there is a role for government as the risk manager of last resort as well as being the lender of last resort.

You know, there's plenty of capital sloshing around our system. It's all really risk adverse. And I can't really blame it right now given the current economic conditions. But it is --

SPEAKER: If I -- the problem that we have is the government is not being the lender of last resort. It's being the lender of second resort. You know, my point, it's stepping between last resort and where it should be in the capital structure of financial institutions. And the unfortunate thing is we're wasting a lot of taxpayer -- we're ultimately going to have to do the right thing because there's just not enough money in the Treasury, there's not enough -- our currency is going to have no value by the time that we finish the program unless we do it in a completely economically rational way. And we could have, in a very short period of time, a totally solvent banking system. We can quantify exactly what kind of contribution's necessary from the private sector. But we have to face the facts, you know. Otherwise, we're going to just --

MR. ANGEL: Although the issue is how much -- risk management, how much deposit insurance does the government provide? Is it only 250,000 to retailer deposits or do we guarantee all liabilities. Now, we discovered in the Depression that we had to guarantee at least the small retail deposits to prevent runs on the bank. But such a large fraction of a

bank's capital is coming not just from the small retail accounts, but also from the larger debt instruments they're issuing. So the debate is how much of a bank's liabilities should we guarantee?

SPEAKER: And I think it should -- the answer is we should guarantee deposits, we should guarantee counterparty risks now because of the systemic implications of not doing so, but we should not guarantee the bond holders who bought a bond, have been paid a return for the risks they took when they bought the bond. There's just no sense in it at all. And if the banks are properly capitalized, there'll be very little risk for the government on both deposit insurance and on counterparty risk.

MR. ANGEL: Yeah, but wait a minute. What's the difference, you know, if I go --

MR. BAILY: Last comment. We're running out of time, but just make your last comment.

MR. ANGEL: -- a one-year bond and a one-year CD from a bank?

SPEAKER: The difference is that it -- a bond holder bought a -- made a bet on the financial institution and the person who bought a CD parked their capital in the bank as a fiduciary. The bank (inaudible) fiduciary.

MR. ANGEL: So you're saying Aunt Sally buys a bond, you know, and her e-Trade account is making a bet on the financial institution.

SPEAKER: That's right.

MR. BAILY: On that note --

SPEAKER: Like an equity holder.

MR. BAILY: -- I'm going to have to wind it up. This was a great discussion. Thank you so much.

We're running about 5 minutes late, so if we could keep this down to about a 5-, 10-minute break, that would be great. Thank you again. That was terrific. Thank you so much.

(Recess)

MR. BAILY: Okay, let's get started again. Sorry, I think that's my fault that I'm holding people up.

So our next speaker is Peyton Young. It's a great pleasure to introduce Peyton. Peyton is a colleague here in the Senior Fellow in economic studies. He and I were also former colleagues at the University of Maryland some years ago. He's now also the James Meade Professor of Economics at Oxford University. And he's going to talk today about why transparency matters. Peyton, thank you.

MR. YOUNG: Thank you very much. I'm here really in a capacity as an economist, not a hedge fund manager, not as a financial analyst. I want to briefly run through some ideas about transparency. This has been a theme that has recurred in almost every single presentation so far and I suspect it will be in the remaining panel as well. And there are a lot of dimensions in which transparency matters.

Broadly speaking from an economic point of view, markets operate most efficiently if there is transparency of information. And, in fact, in

the case of financial entities, assets, trading, funds and so forth, risk and the information about risk is the key. To the extent that the investing public, whether the investing public consists of highly sophisticated rich individuals such as typically would invest in hedge funds or the broader public, all of those people need as great a degree of information, reliable information, as they can get. I do not accept, by the way, the notion that somehow sophisticated or high net worth individuals are different in this respect. They all need lots of information. And actually this is one of the things that government is quite good at providing, a framework in which information is given to the public at large.

Analogies abound. One of them is, of course, what we take for granted, food and drug labeling. Just the simple matter of labeling things that you consume, that you put in your mouth, is a key part of the way in which markets function efficiently for foods and drugs. It's sort of so obvious, we take this for granted. There was a time when this wasn't provided. I would submit that that kind of transparency in the hedge fund industry and, more broadly, in other related kinds of entities, investment entities, will go a long way toward improving the efficiency and reliability of these markets.

Part of the twist I want to put on this is the issue of confidence. The reason that information and transparency is so important is it enhances investor confidence in making those investments, in putting their money in certain entities and not in others. When the information is lacking, confidence can not only decline, it can literally collapse, and that can cause

severe problems and great inefficiencies for a long period of time. I'm afraid that we're looking at such a time right now. There has been a collapse of confidence that you know what you're getting when you invest in various entities. And, of course, this applies not only to hedge funds, it applies to some of the things we were talking about earlier. The banks, what are these toxic assets? We don't want to invest in them because we don't know what's there.

So that's the broader theme that I want to emphasize. It's not detailed regulatory intervention. It's an informational scheme that the government can help support by appropriate agencies and by appropriate legislation.

Now, what I want to do, though, is since this is about hedge funds specifically, I want to walk through a couple of examples which to some practitioners in the audience will be reasonably familiar, not that surprising. It's all about what happens when you don't have transparency. And, I mean, don't have any transparency. What can go wrong? I want to -- since a number of people will not be familiar with this, I'd like to go through a couple of examples and then come back to some of the broader policy implications.

So I'm going to refer to the so-called Black Box Investing Model. First of all, it's been said -- and I emphasize it again -- hedge funds constitute an enormous universe, some of which, in fact, will not fall at all under this rubric. They are registered. They provide all kinds of information

to their investors about what they are and are not investing in. They run due diligence. They have regular audits. They have, you know, beautifully presented returns. I'm not talking about those people. I'm talking about the other part of the hedge fund universe that does not do this, and there is a very significant part that does not. They basically operate a Black Box Model.

We could name names. Some of the biggest hedge funds in the industry actually still do this. Pretty much you cannot find out, if you're just an ordinary but high net worth individual wanting to invest in these, you can't find out what they are doing and they won't tell you. Nothing. They will report returns and that's about it. That's what I call Black Box investing. All you see are the returns. The audited returns say once a quarter, once a year, that's it. You have a history of the returns.

Now, I claim that, unfortunately, that is very, very easy to fake. And it's fake -- can be faked not in the sense of Bernard Madoff. So, again, I want to sort of draw a distinction between what is in the news now, a Madoff or a Ponzi scheme, assuming that it is a Ponzi scheme; we don't actually, by the way, know completely what sort of a scheme it was. Let's say it was a Ponzi scheme. This is a different kind of scheme. I'll explain how it works.

Hedge fund managers, and indeed can quite a few just private partnerships of one sort and another, can engage in a whole lot of options trading strategies, often called dynamic trading strategies. And this uses the

wizardry of financial engineering and the huge number of financial instruments now available that were not available, say -- or not widely available 20 or 30 years ago. But while all of that is very good and in principle efficiency enhancing, what you can do with these options and various forms of derivatives is you can manipulate the distribution of returns to make it look as if you're generating above-average returns when, in fact, you are not doing so. This has been given various names. Some people call it fake alpha, some people call it beta masquerading as alpha, black swans, you know, there's some colorful language to go along with this; all amounts to the same thing.

What I'm going to do is walk you through a very, very simple example, appalling simple. I hope that nobody in the hedge fund universe that's here would ever think of doing this, but it can be done.

Here is a picture of, say, "my" hedge fund run according to my method, and that's the red line. And now the blue line is just a straight line. That's the return on T bills basically over the last decade. And the red line is my reported returns, and I claim this is absolute alpha. This is way -- say this is uncorrelated with the stock market, so it's a dandy investment and it's way, way above T bill returns. But the whole thing is a fake. And the reason it is a fake is that the way I generate this is that I invest in the T bills all right, and then I invest -- I take position, short positions and puts, on some other entities, say some stock market or other. And these are out-of-the-money puts and it's very unlikely that they'll be exercised.

And when I do this I absolutely bet the ranch, meaning I get a position going which, if it ever were to materialize against me, my entire fund will be cleaned out. But it's unlikely that this will happen. How unlikely we're going to go over in just a minute. And if it doesn't happen, the payment I get, in effect, is that it juices up the current returns. And these are bone fide returns; these are not fraudulent. And I want to emphasis this, we're not talking fraud here. It's only fraud if I said I wasn't doing this, if in the prospectus I said I am not going to hold derivatives, say, but I did anyway. That's fraud, but this is not. This is merely a bet. It's a betting model.

You can do this against T bills. You can do this against the Standard & Poor's. You can do this against a wide variety of underlying assets. And basically, my co-author and I call this piggybacking, you're basically padding or building up a return of some underlying asset by an appreciable amount and you're doing this for two reasons.

First, you want to earn the fees that go along with that. In the hedge fund business, that's often 20 percent of that gap between the T bill rate and what you're producing in the red line. Let's go back to this. That would be a big gap and it'd take 20 percent of that difference. Okay? This is a very attractive return.

The second thing is that, you know, I'm not reporting what's driving this. I say, well, that's a proprietary strategy. All you can see is my returns and I attract new money by doing this.

So unless you are contradicting some information you're

providing to your investors, this isn't, strictly speaking, illegal fraud. It's definitely not a Ponzi scheme. I'm not using payments into the fund by Peter to pay Paul. That's who that works and that's fraud. That's fraudulent conveyance. This is not a fraudulent conveyance.

In fact, one of the ways that we work this is all the positions we assume are fully covered and paid for. All the options are covered. There's no issue here of I won't be able to meet margin calls. If you do that, you're going to invent even fancier schemes. I want to keep this very simple to illustrate that you can really look good and not generate any access returns in fact.

The reported returns look very good, but they're -- what's going to happen? Why -- you know, what is eventually going to happen? Well, of course, eventually the fund's going to go bust. There's a hidden black swan there. There it is. It happened in late 2008. That fund, that red fund that looked so wonderful and was drawing in new money crashed in December of 2008.

This is simulation. This is a made-up example, but it's used to illustrate this point. These things can run for a very surprisingly long period of time before the truth is revealed. How long? Well, we can do a little calculation. X is the piggybacking amount, say you're padding by 5 percent or 10 percent or 15 percent, and over on the right-hand side is the expected number of years before that bust will actually materialize. Look at the -- well, with a 5 percent padding you can just basically run till you retire. With the

middle one, you've still got 11 years to go, on average, and maybe you'll go a whole lot longer and you won't get caught.

