

TUESDAY 24 NOVEMBER 2009

Present

Cohen of Pimlico, B (Chairman)
Haskins, L
Northover, B
Trimble, L
Woolmer of Leeds, L

Memorandum submitted by Citadel Investment Group

Examination of Witnesses

Witnesses: **Dr Patrik Edsparr**, Chief Executive Officer, and **Miss Rebecca Fuller**, General Counsel, Citadel Europe; and **Mr Adam Cooper**, Global General Counsel, Citadel Investment Group, examined.

Q418 Chairman: Good morning. Thank you all very much for coming. May I begin by explaining that we are all being recorded and you will be sent a transcript of the session in order that any infelicities can be looked at and straightened out. You are, the last witnesses but for the fact that we are seeing a prime broker next week. We have already talked to a number of people including various people in Brussels and our own ministers. There are two ways that we can go with this. You have seen the questions and indeed have attempted written answers to some of them. Would you like us to begin with the questions or is there a general statement that you would like to begin with? Whichever you would like to do will be fine.

Dr Edsparr: Thank you. I want to express our gratitude for being asked to participate in these proceedings. These are obviously contentious topics and we really appreciate the time the Committee is taking to explore fully the subject. My name is Dr Patrik Edsparr and I am CEO for Citadel Europe. To my right is our Global General Counsel who is based in

Chicago, Mr Adam Cooper, and to his right is my General Counsel in the UK, Miss Rebecca Fuller. Thank you very much.

Q419 Chairman: Perhaps I could begin by asking you for your view because you are the first Americans we have seen, we have only seen European-based hedge funds so far. What systemic risks do the alternative investment funds propose and to what extent do you think the hedge fund industry is systemically significant?

Dr Edsparr: I think that something that gets lost in a lot of the debate is how heterogeneous and diverse the so-called hedge fund community is. You are talking about, I believe, in excess of 6,000 different funds with strategies that vary from different rates based relative value strategies to distressed debt. It is really, I would argue, more diversity across the spectrum that was labelled hedge funds than almost in anything else, certainly compared with the big banks which all tend to have a very similar business model. I would not rule out that there could be certain position concentrations across hedge funds - traditional banks, traditional asset managers, insurance companies and so forth - and I think that there is a legitimate need for a regulator to know what some of those position concentrations can be but, as an industry, we largely represent something very diversified and act as a safeguard to not being exposed to too many of the “too big to fail” risks and systemic breakdown. I think that it is important to note that, despite the massive gyrations in the market and the stress on the system, not a single hedge fund demise – and there were thousands of them, literally – caused any systemic disturbance to mention. I think that the issues are very, very different for the alternative investment community than they are for the major banks.

Q420 Chairman: I suppose that the thing about the alternative investment community is that it has grown so much in the last 20 years and we have had some anecdotal evidence to suggest that the hedge fund community is now so big that, in the ordinary course of business

without doing a single thing you could frown on, they are big enough to destabilise some of the big investment banks if they all withdrew funds at once as I believe happened.

Dr Edsparr: I think the causality goes the other way. The reason that there was some strain on the hedge fund community was that the big banks withdrew the funding, because obviously the whole financial system is based on the central bank providing emergency liquidity to the major banks, and when the banks do not intermediate in that liquidity extension then the people who are beholden to the banks as intermediaries are exposed. That may be a separate subject matter, but I think that there is a legitimate question about how the liquidity provision in today's marketplace should take place and it may not be optimal that it always just goes through the window and through the major commercial banks. I think that the hedge funds are at some level dependent on the financing arrangements that largely happen through the banks. If the banks have access to liquidity from the Bank of England or the ECB or the Fed but the banks start to hoard cash and start to cut all the financing lines, it does not matter whether you are a hedge fund or if you are a corporation or if you are an individual because, if those financing lines disappear, most of those participants have no other source of financing. It is absolutely correct that that would cause some strain for some people including us but I think that systemically the demise, because of that withdrawal of liquidity and withdrawal of financing, actually did not any cause any systemic threat.

