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Statement of the Shadow Financial Regulatory Committee on

**The Usefulness of Hedge Fund Post-Mortems**

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Over the last decade a number of hedge fund failures, from LTCM to Amaranth, have aroused public and political concerns over how they happened and the potential risks to the financial system.[1] LTCM was reported to have lost $4 billion in September 1998 and Amaranth lost more than $6 billion in September 2006. Did either bring U.S. financial markets close to disaster? Many observers believe that the collapse of LTCM was the most serious threat to financial stability in the post World War II era, yet the even larger losses of Amaranth caused barely a ripple in financial markets. In neither case do we have a detailed understanding of exactly what went wrong and how the markets dealt with the ramifications.

In the wake of these failures, inevitably the press and members of Congress note that hedge funds are largely unregulated and call for some regulatory response, usually ill-defined. Next week the G-8 Finance Ministers will consider an as yet-to-be released report by the Financial Stability Forum on improving the transparency of hedge funds. Before the next hedge fund failure transforms these concerns into legislative and regulatory action, a foundation should be laid of detailed knowledge that can be derived from past events in order to lay out exactly what the problems, issues and concerns actually are. Although hedge fund failures are often followed by legal proceedings and Congressional hearings, these are not a reliable means of acquiring systematic understanding.

The Shadow Financial Regulatory Committee endorses the establishment of a procedure in which substantial hedge fund failures are automatically subject to forensic examination. An ad hoc panel should be convened to assemble a team of independent experts that would include accountants, economists, industry experts, and lawyers, equipped with subpoena power. Such a panel should be, to the extent possible, isolated from the political pressures of the moment. It could, for example, be formed by the Government Accountability Office or, perhaps, the Secretary of the Treasury. The panel would conduct a thorough investigation and issue an independent report that would be publicly available. We do not contemplate that such a panel would have a permanent existence, but would be formed from time to time, as needed.

The panel would find facts about the failure of the hedge fund, and the fund governance, investment policy, market, regulatory and other factors that contributed to the failure. It would not be charged with making recommendations for legislative or regulatory action. Over time, however, the accumulation of a number of such reports may provide a sufficient knowledge base for others to recommend policy actions.

A possible analogy (as suggested by Professor Andrew Lo at MIT) would be to the National Transportation Safety Board and the manner in which it investigates incidents such as airline crashes. An airline crash, of course, is a discrete event and the investigation of limited scope; a hedge fund failure could be considerably more complex. The Committee, however, believes this approach is worth serious consideration.

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[1] Some of the most notable failures included the Granite Fund (1994), Long-Term Capital Management (1998), Manhattan Fund (2000), Maricopa Funds (2000), Lipper & Company (2002), Beacon Hill Asset Management (2002), Eifuku Master Fund (2002), Lancer Offshore Fund (2003), Millenium Partners (2003), Bailey Coates Cromwell Fund (2005), Aman Capital (2005), Mother-Rock (2006) and Amaranth (2006).