HENNESSEE GROUP LLC
HEDGE FUND ADVISORY

COMMENTS OF HENNESSEE GROUP LLC

FOR THE

U.S. COMMODITY FUTURES TRADING COMMISSION

CPO AND COMMODITY POOL ROUNDTABLE

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CURRENT AND FUTURE ISSUES

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I. INTRODUCTION TO PANEL

A. Hennessee Group LLC (Hennessee Hedge Fund Advisory Group)

- Provides investment advisory services to investors in hedge funds
- Creates private portfolios of hedge fund managers designed to meet specific financial objectives of the client (Hennessee Hedge Fund Select Program®)
- Provides manager and portfolio monitoring services to clients
- Products are not offered (i.e., no fund of hedge funds); only advisory services
- Clients include individuals, family offices, endowments, foundations and pension plans.

B. Charles J. Gradante – Relevant Background To The CFTC Roundtable

- President and C.E.O. of a U.S. National Bank (Chelsea Bank of New York)
- Proprietary Trading and Risk Management at Drexel Burnham Lambert and Citibank
- Venture Capital and Private Equity Investment Analysis at John Diebold & Associates
- Testified before the House of Representatives Committee on Banking and Financial Services regarding Long-Term Capital Management (October 1998)
- Panelist at SEC Roundtable on Hedge Funds (May 2003)
- Testified before Senate Banking Committee (July 2004)

CURRENT AND FUTURES ISSUES

II. CURRENT MISPERCEPTIONS ABOUT HEDGE FUNDS

The following are direct quotes from various articles written about hedge funds.

A. "The speculation by hedge funds in the oil futures market has caused a $5 to $10 per barrel increase and excessive price volatility."

On March 1, 2005, the New York Mercantile Exchange released a report titled, *"A Review of Recent Hedge Fund Participation in NYMEX Natural Gas and Crude Oil Futures Markets."*

In a press release issued on March 8, 2005 by NYMEX, James E. Newsome, President of the NYMEX stated, *"The findings of the study are consistent with our belief that hedge funds do not negatively impact our markets. They generally hold positions significantly longer than other market participants which support the conclusion that hedge funds are a non-disruptive source of liquidity to the market. With regard to price volatility in the natural gas futures market, when hedge fund activity alone, as well as in connection to inventory changes, the data strongly suggests that changes in hedge fund participation result in decreases in price volatility."*

To receive a copy of the study by email, contact the press office at pressoffice@nymex.com

B. "Hedge Funds Are Known For Making High Stakes Bets In Global Stocks, Bonds And Currencies."

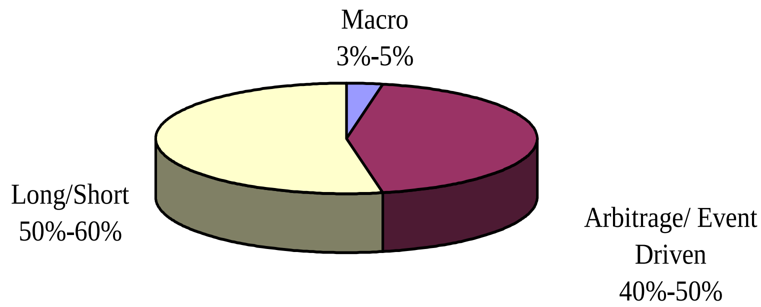
This description of hedge funds who make directional bets on global stocks, bonds and currencies applies to about 3% to 5% of the assets in the industry (i.e., macro managers). Between 50% to 60% of the industry's capital is in long/short equity trading and the balance of 40% to 50% consists of relative value arbitrage, event driven arbitrage and other arbitrage strategies. None of these strategies (97% of industry capital) are making "high stakes bets on global stocks, bonds and currencies."

It is misleading to define the entire hedge fund industry by using macro managers or Long-Term Capital Management as a proxy.