Q421 Chairman: I think that we were reasonably convinced that the banks had not suffered, but the banks had, on the whole, got their money back from hedge funds and hedge funds have gone down. Are hedge funds in a position of holding large deposits with banks that they withdraw or can withdraw or might have withdrawn?

Dr Edsparr: I think that this ties to the prime brokerage issue. I think that any well-managed hedge fund will have a very significant proportion of their assets in an extremely liquid form and, for a number of hedge funds, that means holding cash on deposit with their prime broker.

I think that the demise of Lehman Brothers was disturbing to a number of people because they could not access that cash/liquidity reserve. It is absolutely part of prudent risk management to keep a very substantial portion of your assets in cash or cash equivalence to be able to meet short-term troubles.

Chairman: Indeed.

Q422 Baroness Northover: Picking up on My Lord Chairman's first question which was, had they grown to such a size that they could have a systemic effect, you then turned that around and said that actually they were affected by what happened. If they do indeed hold large deposits in the way that you say, if funds were to decide to withdraw these deposits, that could have a systemic effect, could it not?

Dr Edsparr: I do not think that hedge funds represent any significant portion of the deposit base for the banks. That is very, very marginal. The hedge funds are net recipients of financing. On average, hedge funds own more assets than they have equity, so they need financing on some of those assets, and that is where the banks typically play a role. The only area where hedge funds can significantly contribute to systemic risk is if one particular position, let us say the insured Bank A versus Bank B, if it just happens to be that a lot of hedge funds at the same time as many of the banks and as maybe many of the traditional players, assets managers, insurance companies and so on, if they all end up having the same position, maybe out of coincidence or for whatever reason, I think you can argue that that can create technical pressures in the market.

Q423 Baroness Northover: Of course that was something which was seen and addressed, was it not, that short selling seemed to be undermining institutions where there was some sort of a question mark?

Dr Edsparr: My view, and speaking as a trained economist I guess, is that short selling is actually one of the few safety valves we have against bubbles. I find it intellectually very disingenuous, on the one hand, to say that we want to prevent bubbles, we want to prevent excessive speculation and risk taking, which are largely driven by long positions, borrowing to buy more and keeping the asset values going up and, on the other hand, to say that when those bubbles correct the short sellers are the damaging force. Short sellers keep those asset bubbles within some rhyme and reason when you have a bubbly market.

Q424 Baroness Northover: What pops the bubble?

Dr Edsparr: There is a combination of technical factors and fundamentals that pop bubbles. I cannot say that I have any secret insight as to when that happens, whether it is tulips in Holland or real estate in the US suburbs or, as a Swede, I guess I have a little bit of perspective from the Swedish real estate prices in the early 1990s. I do believe that short sellers play an extremely valuable function in forming efficient prices in the marketplace and I think that there is a crucial difference between saying that, in one particular name and at one particular time, the number of positions add up to too much, so that it is justifiable for a regulator to say, “Well, let’s stop now in this name” as opposed to any kind of blanket restrictions.

Q425 Lord Haskins: The logic of what you said about the hedge fund reliance on the banks for their cash would suggest, if you regulate the banks properly, that is where the systemic risk arises and, if you do that properly, then the banks themselves would be the regulator of the hedge funds because they are the ones who provide the money and, if they are providing money in an irresponsible way, then it is the banks who pay the price. You could argue that there are other reasons for regulating hedge funds but systemic risk does not appear to be one.

Dr Edsparr: I would largely agree with that. I think that the key in this equation is the capital structure and the regulatory regime around banks and obviously that filters through to the access to leverage and financing for other participants. I would say that it is the regulatory regime around banks on the one hand and the access to emergency liquidity from the central banks which are the two macro-levers that, as regulators for setting the stage for the financial market, I believe are the two key features.

Q426 Chairman: I was trying to establish whether hedge funds are now large enough that if, in the normal course of business and perfectly legitimately, they remove all their cash deposits from the banks because they are worried about the banks, they would be large enough to destabilise the bank? I think you thought not, Dr Edsparr.

