Testimony of James H. Simons

Before the House Committee on Oversight and Government Reform

November 13, 2008

Good morning Chairman Waxman, Ranking Member Davis, and members of the Committee. My name is James Simons, and I am the Chairman and CEO of Renaissance Technologies LLC. Thank you for the invitation to appear before you today.

I appreciate and welcome your interest in understanding the underlying causes of the recent financial crisis. This is indeed a serious and disturbing time for the markets, the broader economy, and our nation as a whole. Individual Americans are hurting and are fearful for their financial futures, and businesses of all sizes are facing problems. Hedge funds are having trouble along with everybody else. Some smaller funds have failed, and some others, both big and small, are struggling to stay afloat. Federal agencies are trying to do their best, but this is a very difficult situation. I am pleased to be here to answer your questions about these issues, and I stand ready to work with you and your staffs as the situation unfolds in the months ahead.

Before turning to the specific questions raised by your letter inviting me to testify, I would like to provide you with my perspective on how the crisis came about.

The Roots of the Crisis. The crisis has many inter-related causes, and blame can be laid at the feet of many different parties. Encouraged by the willingness of institutions in the secondary market to buy their wares, banks and mortgage companies were all too happy to originate

mortgages of lesser quality than previously had been thought appropriate. Having been sold to the secondary buyers, these mortgages were bundled up into packages, then sliced and diced in a variety of imaginative ways by investment banks, which created and issued securities based on these bundles. The rating agencies, paid by the issuers, rated these securities, which were then sold to final buyers or, in some cases, held on the balance sheets of the banks and brokerages. As time went on, the quality of the newly created mortgages deteriorated to remarkably low levels, and the rating agencies became increasingly fanciful in their ratings. All this took place at a time when the investment banks and brokerages had moved to a regime of "self-regulation," a consequence of which was exceptionally leveraged balance sheets. It also took place at a time when the (unregulated) market for credit default swaps (CDS) expanded rapidly, enabling holders of the improperly rated securities (and of the debt of others holding them) to purchase further comfort. At the same time, a huge global pool of investment money, coupled with great demand for more and more fixed income investment opportunities, pushed everybody in the chain to create more and more mortgage-backed securities to sell, even if the underlying mortgages were of questionable quality. All of this worked splendidly as long as home prices continued to rise rapidly, but when they began to stall and reverse, the party was over. We have all seen the result.

There is much blame to be shared: the SEC and perhaps the Federal Reserve for taking such a hands-off position on the leverage posture of the investment banks and the uncontrolled nature of the CDS market; the players all along the chain of creation and distribution of the paper, each of whom should have blown a whistle rather than passing the problem on to the next guy; and finally, and in my opinion the most culpable, the rating agencies, which failed in their duty and allowed sows' ears to be sold as silk purses.

Your letter asked me to address several issues specifically relating to the hedge fund industry, and I will do that in a moment. First, let me tell you a little about myself and my company, a somewhat atypical investment management firm, Renaissance Technologies LLC ("Renaissance").

Background on Myself and my Company. Renaissance's investment approach is driven by my background in mathematics. Before I ever entered the business world, I was a mathematician. I have a PhD from Berkeley, won the 1975 Veblen Prize of the American Mathematics Society (given every four years for work in geometry and topology), and taught mathematics at the Massachusetts Institute of Technology and Harvard University before becoming the chairman of the Mathematics Department at the State University of New York at Stony Brook. Along the way, I spent four years as a code cracker for the National Security Agency.

Renaissance, an SEC-registered Investment Adviser since 1998, manages what are termed quantitative funds – funds whose trading is determined by mathematical formulas designed to predict market behavior. Individual trades are generated by computers, based on work continually developed by our researchers. Naturally, human beings carefully monitor the trade execution process, making sure that all parts of the system are behaving properly. We operate in only highly liquid, publicly listed securities, such as stocks, bonds, currencies, and commodities, and do this on exchanges throughout the world. This means, for example, that we do not trade in credit default swaps or collateralized debt obligations, neither of which satisfies the above criteria. In the stock trading of our Medallion Fund, we hold balanced portfolios in each country, *i.e.*, portfolios very close to being equally long and short. Our trading models tend to buy stocks that are recently out of favor and sell those recently in favor. Thus, to some extent, our actions

have the effect of dampening extreme moves in either direction, and, as a result, reducing volatility in those stocks. An example of this contrarian tendency is the fact that during the six-week period ending this September, Medallion held long positions in many of the most troubled of the financial stocks, including Lehman Brothers and Washington Mutual. We of course lost money on those trades!