Of the $934 billion in hedge funds approximately:

- $28 to $47 billion is in macro
- $495 to $560 billion is in long/short equity
- $411 to $467 billion is in relative value, event driven and other arbitrage strategies

Hedge Fund Industry Asset Breakdown by Strategy



Source: Hennessee Group LLC 2004 Industry Research

C. "An Investigation Of Hedge Funds Is Needed Because They Are Driving The Market Wild."

On the margin, hedge funds (if they act in unison) can move a stock or move the broad averages momentarily but they should not be positioned as the cause of systemic shifts in market direction:

- Mutual Fund redemptions were a major force in the bear market of 2000 to 2002.
- Reallocation out of stocks and into bonds by pensions, endowments, foundations, and other large institutional investors.
- Program trading can amount to 40% of a given day's volume on the NYSE. Little of this is hedge fund related.
- Portfolio liquidations by insurance companies to monetize their stock portfolios to fund insurance losses (i.e., natural disasters, etc.).
- Proprietary trading in stocks, bonds and currencies by commercial banks and investment banks can look like hedge fund trading.
- The derivative "portfolio overlays" used by institutional money managers to hedge the long bias of their equity portfolios can result in an offsetting short of a basket of stocks in the cash market by the issuer.

In summary, many institutions act in a manner similar to hedge funds. Furthermore, putting the industry in perspective, the global markets are estimated at $40 trillion versus hedge funds at $1 trillion.

D. "The Reckless Shorting By Hedge Funds Has Caused Us To Stop Lending Securities."

- In 1931, after a study of the 1929 crash was completed, the NYSE concluded that:

  "The real cause of declining securities was not short selling but the lack of buyers against forced sellers."

- The 1991 Congressional report on short selling by the House on Government Operations stated that:

  "Short selling plays an important and constructive role in the markets and that many complaints about short selling are not soundly based and may be a result of a poor understanding of short selling."

E. It is generally perceived by the media, the public, and many on Wall Street that hedge funds contributed extensively to: (1) the bear market of 2000; (2) the recent collapse of the dollar; (3) much of the recent rise in oil. Before anyone can conclude a cause and effect relationship between hedge funds and these events, we should also analyze cause and effect relationships for similar market events that took place prior to the explosive growth of hedge funds in the 1990s, namely:

- The bear market of the 1970s (the Dow Jones declined 45% from 1051 to 577).
- The bull market for gold in the 1970s ($32 per ounce to $850 per ounce).
- The bull market for oil in the late 1970s from $12 per barrel to $58 per barrel.
- The collapse of the U.S. dollar in the 1980s (50% decline in dollar vs. yen from 1985 to 1988).
- The 1987 stock market crash.

III. MISCONCEPTIONS ABOUT LEVERAGE, RISK AND TERMINOLOGY

A. Leverage and Risk

- Many feel that assuming risk creates a risky investment. Hennessee Group believes that the hedge fund industry as a whole exposes itself to risk in an intelligent way.

- Shorting is not necessarily a risky strategy. The intelligent use of shorting and derivatives by hedge funds can reduce risk.

- Leverage doesn't always imply that you are making a risky investment. A leveraged investment that is liquid and has low volatility can be less risky than no leverage in an illiquid, very volatile security.
  - Banks are levered 20 to 1 and they are considered to be relatively safe investments

- Although there have been exceptions, hedge fund managers generally add risk in a measured manner with respect to the portfolio as a whole and the prudence of the strategy being deployed.

- Making an investment, which in of itself assumes greater risk, does not necessarily increase the risk of the overall pool.

B. The use of the term "absolute return" can be misleading to investors

- The phrase "absolute return" is most often used to imply constant positive returns i.e., no down years. *This is misleading.*
  - "Granite Capital will have positive returns in up and down markets."…. *David Askin's marketing material for Granite Capital*

- Hedge fund *returns are relative* to the risks they are taking.

- "Absolute return strategies" can have negative returns.

- The degree of relativity varies.
  - Equity hedge funds……..100% beta net long vs. 25% beta net long…..etc.
  - Arbitrage strategies…credit, VIX, interest rates, convergence/divergence, etc.

- *The belief that certain hedge funds are absolute return strategies (i.e., always positive returns) is misleading.*….*Index arbitrage* is the closest strategy to a true "absolute return" strategy.
  - Short the S&P 500 futures, long S&P 500 stocks
  - Capture spread………convergence at expiration date of futures contract (an absolute occurrence)

- "Non-correlated returns" is less misleading than "absolute returns."
  - Non-correlated does not mean "never negative" nor "absolute"

C. Use of the term "market neutral" can be misleading to investors

- While the goal of a market neutral hedge fund manager is to "hedge out" equity market risk (i.e., beta risk), it is necessary for a manager to take some form of market risk in order to produce a positive return.