Dr Edsparr: I do not believe so. Also, remember that, if you do not keep any cash on hold, you will not be able to borrow anything against your assets. Effectively, if you want to do that on a bigger scale, you would basically just collapse your business.

Mr Cooper: If I might add in response, the US regulators in particular are looking at enhancing the capital requirements applicable to banks so that they are required to post more capital, maintain more equity against their balances. What I think we found in the fourth quarter was that the system was under-capitalised and the banks had not reserved sufficient equity capital against their obligations and certainly great scrutiny is being put into that right now.

Q427 Chairman: They were, in short, relying too much on their depositors?

Mr Cooper: Yes.

Q428 Lord Trimble: There are US proposals as well as the EU proposals which we are looking at. I wonder if you could give us an indication of how the two sets of proposals differ.

Mr Cooper: Broadly speaking, I think they have similar goals of enhancing investor protection and guarding against systemic risk. The approach that the EU takes vis-à-vis these issues as compared with the US approach is, however, slightly different. The US approach – and again these are all just proposals now that are being considered – is based more on transparency, information and disclosure. I believe that the EU proposals are more prescriptive and rule based in nature.

Q429 Lord Trimble: If the EU proposals are more prescriptive rather than just being on the questions of transparency and disclosure, could this then result in a situation of these two regulatory structures developing in the way you have said, which is actually then going to be a commercial advantage for New York based businesses and, consequently, EU businesses might suffer as a result?

Mr Cooper: You may be getting at the notion of, should there be some form of equivalency among regulatory regimes? I am not aware and I am not privy to the inner thinking of the regulators in this. I do not think there is any notion that they are trying to create a regime that would encourage regulatory arbitrage. I think what we saw more than anything in the fourth quarter of last year was the absence of harmonisation in communication among international regulators exacerbated. I think that there is a great drive now to harmonise the approach. You do not want to have the culture of a prudential regulator in jurisdiction A impacting a decision of where a participant goes if the culture of a prudential regulator in jurisdiction B is different.

Q430 Lord Trimble: If we are going to harmonise the regulatory structures and we have US proposals that are concentrating on transparency and EU proposals that are a little more rigid in terms of their operation, how is one then going to harmonise?

Mr Cooper: I think that there is a process in place where the regulators speak to each other. It is an aspiration; it is not necessarily something that can be achieved. I think that the best outcome though is an outcome that permits alternative investment fund managers to operate efficiently and smoothly in multiple jurisdictions. We are an international institution, we operate all over the globe, and it is important for us to be able to continue to keep doing so rather than to be arbitrarily precluded from one particular jurisdiction because of the absence, for example, of equivalency.

Dr Edsparr: I would add, also, that the ultimate decision makers obviously are investors. It is the investors, whether they sit in Asia, the Middle East, Europe or the United States, in terms of tax treatment and in terms of legal treatment. There are all kinds of reasons why you can only operate efficiently in one environment and I think that, in all these proposals, the devil is in the detail.

Q431 Lord Haskins: If we go into a little more detail on the two approaches to regulation, basically the proposal that the EU are putting forward and, you know much better than we do, the proposal being discussed in America. It seems to us that there seem to be three or four areas where they differ and I would like to get your comment. One of them is possibly different leverage requirements of the two regimes; the second one appears to be very important and is a moving scene and that is third-country investment and even the EU will tell you it is changing its position day by day on that; and the third one is a little related to that and that is marketing and scope of hedge fund activities.

Mr Cooper: I will speak briefly and then turn it over to my colleague, Miss Fuller. The EU proposal, as you suggest, would prescribe leverage, marketing and third party services in third

countries as well as depository and marketing limitations. The US provisions that have been proposed do not prescribe or address any of those issues in the same way that the EU does. There are no mandated leverage limits or restrictions under any US proposal. There are some slight proposals with respect to marketing but, by and large, EU managers can market freely in the US their investment products provided that they become registered as investment advisers as US managers must.

