Jay Baris: OK. We’re ready to get started with our second panel. This panel is derivatives and leverage in the investment management context. I am the moderator, Jay Baris, a partner in the firm of Kramer Levin Naftalis & Frankel. I’m going to introduce our panelists. To my immediate left and to your right is Diane Ambler who is a partner with the law firm of K & L Gates. Diane’s practice focuses investment products, mutual funds, private funds and variable insurance products. In addition to being a friend, Diane is one of the top lawyers in the country in my view and is a frequent speaker on these topics and she was the previous chair of the ABA subcommittee on investment companies and investment advisors proceeding yours truly and was my mentor in that respect. To Diane’s left is Meyer Eisenberg, a friend and colleague and former partner who served as deputy general counsel of the Securities and Exchange Commission from 1998 to 2006 and for a few minutes served as the acting director of the Division of Investment Management. Actually for about a year.

Mike: But they were memorable.

Jay: Mike is a professor of law at Willamette University College of Law and is a senior research scholar at Columbia law school and previously had stints at the SEC and as a partner at Kramer Levin. To Mike’s left is Susan Ervin who is senior advisor to the director of the division of investment management at the Securities and Exchange Commission. Susan was previously a partner in the financial services group at Deckert leading the firm’s derivatives practice but before that Susan also had some wonderful experience working as the chief counsel and deputy director of the division of trading and markets at the Commodity Futures Trading Commission where she developed all kinds of expertise in this area and of course to complete the chain many years ago maybe
not that many years ago Susan was with Kramer Levin Naftalis and Frankel which is where she got her real experience. [Laughter]

Mike       It’s been downhill ever since.

Jay        What we’re going to talk about today is the use of derivatives and leverage by investment companies principally. Its evolution, its role in the recent events in the market and where we can expect to go from here. Some of the emerging issues that are coming out. When the Investment Company Act of 1940 was enacted, I think it was in 1940, nobody ever heard of derivatives. *(citation)* It simply wasn’t contemplated in the law at the time. Over the succeeding years, over the next say 50, 60 years derivatives through the innovation of some creative minds on Wall Street were introduced and slowly picked up by investment companies and of course the law and the regulations had to adapt to reflect the use of derivatives because nobody really knew what to do with them. We collectively here have some experience in this. Back in 1996 Susan when she was at the CFTC and I was in private practice together with Buddy Donahue developed and brought public the world’s first open end fund, a mutual fund whose investment objective was to track the Goldman Sachs commodity index. Now that was an enigma wrapped in a puzzle wrapped inside of a birthday present. It was a very very complicated product. It was innovative. Nobody really ever thought about how to do this before. It was almost like a law school exam. It was a set of very complicated different concepts that got mushed together and we had to, every time we solved one problem six other problems popped up but through the diligent work with working with people at the SEC, the CFTC, we had tax issues, FINRA issues, back then NASD, and corporate. Not only that in the mix we had a bona fide rocket scientist, the portfolio manager was a rocket scientist who helped develop some of these structures. We came out with this product and it is still in existence today but that’s an example of how derivatives crept into investment companies and really changed the face of how mutual funds and investment management have come to use and rely on derivatives. I’m now going to turn to Diane and ask her to review some of the
Thank you, Jay. It’s a pleasure to be here. Nice to see everyone today. You know when I was a young associate starting in mutual fund practice I was, being bottom person on the totem pole, given the assignment of looking into a new kind of strategy that these innovative portfolio managers were thinking of to engage in transactions involving financial futures contracts and options on indices like the S&P 500 index. And mutual funds hadn’t before then engaged in these practices and I was of course a very young associate at that time. This was in the early 1980s and I had to research and discover what these things were all about and basically what the portfolio managers wanted to do. They said you know we want to invest in securities but it takes a couple of days to get into the market. We know we have money coming in, we’re a mutual fund, money comes in every day, and we want to put that money to immediate use and in order to do that we’d like to buy a futures contract that gets us into the market pending our ability to actually buy the securities so that we’re getting the benefit of acting in the market without just sitting on this cash. And we also either want to buy a financial future that may be matches the kind of security we intend to buy or purchase engage in these index option transactions. Again to make use of what market movement there is during the period of days that we’re able to close on the securities transaction. They also to some extent wanted to hedge existing positions in the portfolio. May have been interested in forward contracts to hedge currency risks if they were international funds but really it was really a very modest goal here. And at the time a lot of questions came up for lawyers as Jay said you know these innovative portfolio managers have great ideas but then the lawyers have to figure out a way to make it work. So we had issues under the Investment Company Act and we had issues under the Commodities Futures Trading Act which of course I didn’t know anything about because I was a mutual fund lawyer. So had to study this and over time we developed, we arranged with the CFTC a way to work around the requirements for licensing and registration under the commodities laws and eventually this evolved more recently into a rule, an exemptive rule so that mutual funds and their advisors that engage in these
practices don’t as a matter of rule have to register with the CFTC as commodity pool operators or CTAs or get involved in any of that if they’re again if the hedging transactions are relatively modest in size in terms of the value of the fund and also the purposes for which they’re being engaged in. So we were able to sidestep CFTC but then we had to grapple with the SEC and as Buddy said in his opening remarks the 40 Act is a prophylactic statute. It’s regulatory, it had very strict requirements on managing assets in the fund. One of those limitations is that funds have limited ability to leverage. They can only leverage by borrowing from banks and only to a certain percentage of the value of the assets in the fund. But also funds are prohibited from issuing what is known as a senior security which is defined in the Act generally speaking to mean that the fund has to pay shareholders of the same class all equally, cannot put certain owners, certain investors in the fund ahead of other investors. The SEC has interpreted the senior security laws in a way that has that governs the regulation of leveraged transactions and frankly the only real law on the books out of the SEC dates back to 1979. It’s release 10666 and is the law we still to when we deal with leverage or hedging type transactions in mutual funds.

