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SUBMITTED TO THE U.S. SENATE FINANCE COMMITTEE

"THE IMPACT A PROPOSED TAX ON HEDGE FUNDS AND PRIVATE EQUITY INVESTMENTS MAY HAVE ON THE FIDUCIARY PRACTICES OF RETIREMENT PLAN SPONSORS"

September 6, 2007

Mr. Chairman and members of the Senate Finance Committee: There are more than five million men and women who serve as investment fiduciaries; and who serve as trustees and investment committee members of retirement plans, foundations, endowments, and personal trusts. In turn, these stewards are responsible for managing the vast majority of our nation's liquid investable wealth. As critical as their function is to the fiscal health of our country, we still do not have a single federal or state agency that is providing education and training to these five million investment fiduciaries. Nowhere is this problem more pronounced than when we begin to examine the absence of sound fiduciary practices by many retirement plan sponsors when they make investments in hedge funds and private equity.

Good morning, my name is Donald Trone, and I am the president of the Foundation for Fiduciary Studies and the founder of Fiduciary360. I have been involved with writing, teaching, and preaching about investment fiduciary responsibility for more than twenty years.

I appreciate the opportunity to appear before you today and, as requested, my testimony will address the investment fiduciary issues associated with the use of hedge funds and private equity, including the likely impact a proposed change in the tax treatment of carried interest received by hedge and private equity fund managers may have on the decision-making process of an investment fiduciary.

To address the latter issue first, and to cut to the chase: A tax on hedge and private equity fund managers likely will have no more impact on the inappropriate use of these investment strategies than a hike in the capital gains tax would have had on investors during the dot-com bubble. Unfortunately, in many cases where investment fiduciaries have invested in hedge funds and private equity, speculative hubris has supplanted procedural prudence.

Most investment fiduciary legislation is based on a flexible doctrine that gives consideration to incorporating changes in the types of asset classes, asset strategies, and financial products made available to investors. At the root of this doctrine is the concept of a process standard and the requirement that the investment fiduciary demonstrate their procedural prudence.

No asset class is ever inherently imprudent: it is the way it is built and how it is used that determines whether the prudence standard has been met. While even the most aggressive and unconventional investment strategies, such as those employed by hedge funds and private equity, can meet the standard if arrived at through a sound process; the most conservative and traditional asset classes may be inadequate if a sound process is not implemented.

The Foundation for Fiduciary Studies has identified twenty-two practices that provide the details of a fiduciary's prudent investment process. A listing of these practices, which have been modified for the purposes of this hearing to specifically address the special fiduciary issues associated with hedge funds and private equity, is provided under Enclosure 1.

Three of the more significant practices are the requirements that the fiduciary demonstrate the due diligence process that was followed in the evaluation, selection, and monitoring of each investment option. There are numerous factors that should be considered, which are determined by facts and circumstances:

- Size of the portfolio
- The ability of the fiduciary to give investment direction to the portfolio manager
- Investment expertise of the fiduciaries
- Ability of the fiduciary to properly monitor the strategies and/or investment options
- The liquidity of the investment option
- The ability of the fiduciary to fund a strategy with assets-in-kind
- Minimum required investment
- The degree to which the investment is diversified
- The ability for the investment option to meet asset allocation and rebalancing guidelines
- The ability of the fiduciary to negotiate lower fees for growing or larger portfolios
- The degree of portfolio transparency
- Whether portfolio and performance information is audited
- The degree of regulatory oversight
- The ability of the fiduciary to perform appropriate due diligence.

Now compare the due diligence process just outlined to the process described in a recent *Wall Street Journal* article entitled, "Venture Firms vs. Investors." (A full copy of the article is attached as Enclosure 2.) The reporter, Rebecca Buckman, describes how some investment fiduciaries are strong-armed by venture firms into investing in unproven funds in order to remain within the good graces of the venture firms:

> *"These investors—including big university endowments, foundations and pension funds—worry that, if they don't comply, they could damage their relations with the venture-capital firms and possibly lose out on the chance to get into the firms' more typical funds, which invest in small start-ups."*

The investment fiduciary also has a duty to control and account for all investment-related fees and expenses; including the duty to identify all parties that have been compensated from these fees, and the duty to demonstrate that an assessment was made as to whether each party is receiving compensation that is fair and reasonable for the level of services being rendered.

The well-publicized, exorbitant fees that investment fiduciaries are willing to pay for access to hedge funds and private equity also provides convincing evidence that we're witnessing yet another "investment bubble." All bubbles have the same characteristics; best summarized as the "toos"**—too** much product is brought to market **too** soon (not being properly vetted), and it's **too** expensive. As in all previous bubbles, many fiduciaries have joined in the chorus line, singing: "*This time it's different.*"

Specific to the impact a proposed tax on hedge and private equity fund managers would have on the fiduciary's decision-making process: A tax hike would have the impact of reducing the investment's return, as well as reducing the attractiveness of the investment's expected risk/return profile. Unfortunately, even knowledgeable and responsible investment fiduciaries often are not capable of accurately modeling a hedge fund's risk/return profile because of the lack of portfolio transparency and the absence of audited track records.