Now you might say, well, no rational manager would do that. They want to stay in business for 20 or 30 years. Well, you know, there's some -- there are different kinds of managers, aren't there? Some might find that this is a pretty good deal actually.

So, well, what do the investors -- why are the investors going for this? They don't know that that's what is going on. And this is one of the problems with the -- I hate to use the hedge fund industry as a -- it's an umbrella that covers a huge variety of different styles of management and degrees of voluntary disclosure, but let's just use it as sort of a placeholder for now. In principle, you can get away with this under the current regulatory environment. That's just a fact. And as a -- and furthermore, I have to tell you that when I've given this same talk at hedge fund management conferences, I've been told privately by a number of people that they know other people in the business who are pretty much doing this. So I submit, although we can't measure how much it's going on, there's reason to think it is going on.

Also, it can go on to a partial degree. And I think this, unfortunately, could be quite widespread. You've got a great long-short trading strategy. You've got some proprietary method. But in a given year or a given quarter it's not going so well. Gee, it's awfully tempting to pull one of these stunts just for a quarter or just for a year to sort of get through that and

hope you don't get cleaned out. So there may be partial implementation to this going on. But again, investors cannot tell unless they're provided much more detailed information. I'm going to talk about the nature of that information in a minute.

And why is this important? Well, you could say that investors are simply being foolish. I mean, they should not simply look at the return series. They should demand much more. But, unfortunately, that's like saying that there are some drugs in the store that don't have content labels and people are buying them because they think they're going to get well if they take those drugs. My own view of this is that there's a broad remit of government that needs to provide some sort of safety net, both for sophisticated and unsophisticated investors, and that means basically some form of labeling. What is in this and how risky is it?

That doesn't mean you have to give away the proprietary strategy any more than listing what's on a drug or a food as content gives away what the formula is. It's just not so. Furthermore, in fact, there are ways of aggregating the information so that you really don't give much away at all.

The deeper point, though, is that even if we weren't in our current environment, one Bernard Madoff can trigger a collapse of confidence because suddenly people realize what they should have realized earlier, that they really don't know what they've gotten themselves into. And when you're dealing with a Black Box Model, this is the problem. It's a

problem actually not only for the investors, I submit, it's a problem for the industry. The industry itself has a strong interest in promoting greater transparency. That's the message of this talk.

And why is this? Because there are a lot of great players out there. They're very good. They are generating value for their investors. But they're going to be pulled down, too, if there's a collapse of confidence.

So here are sort of my concluding points. There are two. First, there are a number of reforms with weak teeth or let's call them dentures. They aren't going to do the trick and, in fact, they could be worse than useless because they give a false sense of security to the investor community.

And what are those? Some of the standard value at-risk measures are really easy to circumvent using variance of the strategy I just said. They are very weak and not adequate.

Much in the air is the idea of postponing managers' fees. Well, it'll go some distance, but it's pretty easy to get around that, too, using, again, a variant of the method that I'm talking about.

What about assessing personal penalties, i.e., you got to post a personal bond as a manager? And if you do badly, not only are you not going to get paid a bonus, you're going to be out some money that was in your -- in an escrow account. This, of course, would be draconian. I've never even heard of scheme like this except for Lloyd's of London, where the names actually are -- have personal liability for their investments, but this

would be a radical solution. But even that won't work. Why? Because basically this means that even the smart managers, the start-up guys, aren't even going to want to participate in the scheme to begin with. Either they don't have a personal bond to post or they won't want to do it.

That leaves us then with, in my view, some steps should be taken. It's in the interest of the industry to take those steps, but they are fairly mild. As somebody who does research in this area I have to tell you that the amount of data, reliable data, about hedge fund returns is appallingly low. Hedge funds need to be registered at inception. Their managers names need to be known. All of this must be -- returns have to be audited frequently and publicly by an auditing firm with expertise in the relevant financial instruments. And finally, what is not the case now, unless it's voluntary, when a fund closes down, we don't even know the final value paid out to the investors. So actually this business about crashes and that causes the fund to close down, we don't even know how often this is occurring in the data. So as an absolute minimum I would suggest, and I don't think this is terribly controversial, we need to have registration, regular reporting on the part of all hedge funds. And I actually think it's in the interest of the leaders in the industry to promote that.

Thank you very much.

MR. BAILY: So we're going to move into the next panel. Sebastian Mallaby's going to moderate.

MR. MALLABY: Okay. While my panel is getting miked up I

think we can get started. My name is Sebastian Mallaby. I direct the Center for Geoeconomic Studies at the Council on Foreign Relations. I'll be moderating the second panel, where we're going to talk about the emerging regulatory environment for hedge funds.

We've got a terrific group to talk about this. On the very end there is Professor Andrew Lo of the Harris & Harris -- is this mike on? Maybe I should have this higher. How's that? I will try and speak up.

So at the end there is Professor Andrew Lo from MIT, Harris & Harris Group, professor of finance. He's written a lot on hedge funds, including a book which I think came out last year, and has testified before the House Oversight Committee on hedge funds. I have -- the next is Peyton Young you've just heard from of the Brookings Institution. Then there is Jim Chanos, referred to many times in the previous panel as "the famous short seller." He is also -- his fund is called Kynikos -- am I pronouncing it right -- Associates. And he is the president of the Coalition of Private Investment Companies, which is an investment fund industry group. And next to me you've heard already this morning from Glenn Hutchins, a trustee here at Brookings and co-founder and CEO of Silver Lake, a private equity fund in New York, and part owner of the Boston Celtics.

Now, I think we're going to start with opening remarks from everybody. So why don't we go first to Andrew Lo to get some opening remarks?

MR. LO: Well, first, I want to start by thanking the Brookings

Institution for inviting me here today. And in the interest of full disclosure I should mention that I'm also affiliated with an asset management company that manages hedge funds as well as my academic activities.

I won't say too much at the start because I think the most interesting part of this panel will be the interaction with audience questions. But the regulation of hedge funds I think is a very important issue that has obviously surfaced over the last few months. And in the research that I've done with my co-authors over the last few years, we've been calling for more transparency to regulators because the systemic risk posed by hedge funds can be considerable.

Obviously the hedge fund industry is an incredibly valuable part of the economy. It's one of the most vibrant parts of the financial services industry. And frankly, the hedge fund industry's one of the reasons why we've experienced such tremendous growth in the real economy over the last couple of decades. But at the same time, there's a number of systemic issues that have been arisen because hedge funds engage in such a wide variety of activities and because there isn't any central regulatory authority that understands the risk exposures. But I think that it's possible to have our cake and eat it, too, in terms of being able to benefit from the capital-building benefits of hedge funds while, at the same time, providing limited disclosure of the systemic exposures to regulators. And the hope is that over the next few months we'll see new regulations drafted to effect those changes.

MR. MALLABY: Okay. Peyton, do you want to say something or you feel --

MR. YOUNG: No, I'll pass.

MR. MALLABY: Okay. Let's go to Jim Chanos.

MR. CHANOS: Thank you, Sebastian, and thanks again to Brookings for doing this. I think this is a tremendous forum for getting these issues out, and the timing couldn't be better.

I'll make a few remarks about hedge fund regulation going forward, but just in a move one step backwards to the previous panels to where we've come, I would stress to everyone that, in fact, despite the federal courts dropping the SEC's move to register, on a mandatory basis, hedge funds, we've had hedge funds regulated for the past number of years by federal agencies. They were called Lehman Brothers. They were called Bear Stearns. And I say this only half tongue in cheek because what drove those entities into the ground was, in effect, their proprietary trading desks and the residuals that they kept on their books from their securitization activities, where the accounting was if not questionable, outright fraudulent in my opinion. More on that later.

So, again, to my questions earlier to the panel and to speakers and to Senator Reed, keep in mind that more regulation doesn't mean better regulation. We need smart regulation. We really need people who've sat on trading desks, people who've run hedge funds, people who've run investment firms to be SEC commissioners, to be new risk regulators, to be

systemic risk regulators if we end up with that. Where are these people? They are few and far between. We need to call them into public service and to get them on behalf of the U.S. citizenry and the taxpayer to safeguard their investments and to safeguard the financial system.

Unfortunately, we have, seemingly, from the industry's perspective, too much of a revolving door of the people who are at the top of regulatory environment over and over again with very, very well-educated and well-meaning staffs below them, who are simply overwhelmed because, in many cases, they don't have the day-to-day experience of the types of businesses of that of which they're regulating. And I can't stress that enough.

I think it was FDR who put the biggest short seller was Joe Kennedy as the first chair of the SEC, saying something like who better to guard the henhouse but the chief fox?

MR. MALLABY: Are you looking for that joke, too?

MR. CHANOS: No. (Laughter) It just makes my point, Sebastian, that we need people, you know, the Julian Robertson's of the world, people like that, who've maybe made their money, but have a sense of give-back, to add their weight of years and experience to basically help these, again, very well-meaning staffs and guide them in the right way in what to look for and what might be problematic in the future.

Having said all that, our industry knows that it will become part of the regulatory framework. We fully expect it. Our organization (inaudible)

expects to cooperate fully with our membership in being part of that process and being part of that dialogue. I think for the industry to stand outside with its nose pressed against the window would be the height of irresponsibility and foolishness.

We hope that we can stress the role that hedge funds do play in capital formation and in price discovery, not least of which, from my perspective, also is real-time financial watchdogs, which is not discussed enough in terms of the role hedge funds played in warning our regulators in '06 and '07 about some of the looming problems. Those warnings were, by and large, ignored.

So I think that the industry stands ready to be part of that dialogue. I know there's going to be a wide variety of ancillary subjects that are going to come part and parcel with that, taxation, for example. The whole concept of offshore funds I think is going to be revisited. And our organization thinks it probably should be revisited. Corollary items would be possibly some sort of watering down or elimination of UBTI, which is an anachronism, in my opinion, and prevents an awful lot of capital from going to domestic fund managers. Instead being forced offshore for no good reason. In fact, one could argue the whole offshore structure from an optics point of view probably should go away. And I think personally I would applaud attempts to make that happen.

Furthermore, the issues of transparency which were touched on in the last presentation and in the previous panel I think will be discussed

pretty aggressively on both sides. I can argue that better transparency is, of course, almost always good, but that proprietary information is, as Professor Angel said, is something that also needs to be protected. If I have to put out my entire portfolio every 90 days, I think that that intellectual property that my clients pay good money for, you know, is given out for free 4 times a year. I would have a problem with that. Disclosing positions to regulators, I think, almost nobody at this point in the hedge fund industry has any problem with. And my guess is we're going to see some sort of regime like that going forward.

