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CHAIRMAN'S OFFICE
MAILED

JUN 28 1968

Signed by: __________

Honorable Harley O. Staggers
Chairman, Committee on Interstate
and Foreign Commerce
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Your letter of May 29, 1968 asks whether I have any comments concerning the activities of investment groups commonly referred to as hedge funds. As you know, a hedge fund is an investment vehicle which makes use of borrowed funds for leverage and commits a portion of the fund's capital to selling securities short.

Hedge funds may be classified into two groups, those which have registered with the Commission under the Investment Company Act of 1940 and those which have not done so, and which claim to come under one or more exemptions contained in that Act. As to those funds which are registered with the Commission, they are, of course, required to make the same filings as other investment companies and, accordingly, we have the same information concerning them in our files. While this is not the case with the unregistered funds, nevertheless, we have endeavored to obtain as much information as we can as to their identity, composition and trading practices.

I believe, however, that much more information and analysis will be required before any definitive conclusions can be made as to the need for additional regulation in this area. Moreover, the problems that we have been focusing on do not seem to be much different from those presented by trading activities of certain of the registered mutual funds. It, therefore, seems to me that the most expeditious and appropriate way to deal with the problems in this area would be to consider them in connection with the proposed institutional study which is now before your Committee. For your information I am enclosing a memorandum prepared by the Division of Trading and Markets which discusses this subject in more detail.

If you desire any further information concerning this matter, please let me know.

Sincerely,

Manuel F. Cohen
Chairman

Enclosure

SSporkin/pjm
IHPearlee

MEMORANDUM PREPARED BY THE DIVISION OF TRADING AND MARKETS, SECURITIES AND EXCHANGE COMMISSION, IN RESPONSE TO A LETTER DATED MAY 29, 1968, FROM THE HONORABLE HARLEY O. STAGGERS, CHAIRMAN, COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

On the basis of information available to us at this time, we understand that the hedge fund concept, generally speaking, is predicated upon two basic investment techniques; the maximum utilization of borrowed funds for leverage, and the commitment of a substantial portion of the total available capital to the short side of the market. Leverage is accomplished by purchasing, on margin, securities listed on national securities exchanges and using other securities to collateralize bank loans. As protection from adverse market conditions, such funds maintain substantial short positions in certain securities at the same time as long positions are held in other securities.

In essence, portfolio managers of hedge funds commit most of their available funds to acquire long positions in securities which they anticipate will experience a price rise greater than the market average in a rising market or decline less precipitously in a declining market. At the same time, remaining available capital is used to assume short positions in other issues which the manager feels will decline in price more rapidly than the market average in declining markets, or rise more slowly in a rising market. Consequently, it is theoretically possible for a portfolio to profit or experience losses on each of its positions, irrespective of the general trend of the market.

Rapid portfolio turnover is another common characteristic of hedge funds. This is occasioned partially, at least, by the unavailability of long-term capital gains tax benefits to profits realized on short sales.

Hedge funds, historically, have been organized as partnerships with one or more general partners and a number of limited partners. Recently several investment companies, employing "hedge" and "leverage" concepts, have registered with this Commission and have offered their shares to the public.

S. Pollock
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Promptly

Congress of the United States
House of Representatives
Committee on Interstate and Foreign Commerce
Room 2125, Rayburn House Office Building
Washington, D.C. 20515

CHAIRMAN'S OFFICE
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MAY 31 1968
SEC. & EXCH. COMM.

May 29, 1968

Hon. Manuel F. Cohen
Chairman
Securities and Exchange Commission
Washington, D.C. 20549

Dear Chairman Cohen:

The enclosed article from the London Economist on the hedge funds may have escaped your attention.

You will note that the Economist states that the Commission has not yet expressed its concern over the activities of these arrangements although the New York Stock Exchange warned its member firms some weeks ago not to become so deeply involved in the funds' speculative activities as to imperil the funds' own capital stability.

Do you have any comment in this area?

Sincerely yours,

Harley O. Staggers

~~HARLEY O. STAGGERS, M.C.~~
CHAIRMAN

HOS:mhl

Hedge funds

Prickly

New York

American stockbrokers, like others, do the best they can for customers but isn't it likely that when investing for themselves the brokers should try to do even better? This question of a possible conflict of interest emerges as a principal concern of securities industry regulators in the wake of the recent proliferation of hedge funds in Wall Street. These funds are private investment partnerships which have been formed increasingly lately by people in securities firms and in which a select, few, normally well-to-do clients are invited to participate. The funds most closely resemble mutual funds (units trusts) that sell their shares to the public at large. As private operations, however, the hedge funds use highly speculative investment tactics generally denied to the mutual funds, such as selling short and making the fullest use of credits. This latitude gives hedge fund managers considerably more leeway to cash in on special situations which for the most part have paid off handsomely. The hedge funds have grown spectacularly to about $11 billion, double the figure a year ago, and five times the figure two years ago—and against total assets of the US mutual fund industry of about $42 billion.

But problems have been multiplying right lang with the hedge funds' size. Except for a handful of publicly offered hedge funds, the partnerships don't have to register with the Securities and Exchange Commission and thus don't have to make periodic reports on their investments or other disclosures. The American Stock Exchange is to find out how many firms are involved in the funds to get a head count as well as an idea of the amounts involved.

Even when the ASE pools its findings after they're compiled this summer with the New York Stock Exchange the data won't be all inclusive because a number of older hedge funds are private investment companies that aren't affiliated with brokerage houses. The NYSE warned its member firms some weeks ago not to get so deeply involved in a fund's speculative activities as to imperil the firm's own capital stability. Under Exchange rules a brokerage house cannot let its capital drop to less than 5% of its liabilities. But borrowings by hedge fund partners who are also partners of the brokerage house would count against the member firm's liabilities thus risking depressing the house's capital ratio below the permitted level.

The SEC, which oversees the self-policing exchanges, hasn't made any moves of its own as yet to restrict the hedge funds although it admits it's been looking into their activities for nearly a year. The SEC seems mainly concerned that the diversity of investment techniques open to hedge funds' managers can and does lead to trading abuses. The funds can, in theory, use their highly geared buying power to move up the price of a stock only to unload their holdings as unsuspecting investors jump on the band-wagon. It would be even worse if the lambs that are thus shorn were customers of a brokerage house that sheltered the hedge fund responsible. And some partners in hedge funds are executives and directors of large corporations and in that capacity have access to information about company affairs not known to most investors that can be useful to the funds in making their investments. Seen in the light of possible abuse the moves by the two New York exchanges to restrain the hedge funds are, at best, temporary holding actions and much obviously remains to be done to subject the hedge funds to meaningful controls. The next move clearly is up to the SEC.