Q432 Lord Haskins: Is that easy to achieve?

Mr Cooper: Yes, I believe it is. These are just proposals, but I am confident that the US will pass legislation requiring investment advisers to register and I think that the rules and the way in which they are satisfied will be equally convenient or applicable to US and non-US managers, and then we permit them to freely market within the US provided that they maintain compliance with various marketing and private placement rules that exist. These are all private investment funds, so it is not a public offering to retail.

Q433 Lord Haskins: Do you think that, if the proposal goes through, the gap in approach between the two regimes is widening or narrowing? We keep hearing that it is important that hedge funds can trade freely across the world. Is the gap in approach widening between the two regimes or narrowing?

Mr Cooper: I would like to defer again to Miss Fuller with respect to the EU Directive, but some of the prescriptions of the EU Directive I think would make it very challenging for an international institution to freely deploy capital throughout markets in the EU.

Q434 Lord Haskins: Including the recent Swedish compromise on third country private placement?

Miss Fuller: I think that the third country private placement under the Swedish compromise text is definitely a step in the right direction. What remains unclear though is the ability of offshore managers to continue to market through the private placement regime into the EU and, just standing back, conceptually, nevertheless it is still going to be more difficult for third-country funds to be marketed in the EU. The Swedish text is definitely a step in the right direction but it is still a move away from the status quo which relies purely on the national private placement rules.

Mr Cooper: If it is harder to market, I think it is ultimately the investors in the EU who suffer the consequences of that with the absence of alternatives in deploying their capital.

Q435 Lord Woolmer of Leeds: Picking up that point, 80 per cent of funds managed by alternative investment fund managers are outside of Europe, overwhelming through the United States. I suppose that one could say that United States fund managers can do without Europe but European fund managers might find it not quite as easy to do without the United States and the rest of the world. In other words, if Europe has a regime that is tighter and much tougher and more regulatory than the United States, that could result in relative damage to investors in Europe compared with elsewhere in the world. First of all, is that a fair assessment of the way in which things could be going in Europe compared with the United States? It would be helpful to know that. Secondly, coming back to the point of arbitrage, if there are real differences, taking up Lord Haskins's point, will the result be arbitrage or simply less business and less opportunities and choice for European investors, pension funds and so on?

Dr Edsparr: I believe that there are two aspects to this and you touched on both of them. I think there is one question of where you can conduct business as a hedge fund and the second issue is where you can attract capital from. If I may start with the latter one, I think it is clearly one of the issues in the current draft EU Directive to what extent international funds

can market and engage European investors. Ultimately, the concern that I have as a European is that sophisticated institutional investors in Europe will not have access to some of the state of the art investment products. Obviously, 2008 and early 2009 created an enormous strain on the system and hedge funds, along with a lot of assets, went through some extreme gyrations, but I think the basic premise that they provide value-added returns with relatively low correlation with the other major asset classes is still the outcome and it is the common conclusion based on any kind of statistical econometric analysis. I think it would be very unfortunate if the European investors, the pension funds and the rather larger more sophisticated investors, were not to have access to those products because of the regulatory regime. I think that there is a second discussion obviously where you can conduct that business and, yes, in order to protect your investors, you have to find a reasonable regime to operate under.

Q436 Chairman: May I ask again about the latest Swedish draft. If the private placement regime remains in place – and I appreciate that in the present version private placement, as in the Swedish Presidency’s draft, remains in place – accepting that it is not as good for American investors as the existing regime, will it drive away hedge funds provided the private placement regime remains in place? I think it is the general European assumption that while the Commission would rather have a proper equivalency regime, if that is not possible the maintenance of national state private placement regimes will enable hedge funds to go on operating.