As to better transparency for investors, I'm all for it. These are private deals, typically between the investor and the manager. I would love to have lots of investors of the type you were referring to, who apparently do no due diligence whatsoever. I found that not to be the case, unfortunately, in my fund-raising activities. I spend an awful lot of time, as does my CFO and my head of research and my head of trading, going through all sorts of processes, people looking at trades, looking at past trades. So -- although I do think some piggybacking type strategies have occurred, and, in fact, in two or three large circumstances still continue, I think that anyone in this day and age who gives their money to a manager and says I'm just simply not going to tell you what I'm doing with your money, you know, really ought to have their head examined. But I guess, as they say, there's a sucker born every minute.

And finally, to that end, I would point out to something that kind

of went a little bit unnoticed in the days leading up to the inauguration, and that was the release of the President's Working Group best practices proposals put out by the investment managers and also by the investors committee. There were two committees the President's Working Group empowered two years ago to come up with a first stab at U.S. best practices for hedge funds.

And one of the things that I would point out to our previous speaker which might help is that in the evaluation section, which the committee I was on, we went to great lengths to take the FAS 157 rules on asset valuation -- the so-called level 1, 2, and 3 assets -- and not only embrace that as we had to under GAAP for purposes of disclosure, but we took it one step further. We asked that managers embracing our best practice proposals actually give their investors either quarterly or annually an attribution table as to how much of their profits and losses, both realized and unrealized, came from level 1, level 2, and level 3 assets.

MR. MALLABY: Can you just explain? Level 1 is equity.

MR. CHANOS: Level 1 would be the -- well, to use the professor's example, Professor Baily's example, level 1 would be the S&P you bought. Level 2 typically are derivatives and anything pricing off of something else based on observable inputs. So the short put transaction, custom put transaction would fall under, in his example, would fall under level 2 assets. Level 3 are what I call "mark to this" on the oxymoronic phrase of "unobservable inputs," which really means management's best guess. And

level 3 is where we've really had the problem, in my opinion, in our banks and brokers, or shadow hedge funds as I dub them.

So using the professor's example, in his case you would see immediately how much of the attribution, even if he wasn't telling you what he was doing, was coming from level 1 assets, the S&P, and then the short puts, you would see that as the level 2 profit and loss. And at least it would give investors a guideline as to questions to ask their managers. And, of course, if the hedge fund was deriving most of their profits and paying most of the performance fees to its managers based on level 2 and level 3 unrealized gains and losses, I would think that would be a great red flag.

So I commend anyone to go to the President's Working Group release that was done in January. The Paulson Treasury put it out I think a day before they left office and it kind of got lost in the shuffle quite literally. But I think there are some very good proposals in there that really haven't been picked up on by the press that the hedge fund industry that wrote this feels pretty good about, particularly in regards to enhanced disclosure.

MR. MALLABY: Okay, thanks. Glenn.

MR. HUTCHINS: Well, I think James has said some very thoughtful and astute things. Maybe we ought to just close the panel now. I'll make just three --

MR. MALLABY: Not yet.

MR. HUTCHINS: Not yet, okay. I'll make just three very quick comments because I think he said most of what is the right thing -- the right

way to introduce the subject. But one is that I want to amplify something Professor Lo said. We can't lose track of the fact that the hedge funds as an industry have been a source of capital and have both made the markets more efficient, much more efficient. In large part, not entirely, but short-selling is an aspect of efficiency of the capital markets and more information coming out. And when you make decisions like -- that we made earlier this year -- or later last year, pardon me, to ban short-selling in certain instruments for certain periods of time, you are significantly reducing market efficiency.

And the short -- the hedge funds have been a real force for funding entrepreneurial and innovative activities. And that's something which we also don't want to de-emphasize. As we get into regulation, you don't want to have a Sarbanes-Oxley style regulation of the hedge fund industry that becomes sort of the regulatory equivalent of bleeding the patient. So you're going to be -- we need to be very, very careful about that. I was pleased -- I was struck and very pleased by the moderate and highly informed tone that Senator Reed took earlier today. I think we're sort of on the right path in that regard.

I'd say, secondly, you alluded to something which I think is very important, which is that the hedge fund like activity takes place inside lots of different kinds of institutions. It doesn't just happen at, you know, these private, regulated or lightly regulated -- because there is a lot of regulation that goes on at the investment level at least. Partnerships. It

happens inside of banks, inside of what were -- used to be investment banks -- and insurance companies, etc., etc. -- those type of investing activities. And I think one of the things that regulators are going to have to think hard about is what kinds of activities they'll allow deposit taking, systemically important, too big to fail institutions to do. I think that's where this notion that there was this issue on Wall Street and it was the hedge funds fault -- and this is the fact that a lot of the problem comes from -- these types of assets being on the banks -- being on the balance sheets of banks and them not doing as good as job with it as people who were directly bearing the risks more themselves in the hedge fund industry. And I think third, the other dimension of this -- and I come at this now from the point of view I've been a fiduciary of institutions that invest in hedge funds among other things. The third dimension that people paid much less attention to and the hedge funds have been much less good about than the industry had expected is liquidity.

SPEAKER: Yeah.

SPEAKER: And the real issue right now -- and some of the level one, two and three gets that because almost by definition, level three is illiquid. If you can't observe if, it just means it's not trading, right?

SPEAKER: That's one problem.

SPEAKER: Exactly. So, and when people -- you know -- people thought they had certain kinds of liquidity with -- in the hedge funds. They went to get their money out and the gates went up. They thought the

hedge funds were investing in in many cases instruments that were liquid that turned out not to be liquid and many hedge funds are now restructuring themselves to take these illiquid things they own and put them in different pockets and sort of manage those out over time. So people are quite surprised by the liquidity dimension of what they got themselves into. And I think that's a dimension I haven't heard much discussion about in the regulatory debate, but a subject that needs to be paid a lot of attention to -- certain from a -- a disclosure point of view. And that'll be a dimension, I think, which as we get into this, people will want to pay more attention to.

SPEAKER: It was the biggest self-inflicted wound, I think, the hedge fund industry gave itself last year. It wasn't performance. It was the gating.

SPEAKER: Gating. Exactly.

SPEAKER: Really. And I agree with you 100 percent and it was -- it was something, I think, my industry really needs to do a better job both explaining and improving upon.

SPEAKER: Right.

SPEAKER: Let me just press on. I mean it seems like one idea in this space that seems to connote a lot of consensus is transparency -- both Payton Young (inaudible) before and Andrew Lo's opening comments refer to this. Can I just get maybe Professor Lo, first of all, to focus on one potential down side. It seems to me there are clearly gains from

transparency, but it seems to me if you look at what Goldman Sachs, for example, did last year -- in making lists of stocks that were intensively held by hedge funds, and then bundling these into a tradable basket and saying look guys, we know that hedge funds are deleveraging. How's about you go short this basket of hedge fund intensive stocks because we know they're going down? This is an example where forced disclosure through required filings by hedge funds of positions enables a broker to target positions of hedge funds and increase the volatility in the market. Isn't that right?

PROFESSOR LO: Well, I think that's right. Transparency is a two edged sword and I think one has to be very careful about how you wield it. But, you know, I'd like to make the distinction between position transparency, which is what you're talking about, and risk transparency, which is what I think investors really want and need. For a number of hedge fund strategies that involve, in some cases, thousands of positions, giving investor position transparency does nothing to allay his or her fears about what's going on with the fund. What investors need -- and what I think hedge fund managers will have no problem providing -- is risk transparency, which is what kind of risk exposures can I expect if I invest in this fund based upon the complex strategies that the fund is engaging in. And so I think that that's a very important distinction where we can have our cake and eat it too. We can provide -- using sophisticated risk analytics -- risk transparency without jeopardizing the intellectual property

that hedge fund managers work so hard, and investors pay so much money for. A good example of this is Coca Cola. Coca Cola is a publicly traded company. We have a lot of information about it, but I don't think we want to compel Coca Cola to post its formula on its website because that reduces the economic value that its founders and its investors created. And I think in the same way for hedge funds that are engaged in these kinds of strategies, it's possible to provide investors, regulators with the kind of risk transparency that they need to manage those risks while at the same time protecting the economic value that hedge fund managers create.

MR. YOUNG: Can --

SPEAKER: Yeah, sure Payton.

MR. YOUNG: Can I just jump now though? The problem is that some of the standard plain vanilla risk measures are not adequate --

PROFESSOR LO: That's right.

MR. YOUNG: -- to the task and so my worry is that we'll get some sort of mandate to do this, but with the wrong risk measure. And then investors could be lulled into complacency. I mean one of the problems that you can -- a so-called dynamic -- trading strategies where you can, in very short periods of time, take on a series of positions depending on what happened the minute before and the hour before that, which can undue -- undermine at least a lot of the more simplistic risk measure. And so it's a big challenge for the profession to design the right ones.

SPEAKER: Let me just see if I can therefore draw out points from what you just said. Everyone agrees on transparency, but Professor Lo says he does not mean position transparency. That sounds right to me. But I would just observe that whenever there has been any disclosure to the Government -- SEC filings and so forth -- in fact, it has been position transparency. So, if we're going to go down this road, it sounds like you would agree that the common understanding in Washington of what transparency might entail needs to change. Now, building on that, Peyton Young says yes, but you know the analytics have to be sophisticated ones. They can't be simple ones. And this gets to a point that, you know, we might want transparency, but do we know how to require the right sort that it will actually help. And let me press on one particular issue that I think is key here. And that is that to understand the systemic risk inherent in any trading strategy, you have to know what everybody else is doing in the same trading strategy. It's all about crowding. It's all about is somebody else doing the same thing so that if this guy over here blows up, it's going to have a knock-on effect in 10 other guys who are also leveraging the same trade. We are never -- surely this is right -- we are never going to know --

SPEAKER: Good luck with that.

SPEAKER: -- who is in one space, because it could be a Brazilian trading company. Isn't that right? Isn't this just a fool's errand to get to --

SPEAKER: Well, can I address that? I actually think that there's a

greater possibility of creating exactly that kind of systemic transparency than you might think. And the reason is that you don't have to go to the thousands of hedge funds to get that information. All you need to do is to go to the very small handful of prime brokers that all hedge funds route their trades through. There are probably five to ten major prime brokers. These are --

SPEAKER: Not any more.