Jay: And one of the authors of that release is sitting in this room today. You can raise your hand if you want to.

Diane: Good job, Marty. So we still rely on that and the basic concepts of 10666 basically require that a fund protect its assets and limits its flexibility for investing assets that are pledged against the leverage created by these types of transactions. And basically you have to set aside assets in a reserve capacity, mark to market daily so that in effect the fund will have assets to pay whatever might come due based on these sorts of transactions. Well, alright, you know, fast forward. Where do we get from the early 1980s to now? Back in 1994 or so

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2. Id.
5. Id.
6. Id.
the SEC did a study on derivative transactions and determined generally speaking that mutual funds did not engage extensively in derivative transactions, that there were limited, really limited activity and of course keep in mind that a lot of these transactions are expensive so the fund has to recognize gain that overcomes the expense of engaging in the transactions.

Jay: Diane, when you say derivatives, what exactly do you mean?

Diane: Well, that’s a good question. I mean a number of definitions I guess revolve around derivatives but in effect a derivative is a security that has been created around another security. It derives from a security such as a stock or a bond. It’s a structured investment and it involves a leverage piece and potential risk beyond the risk of simply the underlying investment such as the risk of so-called counterparty risk which is you have somebody on the other side of this transaction. That counterparty may or may not be able to respond to their responsibilities under the transaction, thus counterparty risk. In any event, pretty much the SEC has depended on disclosure as a way of managing derivative involvement by mutual funds and also over the years has increased the expectations of mutual funds boards of directors to oversee derivative investments and handle derivative investments and at the same time has recognized the credit rating agencies’ views of what these derivatives are worth. In other words if they get a high credit rating then in many cases that gives them sort of a first tier pass of being suitable for mutual fund involvement. So we wind up in the situation and then there’s this explosion of a variety of other kinds of instruments and a variety of other kinds of transactions. We have short sales that became prominent and securities lending, various strategies to enhance return and to engage in hedging transactions. And this has all created additional risk in funds that were not anticipated back in the early 1980s, 1979 when 10666 came. So we’re now in this situation where what do we do next? And there’s legislation as you know on the table -- this was discussed earlier -- to reconsider this confluence of regulation between the SEC and the CFTC and whether the concept of which agency regulates which type of transaction ought to be rethought.
Jay: I think that’s a good segue into asking Susan to describe the regulatory and legislative scenario and where we are in the regulation and where we’re going.

Susan: Thanks, Jay, and good morning everybody. First thing I have to I have to give the disclaimer. This is actually the first time I’ve ever given this disclaimer since I recently joined the SEC and the views I express today are my own and do not necessarily reflect those of the commission or individual commissioners or the commission staff. Now when we talked at our panel discussion before the program and I was asked to talk about the regulatory and legislative scene I realized in thinking about it that actually I was being given the task of kind of giving the entire history of derivatives regulation in a couple of minutes. So that’s what I’m gonna do.