Miss Fuller: My view is that the maintenance of national private placement regime is the pragmatic solution on the table with respect to the marketing issue. However, I do think that we need to be somewhat careful with respect to what the Swedish draft has and has not achieved, though certainly a number of steps in the right direction. However, it remains unclear whether managers who are based outside of the EU managing funds outside of the EU

will, going forward, be able to avail themselves of the private placement regimes. Certainly for managers who are based within the EU managing off-shore funds, the private placement regime will be maintained to an extent, although I note that the Commission is due to review that three years into the operation of the Directive. So, I think, yes, as an outcome, maintaining private placement regimes is a good result, but we have to be somewhat careful with respect to the detail.

Q437 Lord Woolmer of Leeds: The latest Swedish draft of the Directive suggests or proposes certain restrictions and conditions on the payment of bonuses in the alternative investment fund management field. What is your understanding of the current position as proposed by the Swedish Presidency and would you care to comment on the proposal as you understand it?

Dr Edsparr: My belief is that this is something that is very much at the heart of the discussions between investors and fund managers and I think that fee structures for different products are intensely debated between investors and managers on an ongoing basis, along with a range of other issues, and are very much negotiated in the context of that relationship. There is a huge difference between privately held institutions dealing with sophisticated international investors determining what is fair compensation for different services and, let us say, the remuneration debate around institutions that received explicit government aid. I feel that there is a legitimate desire from investors to have a tight link between the timing of realisation of profits with the timing of the remuneration. I think that is something that permeates the hedge funds and private equity communities and I believe that all the events of the last couple of years have made those links tighter and much more precisely defined. What I am referring to is, obviously, that if you make an investment today and the realisation happens three years from now, people should primarily get compensated on the ultimate resolution of that, not on some intermediate mark. Personally, I believe that most of the

excesses which took place in the system were when that close link between realised profits and remuneration was broken because positions were kept on the books for a very long time. I do not see that it is appropriate for a regulator to dictate that. It is a very dynamic environment and it is, as I say, negotiated on a daily basis.

Q438 Lord Woolmer of Leeds: You know that the public are greatly concerned about the issue of reward and excessive reward which is apparently related to excessive risk taking. What is your answer from the point of view the alternative investment fund industry because they would say, “We hear what you say, nevertheless these are tough times and there should be seen to be some restraint”?

Dr Edsparr: My answer would be that, unlike banks and large public institutions, most of the principals in major hedge funds have very significant amounts of, if not most of, their net worth tied up in exactly the same product as their investors. There is no misalignment of interest between the investors for whom you work and your own remuneration. It is not as if, I can book things in a non market-to-market bank book (available for sale – AFS) that sits on the books, for ten years while I will get my bonus in a year or two. Most senior principals in the hedge funds community have a total alignment with their investors through their own pocket books. It is a simple discussion between serious experienced investors and serious investment professionals to determine what is a fair compensation structure for different services/different products and it is very much at the heart of these discussions.

Q439 Lord Woolmer of Leeds: Are there any proposals in the United States to cap, restrict or regulate payments of bonuses in the alternative investment fund industry?

Mr Cooper: There are none.

Q440 Lord Haskins: Following on from that, two interesting points have been made. There is a significant difference therefore between hedge fund managers who are putting their own money in alongside the investors and many of the main banks where the executives were not putting their money in alongside, and therefore they were risking other people's money without risking their own. I think that is what you are saying.

Mr Cooper: That is right.

Q441 Lord Haskins: Then you said another remarkable statement that hedge funds, like banks, were paying bonuses before profits had been realised. Were they paying bonuses on anticipated profits? How could you pay a bonus without profit having been realised?

Dr Edsparr: Let us say that you do an underwriting deal for Company A. I am a big bank and I underwrite this deal and I book \$10 million in fees that year but, in order to get that deal, I also need to lend money through more traditional banking relationships, maybe a ten-year loan. Maybe that loan is actually quite risky and, five years into the loan, the company defaults. Well, you only got the underwriting deal that generated the \$10 million profit that is accounted for in your income statement day one because you kept on that exposure for ten years. That is one example. The other one would be, let us say that I design a structured note, so some form of derivative overlay, very, very popular products among wealthier affluent individuals in Europe. So, as long as the pound and the euro move in a certain band, I get a ten per cent coupon. If it moves outside of that band, I get a zero coupon. That derivative has a certain embedded profit that is booked through totally transparent gap accounting in the income statement of the bank today. You have the risk management, the operational responsibilities to manage that derivative structure for maybe five years. Let us say that there is a hiccup in the risk management or that there is a drastic deviation from any of the assumptions, that results in a big loss. Obviously, a third example are these credit tranche tradings where companies like some of the big banks, AIG et cetera, would