SPEAKER: -- smaller now. Smaller now. But these are brokers that act as brokers for hedge funds.

SPEAKER: It makes it easier.

SPEAKER: And if you approach the prime brokers and ask them to disclose information -- say to the Fed or the regulatory authorities -- you can very quickly and very efficiently aggregate the picture that you're looking for -- namely what the exposures are system-wide across all hedge funds. And you can do it in a very anonymous and very efficient manner so that it's really quite doable in my opinion. It just requires the particular regulatory authority to be able to do that.

SPEAKER: You also have this very important -- that's a -- I think that's a very good point. You also have information that you can gather from exchanges in clearinghouses, because of the huge amount of price information and volume information that comes from the exchanges. Part of the problem, for instance, in the CDS market was that it was an OTC market without an exchange, without a clearinghouse. So I think there are

some regulatory mechanisms that are market-based mechanisms you can set up to allow you to gather lots of information about these things. But, so I was going to make one other -- two other points I would make. One is that -- I think you make a distinction between position data being published for the world to see and position data being available for the regulators to see. Right -- I don't -- I think that that might be a distinction that you end up with. So the regulatory leaders could have --

SPEAKER: The industry is clearly hoping that's the distinction that's made.

SPEAKER: Right.

SPEAKER: And I don't think anybody any more reasonably thinks -- from our side of the table -- that disclosing to the regulators and risk monitors is something that they should reasonably fight.

SPEAKER: But I think our discussion shows that it's an open question. Politically, I think you're right. But whether this is actually going to help anything --

SPEAKER: Well, that's a different --

SPEAKER: -- depends on what gets disclosed.

SPEAKER: That's a different issue. But the distinction is that I don't think anybody -- it sounds like they're not -- the industry is not fighting position information being available in a confidential manner to the regulator who is evaluating systemic risk. Right. What they're fighting is that becoming available generally (inaudible) --

SPEAKER: Giving away -- giving away our intellectual property.

SPEAKER: Right. So, I think that that's -- so I think you'll have a lot of more information -- that's an important distinction so the regulator can have the information necessary to do the regulatory job. But the other thing that's going to be interesting and important is that the people who own these assets often times have the -- the investors in these assets -- have their own reciprocal obligations to do FAZ 157 accounting for their own balance sheets. And the kind of information they need -- the question will be is level one, level two, level three enough information for them to be able to certify their own financial statements. Right? Or are they going to need more of this kind of position like information? Is there -- and that would be probably be as a result -- there will probably some private contractual work that will happen between the -- you know, the GP and the LP in that regard. But that's another place where the quality and depth of the information becomes very important.

SPEAKER: Can I just make one point, Sebastian? One thing that the hedge fund industry also worries about as we're talking about the regulatory framework and sort of the constitutional protection of intellectual property and risk management -- there are some asymmetries at work here from the legal point of view. And, in particular, one of the things the industry is worried about is issue retaliation in a full disclosure regime. And we raised this with the SEC in August when they did the first set of the so-called gang of 19 restricting pre-borrowers and shorting. And one

of the points we made was was that there is an asymmetry -- due to human nature and due to the legal system particularly in the U.S. -- in which if positions -- large, short positions -- were disclosed by investor to the marketplace, there's a very easy way for CEOs of questionable companies to squelch -- squelch true public debate about their accounting practices or their business practices, if in fact those are in question. And that is to simply take an aggregate look of everybody who short their stock, file a RICO suit in state court with shareholder money, and what's the first thing your lawyers do when you're part of a RICO suit as a defendant -- no matter how frivolous -- he tells you to shut up. Stop talking. Don't say anything. Don't write research reports. Don't talk to reporters about the funny accounting. Wait 'til the court is done. And that has a very, very chilling effect on so-called price discovery issue -- in very legitimate issues. I can only imagine if ENRON had had a list of everybody short their stock prior to that collapse. I have no doubt Skilling and company would have gone that route if they had that tool available to themselves.

SPEAKER: Let me make a connection between what Glenn said about exchanges and the earlier discussion over there. Seems to me that we've actually been -- I'm writing a history of hedge funds. I'm so steeped in this. But there have been other moments in the past -- whether after the '94 bond market collapse or the '98 LDCM episode -- where regulators have taken a hard look at hedge funds and they've never done anything.

And they've never done anything because actually they couldn't think of good things to do. And it strikes me that listening to Professor Lo -- who you've testified in Congress; you've advocated various measures -- but, if what you're saying actually that the best way to get a handle on the types of risks you think are relevant is through prime brokers, you sound to me like you're going back to the consensus of 1998 where the idea was you go to the providers of the leverage -- the prime brokers -- and you try and monitor excess leverage through the brokers. Not at the hedge fund level because there's too many of them and so forth. Isn't that right that you are --

PROFESSOR LO: That's right. I think that it would be impractical to try to manage that kind of regulatory and oversight at the level of the hedge fund. There are just too many of them. And, by the way, I'm not arguing that one shouldn't ask hedge funds to register. But in my view, registration solves a different problem. Registration is all about investor protection -- which is important and legitimate -- but it has nothing to do with systemic risk.

SPEAKER: Yeah. I think that's right.

SPEAKER: So, I would look at those two things very separately and for the purposes of addressing systemic risk, dealing with the prime brokers is both more efficient and more effective.

SPEAKER: Is a panelist allowed to ask a question instead of answer it?

SPEAKER: Alright.

SPEAKER: So what kind of an agency -- what would an agency look like that has the expertise to investigate the question of systemic risk?

SPEAKER: Well, I've actually written about that kind of an agency. I propose that we create a new agency patterned after the National Transportation Safety Board -- which I've called the Capital Market Safety Board for lack of anything better. The NTSB, as many of you know, is the agency that is actually an independent part of the government. It has no regulatory authority whatsoever, but it's the organization that swoops in and -- at every plane crash -- collects the black box, reassembles the plane and ultimately engages in a forensic examination and produces a publicly available report that provides everyone with complete transparency about what happened, how it happened, why it happened, and how we might prevent it from happening again. And having an agency like the National Transportation Safety Board for capital markets to examine every single blow up and go through that process of sifting through the wreckage, I think, would provide a great deal of information about how we can prevent these things from happening again.

SPEAKER: Can I now play devil's advocate as having the raised question now? I mean so suppose that that agency were in, you know, operating today.

SPEAKER: Well, first of all it would be doing a land office business.

SPEAKER: It would be what?

SPEAKER: A land office business and then the argument would come out that nobody would ever get in a plane again because they'd be investigating 100 downed planes and, of course, that would undermine sort of the broad confidence in a financial industry itself. So, this -- it sounds -- I love the suggestion. On the other hand, if it's one at time, it sounds okay. But if there actually is a systemic event -- which we're experiencing now -- then I could see that an agency like this could contribute to the fear.

SPEAKER: Actually, I would disagree with that. I think that what contributes to fear is lack of understanding -- not greater understanding. I'll give you an example. A few weeks ago a USAIR flight ended up in the Hudson River -- New York City -- and at first nobody knew what happened. And so naturally given that if you're in New York and you've spent the last few yeas there, the first thing that would come to your mind is terrorist attack. And it would have been very easy for there to have mass panic ensue in New York City shortly after this flight went into the Hudson. But the NTSB took control of the situation immediately, held a press conference and while they didn't have any obvious answers at the time, they had a conjecture which they communicated to the press and they described that it might be a flock of geese and this has happened in the past so many times, and these are the things that we're going to do. This kind of transparency produces trust, confidence and a sense of calm.

And I think the reason that we are in such a crises today is precisely because of lack of transparency, lack of understanding and lack of trust. The most potent kind of fear is the fear of the unknown and that's what we're in today.

SPEAKER: (Inaudible) want to say something (inaudible)?

SPEAKER: I read your piece and I think your proposal is a pretty -- is a very interesting one. The problem with it is -- and I think gathering the information and getting the lessons learned and having that available is a good tool. The problem with it is it's backward-looking not forward-looking. And it's based -- you look at individual events, as opposed to systemic issues. There are many proposals being brooded about because remember financial -- hedge fund industry regulation, while very important, is going to be one piece of a much larger program for the reform of our financial market's regulation in general. And one large piece of this is clearly going to be a systemic regulator -- someone who is given a mandate for that. My personal view -- just completely personal view -- is it's best put at a place where there is the greatest degree of professionalism and the lowest degree of politicization and that's probably the Fed. But we'll see what happens. But that will be -- this will, and should be, an important part of the mandate of the systemic regulator -- looking at the hedge fund industry as one of the players in the overall financial service industry, rather than regulating it into thinking about its systemic issues individually or in a microcosm.

SPEAKER: But then comes the question -- supposing you do this and you have this systemic regulator which includes the component that Professor Lo was talking about -- what do you do with that funding? Because I think that I know roughly the recurring theme in hedge funds that have gone bust -- whether it's Michael Steinhart in 1994, Tiger in 2000, LDCM in 1998, the (inaudible) fund in 2000. All of these guys did one thing. They went into a position which they thought they could get out of and then it turned illiquid and they couldn't get out. Everybody who manages money knows this. But the question is, you know, how do you -- how do you implement that? How do you avoid being trapped? Because there can be liquidity one day and then it dries up.

SPEAKER: Can I respond to that because I think that's a very important point -- this notion that illiquidity is a very, very potent component of these crises. And the reason that there was so much illiquidity surrounding those events that you describe is because the particular managers involved had very large positions, but had no idea that so many other people had similar large positions precisely because of that lack of transparency. And so the problem is not so much leverage by itself, but it's the combination -- the unholy mixture of leverage and illiquidity. And so the question of what you would do about it -- what a regulator would do about it. If a regulator had information that a large number of hedge funds and other financial institutions had very, very similar positions and they were building to a catastrophe kind of a

scenario, they could at that point start to impose a leverage constraints -- put on the brakes -- and engage in what policymakers now call counter cyclical policy.

SPEAKER: (Inaudible.) I agree with that and this kinds of gets to the point earlier about crowding.

SPEAKER: Yeah. That's right.

SPEAKER: Trades are dangerous when they're crowded, right?

SPEAKER: Wait a minute. Every one of those investors you cited is and was and a world class investor.

SPEAKER: True.