Jay: Keep it to one minute.

Susan: And then I’m going to go to the current legislative scene. And I think for those of you who have an idea as a circle you find derivatives regulation very gratifying because in a very simple way what we have done is come full circle to about 1922 when the first futures regulation was adopted in the United States and you will see in the current legislation that the roots are really in the same notions that were imported into futures regulation in the first federal statutes which basically were adopted to create a transparent open marketplace for trading in contracts that were viewed as critical to the economy in general. And then the crisis that we were talking about, the contracts that we were talking about, were prices of commodities which were fundamental at that time and still are to the economy in general. So the notion was that you had to have federal oversight of open marketplace backed by a clearing system that would reduce the risk of the risk shifting contracts that were being traded to convey the risk of commodity prices. And these are highly leveraged contracts that convey a lot of risk. So from 1922 to about 1985 and the 1990s we had the development of a full fledged futures regulatory structure for risk shifting products which came to include both financial products as well as commodity products. In the late 80s and 90s the products that we are talking about today developed and became important.
Swaps and other over the counter derivatives traded outside of futures exchanges and at least initially strictly between banks and similar institutional parties and the Commodity Futures Trading Commission, my former employer, was then faced with the question of should these contracts be treated as futures contracts and forced on to futures exchanges or could they reside and continue to flourish as they seemed to be in an over the counter market subject only to the private negotiation of two parties who were sophisticated, highly accredited and presumable capable of managing the risks of those transactions. And that was essentially the regulatory and policy consensus for awhile. That is that you had knowledgeable parties contracting with each other and presumable they could address any risk that arose in the context of those transactions and really these private contracts should not be regulated as futures contracts. And to just give you a flavor of the times, in the year 2000 when federal legislation to actually codify clear exemptions from any regulation for swaps and similar products, the Federal Reserve Board chairman Greenspan articulated the view which was very widely held that private parties were better at dealing with the risks of swaps than regulators and he said “we regulators cannot conceivably substitute for the effectiveness of containing risk that counterparty judgments in the market create. It is not even a close call.” So the marketplace was viewed as much better situated to assess the risk of swaps than regulators.

Jay: In retrospect, was that a good idea?

Mike: He had to apologize for that publicly before two congressional committees.

Susan: So but that view then was basically codified in the Commodity Futures Modernization Act of 2000 and that is the legislation that laid the legal framework for the swaps market as it has grown into fruition to this moment and that statute is very much viewed as part of the problem underlying the financial crisis of the last year. Now in 2009 we have multiple pieces of legislation that have either been introduced or circulated on Capital Hill for discussion that essentially would reverse the decisions that were made in the year 2000 in the Commodity Futures Modernization Act. And what these various pieces of
legislation have in common is in my view to go back, to turn back the clock and say the safest way to transact in risk shifting instruments like swaps which essentially carry the same risk as futures contracts is to have them traded on exchanges in a transparent way, backed by a clearing house that removes the credit risk of those instruments and prevents the risk that is created in the transactions from spreading to other parts of the economy. So now turning to the relevance of all of this to investment companies I would say what we have is a new view of investment companies transacting in swaps as in the terminology of the new legislation as end users as opposed to dealers so the new legislation would create both an exchange trading and clearing framework and it would also create regulation of dealers in these transactions. More or less equivalent to the regulation that exists now for futures commission merchants and in addition many pieces of the legislation, many versions of the legislation in circulation would create a category of so called major swap participants which would include parties who maintain a substantial net position in swaps other than for risk management or hedging purposes and much of the hedge fund community and perhaps the mutual fund community could be captured within that category. So if I were to ask and answer the very simple question of what impact will this legislation have on investment companies I would say the legislation promises to create a more transparent, safer marketplace in general but it also carries the possibility that some of the institutions that we already think of as fairly highly regulated would be caught up in further regulation as major swap participants which could entail capital requirements, margin requirements and registration with either the SEC or the CFTC or both.

Jay: Susan, if this legislation goes forward, what would the effect be on credit risk? Now one of the big concerns among mutual funds of course is to manage credit risk and they are subject to credit risk if the counterparty fails. How would an exchange traded derivatives contract affect that?