effectively insure some of the risks; they would charge a certain premium to take losses above a certain level; they were priced at one level and then, five years later, you take a big loss on that. The people who booked those transactions going in could presumably have got a bonus based on what was booked and would reside on those books for a long time.

Q442 Lord Haskins: In the first example you gave where you might have a ten-year exposure, are you saying that the manager should have to wait for ten years for his money?

Dr Edsparr: I am not trying to state what is a fair trade off. I am simply stating that there is a very big difference between, taking one extreme, a private equity investor who buys a company, restructures it and sells it out five years later, and the investor manager who invests in liquid products and gets paid his bonus when he realises the profits on that investment.

Q443 Lord Haskins: That is at the end?

Dr Edsparr: That is at the end as compared to traditional banking business where you have many things that are intertwined and many of the risks linger for a very long period of time, whether it is explicit economic risk or operational risk and so forth, and I think that most of the big losses that came happened through exactly those types of positions.

Q444 Baroness Northover: May we come back to the process in the United States. I wonder if you could fill in for us what the process would be for the US proposals to become law and when you expect that to come into practice.

Mr Cooper: The first is probably easier to answer than the second. In the US, the executive branch of the sitting government can make recommendations but laws are drafted by and derived from both Houses of Congress. There was some publicity about what was referred to as the Treasury Draft; it was a proposed draft piece of legislation that the US Treasury on behalf of the President's administration submitted to Congress as sort of an informational

matter to let Congress know what they were thinking. Each House, the Senate and the House of Representatives and especially the committees within each House that have a jurisdiction over the subject matter of regulatory reform, that is the House Financial Services Committee chaired by Barney Frank and the Senate Banking Committee chaired by Senator Christopher Dodd, have now at this point drafted pieces of legislation. Generally speaking, both of those bills are similar to the administration's initial draft but do differ. Within the committees themselves, there will be hearings, debate, amendments and fleshing out very specific details relating to the legislation. Structurally within each House, these processes are proceeding in a different way. In the Senate, you may have read that Senator Dodd introduced what was called the Discussion Draft of a comprehensive 1,100 page bill addressing every aspect of regulatory reform. The provisions relating to alternative investment fund managers were just one chapter of that massive Omnibus Bill, as it is called. In the House of Representatives, in the financial Services Committee, the legislation that is proposed with respect to alternative investment fund managers stands alone, by itself, but it is anticipated that Chairman Frank will wrap it all up into an Omnibus Bill. Right now, we are in the process of the committees debating and discussing the issues and holding some hearings. What happens after the committees have drafted, and amendments are made is that the legislation will be called to vote. If it is voted out of committee, it then goes down to the floor of the relevant House for debate and discussion. There is an interim step that may take place where other committees that have interest in the subject matter, principally in this case the agricultural committees because of their oversight of the derivatives markets, may have the opportunity to formally weigh into some of the legislation, but then it just goes down to the floor once the committees have concluded their drafting for a vote and is put to a vote. If passed in each House, these bills, which will not be identical, are then submitted to a joint committee whose sole job is to reconcile the differences between the two bills. That then goes back down to each House for