SPEAKER: I know them all personally. Every one of them I can bet your bottom dollar, knew full well that there were lots of people on the same side of the trade they were and they took a judgment that may -- often has panned out -- and in this case didn't pan out. Those were investment decisions gone wrong. I don't know that they would have happened in any other way.

SPEAKER: But that's sort of my point -- that these are world class people. I've interviewed them all. They go into it and they took a risk and the risk went wrong.

SPEAKER: Exactly.

SPEAKER: It's not -- it's not an indictment of the rest of their career (inaudible). It's precisely the point that even the most successful people can make this mistake. We're not going to limit the mistake. Even if we

had the NTSB come in and do the postmortem and tell you how it all went wrong, it wouldn't prevent very good investors from making the mistake because we've run the experiment. They did make the mistake.

SPEAKER: Just as a precaution, I'm going to go long black box makers, I think.

SPEAKER: You know what? I would go a little bit farther though. I would say that it's not their job to know how big they should get before threatening the global financial system -- because they don't have that mandate; they don't have that authority and they don't have all the data.

SPEAKER: But in none of those cases were they threatening the global system.

SPEAKER: I do think this is actually the key point though. I mean if -- so the question at the end is if you are leveraged and you are in a crowded trade, you may get badly hurt. Are you more likely to avoid that disaster because you, the investor, are frantically talking to all your buddies in the business and trying to figure out how crowded it is? Or are you more likely to avoid the disaster because some government agency, which typically is slower and less incentivized to do it right, is going to give you the information?

SPEAKER: But, wait a minute here. I mean one of the reasons for being in that trade in the first place is on the way up, the crowding has paid off.

SPEAKER: Right.

SPEAKER: Handsomely.

SPEAKER: Right. Right.

SPEAKER: I think that's why it's very difficult for you to expect that hedge fund managers or any investors will voluntarily pull back and give up market share and profitability for the sake of preserving systemic safety. That really is the role for regulation -- regulatory oversight. I'll give you an example -- a very simple example. If you were the chief risk officer in Lehman Brothers in 2005, and you knew full well that it was crowded trade, and as Mr. Chanos said, everybody does know and did know back in 2005 that mortgage backed securities was a crowded trade. Nevertheless, in 2005 you're making a lot of money from that business and Lehman Brothers worked hard to gain market share. If you were the chief risk officer of Lehman Brothers in 2005, what would you have recommended to the CEO, knowing full well that it was a crowded trade fraught with risk? Would you say to the CEO it's time to get out of the mortgage backed securities business. Let's just shut down the whole unit. This is a unit that's been contributing record profits to your company for the last eight years.

SPEAKER: Well, maybe not to that CEO. But, you know --

SPEAKER: The famous one, right?

SPEAKER: Yeah.

SPEAKER: But, see --

SPEAKER: As long as the music is going on, we have to dance.

SPEAKER: Well, moreover, if you did shut down that unit, what do you think the shareholders would say shutting down a multimillion dollar business?

SPEAKER: I mean I think --

SPEAKER: This gets back to the issue -- I want to address this quickly -- the question of kind of what -- who's allowed to do what. In other words, I haven't heard -- maybe you have examples -- I haven't heard yet of a crowded hedge fund trade that created systemic risk because of what the hedge fund industry did. I mean we're sort of assuming something that might not have happened if you know what I mean. What the -- you keep coming back to the Lehman example. That was an example of a regulated institution that got overleveraged. Right? And was taking on certain kind of hedge fund activities inside their own -- on their own balance sheet. It gets back to --

SPEAKER: And not accounting for them accurately. I keep coming back to that. That makes a big -- there's an asymmetry here. If you don't have --

SPEAKER: LTCM was a trade.

SPEAKER: LTCM might be the example -- right -- in that case.

SPEAKER: You don't have to mark those positions accurately. You can take risks and convince your shareholders and senior management with the wrong reporting that you're doing just fine, when in fact you're not. And I can't stress that enough.

SPEAKER: Let me just -- before going to the audience -- ask Peyton Young one question. You know you raised this possibility that the hedge fund manager would put money in an escrow account and sort of said it was implausible. But, actually when hedge fund managers have their own money in the fund, that's the same thing isn't it?

MR. PEYTON: No.

SPEAKER: They lose their money if it goes wrong.

MR PEYTON: It --

SPEAKER: If they have a significant portion of their net worth, then their --

MR. PEYTON: If I had a blackboard, I could show you that that's not the same. But at any rate, let's distinguish the two. First, it's a good thing if the manager has a big stake in the fund. I mean big. But it's not enough that it be big relative to the fund. It has to be big relative to the manager's whole wealth.

SPEAKER: Right.

MR. PEYTON: I mean there's a trick here that you can do which is if I've -- you know -- a billionaire, well I can have big stakes in 10 funds. And, well, you know, so one or two of them go bust completely. That's -- that's okay because I've made tons of money on the others. So that's just the way of spreading a risk around. So it's not enough to just talk about having a large stake in a given fund. What I was talking about was -- as in Lloyds of London. This is a really drastic proposal that I do not believe

would ever be taken seriously. Yes, you post a personal bond. Yes, and if there's bad performance for say two or three years running, you're -- you know -- you have to sell your house and everything else. They go after you. There's effectively no limited liability. And that would be a corrective, but one that won't work either. Why? It'll keep everybody out of the market. I mean essentially you won't get any of these innovators who would want to open under those terms.

SPEAKER: Don't general partners have unlimited liability anyway?

MR. PEYTON: Not in the sense that I'm just talking about. No. They don't go after your house and your future income -- which is really possible with Lloyds of London. But that's a really drastic and extremely rarely used incentive device. And I'm trying to say that even then, it won't work.

SPEAKER: There's another proposal that managers take their incentive compensation in the same way it's earned, i.e., if you have unrealized --

MR. PEYTON: Right.

SPEAKER: -- unrealized gains and losses, for example, level three.

MR. PEYTON: Yes.

SPEAKER: Whack it up into a manager's --

MR. PEYTON: UBS proposed that, right?

SPEAKER: Well, they paid their -- I think Credit Sweeps paid

people --

MR. PEYTON: Credit Sweeps, right.

SPEAKER: -- paid people in that form and there's a certain sort of elegance to that, I guess. Where if this is what you're putting on the books and this is what you're booking as profit, take it back.

MR. PEYTON: So all the bonuses -- even we can carry that over to the banking industry right now.

SPEAKER: Well, actually we should have done that in the banking industry. That was my point I've been making all along.

MR. PEYTON: Why? We're still paying them bonuses? Let's do it in toxic assets.

SPEAKER: That's actually -- I'm surprised it hasn't been talked about more.

SPEAKER: You know we've gotten to the point where risk has become a four letter word and the thing we've got to remember is two things. One is taking risks has its rewards and they're both individual rewards and social rewards in terms of benefits to the economy of what risk capital does. But, nobody should have had all their money in hedge funds. Everybody should and was supposed to have understood -- and should understand -- who plays in this which would rather sophisticated investors -- that hedge funds take a lot of risks, have high rewards. Private equity funds take a lot of risks, have high rewards. You should have an asset allocation strategy where you have a small amount of your

assets allocated to that. Similarly, I personally would not want to invest with a hedge fund manager who had all his assets and his net worth kind of in the fund, because that would tell me about some -- that person's propensity for risk, so it would make me a little concerned about the person I was investing with. And I'd rather be investing with someone who had a more -- who had a more thoughtful, broad based allocation strategy themselves. It is a good thing that private equity funds and hedge funds take risks. That's where the returns come from and that's where the social benefits to the economy come from because when those risks pay off, we're generating wealth that taxes are paid on and enterprises that hire people. That's important. We don't want to drive risk out of the economy. We want it to be managed correctly and carefully.

SPEAKER: Actually, can I follow up on that comment because I think that's a very important point. Mr. Hutchins made the point earlier as well that, you know, we have to keep in mind that while we are talking about the hedge fund industry in this panel -- that's what this session is about -- that a significant fraction of the dislocation that has been talked about has happened outside of the hedge fund industry. In fact, the biggest form of dislocation is related to this issue of risk taking. It's risk that is being inappropriately taken by the wrong parties. In other words, losing money is not a problem. Hedge fund investors and managers have been losing money for decades and as long as you're prepared for those losses, that's fine. That's part of capital formation -- taking risks and

ultimately, in some cases, bearing those consequences. The problem comes -- and the reason that we are in such dire straights -- when the wrong parties who didn't think they were bearing the risks that they ultimately bore, end up losing money. So when a money market fund who invested in triple-A securities ends up losing 30 percent of their investment, that's a problem. And that's something that is happening outside of the hedge fund industry in the banking industry -- which, by the way, is the most highly regulated industry in the world. So I think that what we're talking about today has to be put into context of the larger issues about how we're going to reform regulations for all financial institutions -- not just hedge funds.

SPEAKER: Okay. Let's go to the audience. There's a question right in the front here to start off with. I'll go around the room.

MR. SCHRODER: Thank you. I'm Robert Schroeder, President of International Investor, and I think this panel has been skirting an issue that I believe is the biggest transparency issue of all. We've learned about the individual investors, who as you pointed out Mr. Chanos should be well educated and understand the risk before they enter into these.

But, we're all very concerned, when this activity starts threatening the entire financial system. So, the transparency question that I'd like to pose is – and the reason I believe that this industry certainly needs to be regulated is the connection between the commercial banking world, and the hedge fund world.

In 2007 by some estimates, over 50 percent of the commercial banking activity and profits relied on trading activity and lending to the hedge fund, in private capital world. Much of that of course doesn't appear on the balance sheets of the commercial banks and it certainly doesn't appear on the balance sheets, which we never see in the black box hedge fund world.

The – if you or I tried to get a loan from a commercial bank for our business or personal loan, we have to show everything to them, in terms of a credit report so they understand the risk involved in lending to us. The hedge fund industry would keep much of what they were doing secret, so they could leverage up to 50, 100 times in some cases, because they were able to convince commercial banks, because they were willing to pay a higher interest upon those loans that it wasn't important for them to understand how many other debts or liabilities they had on their balance sheets.

SPEAKER: Okay. Well, let's see that –

SPEAKER: All right. So, my question is this. When it comes to lending from the commercial banking world, to the hedge fund world. Does the Federal Reserve even know enough at this time? Does the Treasury Department fully understand the implications? Or are they actually holding a lot of the information back as they slowly uncover some of the liabilities that these commercial banks have to the hedge fund industry?