Susan: Well, you know, the general approach of the legislation is to try to create an incentive on the part of the parties to have their contracts cleared through a
regulated clearing organization and the legislation would compel to some extent that standardized contracts actually go through clearing houses but the line between the contracts that would have to be traded on exchanges and cleared through clearing houses and those that would not is a very fuzzy one that would be open to the regulators to define. And one of the big issues is to what extent can you take a contract, a conventional swap contract that a regulated mutual fund might trade now for example and put it on a regulated exchange and clear it through a clearing organization without undermining customized features of the contract and you know the ultimate issue is how safe can a clearing house be if it actually backing financial contracts that may not have easily accessible prices, that will enable the clearing house to protect itself. Because if you create a clearing system that depends on modeled prices that depend on non-liquid markets the clearing house itself could be a source of risk as compared to the individual transactions that it’s clearing.

Jay: One other question for Susan. One of the efforts now going on in Washington is to harmonize the regulation between the CFTC and the SEC, two regulatory organizations that regulate different aspects of the financial markets. How is that harmonization likely to unfold? And is it possible? Or are those two regulatory schemes so irreconcilable that it can’t be done?

Diane: Well is it the regulatory schemes or the congressional committees that oversee the regulatory schemes?

Susan: Yes. You know for those who spend a lot of time inside the Beltway this issues of SEC CFTC merger has been a topic for decades and the administration seems to have flirted with the idea of merging the SEC and CFTC and then probably decided that it was a labor that would not be very fruitful given the fact that the CFTC and the SEC have different oversight committees and that the congressional difficulties in getting a merger would make having that happen in the short term virtually impossible so perhaps taking that into account the administration did request that the two agencies go through a process of trying to harmonize the regulations and consistent with that request the agencies, the two
full commissions actually held for the first time joint hearings on harmonizing their rules and as a product of that exercise there will be a report issued very shortly I believe by the two agencies that will have their analysis of areas in which harmonization may be possible and a kind of plan for going forward with that. I think it’s premature to say how that will come out. I think that one of the lines that has to be drawn is between areas where the agencies differ but they differ because of underlying differences in the products and areas where they’re inconsistencies that could perhaps be rectified if people really put their heads together and tried to do that.

Diane: Just to put a fine point on this. I mean the issue is you’ve got swap for example, you’ve got commodity based swaps like gas that airlines use and you have securities based swaps that are credit default swaps and that sort of thing and if you say ok commodity based swaps will be regulated by the CFTC and securities based swaps will be regulated by the SEC but if a security is an energy based security that relies on the energy market that these various instruments are so intertwined and if they’re regulated by different agencies with different views of how those should be regulated there’s complication that’s created.

Susan: Yeah, now I would say on that point of just looking strictly at the over the counter products like swaps most of the legislation does draw a line between security based swaps and non security based swaps and contemplates joint oversight framework between the SEC and the CFTC with a number of joint rule makings to define key terms but basically separate but more or less parallel oversight duties on the part of the two agencies with respect to different parts of the swap market.

Jay: Moving right along, one of the special aspects that we have to consider today is the use by investment companies, mutual funds and closed end funds of derivatives and the special responsibilities that directors of those mutual funds in overseeing the use of these types of instruments. Monitoring of these derivatives are part of the overall responsibilities of fund investments that directors have but it is getting more and more complicated. Derivatives are considered to be in a
special category of their own because so many of them are complex and involve leverage and require careful monitoring. Sometimes however the extent of the leverage is not readily apparent and the SEC has been aware of this going back to 1994. Then Chairman Levitt said fund directors have critical oversight responsibilities in their funds’ use of leverage and that has become more and more apparent over the last 18 months, two years, as derivatives have played a role in some part of liquidity or failures of liquidity in some notable cases. Mike, what do you have to say about oversight responsibilities of directors?

Mike: There should be a lot of oversight. I’m glad to be here and have an opportunity to participate in this discussion which I gather is going out to a number of law firms and universities as well. I think just to put some further background on this. There was a cartoon in *The New Yorker* I think about two months ago and it shows the king with his head on the chopping block and the ax man about to chop his head off and a messenger runs into the castle and he has a document in his hand and he says “Stop! Stop! The government is the solution not the problem.” That of course is a play on the Reagan deregulation and it’s this deregulation that Greenspan encourage and was wrong about. And one of the things about the Investment Company Act\(^7\) is, as Diane pointed out, this is a regulatory statute and the reason it’s a regulatory statute is because the disclosure was held not to be enough. The 34 Act, 33 Act were not enough so that set up a structure in the Investment Company Act which by the way was not a friendly little operation between the investment company industry and the SEC. It was a highly contentious one and anyone who reads the investment trust study and looks at the outrageous stuff that was going on in the industry at that time would recognize that there had to be an act and Senator Wagner, the chairman of the committee, was going to have an investment company regulatory act and they had the votes to get it. So the question was ok how to you get there. One of the things in the structure was the role of the directors. Now the directors were given a key role wherever there was a conflict in the role of the directors as distinguished from the