- Most market neutral managers are basically beta neutral while taking market risk in one or more of the following:
  - Sectors, market cap, interest rates, volatility, convergence/divergence, etc.

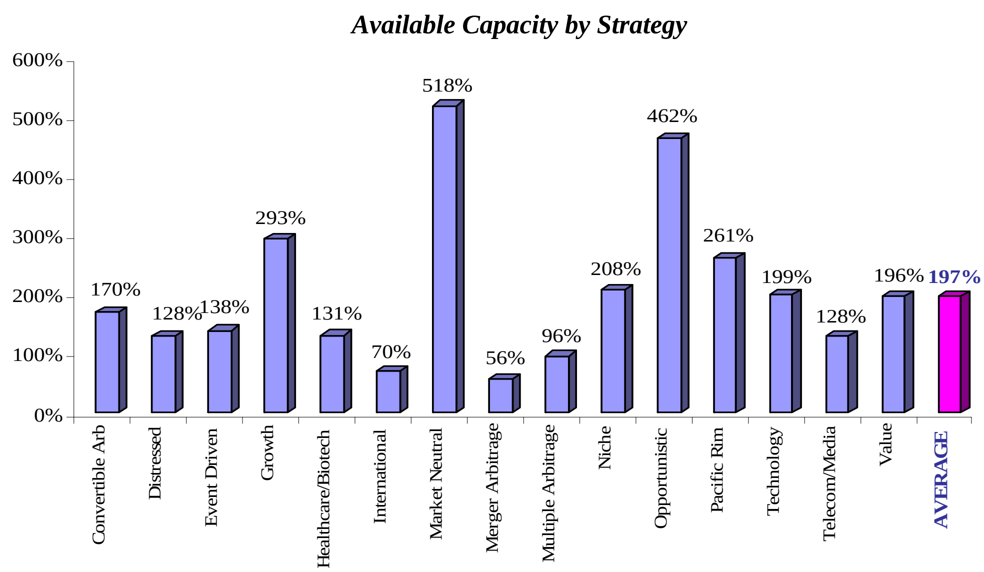
- Market neutral does not mean no down years.

- *It is misleading to imply that "market neutral" strategies are neutral to market risks (i.e. neutral to market downturns.)*
  - Market neutral is another "non-correlated" strategy

IV. THE FUTURE ECONOMICS OF SHORTING SECURITIES AND ITS IMPACT ON THE GROWTH OF THE HEDGE FUND INDUSTRY

A. Recent forecasts by third party surveys of hedge fund asset growth have placed the industry at $4 trillion by the year 2010. Hennessee Group's Annual Manager Research for 2004 indicates that, on average, hedge fund managers believe they have available capacity for 197% of new assets. With hedge fund industry assets at an estimated $934 billion, Hennessee Group research would extrapolate that nearly $1.8 trillion of new capacity is currently available ($2.7 trillion total asset management capacity).

The Hennessee Group Annual Manager Survey for 2004 included 11% of the industry's estimated managers and 18% of the industry's estimated capital.



Source: Hennessee Group LLC 2004 Industry Research

B. This difference between the industry's perceived total available capacity for new capital recorded by Hennessee's 2004 Manager Research ($2.7 trillion) and the $4 trillion estimate for 2010 by other independent researchers presents a future supply/demand imbalance. However, the demand for hedge fund capacity may be met in one of the following ways: (1) hedge fund managers will go beyond capacity limits they currently foresee according to Hennessee Group research; (2) new capacity will be added by new managers entering the industry who will manage much of the new capital added to the industry or; (3) a combination of both will take place.

C. ***Elasticity of supply of new managers is of concern to the Hennessee Group.***

D. The growth in new managers may be stymied because the industry has evolved to the critical point where "success breeds more success" in attracting new capital. Consequently, upstart hedge funds may not get substantial new capital inflow until the well established hedge funds with available capacity are closed to new capital or have performance issues before they attain their desired capital level.