SPEAKER: Okay. Who would like to –

SPEAKER: Well, first and foremost. The type of lending you're talking about I believe is almost all collateralized. We understand that. It's not unsecured.

SPEAKER: In the form of stock?

SPEAKER: In the form of borrowing to finance bond positions, stock positions, wherever it might be. The banks aren't that stupid.

SPEAKER: Financial assets.

SPEAKER: Financial assets, their collateralized but with a haircut usually. Now, what happens is as the credit cycle goes on, and people get emboldened as in all credit cycles, the haircut gets less and less. The banks are willing to extend more credit on any given security.

If we go back to LTCM, which you know well – I mean at one point supposedly the leverage was $100 billion on $3 billion of equity or more. But keep in mind there were assets, or at least the lenders thought they had secure assets against their loan, maybe to collateralized 120 percent against the value of the loan, or 110 percent of it's value loaned.

The problem is the assets became more illiquid as someone said, you know assets can be a ephemeral debt is forever, and that as credit cycles go on, creates the problem. But, please be clear by in large that this type of lending does not go unsecured. At the prime broker level, or at the banking system –

SPEAKER: But there's a better point isn't there. That after 1990, in the LTCM episode, it was the case just as the question suggested. The banks had lent LTCM without asking how much money did you borrow from all these other banks –

SPEAKER: Aggregate.

SPEAKER: And in aggregate it was such that they were not going to get their money back. That's why in the end they –

SPEAKER: Everyone thought their own position was secure but everyone trying to get out through again the crowded trade phenomenon destabilized the system.

SPEAKER: Maybe I don't want to comment on this, but to my understanding that in the past decade you know, that lesson at least was absorbed, that banks now push for more information from hedge funds about whether the other –

SPEAKER: Hedge funds have become much less levered as banks became more levered by the way.

SPEAKER: Thank you.

SPEAKER: I don't actually – I'm not proposing this as the solution, but I mean in the insurance industry there long standing ways of dealing with this. I mean there's forced diversification. So, an entity is regulated heavily and the way they do it is, you can't take you know, more – put more then say 5 percent of your risk in any one sort of pot. And this is applies to earthquake insurance, flood insurance, things like that. And

so you can see there would be a possibility of applying this same principle to banks or even large hedge funds, that there actually be forced diversification to avoid this piling up phenomenon.

But that would be going way beyond where we are now. All I'm saying is there is precedent using the insurance industry as a model, which by the way I think actually is quite similar in some ways to our modern financial institutions taking huge risks.

SPEAKER: Well, I think this could break this point here. The question, which is a very good one really pertains to the capital structures and lending practices of already regulated institutions.

And so there's nothing in the hedge fund regulation that's going to propose regulation that can, should, and will address that, because that's about kind of what the balance sheets of the big banks should look like and what their lending practices should be. And so that will of course be a very important part of what the new financial services regulate – regulatory structure is.

SPEAKER: By the way, I think you're incorrect. I don't think half of the earning stream for example of Citi Bank comes from dealing with hedge funds.

SPEAKER: Trading activity.

SPEAKER: Well, trading activity is different. Trading for your own account.

SPEAKER: Yes, trading activity.

SPEAKER: For their own account, not trading with hedge funds, trading for their own account. That's a much different animal, and I got –- I alluded to that earlier in saying that banks and brokers were the largest, and are the largest hedge funds, in effect because of that activity.

But again, as Glenn points out, they're already regulated.

SPEAKER: Right. Well, I was going to say that you know, much has been made of the fact that hedge funds are part of the so-called shadow of banking system. But I think the question points out the reverse, and something that Mr. Chanos mentioned, is that banks are now part of the shadow hedge fund system. And the problem –-

SPEAKER: Yes, yes.

SPEAKER: The problem is not so much that it's the prime brokerage activities –-

SPEAKER: That's a good point.

SPEAKER: But it's the proprietary trading –-

SPEAKER: Yes.

SPEAKER: Coupled with the fact that banks have this wonderful facility that when they buy certain assets, they actually don't have to mark them to market until maturity, which is a wonderful gizmo that I wish hedge funds would have access to, because it would allow them to –-

SPEAKER: Don't start that now we have enough problems.

SPEAKER: Well, that's for –

SPEAKER: But this ability to not have to mark your assets to market is one of the reasons that we have created the problems that we have today. And the so-called toxic assets that sit on these bank balance sheets – I feel like I have to speak out for them, because I think toxic assets is a very pejorative word. There's no such thing as bad bonds, only bad prices. And so I think that with the proper pricing we can actually get around these problems quite effectively.

SPEAKER: Yes.

SPEAKER: Okay. Let's go out to the origins let me see, I mean the gentleman with the purple tie over there.

MR. SMITH: Bruce Smith from Brookings retired. I sat and watched the bankers yesterday, and they were very impressive by in large. I especially like that Jamie Diamond he was very good. But the upshot from that was that we really have the tools we now need. So, I have a solution borrows from Anders Ashland, and I think one other colleague.

Let's say we go through this stress business, and we decide what constitutes stress in the banks, and it's not really your problem, you want to pile on to the regulated sector, where the problem really is. Including in the Fannie and Freddy, the most regulated. But okay, we identify now what is a toxic asset and I think we do suffer from a bad metaphor there. As if this you know is radioactive spreading all over,

killing everybody. Okay.

So the – we take the toxic asset and we put not in one big thing, but each bank has its own bad bank. We segregate that into the individual banks bad bank, and we don't liquidate things right away. Let that go for 10 years, 15 years, let them figure out what to do with it. With the rest, now the clean part of the bank, we recapitalize because that is now clean, it's put in its –-I don't know what legal form it is, a holy owned subsidiary. But, it's sitting over there to be gradually worked into the market somehow, and the banks meanwhile have become healthy. Is that a possible –-

SPEAKER: Let's actually go the next question here in the front from –- I take that as a comment on bank recapitalization, more then a question on hedge fund regulation. If others want to come back to that in a second we can, but I would like to go to the next question.

SPEAKER: -- problem really is the banks, not the hedge funds.

SPEAKER: Fair enough, but this is a panel about hedge fund regulation. I agree with you but – okay. Question.

SPEAKER: I'm Darrell West of Brookings. I have a question about the international aspects of regulation. How much of this in regard to hedge fund should be an American conversation versus how much should it be the United States negotiating uniform standards that apply to everybody regardless of country of origin?

SPEAKER: Who'd like to take a crack at that?

SPEAKER: Well, having just read the FSA paper on short selling, which was released last week, and having addressed the AMF personally a couple of weeks ago in Paris, as well as the E-regulators, I mean everybody's kind – is trying to come to grips with these issues, and is talking about uniform standards. But on a practical matter everyone is looking at two countries: the U.S. and the UK as the leaders really in regulation and in the thought process. And are going to look off of that from a practical matter.

I think that of course hedge funds are global, and despite my earlier comments about the offshore system I think that we have to understand that there are managers in London who are trading things in New York, and visa versa. I personally have offices in both cities and go back and forth quite regularly. And I think that there does need to be some global framework through the G-20 or G-7 vehicles, to get some sort of coherent standards.

But I think this is a case in which if the regulators in the UK and the U.S. lead, I am reasonably certain that most of the important industrialized country financial regulators will come into line. I think waiting for a broad consensus might be too long. I mean we'll – a missed opportunity, someone's got to show some leadership.

SPEAKER: I mean, I would argue that it's probably impractical to expect that there would ever be uniform standards for

regulations. You know, we have a national organization called the United Nations, and we can't even agree on you know, international coordination and uniform standards for genocide, never mind financial regulation. So, I guess –-

SPEAKER: You're not suggesting they're the same?

SPEAKER: No, no but I would suggest that what we should do is to have international coordination. I mean ultimately I think that will be the best we can hope for, and I think the regulators are engaged in that right now, they should probably be doing more of it, because there are regulatory arbitrages that hedge fund engage in across these various different jurisdictions. But if there's more coordination, we can close up a number of those loopholes.

SPEAKER: I think it's fair to point out that there's another total nonsense spoken about this idea of international need for international coordination. Because finance is global, it has to be globally regulated. The truth is that if you're trying to look at systemic risk in the U.S. markets, most of the actors that you care about have a physical presence in the U.S. Never mind that they're registered in the Cayman Islands, they are physically here, they come here, and therefore they are subject to U.S. law enforcements. So you don't need to worry – but Peyton wanted say –

MR. YOUNG: Well, I just – the other way you can at least in part deal with this is ring fence schemes, in which there's sort of those

who are adhering to an international regime and those outside. And what you do as part of the internal regime is you restrict say lending activities across the boundary. So, that would be part of the regime that can be enforced by say the U.S. and the UK and that leaves others outside of it at you know, sort of at loose ends. They don't have any sources of funds or not as many.

SPEAKER: Let's go to the gentleman with the yellow tie back there.

SPEAKER: Alan Meddy in LECG. I wonder if some members of the panel might comment on some of the benefits and costs of imposing a max I cap on leverage for hedge funds?

SPEAKER: I'll be happy to start. So, I think that the benefits of course are we have some limitation on the kind of risks that hedge funds pose to the financial system. But, I think the costs might be quite a bit more significant in the sense that leverage across different hedge funds means different things. In some cases very high degrees of leverage, actually poses very little risk. And what it depends on is the underlying riskiness of the hedge fund activities.

For example, those of you who have ever taken out a mortgage with 5 percent down, which is what my first mortgage looked like many years ago. That's 20 to 1 leverage right there, but at the time it was relatively less risky then you might think nowadays, and so the kind of leverage, the degree of leverage that you use very much needs to be

keyed into the kind of risks that underlie various hedge funds.

Now, one of the benefits of having a central regulatory authority monitoring the leverage across various different hedge funds through prime brokers is that they can make these types of decisions as a function of market conditions. During business cycle peaks I think it's a lot more important to pull in the reins, then during business cycle troughs. And so the hope is that we can actually engage in exactly that kind of limitation, but in a somewhat smarter fashion to be able to help buffet the ups and downs of our business cycles.

SPEAKER: And I've been told we have to wrap up pretty soon. So, let me just close up with one question I want to ask. It is one question I want each of you to answer very briefly, which I think kind of joins it all together. We've all agreed, and it's already the case that various types of indirect regulation already exists for hedge funds. It's also the case that the system is looked at, direct regulation in the past and backed off. If you had to predict whether this time there will be some form of direct regulation, and secondly should there be? What would that particular direct intervention be? Let's start with Professor Lo.