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\(^7\) 15 U.S.C. § 80a-1 et seq.
role of the management companies and their affiliated parties. For instance, obviously in a management situation, if you’re a management person you would want to get more in the management fee. If you were arguing for the fund and the shareholders you might want to pay less. So there was tension there and everything that came up later in the area of research, use of commissions for research, well if the management could use fund assets through executions of portfolio securities, they could use that to pay for research, that would be a good thing for management as well as it might be a good thing for the funds. If 12(b)(1) which was the use of fund assets for distribution, the more distribution the higher the _____. So these are all areas of conflict. And now comes the situation where there is a responsibility on the part of the board, a fundamental responsibility to make sure that things are running right and since these are open end funds and since other institutions which are like that, like pension funds which have to pay out money and endowment funds which have to fund universities and so on, this question of valuation becomes the heart of what is going on. Barney Frank, the chairman of the House committee, was asked what’s the most important part of financial regulation and he said “Limiting securitization.” Now securitization and derivatives are part of the same problem. Not only is a derivative based on another security but when you take the subprime mortgages and put them into tranches and you have thousands or mortgages in each tranche, each one with respect to a different mortgage holder, how do you value that? Especially when you have outfits like Countrywide and WAMU selling mortgages to people who are totally unqualified, calling up people, telephone banks used to called bucket shops, in effect offering mortgages of $250,000, $300,000, $500,000 to people who couldn’t speak English well, didn’t understand what they were signing, and the salesmen were being paid, and the Wall Street people could offload these and take no risk and that was the story of Lehman and Bear Stearns. So what do directors do? Directors have some real help in getting to the valuation issues and what they’re supposed to do. First of

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8 17 C.F.R. § 270.12b-1(b).
all, there is the whole management arrangement which they’re responsible for. The first thing you see is a 15(c) letter which says that these are the questions that we as directors would like to have management answer and Section 159 provides that management will provide those answers and the directors are basically going to review them. Most almost all that I know of fund groups, major fund groups have an independent counsel. The independent counsel become much more important a factor in helping the directors as anything else. The other thing are the accountants, the outside accountants report to the board. They are not management’s accountants. Now if you’d have the same accountants for management and for the board then there have to be some understandings that the directors will have access to material that they defined in terms of their review of the management company.

Jay: Mike, putting aside the conflicts which of course are very important, to what extent do fund directors have to become experts in derivatives in their oversight?

Mike: They don’t have to become experts in derivatives but they have to understand and they have to monitor or supervise the people who do understand it. They have, I’ve said they have independent counsel that should have some understanding of derivatives. They have an audit committee which consists of independent directors. The audit committee has an outside auditor which is an independent auditor who is responsible for discussing internal controls and they could be and are tasked with making sure that the valuation issues are appropriately resolved. Unfortunately, there has been some controversy over what happens with the general rule which was mark to market. Since many of these derivatives have no specific market value, it has to be estimated and what do you do? Usually if there’s no market then the answer is well the value is zero. Well you can’t do that, things would be terrible, bank regulators don’t like it, so they have value accounting and there was a hearing before the Kanjorski committee in which the Kanjorski committee beat up on the head of the FASB and in effect told him that they will not do this mark to market with respect to these, that they will come up with value accounting. Well lo and behold they were doing value accounting.
anyway and the question is what’s the definition of value accounting. And just what two weeks ago the *American Banker*\(^\text{10}\) reported that Ms. Duke who is a member of the Federal Reserve was warning that this business about value accounting banks have to have different kinds of value accounting which would assume if the managements say so which would assume that you’re going to hold it to maturity and therefore you could mark it fully and that really is not the real world and that tells you the difference between the responsibilities of directors and the responsibilities of managers both of whom are fiduciaries to the funds and the shareholders but the difference between their responsibility is the SEC’s responsibility is to protect shareholders and the bank regulators who were blind to what was going on. And I’m not just making that up. There was . . .

Diane: Valuation is key. You’re right, Mike, I think that’s really one of the key issues.

