MANAGED FUNDS ASSOCIATION

The Association for investment professionals in futures, hedge funds and other alternative investments.

House Banking and Financial Services Committee
Hearing— Thursday, May 6, 1999

Hearing on:
President's Working Group on Financial Markets

Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management

Managed Funds Association
Mr. George E. Crapple
MFA Chairman

1200 19th Street, N.W. Suite 300 Washington, DC 20036-2422 Tel: 202.828.6040 Fax: 202.828.6041 Web site: www.mfainfo.org

Testimony of George E. Crapple

Chairman

Managed Funds Association

Before the Committee on Banking and Financial Services

House of Representatives

May 6, 1999

Mr. Chairman, thank you for the opportunity to testify here today. I appear here as the Chairman of the Managed Funds Association ("MFA"), a national trade association representing more than 700 participants in the hedge fund and managed funds industry. I am also the Vice-Chairman and Co-Chief Executive Officer of the Millburn Ridgefield Corporation, which has since 1971 managed money in the currency and futures markets and sponsors funds of funds and equity hedge funds.

MFA appreciates the opportunity to testify before this Committee concerning the report ("Report") of the President's Working Group on Financial Markets' ("Working Group") concerning the public policy implications of the recent events involving Long Term Capital Management ("LTCM"). MFA commends the Committee for its continuing interest in this important subject. MFA congratulates the Working Group on the completion of its extensive review of the LTCM events. In brief, MFA believes that the Report is a comprehensive and constructive contribution to the debate concerning the public policy implications of the events surrounding LTCM. MFA concurs with much of the Working Group's analysis and many of its recommendations. However, MFA believes that certain of the recommendations for further government action do not satisfy the tests of efficacy and avoidance of undue costs advocated in the Report itself. MFA urges this Committee and other public policy makers to be skeptical of purported solutions to the LTCM "problem" that consist of creating yet another Washington information "warehouse," which is unlikely to advance the important task at hand of improving credit assessment and risk management by lending institutions such as those who extended credit to LTCM.

I will address these points briefly in my testimony and I note that MFA has also submitted for the record its own report on the public policy implications of LTCM.

The Public Policy Implications of LTCM.

In many respects, the Working Group's conclusions accord substantially with those of a number of other valuable analyses undertaken to date by other regulatory organizations, as well as with those of the MFA in its own report on the same subject. Like MFA's report, the Working Group's Report underscores several key points, which I also highlight here:

1. Uniqueness of LTCM. LTCM was an extreme, apparently unique, case. It was distinguished by the scale of its activities, the large size and illiquidity of its positions in certain markets, and the extent of its leverage. LTCM was not typical of hedge funds. In actuality, the concerns as to size and leverage raised by LTCM are more aptly associated with other types of large institutional traders, such as the proprietary trading desks of commercial and investment banks, than with hedge funds generally. The Working Group Report recognizes this.

2. Needed Improvements in Credit Risk Management. The Working Group's Report stresses the extent to which LTCM was permitted to attain its extraordinary

market positions due to laxity in credit risk assessment and monitoring of lenders and other counterparties. The Report underscores that "LTCM seems the extreme case that illustrates the inherent weaknesses of some prevailing credit practices." LTCM achieved its extraordinary size and leverage due largely to deficiencies in credit risk management practices by its lenders. In particular, in managing the LTCM relationship and those with certain other hedge funds, banks relied on significantly less information on the financial strength, condition and liquidity of their counterparties than that required of other types of counterparties.

3. Credit Risk Management Is the Preferable Tool for Constraining the Type of Market Activity Illustrated by LTCM. No substitute exists for rigorous risk management by lenders and counterparties, who have both the incentive to obtain and assess the complex of risk-relevant information necessary to assess and monitor their exposure to hedge funds and other borrowers. The individualized risk management of lenders and counterparties is a key foundation for management of risk in the financial system generally. As the Working Group noted, "[t]he exercise of credit discipline in trading relationships has the potential to provide a balance between the benefits and risks of leverage." Following LTCM, regulators and supervisors have made significant progress toward assuring enhanced effectiveness of credit risk management by lenders to entities such as LTCM. Public policy initiatives relating to hedge funds should focus on identifying sound credit practices and fostering their implementation.