a final “yes” or “no” vote. If both the Senate and the House of Representatives vote in favour of the legislation, it then goes to the President for his signature and the President has the ability to veto that legislation. The rules of each House sometimes make it more challenging than not to move quickly on legislation. Right now, there is a great deal of debate about healthcare legislation in the US and that is consuming a lot of band width; it is consuming a lot of floor debate time. If I were to guess – and I caution that it is really nothing more than that – I would say that it is unlikely we will see final legislation that is ready for a vote until late in the first quarter, possibly into the second quarter of 2010, and perhaps much later than that. Remember, these are massive regulatory reform issues; it addresses consumer finance laws and banking laws and derivatives laws as well as alternative investment fund managers. I cannot predict what the final provisions of the bills will say, but I will say that one of the draft provisions in the AIFM comparable legislation in the US calls for a one-year transition from passage to registration. For example, if the bill were passed into law let us just say on 1 January 2010, which it will not be, it would go into effect the year following. So, in addition to the process, the bills themselves typically contain transition periods, dates on which the law will become effective, and that is rarely immediately.

Q445 Baroness Northover: But it is actually potentially moving faster than the EU one where they are looking at July for bringing the various elements together, the Commission, Council, Parliament and so on. You have mentioned the dialogue that we hope is happening between the EU and the US. What dialogue is happening with other parts of the world?

Mr Cooper: That is a very good question. I cannot tell you that I can specifically identify any dialogue that is going on. Earlier on, I know there were reports, though I do not have first-hand knowledge, of discussions between US regulators and the Hong Kong officials for example. Certainly we all know that G20 nations have met and regulatory reform has been

a very significant piece of the debate, first in London and then in Pittsburgh. So, I would imagine, through those forums, there are ongoing discussions.

Q446 Chairman: Can I pick up something from an earlier question about the Bank Holding Company Act and the extension of that to alternative investment funds. What is your view? Do you have a view on that? Do you think that you ought to be in or out, as it were?

Mr Cooper: Out. The way in which it would be implicated, if at all, under current proposals is that if a hedge fund or alternative investment fund manager were deemed to be systemically significant. It is only when there is a determination of systemic significance would the Bank Holding Company Act provisions then apply and, quite candidly, I believe that trying to apply the Bank Holding Company Act provisions to alternative investment fund managers is like trying to fit a square peg into a round hole. It is a regime that is designed to prescribe activities and capital and the integrity of depository institutions that in part have a federal guarantee of the deposit base. It is in a completely opposite position to the business model and the goals of private alternative investment fund managers. It would essentially preclude the hedge fund manager from continuing business if they were subject to the Bank Holding Company Act, which does not permit non-banking activities except in very narrow circumstances.

Q447 Lord Haskins: It is clear that what is developing here is a very different approach towards alternative investment funds between US legislators and EU legislation – your description about a small proportion and Senator Dodd is all to do with this alternative investment funds – and it is becoming a very big issue here in terms of what the Parliament certainly thinks and how the Commission has responded. If the present arrangements as proposed by the Commission went through, how would it affect Citadel's attitude towards

doing business in the EU and what significant changes in the present proposals would you be really looking for if you had to choose one?

Dr Edsparr: It is very hard to speculate at this stage because I feel that the devil truly is in the details and we are obviously deeply committed to our businesses in Europe. I personally believe that hedge funds through the innovation and the constant experimentation, if you will, of the business model are very much a positive force in finding systemically more robust solutions in the marketplace. An example could be OTC derivatives and how to separate them from the major banks and to create a robust market structure where any one institution can go down without jeopardising the whole market place, I think that separation of these roles is crucially important if you believe in free markets and I think that hedge funds and other alternatives really represent the only other solution to, at this point, an extremely consolidated banking sector. Whether that has to migrate in products on to exchanges, having to lower the barriers of entry for individuals as well as former players in terms of execution, I like to think that we as a firm are at the forefront across a whole range of those activities and they are all part of, or could be part of, systemically more robust solutions than actually alleviate the 'too big to fail' problems. I think that we have to evaluate what businesses we can be in given any regulatory regime and we have touched upon a couple of the key themes. One is, will we be able to market to European investors, and I think that it is fair to say that we could go on without a European investment base but it would be far from ideal and I believe that it would be very unfortunate for European investors. I think that, in terms of where you conduct your business, you want to be as close to the markets that you are involved in and that it would be represent a serious deviation from all our thoughts so far not to be operating within the EU.