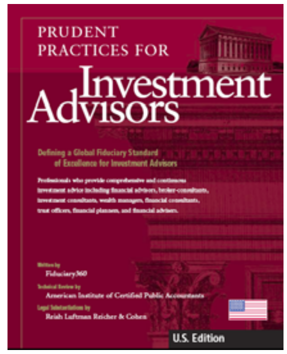
In theory, a tax hike would have the effect of making hedge funds and private equity investments less attractive in a prudently diversified portfolio. In reality, the current, unbridled exuberance for these investment strategies means that a tax increase will have little-to-no-effect on their use.

Thank you.

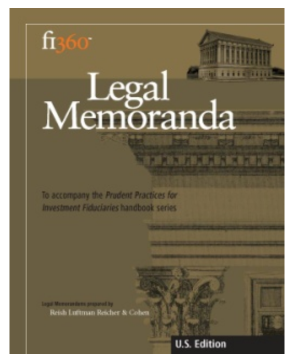
Enclosure 1:

Fiduciary Practices Associated with the Use of Hedge Funds and Private Equity

The fiduciary practices which follow are based on the handbooks ***Prudent Practices for Investment Stewards*** and ***Prudent Practices for Investment Advisors***. Both handbooks were written by Fiduciary360 and edited by the AICPA (American Institute of Certified Public Accountants).



Each of the practices is substantiated by legislation, case law, and regulatory opinion letters. The legal memoranda were prepared by the law firm of Reish Luftman Reicher & Cohen.



1. The hedge fund/ private equity manager demonstrates an awareness of their fiduciary duties and responsibilities.

2. Investments are managed in accordance with applicable laws, trust documents, and the fiduciary's investment policy statement (IPS).

3. The roles and responsibilities of all involved parties (fiduciaries and nonfiduciaries) are defined, documented, and acknowledged.

4. The hedge fund/private equity manager is not involved in self-dealing.

5. Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.

6. Assets are with a custodian that can provide an independent and objective valuation of the portfolio's holdings.

7. The hedge fund/private equity strategy is consistent with the portfolio's investment time horizon.

8. The hedge fund/private equity strategy is consistent with the portfolio's risk level, and the fiduciary can demonstrate an understanding of the portfolio's risk exposure.

9. The hedge fund/private equity strategy is consistent with the portfolio's expected, modeled return.

10. The selected hedge fund/private equity strategy is consistent with the portfolio's identified risk, return, and time horizon.

11. The selected hedge fund/private equity strategy is consistent with implementation and monitoring constraints of the fiduciary.

12. The fiduciary's investment policy statement contains the detail to define, implement, and monitor an investment in a hedge fund/ private equity strategy.

13. The fiduciary can demonstrate that a due diligence process was followed in selecting the hedge fund/private equity strategy.

14. The fiduciary considers the impact an implementation in hedge funds/private equity may have on "safe harbor" procedures available to the fiduciary.

15. The investment in hedge funds/private equity is appropriate for the portfolio size.

16. The fiduciary can demonstrate that a process was followed in vetting the hedge fund/private equity manager's custodian.

17. The fiduciary receives periodic reports which compare the investment performance of the hedge fund/private equity strategy to an appropriate index, peer group, and objectives outlined in the fiduciary's investment policy statement.

18. Periodic reviews are made of qualitative and/or organizational changes of the hedge fund/ private equity manager.

19. The fiduciary has control procedures in place to periodically review the hedge fund/private equity manager's policies for best execution, "soft dollars," and proxy voting.

20. Fees for investment management are deemed reasonable, and are consistent with agreements and with all applicable laws.

21. “Finder’s fees” and other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented by the hedge fund/private equity manager.

22. The fiduciary has a process to periodically review its effectiveness in managing its fiduciary responsibilities.

Enclosure 2:

Venture Firms vs. Investors

Yale and the Like Quietly Cite Pressure to Back Offbeat Funds

By Rebecca Buckman
The Wall Street Journal, August 28, 2007, Page C1

Some top venture-capital firms eager to expand into new markets are twisting their investors' arms to get them to go along—or so say the investors.

Investors said big-name firms such as Sequoia Capital and North Bridge Venture Partners have been exerting subtle—and not-so-subtle—pressure on some of their limited partners, as these investors are called, to put money into unproven investment vehicles, including funds that invest in China, India and so-called later-stage U.S. companies.