Renaissance manages three fund families: Medallion, RIEF and RIFF. The first is our flagship fund, which we have operated for twenty years with great success. In the early part of this decade, we determined that the fund had grown too large, and we began to return capital to investors who were not employees of the firm. That process was completed in 2005, and since then the fund has been almost entirely owned by the people who operate it – Renaissance employees. We charge ourselves fees because fund investment is not allocated in the same proportion as is employee compensation. For example, my share of Medallion is far greater than is my share of employee compensation. Thus, the fee mechanism moves income away from the largest owners of the firm to the rest of the employees. Nearly all of the income of the firm and its employees is based on the performance of Medallion, a fund whose investors are almost exclusively its managers.

In recent years, Renaissance started two new funds aimed at outside investors: the Renaissance Institutional Equities Fund (RIEF) and the Renaissance Institutional Futures Fund (RIFF). The first is net long one dollar of U.S.-traded stocks for each dollar of equity in the fund and is designed to be a lower-volatility and higher-return substitute for an index fund. The second is a slow trading fund, investing in commodities, currencies, bonds, and stock indices, and is designed to deliver an attractive return at relatively low volatility. RIEF has done a fine job during its three years plus of existence. RIFF, started 13 months ago, did well during its first

nine months but has been challenged by the turbulence of this fall, during which its returns were disappointing. Both of these funds, designed for institutional investors, are lightly leveraged and charge fees less than half of those charged by mainstream hedge funds. These institutional funds are a new business for Renaissance, and while their financial contribution to the firm has been exceptionally modest, we have high hopes for the long term.

I will now turn to the questions the Committee raised.

Do Hedge Funds Cause Systemic Risk? As I have already mentioned, the behavior of institutions in several financial sectors contributed to the recent crisis, but, in my view, the hedge fund sector was not among them. While there are exceptions to any rule, I believe that hedge funds by and large have made an important contribution to the financial industry, and, as indicated in what follows, are unlikely as a single class to be a substantial contributor to systemic risk. Generally speaking, hedge funds have provided to the markets an increased level of liquidity, reduced volatility, improved price discovery, and enhanced the returns of many large endowments and pension funds. Moreover, by pursuing a rather diverse set of strategies such as long/short equities trading, convertible bond arbitrage, merger arbitrage, statistical arbitrage, global macro, distressed debt and workout activities, and old-fashioned deep value investing, hedge funds are sufficiently spread out that, as a class by itself, they do not seem to present a source of systemic risk. I say this with the knowledge that hedge funds indeed employ leverage, and there are doubtless individual examples where this is overdone. Nonetheless, the leverage posture of each participant in the industry is monitored carefully by its lenders and is controlled far more stringently than is the leverage posture of many participants in the investment banking industry. The latter is subject to no such monitoring and in many cases achieved leverage levels far in excess of those of hedge funds. The results of such excess are now well known.

Do Hedge Funds Require Further Regulation? Let me first note that hedge funds are presently regulated in a variety of ways. For example, the Investment Advisers Act of 1940 imposes anti-fraud requirements on all hedge fund managers. Moreover, they are subject to a variety of securities position reporting requirements under the Exchange Act. Unlike other financial institutions that handle investments by the general public, hedge funds (by law) are accessible only to large and sophisticated investors. Therefore, new regulations focusing on customer protection, such as apply to mutual funds and brokerage firms, are probably not necessary or even desirable. On the other hand, I do think that regulation focused on ensuring market integrity and market stability would be useful and welcome. I will briefly address this subject below in the section on transparency.

Should Hedge Funds be Registered with the SEC? There has been a great deal of discussion over the last few years about whether hedge fund managers should be required to register with the SEC as investment advisers. This debate has been a moot point for us, because we voluntarily registered in 1998. Our business model is relatively simple, and we have not considered SEC registration to be an undue burden, but other, more typical, hedge fund managers likely have been deterred from such registration because the regulatory authorities have not always administered the Investment Advisers Act in a way that takes account of many hedge fund managers' business models. If the Committee pursues a registration requirement for hedge fund managers, I would encourage you to see to it that the design and implementation of the requirement fit the way our particular industry works.