Chairman: Did that answer your question?

Lord Haskins: I think so.

Q448 Lord Woolmer of Leeds: Why do so many hedge funds within Europe centre in London?

Dr Edsparr: Theoretically, I think that it is a very interesting problem. It is sort of, why are all the bookshops located on one street and why is Silicon Valley, the computer industry, centred in one place? There is obviously a body of literature on that subject. I think that a great deal of it is tied to the labour market. If you find a spot where business conditions are good and the skilled labour tends to congregate, it is a lot easier for both customers and employees to be in the vicinity of each other. If I need to hire another operations manager, well, there are plenty of skilled people around. That does not mean that those relationships stay forever. If a certain location becomes too uncompetitive, then obviously you will see migration. You have seen Singapore emerge as much more of a centre, if you will, for innovation over the last maybe ten years, but I think that London became competitive early through language, through predictable regulatory and legal regime and espousing general free market values. That is where most of the European financial creativity ended up and obviously, if you go back 20 years, there was a much more vivid debate between Frankfurt, Paris and London as to where the centre of European finance would be and I think that largely London won.

Q449 Lord Woolmer of Leeds: Many people, who do not necessarily understand the business, have suggested that equivalency would be a good thing and others have said that it might be a good thing but it is very difficult to achieve, not least, as you have said, because of two rather different approaches. Is equivalency an issue worth pursuing?

Mr Cooper: No. I think that the concept that existed before is an attractive principle but in practice is virtually impossible to achieve. I think that, given the events of last year, the fourth quarter of last year, and the volatility that we saw in the marketplace and the real

opportunity to drive thoughtful regulatory reform efforts, I would hate to have the perfect be the enemy of the good here.

Q450 Chairman: There is a prevailing view inside at least the European Commission that we must go for equivalency because everybody will have to do it because they need to operate in Europe. I would be interested in the views of a really substantial American hedge fund on this point.

Mr Cooper: I do not want to oversimplify the issue and I hope I am responsive, but the cultures within the regulators, the prudential regulators, who must oversee and execute and implement the rules that are generated within the United States and jurisdictions in the EU are very different and that is not a bad thing, it is just a fact. The cultures have evolved over years and years. To try, if you will, to force a regime that has equivalency that is identical regulation, is challenging, but I think that to think then that the application of those identical rules by regulators who have very different histories, perspective and impact is a dangerous combination. I hope that has been responsive.

Chairman: I turn to my colleagues and see if I have suppressed anybody or failed to get the question answered. Lord Haskins?

Q451 Lord Haskins: I do not think so. It seems to me that you are watching very carefully what is happening within the EU, as we all are, but when do you think that this is all going to come to a head? You are very optimistic that the US Congress are going to come to a conclusion at the end of March and we are told that the EU is going to come to a conclusion at the end of the year, but is that all a bit too rushed?

Mr Cooper: If I said or gave the impression that I was optimistic that the US process would be done by the end of March, I would like to retract that statement.

Q452 Lord Haskins: I am slightly pessimistic because I am worried that regulation is going to be rushed through without proper thought for the unintended consequences in both places. That seems to me as much a danger as anything else that is going on.

Mr Cooper: I could not agree more with you. One of the things that I like to think about is, in the United States, we have the Securities Act of 1933 and the Securities and Exchange Act of 1934 and it is a good thing we have neither of those Acts dated 1929, immediately following the great market crisis. The point being that there was a very long and deliberative process ---

Q453 Lord Haskins: Four years.

Mr Cooper: --- where it could be studied carefully to ensure that there were no unintended consequences. I think realistically much of the process in the US will be driven by other issues that are being debated and there are elections that will take place in the fall of next year and that will distract members from careful deliberation of important legislation.

Lord Haskins: On the other hand, they want to be demonstrating that something must be done and that they have done something.

Chairman: On that pessimistic note, Lord Haskins, perhaps we should conclude. Thank you all very much for coming and for giving so generously of your time.