4. Direct Regulation of Hedge Funds is Not Warranted. For the reasons stated above, efforts to fortify market discipline to present lapses such as occurred in the case of LTCM should be the focus of regulatory and industry initiatives. Further, before any direct

regulation is pursued, the difficulties of formulating an effective regulatory approach that does not create more public costs than benefits should be fully considered. MFA strongly agrees with the Working Group's conclusions that the primary mechanism that regulates risk-taking by firms in a market economy is the market discipline provided by creditors, counterparties and investors. Moreover, the voluntary industry initiatives described in Appendix F to the Report are strong evidence that the financial services industry has the motivation to improve market stability and efficiency through self-regulation and has undertaken important initiatives to that end. As a general matter, as the Working Group stresses, government regulation of markets is properly achieved by regulating financial intermediaries that have access to the federal safety net, that play a central dealer role, or that raise funds from the general public. Government regulation is the preferred response only in exceptional cases, due to market failure or failure of pricing mechanisms to account for all social costs, circumstances which do not characterize the hedge fund industry.

I also wish to highlight MFA's views on several other aspects of the Working Group's Report.

The Critical Role of Private Sector Initiatives to Enhance Risk Management Practices.

MFA believes that the private sector initiatives underway or contemplated to address the risk management issues raised by LTCM are critically important and strongly supports those efforts. In particular, MFA wishes to voice its support for the recommendation that a group of hedge funds develop a set of sound practices for their own risk management and controls. Hedge funds currently devote extensive attention and resources to their own internal controls and risk management. Development of "best practices" guidance for the industry can only enhance and further these efforts. MFA thus endorses the Working Group's recommendation and is prepared to take a leadership role in such an initiative, which would include representation from throughout the hedge fund industry. MFA also supports the efforts of the Counterparty Risk Management Policy Group, comprised of twelve major internationally active banks and securities firms, which is developing standards for strengthened risk management practices for banks, securities firms, and others providing credit to major counterparties in the derivatives and securities markets.

Recommended Disclosure and Reporting Requirements Lack Utility and Impose Undue Costs.

MFA supports the objective of increased transparency in credit relationships between lenders and hedge funds and other borrowers, as recommended by the extensive guidance issued to date by the banking regulators and endorsed by the Working Group. MFA believes that this objective is best advanced by the credit practice enhancements recommended to date by federal, state and international banking regulators and the private sector initiatives underway to strengthen the credit risk management process. MFA does not believe that the Report's recommendations for more frequent or augmented reporting by hedge funds to regulators and the public respond to the concerns raised by LTCM or otherwise satisfy the standard set forth in the Report that "government regulation should have a clear purpose and should be carefully evaluated in order to avoid unintended outcomes."

Both the utility of such regulatory and public reporting to its intended recipients and the potentially adverse impacts of requiring it deserve serious attention. The reports envisioned would appear to be inconsistent with the private nature of hedge fund offerings, as defined by fundamental regulatory constraints under the securities laws precluding advertising and public solicitation, and would invite public competition among entities whose regulatory status is premised on the private conduct of their business. Further, the information that would be reported would be of highly questionable utility to its recipients. The Report suggests that the recommended disclosures include value-at-risk reporting, which generally does not reflect the type of extreme market fluctuations which imperiled LTCM, or stress test results, which cannot be readily interpreted without significant explanatory material. These types of snapshot data presumably would be intended to capture complex portfolio risk data in a public report but are as likely to distort as to advance understanding and hold real potential for inducing a false sense of security or concern. Such reporting also would direct attention to inherently stale data that do not provide a solid basis for assessing the risks of a given fund and may, in fact, have the perverse effect of creating a false sense of assurance concerning the condition of a fund.

Further, and perhaps most importantly, a new disclosure framework of the nature contemplated would not help to provide a solution to the concerns the Report itself identifies as central to the LTCM event; it would not be designed to -- nor would it serve to -- augment the risk management of the parties who made possible LTCM's market positions. It would not enhance the quality of the lending and counterparty relationships that are key to the concerns presented by LTCM. These lending and counterparty relationships will not be served by a newly devised information "dump" on the public and the regulators; they require the close review of a complex of individualized, risk-related data -- more comprehensive and timely data than any public reporting system is or should be calculated to produce. Finally, any additional disclosure requirements of the nature proposed may create incentives for funds to move offshore to jurisdictions without such requirements -- ultimately creating unintended, negative consequences for U.S. regulators seeking to manage systemic risk.

Conclusion

In conclusion, MFA applauds this Committee, the Working Group, other regulators and market participants who have acted in the wake of LTCM to identify the causes of the LTCM events and to foster, initiate and promote action to rectify lax practices, fortify risk management best practices and improve supervisory oversight. MFA urges the Committee and other public policymakers to avoid "quick fix" legislative or regulatory solutions that do not address the fundamental risk management issues presented; only by requiring market participants to bear the burdens of risk management, with the guidance and encouragement of public overseers, will the most enduring and effective "best practices" be implemented. We believe that the efforts of public and private sector groups to develop more effective, sophisticated and rigorous risk management practices should be the central focus of regulators and the marketplace in seeking to reduce the potential for future market disruptions.

113637.0.