Should Hedge Funds be more Transparent? Proposals for greater transparency into hedge funds' investments also have received a great deal of attention lately. We agree that transparency to appropriate regulators of all market participants can be helpful in monitoring

systemic risk and manipulative practices. In spite of my belief that hedge funds by themselves are unlikely to be a source of systemic risk, it could be the case that aggregate positions of hedge funds, together with those of other industry participants, could sometimes present that possibility. A proposal the Committee may wish to consider is to require hedge funds' positions to be reported to an appropriate regulator and then to allow the Federal Reserve Bank of New York, or some similar such authority, to have access to aggregate position information and to recommend appropriate action should the situation warrant it. I stress, however, that information so provided by individual funds or institutions should never be released to the general public in disaggregated form. Such disclosure can serve no useful purpose and indeed can cause harm to small investors, who, unfamiliar with the strategies leading to certain individual positions, may act upon an erroneous understanding of the data.

Does the Compensation Structure of Hedge Funds Lead to Excessive Risk Taking? While this question does not really apply to us, as almost all of our income is based on profits on our own capital, generally speaking I would say the answer is no. In the first place, contrary to what one might think, hedge funds are not a particularly volatile asset class. For example, over the past ten years the annual volatility of the capital-weighted HFI, the standard hedge fund index, was 7.2%, whereas that of the S&P index was 15.4%. From these statistics, one can see that, on the whole, hedge fund managers turn out to be relatively cautious. Yes, they receive a performance allocation of 20% or 25% of profits each year, but if the year is a loser, those losses have to be earned back before there are any such allocations in future years. Since most managers wish to remain in business for a long time, they are unlikely to run the risk of a large loss (which would lead to massive redemptions and the end of the fund) in the hopes of having one great year. Moreover, it is typically the case that a manager's largest investment is in his

own fund. That is certainly the situation at Renaissance and at most other funds with which I am familiar.

Is Special Tax Treatment for Hedge Fund Managers Warranted? With the exception of offshore deferred compensation, a practice recently prohibited and one in which we never participated, I know of no special tax treatment for hedge fund managers. It is true that much of their compensation is via profit allocation from their funds, and this is taxed in the same manner as profits earned by the fund's investors, but that arrangement is standard in all partnerships, including, for example, partnerships engaged in manufacturing, services, real estate, and natural resources businesses. As to whether such income to managers ought to be treated in that manner, I have no opinion except to observe that partnership taxation has always worked that way. Of course, if it is good public policy to alter that treatment, it should apply across the board to all types of partnerships, not simply to hedge funds.

Before concluding, I would like to take this opportunity to reflect on how we may best get out of this hole, and to make a specific proposal, the implementation of which may prevent us from ever getting back in.

I believe the most important thing we can do in the near term is to keep as many people as possible living in the homes they now occupy, even if their mortgages are in default and they have negative equity in their property. There have been a number of plans put forward to achieve this end, and I will not opine on which is best, but I will opine on the great importance of that result. Not only would it provide an important measure of stability to millions of families who already will be coping with an economy marked by growing unemployment and other destabilizing factors, but it will maintain the values of their homes at a far better level than would

be the case in foreclosure, thus mitigating the impairment to the trillions of dollars of securities collateralized by mortgages on these homes. As for the longer term, I propose the following.

A New Rating Organization. Historically, the bond rating agencies worked for the bond buyers, being paid through subscriptions to the agencies' publications. This model changed in the 1970s to one in which the agencies were paid by the bonds' issuers. In spite of the obvious conflict of interest, the new model worked reasonably well for conventional bonds subject to conventional financial analysis. The situation changed considerably, however, with the advent of financially engineered products.

I very much believe in the value of these products, but it is crucial that organizations rating them are appropriately staffed with personnel well trained in quantitative methods, and, even more importantly, that the organizations owe their allegiance to the buyers, not the issuers.

I therefore would encourage the major organizations who are the traditional holders of these bonds, such as CalPERS, TIAA-CREF and PIMCO, to band together to sponsor a new, not-for-profit rating organization, focusing on derivative securities. Representatives of these organizations could serve on the board of the new organization. Another option might be for Congress to charter such an organization, in which case representatives of the private entities might be joined on the board by specified officials from the Federal Reserve or other appropriate government agencies. Revenues for the new organization could come from fees, paid by the buyer, whenever a transaction took place in a bond rated by the new organization. I believe that these fees would be miniscule relative to the value of the bond, and every buyer very likely would insist that merchandise being purchased bear a rating from the new organization.

As a result, these complex instruments would be subject to proper analysis and rating, the interests of buyers and raters once again would be aligned, and the probability of reoecurrence of a problem anywhere near the extent of that which we are now facing would be dramatically reduced.

Again, I appreciate the opportunity to testify before the Committee, and I hope my testimony has been helpful.