MR. LO: Well, if I had to predict what kind of regulation there would be I would argue that there will be more regulation for the hedge fund industry, and that that form will take registration of hedge funds with the OCC. I don't believe that will address the issue of systemic risk. And I'm hoping there will be additional regulation that would compel

hedge funds to provide information to their regulators through their prime brokers, and for creating this separate independent watchdog agency to focus specifically on systemic risk.

SPEAKER: Good, Peyton.

MR. YOUNG: I pretty much give the same answer, with the additional proviso that something like the government agency that simply does regular reporting on the industry. So, it's not regulating per se, it is – - and nor is it –- I agree that it should look at systemic risk measures, but a step before that is simply the provision of reliable information across the whole swath of hedge funds. Their risk exposures and so forth, without giving up proprietary information. We would be a lot further ahead, if we just had that information today.

SPEAKER: Jim.

MR. CHANOS: I would echo those two, and say that again going and looking at the presence working at best practices would be a good place to start. Because it embraces a lot of what you just asked for, and I would agree as a betting man, I would agree we're going to see direct regulation, but I suspect that it will be of –- I hope will be of a regulated disclosure as opposed to open disclosure regime. I also suspect that there will be ultimately a regulatory body, whether new or within an existing body for systemic risk. And hedge funds will fall in under that rubric through their prime brokers and banks.

SPEAKER: I think that's right. The only thing I would add

is there would obviously be a part of this and maybe subsumed in what you've talked about that will be about investor protection. So, that this is a made off type of scandals that will have a much lower probability of happening.

SPEAKER: Okay. We have four votes out of four for the idea that there will be some direct regulation; it's been a great panel. Thank you to everybody and thanks to the audience.

(Recess)

SPEAKER: Okay. Let me try again, could we -– we're going to get started on the last segment. Bob Greifeld's speech. So, if I could ask everyone to take their seats. Okay. Let's get started.

MR. HUTCHINS: All right, everybody please have a seat. We have for reasons that will soon seem obvious, saved the best for last today. And it's my pleasure to introduce a good friend of mine, Bob Greifeld, the CEO of NASDAQ OMX Group. Did I get that right Bob? Bob, I'm on the board of NASDAQ and Bob finds us if we don't get the name right because we've recently merged with the OMX stock market.

NASDAQ OMX is a global exchange company, operating on six continents now. With $23.9 trillion, almost $24 trillion dollars in value trade on those markets; it's the world's largest exchange. It's really quite remarkable, because when Bob joined the NASDAQ it was a relatively small organization, it was owned by its members, it was barely even -– it wasn't even traded on its own exchange, it was exchanged on the pink

sheets. And over the course of the time Bob's been there, he's made it the one –- the world's leading exchange, and become himself the dean of the exchange industry. And now he even –- after residing in the shadow of the New York Stock Exchange for years, he now actually trades more then 20 percent of the New York Stock Exchange stocks himself, on his own exchange.

Bob has a 20 year history of -- in the technology world as an entrepreneur. And under his leadership the NASDAQ has enjoyed 16 straight quarters of growth in revenues and earnings. Today we've heard a lot about the OTC Market for derivatives, particularly the CDS Market, and then need for an exchange and or central clearinghouse. NASDAQ recently entered that field with the international derivatives clearing group, which is an exchange for interest rate swaps, which there are I think there 400 trillion notionally in the world today. The largest derivatives market in the world. So I hope Bob will have something interesting to say about that today because he's got one of the important solutions to the problems we've talked about today.

We've also heard a lot about Hedge Fund Regulation, of course we had the previous panels on that, and NASDAQ has been at the center of those discussions. They were obviously very important in the decision for better, for worse to stop short sales on certain financial service companies in the fall. And now will be a key participant in the new regulatory scheme, and I think Bob might have some things to say about

that today too.

So, it's my great pleasure to introduce Bob Greifeld. Bob, one thing I did want to say about him before he comes up. He's recently taken up golf, and I just want to ensure his investors that he has very little time to practice, which his game clearly demonstrates. So, welcome Bob to the podium.

MR. GRENFELD: Now, I have to say Glenn's comments about my golf game are correct, but I play golf with him, and we were on the second hole, and I happened to quickly turn to my left -– to my right and I see the caddy is kind of rolling his eyes as he sees the shot of either you or I, because we are equally inept at it. So, we'll see.

But certainly it is my great pleasure to be here today. I thank Glenn and The Brookings Institute. You know today, and I think for the short-term the discussions have been about economic and financial stimulus packages. And that's rightfully so, but we know that in short order the major topic of discussion will be the reform of the regulatory regime that really has existed in this country since the 1930's. So, as we contemplate the various institutions that comprise our current regulatory regime, we have to think what are their proper roles in the future?

And I, as somebody running a public company who's been involved in a number of different mergers and acquisitions, probably from a failure of imagination think of the problem set in slimmer as any other merger and or acquisition.

After you establish a defined list of objectives and responsibilities we have to determine the competencies of the various parties, and which institution on a meritocracy is really the best to breed. And as we stand here today, we believe in the fundamental premises of the fall –- Paulson plan, we certainly see the need for a systemic risk regulator. We certainly understand very fully the need for market regulation, and also a regulator concerned about investor protection.

Given those as basic belief, we see there's a natural development where the Fed takes on systemic risk, the FCC takes on responsibility, and a focused responsibility for investor protection, and the CFTC and their principle based regulation takes on responsibility for market regulation.

Now, there are many complex details to be worked out. But the first level analysis it's quite easy and quite straightforward. The Fed today has unique expertise, which they can lever with respect to risk. The FCC is uniquely positioned to focus on investor protection. And the CFTC through its principle's based regulation of the markets has allowed our futures markets to really succeed and thrive on a global basis. So, in our very first pass we see this as the structure that certainly we at NASDAQ OMX will advocate.

Within the regard of investor protection; and in particular Hedge Fund regulation. The first point is the debate about regulation of hedge funds is really over, in that the systemic risk regulator will clearly have

responsibility for all different forms of investment, and hedge funds will fall into that category. So that is a virtual certainty, and when we look at the hedge fund regulation, and we look at the leverage that existed in hedge funds, and people saying that is a cause of the problem of the system. The point I would make is that the leverage that the hedge funds have or had, is certainly a derivative of the leverage they received from their banking sources. So, the real sense in the new regulatory world, that problem has the ability if you so believe it's a problem, to self-correct.

Now within the hedge fund world, we see the concept of an accredited investor. That investor who has enough financial wherewithal to essentially protect themselves. But we have witnessed in the last decade a convergence between mutual funds and hedge funds. I myself remember going back in 2008 where I received solicitations to join a mutual fund where there was a $50,000.00 minimum investment. And we had hedge funds coming through funds of funds, where $50,000.00 allowed you to invest in a hedge fund. So, clearly those worlds have converged, and it would be our view that the regulation of those worlds will converge.

We think there is basic credibility to the concept of accredited investors having better ability to protect themselves, but when you think about yourself trying to protect your investments, clearly you need to have transparency, you need to have information, you have to know the investment strategy, and you need to know the positions, and

certainly the mark to markets of those positions.

So, as we look at the hedge fund world going forward under the basic premise that you still have accredited investors, clearly if you want to avoid a made off type situation, or if a made off type situation develops, you can clearly point to the lack of rigor of the investor, then you need to bring some transparency to the LP's who invest in those hedge funds. So, we certainly see that will happen.

Now with respect to a topic I do want to spend some time on today, we mentioned that if you get your hedge fund statement clearly if it's a position that's marked on an available exchange, you know what the mark is, and it's been validated by the market. But other positions will be, especially in these –- some of these hedge funds will be illiquid, and not available on a market, so you'll be marked to a model. In a real sense it's important for you to see that, but it's also important to recognize that it is a model, as Warren Buffett described that mark to model could be a mark to a myth. We think most of the times the models are actually fairly accurate, but certainly in the time of tales, when you're on the extreme parts of natural outcomes that can lead you in a different direction.

So, this question of a mark to market, or mark to a myth leads me to you know, back to really the credit crisis, and you know how did the credit crisis happen? And how can we assure that it never happens again?

So, how do we get to where we are today? The short form answer,

and it's a very short form answer, is there clearly was irresponsible speculation in real estate. The speculation was enabled, multiplied, and securitized by Wall Street. And that securitization moved the asset 10 iterations away, from the root investor. In another time and place, the local bank that held the mortgage understood the value of the asset. He could drive by it everyday, he or she. And he understood the risk for default; the neck was on the line. But Wall Street took this 10 iterations away risk, and the actual risk and the value was not apparent to anyone. Not to the public, and I think most interestingly not to the executives of those institutions themselves.

So, the question is how do these very smart financial system -– financial services CEO's make such disastrous decisions about their businesses? Did they ignore fundamental business metrics that we all rely on everyday to make these business decisions? Certainly it's my viewpoint that the crucible of the problem was bad decision making, based on bad information. So, then the question is, what was wrong with the information?

So, if we look at what has transpired, we see that throughout the economy trillions of dollars of investments were never subject to the rigor of trading on a transparent, well-regulated market. In the absence of the market (inaudible) price, which was in fact 10 iterations away from the risk, the assets were valued on a theoretical model, which turned out to be a myth as Warren says.

We had a tremendous number of these complex instruments on the books of banks and businesses, where the value was opaque, and ultimately was horrifically mispriced. These instruments were traded over the counter in the industry jargon, and it means they were traded between a limited number of parties, with no external validation of the pricing.

In the OTC world values were distorted in a fashion, not unlike the game we played as kids, such as telephone. Where each step away became more unrecognizable in terms of what the risk was. And I would say to you, and it might disagreed by many, but CEO's typically are not stupid, and not all of them are greedy. And we certainly see everyday that highly respected household names in the banking world came in the morning, and left everyday without any true concept of the true value of the assets that were on their books. The former heads of Citi, Merrill, and other institutions never got a report that says you lost $5 billion dollars in the market today. Never got that report, they were not traded in the market, and I would submit to you that if they had that report their actions probably would have been different.

What's interesting here, and I think is somewhat unique. Is that previous financial scandals have involved knowing financial service executives foisting inappropriate products on unknowing investors, right? That's been the normal hallmark. In this crisis, we have witnessed these financial service executives even though they're 10 iterations away from the risk; they so believed in their mark to market models, they foisted

these misvalued assets on their own balance sheets. First time that's happened.