Mike: 157\(^\text{11}\) is still in place.

Diane: Well and what they’re doing with 157 now which is very interesting is there’s talk about requiring a so called sensitivity analysis around tier 3 investments so there’s a thought that the auditors may have to not only audit the value that’s been ascribed to investments that are not for which there’s not a ready market but also create this penumbral value about how sensitive is that value to various market activities.

Mike: Ok. Now what do directors do when they’re confronted with that kind of thing? I think . . .

Jay: Will you please summarize that briefly?

Mike: I’ll summarize it briefly. It’s hard but we’ll try. But what they need to do is in the course of the audit committee’s work, in the course of the director’s, the board’s work, the auditors will play a role like they and they have to understand and counsel has to understand what model it is they’re following, how much

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\(^{10}\) Steven Sloan, *Fed Seconds Fair-Value Plan Critique* THE AMERICAN BANKER, September 15, 2009

flexibility there is, and the directors have to at least ask the right questions. You know a major percentage of the role of the directors is in asking the right questions and in getting answers which make some sense.

Diane: And many funds now have risk officers

Mike: Let me

Diane: Oh you’re going to get to

Mike: There are two officers, they’re officers within the investment company who generally are paid by management like the chief compliance officer and like the risk management officer who should also report to the board and the board’s minutes ought not be just summary minutes. They ought in fact say what is going on, what questions were asked and what the answers were and that provides a record that the directors have asked the right questions, they’ve gotten reasonable answers and consequently there would be a defense if there was a law suit.

Jay: No. We just want to take a look briefly at some of the oversight guidelines that fund directors should have. I mean certainly as Mike said you don’t want to have directors becoming experts in individual derivative instruments but directors should review each instrument and its purpose in the context of the funds’ investment objectives, insure that disclosure is adequate, understand the risks to shareholders, and whether the risk of loss is limited to the amount of the amount invested for example, insure that the advisers operations and systems are adequate certainly in the context of compliance and risk management, insuring that the compliance systems are appropriate, and looking at other, as Mike mentioned, look for red flags. Directors should be looking out for red flags and act on them. How do you do that? Look for aberrations, report, ask questions, follow up and rely on your experts.

Mike: One more thing. And also you do not rely as they’ve relied historically on the credit rating agencies and the triple A ratings which are now under separate scrutiny.
Jay: Diane, what are some of the other or newer innovations involving derivatives?

Diane: Yeah, I mean these products come out because there’s a market for them and right now the newest thing and you may have read there was an article in the Sunday Times\textsuperscript{12} about this a few weeks back are life settlements or so called STOLI products, stranger owned life insurance, where the same brokers who were selling the subprime mortgages that Mike was talking about are now hawking interests in life insurance policies and they’ll go on cruise lines and prey on people on vacation and say you want to make you know ten thousand dollars, a hundred thousand dollars, if you sell, if you buy a life insurance contract and then sell it to me our group will take that from your hands and we’ll pay your annual premiums and we’ll get the death benefit when you die and so people are doing this, they’ll make a quick buck by selling their life insurance, what they don’t realize in doing that is they’re maxing out their life insurance coverage and any privacy that they might have in information they provide on these policies now goes to these big ____ that are being created. These policies are all packaged, put into investment pools, and structured just as subprime mortgages were and sold to hedge funds and other institutional investors who are interested in some liquidity. So we have, although we had a current crisis in subprime, there are other products that are coming out now to fill the void of the market that’s created because of the demand for these products.

Mike: And that demand is fed by the idea that we have got to get the maximum amount and that we are willing to take risks. Kalpers recently suffered -- the largest retirement fund in the country -- suffered severe losses because they were investing in the subprime and they also were investing in other areas like hedge funds which the question of valuation on hedge funds. That was one of the things I was supposed to cover is that you have special deals on hedge funds. You have side pockets on hedge funds. An important thing in an hedge fund is side by side management which means what does the manager of the hedge fund charge the

hedge fund and the same manager charge the mutual fund. And that’s one of the
questions which will come up in the *Jones v. Harris*\(^\text{13}\) case which is clearly a
factor and a significant factor which directors have to consider and they’ll get
into that later but all of these things aside from those you have black pools. We
don’t know what’s in it. Trust us. Invest with us. We’ve been very successful.
Just give us your money.