These investors—including big university endowments, foundations and pension funds—worry that, if they don't comply, they could damage their relations with the venture-capital firms and possibly lose out on the chance to get into the firms' more typical funds, which invest in small start-ups.

One limited partner feeling the heat is Yale University and its $18 billion endowment fund. Yale declined to invest in some funds launched in the past few years by Sequoia, including a 2005 fund focused on Chinese companies. Sequoia later decided to "oust Yale from its partner group" because the university passed on the new funds, which targeted "later-stage deals, China and Israel," according to a September 2006 internal Yale review of the endowment's private-equity portfolio.

Sequoia told Yale it preferred investors that would give the Menlo Park, Calif., venture-capital firm a "blank check" to invest as it saw fit, according to the 39-page Yale memo, parts of which were reviewed by *The Wall Street Journal*. A Yale spokesman declined to comment.

Sequoia partner Doug Leone declined to comment on the Yale situation, citing privacy agreements with the firm's investors. He said Sequoia doesn't pressure its investors and has "multiple" investors who have declined to put money into the firm's many overseas funds "without repercussions of any kind …. We encourage our limited partners to invest only in the funds they believe in."

Some Sequoia investors said they felt no pressure to invest in the firm's overseas funds. One Sequoia investor, Massachusetts Institute of Technology, provided a statement at Sequoia's request saying the university has "on more than one occasion declined to invest in name brand venture capital firms' affiliated products that did not match our portfolio requirements," and "we continue to maintain excellent relationships with those firms."

The discord offers a look inside the culture of the venture-capital world, highlighting the increasing power of the industry's top firms. With median industry returns lackluster lately, spots in venture funds that are performing well are more highly prized than ever—and new spots seldom open up, except when firms launch new investment vehicles.

So, even large investors like universities and foundations generally are loath to publicly criticize the firms, partly for fear of getting kicked out of their funds. Many investors also pony up for new types of funds because they don't feel they really have a choice of not investing—even though some venture firms tell them they won't be punished for passing. Still, some investors are skeptical about the ability of even the best-performing firms to succeed in such areas as investing overseas and in larger companies at home.

In some cases, investors "have really felt like there's been a gun held to their heads," says Josh Lerner, a Harvard Business School professor who has studied the venture-capital industry. Some venture-capital firms tell investors that "if you want to continue to be able to invest in the mother ship, you've got to play ball and invest in the secondary funds," he says.

Apart from Sequoia, investors said North Bridge pressured some existing investors to put money into a new growth fund of roughly $500 million the Waltham, Mass. firm raised last year. At least one institution said it was told that how much it put into the growth fund would help determine how much the institution could invest in a coming early-stage fund. The other criterion was how much money it had invested in North Bridge's previous early-stage fund, these investors said.

North Bridge declined to comment. Three investors with the firm who were asked by North Bridge to comment on the issue said they weren't pressured to put money into the growth fund.

Some investors said they don't mind any subtle arm-twisting over secondary funds because they are happy to put money into any product offered by such top-ranked firms as Sequoia and North Bridge.

Many investors said they don't begrudge the best venture-capital firms using their increasing influence to expand into new markets. Sequoia, which has funds targeting China, India and Israel, said in June regulatory filings that it was raising two additional China funds of about $225 million and $450 million.

Kleiner Perkins Caufield & Byers, which famously backed such companies as Amazon.com Inc. and Google Inc., started a $360 million China-focused fund this year and last year launched a $200 million fund focusing on companies that make drugs or disease-detection products used in health pandemics. And Silicon Valley's Accel Partners this summer said it had teamed up with IDG Ventures to launch a $510 million fund focusing on China, two years after the firms raised their first joint China fund.

“All the first-tier funds are sort of rolling into this new model of multisector venture funds, which is a way of having your finger in a lot of pies,” said Paul Kedrosky, executive director of the William J. von Liebig Center for Entrepreneurism and Technology Advancement at the University of California at San Diego. It also means funds can collect more fees from investors, because fees generally are based on assets under management. Most venture-capital firms expanding overseas said they are simply responding to increasing globalization in the industries in which they invest.

Still, limited partners who don’t want to go along worry they may get cut out of future funds if they don’t invest in the new offerings. Sometimes the pressure is subtle, with firms saying that declining to participate in new funds is “fine” but may “change the relationship” between the firm and the investor, according to one university endowment official.

What makes Yale’s falling out with Sequoia so unusual is that big investors known for their long-term outlooks, such as Ivy League endowments and well-known charitable foundations, often have more clout and receive better treatment from venture firms.

“With our relationships, we’re close enough with the [fund] managers that we’re part of the dialogue when they’re thinking about doing something with a new fund” and are rarely “approached after all is said and done,” says Dan Feder, who helps manage the endowment at Princeton University in New Jersey. “But I understand that our experience is probably not typical.”