The other factor when we look at this credit crisis is executive compensation. I'm not commenting on the amount of the compensation, many other will do that, but on the fact that the compensation was really paid on the interim performance, not on the completed performance of an employee.

Many financial service executives were paid as if they got over the goal line, when in fact they were still on the 20-yard line. So, the short-term nature of the compensation certainly had to be a factor that caused many executives to take action or not take action, which was the immediate advantage of themselves, and their institutions, but obviously the longer term detriment for themselves and their institutions.

Now when we think of a world that existed and we say that if they had a compensation plan that reflected the long-term outcome of these transactions. And you had a market that showed them exactly what they were making or losing in a given way, and not through a model we clearly would have had a different scenario, different outcome.

Now how do we move forward from here? NASDAQ in a certain way is uniquely positioned to comment on this and hopefully bring some positive value added to the equation. NASDAQ was formed back in 1971, and it was formed as a result of the scandals that existed in the trading -– the over the counter cash equity marketplace. We were formed

to bring organization to that marketplace, to bring clearing, and to bring transparent price discovery. And as I said before in 2008 the exchanges, the regulated markets in the world had issues. Their issues were the volume was so heavy. Heavier then we had ever foreseen. We were processing over 150,000 transactions a second for extended period of times. But each and every second we did that, every investor on the planet knew exactly what the mark was, and it was an actual mark they could trade against that, and they could clear against that.

So, we've come a long way, and through that world we lived in the world where there were penny spreads, where investors were able to get in and out very quickly. And what we know here is that the best price discovery mechanism is where a willing buyer meets a willing seller, to discover price. Right? It's what the caveman discovered, and what we're learning again. A model is not a market.

So, clearly we have to bring some market discipline into that environment, and let's see –- say how important this is. We are focused on the interest rates swap marketplace. We have our commercial reasons for doing it, but what's fascinating to me is that the notional value outstanding of the interest rate swap market is about $360 trillion. There is about $1.1 trillion of capital tied up with the bilateral clearing of these interest rate swap products. So, in bilateral clearing I am relying on the health of my counter party, and I obviously have to tie up a certain amount of capital to make sure that the transaction is good.

Of that $1.1 trillion of capital tied up as a result of bilateral clearing, if they moved that to a central clearinghouse where there is safety in numbers, where there is soundness in numbers the capital requirement would be reduced by about $700 billion. Happens to be a number I recollect from something else, like the talk program?

So, to understand the magnitude of this, you're talking about the amount of capital that can be freed up from the balance sheet to be used for lending, for other commercial activities by moving these type of instruments from a bilateral agreement, where everybody has to worry about the weakest link in the chain all that what happened with Bear Sterns or like Lehman, or to where you have safety and soundness in numbers.

So, certainly there's a lot of regulatory and legislative conversation about that. I think it's hard to debate it, and certainly it's out self serving opinion, because clearly we want –- you know we're focused on the interest rate swap space, not so much to credit the full space, but this is a major factor that we can do to move ourselves out.

So, when we look at the over the counter derivatives products, we clearly have to move that forward, like we moved the NASDAQ forward back in 1971.

So, in conclusion and summarizing what we spoke about today, we say first and foremost we have a new regulatory regime coming about, we have to lever the assets we have within the current regulatory

regime, we need to look at it as a best of breed meritocracy approach to the situation. And the FCC has clear competence in investor protection as part of their innate culture. The CFTC has been a leader with respect to principle-based regulation, that's allowed markets to flourish in the Fed uniquely positioned on systemic risk.

Hedge fund regulation, there'll be debates on the finer points, but there'll be no debate on systemic risk, they will be regulated. We certainly see convergence between regulation for any fund –- mutual hedge fund that takes in investor assets. We'll certainly see that there'll be some differences. The concept of an accredited investor is a valid concept, but they're closer then you think and the regulatory structure will reflect that. And the sooner we move on to getting the over the counter products into a regulated exchange and clearinghouse, the sooner we can have executives making proper business decisions based upon real numbers, not on theoretical numbers. And we certainly get introducing a new level of capital efficiency into the marketplace. So, I thank you for your time, and I look forward to taking some questions.

SPEAKER: Chia Chen, freelance correspondent. An observation, the session before you talked lots about regulation. And we have information that U.S. best practice for hedge fund, and also presidential working group. I don't know the content of those, and now you mention about your experience.

I think with this as three information, Congress is able to

have an -– enact a I will call it a hedge fund act, and then create agency. This could patent OSHA Act in OSHA, that means that Occupation Safety House Act and Occupation Safety and Health Administration. And this OSHA administrator safety and health of all U.S. industry, and commerce, and same as the working world. Do you think the hedge fund could patent that?

MR. GREIFELD: Could add that? Follow?

MR. TIEN: Yes.

MR. GREIFELD: Well, I would say on thing. I think my personal feeling is that legislation should address a broad structure and the details of how the particular industries should be regulated, should be left to the agency. Because the legislative action I think by definition is somewhat a blunt instrument. So, I think the proper roll of Congress and the president here, is to set up the basic framework of regulation. As I said, we support the concept of the three main regulatory functions, and give them their charter and have the agencies then work within the charter given by Congress to flush out you know, the details of the operations of the respective operations.

With respect to OSHA, I don't have any particular comment on how that relates to the hedge fund regulation, I don't really know.

SPEAKER: Roy Cansovitz, CPAC member Pershing Square. I love the math you gave us on the $1.1 trillion dollars and the $700 billion, but if the clearinghouse holds that collateral that's $400 billion

that ends up in your hands. How are counter parties protected under your vision for the clearinghouse?

MR. GREIFELD: That's considered a detailed discussion. The clearinghouses have what you call a waterfall of protection. So, there is member margin, there is a default fund in the clearinghouses that we see in the future there'll be an insurance wrapper in that. So, there's different constructions, but the key thing is there's X number of layers you can penetrate before you have any sort of systemic risk.

And what's interesting to give praise to LCA, showing in the Lehman clearing -– in the Lehman failure, it took a long time and I think it could've been done quicker, but at the end of the day you know, the members of the clearinghouse came out clean. So, the key thing that a clearinghouse does on a day-to-day basis is to manage the members margin. And on the predefined rules, and to know when to make the proper margent calls, and know when to cut the individual firm off of the system.

So, the clearinghouses have a tremendous record of not piercing the member margin. So, you'll have behind the member margin, probably three layers of protection within the fund. You know, whether it be default funding an insurance wrapper.

MR. CANSOVITZ: Is it possible, that as an alternative you would have a tri-party arrangement, where as a clearinghouse you do all of the clearing functions, and all the market marks. But that a third bank

custodian that doesn't actually make margent decisions at all, but that are just functions of bilateral credit arrangements would work with that model work under your vision?

MR. GREIFELD: Yes, I've heard that discussed. I said it could, but that has a lot of inefficiencies in the system, and there's something to be said to have a clearly defined margin rules that are known by the industry that applies equally to all players. And that's one of the fundamental benefits of the clearinghouse. I see the clearinghouse model being the predominate way we go.

SPEAKER: Neil Roland with the Crane Business Publications. Any thoughts of the virtues of the G-30 proposal last month, under Paul Volker that hedge fund regulation go beyond just registration to include regulation on leverage capital, and risk management?

MR. GREIFELD: Well, first I think the agencies should decide the proper level. And as a general comment I would say, if you start contemplating the powers required to be a systemic risk regulator, it's quite impressive or scary depending on your point of view. So, a systemic risk regulator, if he's –- that institutions going to fulfill its role, will have more pervasive far reaching powers then we've ever given to any regulatory body. Because by definition it has to be a principle's based approach to systemic risk, and you have to be able to walk into any institution you think is necessary. So, hedge funds will fall under that orbit there's no two ways about it.

With respect to some of the details of how you'll regulate hedge funds, you know, my comments were more from the investor point of view, as coming in the post Madoff scandal. If you're going to be an accredited investor looking at a hedge fund investment, you have to have transparency of the investment strategy; you have to have transparency of the positions in the marks and on a periodic basis to make an informed decision. And clearly the funds of funds we're supposed to do that.

With respect to leverage I believe that the leverage and hedge funds sooner or later will have some regulatory aspect to it. That would be my personal feeling, but I'm also keenly aware that lacking banking support the leverage issue, you know basically self-corrects, or it's a derivative of the bank leverage. To the extent that the banks are less leverage then the hedge funds will be less leverage also. But if I was to make a prediction, I would say there will be regulation on that in the years to come.

SPEAKER: One –- more?

MR. GREIFELD: Sure.

SPEAKER: Thanks for coming. I think you're at a very special advantage point. From what you can see, what are the potential downside to this crisis, and what do you worry about? What do you really worry about at this point?

MR. GREIFELD: The downside to this crisis? I think we –-

SPEAKER: What do you not worry about?

MR. GREIFELD: I know. I think we live it everyday. Certainly from the downside of the crisis, I mean clearly you know, our direct business model there were essentially no IPOs in 2008, and it's looking to be that way in 2009. And it's interesting that from our accounting treatment, we treat IPOs revenue over six years. We have to recognize the revenue over six years, so you're building an increasing headwind. And I look at it in the same way in the economy, right. So, lack of IPOs in a given year those indirectly impact the GDP or the growth rate. But it compiles upon itself. So, we'll have a time to work out of the you know, this headwind that we've developed, even when we're post recovery since we're missing these years of growth.

I mean we have now two lost years; I'm not talking about a lost decade, but two lost years certainly with respect to new business formations, raising capital and being able to grow in a rapid fashion. So, we'll feel that for a period of time.

But, I certainly think like many there's opportunities in this type of crisis, and when you look at this derivatives world, it has done many good things in the financial services arena. It has certainly allowed us to mitigate a risk and when we get the market structure right, and people have real markets and real clearinghouse, then we'll be in a fundamentally stronger place. And the regulatory regime was always curious to me that the 1930's were where all wisdom was gained. So, it's been a long time ago, so for us to you know craft a forward looking

regulatory regime will be a clear positive to us in the decades to come.

SPEAKER: Thank you very much.

MR. GREIFELD: Thank you.

SPEAKER: Well, that concludes our forum. Thank you all for coming, thank you for our sponsors. Thank you to Gordon who led the way in organizing this, and the support staff here at Brookings that made it all possible. So, thank you all for coming, and I think it's been a great session.

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