Jay: What role, what role, another innovation is this area are exchange traded funds
and leveraged exchange traded funds, these have come under scrutiny lately,
certainly Jim Kramer has blamed these things for everything from not only the
fall of the, the collapse of the financial system but

Mike: Because he doesn’t want to blame himself for the advice he gave previously.

Jay: Yes, as evidenced by his appearance on

Diane: That’s right.

Jay: On the

Diane: Daily Show

Jay: I’m sorry the . . . The Daily Show with Jon Stewart. What role, Susan, do you
have any sense of what role the leveraged ETFs are playing and where is that
going to play out?

Susan: I don’t know how it’s going to play out in the future but it seems to me that we
have seen a response by FINRA and the SEC to some of the disclosure issues
raised by leveraged ETFs and there seems to be increasing activism by some of
the sponsors of leveraged ETFs to make sure that investors in those products and
prospective investors are alerted to the mechanics of those funds and the types of
return they actually give which is not easily conveyed by 2 times S&P return or
negative 2 times. It’s a daily return and it may be a product that is not suitable a
long term investor. It may be suitable only for someone who is monitoring their

\(^\text{13}\) *Jones v. Harris Assocs., L.P.*, 527 F.3d 627 (7th Cir. 2010)
investments on a daily basis.

Jay: By way of background, these exchange traded funds are investment companies whose shares are traded on an exchange. You can’t buy them from the issuer. You have to buy them on an exchange and they’re designed so that they replicate an index or a multiple of an index both going up and going down so that a negative 2 beta exchange traded fund, for example, I love throwing out these fancy words, will, every time the S&P 500, for example, will go up 1 point on a daily basis, the negative 2 beta exchange traded fund will go down 2 points or, vice versa, if the index goes down 1 point, a negative 2 beta will go up 2 points so it does bring leverage into a new dimension here and

Diane: But only on a day to day basis.

Jay: Only on a day to day basis.

Diane: And that if you hold it for more than a day, the compounding effect distorts the return.

Jay: Over time.

Diane: Over time.

Mike: Well investment companies, open end mutual funds really ought not get involved in those kinds of trades. Is there anyone on the panel who thinks they should or do?

Diane: I’m not a portfolio manager.

Mike: Ok, but you’re an advisor to a portfolio manager.

Jay: We just have a few minutes left. Are there any questions? We have a question here.

Questioner: . . . this may be covered later, I don’t know. With respect to hedge funds, side pockets, and separately managed accounts, if these are in partnership arrangements, you don’t necessarily have a board of directors to look to.

Mike: That’s right.
Questioner: for governance. Do you think this area, we’re talking about governance, is ripe for a revisit by not only the regulators but also the bar association?

Mike: That’s a very good point. And I think that number one if there’s anything that’s going to go through in this financial legislation the only thing the G20 could agree on is that hedge fund managers should be registered which is a replay of what we tried to do when, back in 05, 06 at the District, the Court of Appeals threw it out. We exceeded our jurisdiction so that’s going to come back. That not only makes disclosure of these side pockets of the side by side arrangements and the specialty arrangements. Oh, we have quarterly open periods but for you because you’re really a good guy, we’ll open it monthly. And also there are different rates charged to everybody. All of those things will see sunshine in the ADV report that they have to file. Now, so and the answer is yes, the bar associations probably ought to deal with it but it’s really the commission that has the authority under the Advisors Act to deal with it and they also now will have an inspection authority which I think becomes important in opening up the hedge fund world and also that will go. You know it 2 and 20, 2 percent management fee, 20 percent of the up side, nothing on the downside. But some of these guys are getting 40 and one guy was even getting 50 percent.

Jay: Well we’ll be discussing this later at the hedge fund private equity panel.

Mike: I was just answering the question. [Laughter]

Jay: There is a lot to talk about in this particular area and we could go on for another 5 or 6 hours. I know many of you have breakfast meetings tomorrow so we’ll try to keep it short. We’re just about out of time and I would tell you many of these issues will be addressed by a task force on the use of derivatives and leverage by investment companies. It’s a task force formed by the business law section of the American Bar Association. We are now in the process of examining these issues and we will be writing a report which I know that all of you are very eager to read. So on that note . . .

Diane: We’re also having a board of directors meeting this afternoon, right before this
group.

Mike: And they’re going to harmonize everything and harmonize is a very slippery word.

Jay: I want to thank the panelists for being with us today and for examining these very complicated issues and we’ll now take a 5 minute break as we set up for the next panel.