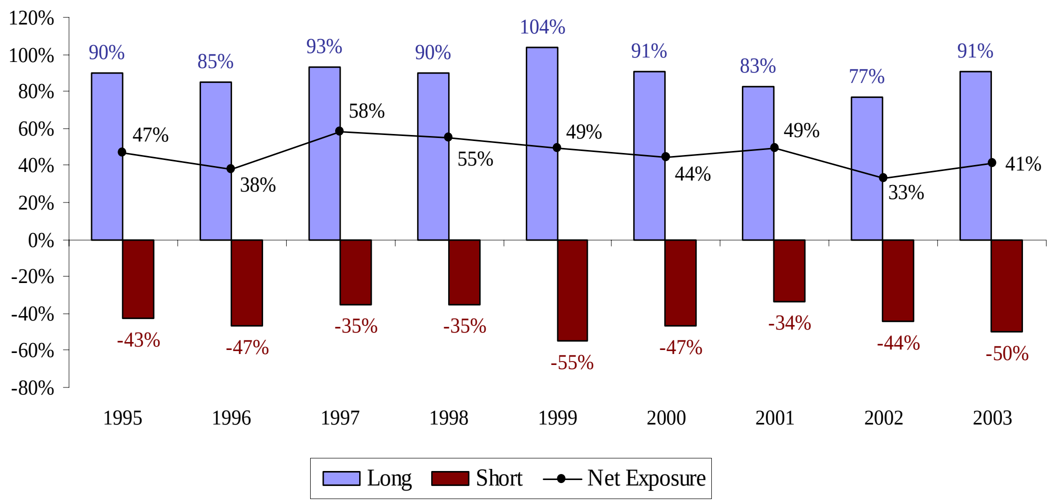
E. ***The industry is at the early stages of its maturation where new upstarts may be "squeezed out" in competing for new capital by the more established players.***

F. ***Hennessee Group believes estimates of $4 trillion by 2010 are extrapolations that may not take into account the greater difficulty, and therefore slower growth rate, new hedge funds will have in attracting new capital.*** New hedge funds are entering the industry at a time when a significant portion of the industry is already established with respectable track records of 5 or more years who are also capable and willing to take on substantial new capital.

G. ***Elasticity of supply of stock to borrow to maintain traditional hedge ratios is of concern to the Hennessee Group. This factor could present a "glass ceiling" to the growth of the hedge fund industry.***

H. Hennessee Group's analysis indicates the growth in demand for stocks and bonds to borrow by hedge funds is estimated at $430 billion (43% short exposure on $1 trillion). Shorts would need to grow to $1.7 trillion by 2010 to maintain the historical 43% short hedge ratio for all strategies combined (at $4 trillion). Although hard statistics are not available as to the amount of inventory of securities for borrow over and above what is actually used in the market, Hennessee Group's research indicates at least a verbal confirmation from a few stock loan departments and managers that the demand for securities to borrow is more difficult to satisfy than just four (4) years ago. Hennessee proprietary manager research for its clients indicates sporadic "buy-ins" and the need to forego short rebates and pay securities lenders far more frequently than ever before (i.e., "negative short rebate" to hedge fund managers).

Long/Short Exposure Analysis
1995 - 2003



Source: Hennessee Group LLC 2004 Industry Research

I. ***Although not a major problem at this time, unchecked dislocations between supply of and demand for stock to borrow will present portfolio risk management issues and perhaps the use of less familiar techniques to achieve the same hedge.***

J. ***Ultimately, the concept of being simultaneously long a security (whether bond or stock) and short a security will be challenged on the short side not the long side.*** Either the stock loan function on Wall Street will keep pace with demand or, if not, "negative short rebates" and "buy-ins" will increase, creating the need to rethink today's hedge fund portfolio business model (i.e., the use of derivatives in lieu of shorting the security).

K. ***In conclusion, capacity for asset growth of the total hedge fund industry is a function of the survivorship of new manager talent and the industry's ability to borrow stock to sell short and, thereby, maintain the "hedged" strategy that characterizes hedge funds today.*** The amount of stock available to borrow will ultimately put a "ceiling" on the assets managed by hedge funds provided hedge funds stay true to historical hedging ratios. For hedge funds to maintain their historical allocation to shorts of 43%, at $4 trillion in assets in the year 2010, the industry would need $1.7 trillion of shorting capacity. To physically borrow sufficient securities economically and maintain the integrity of the "A.W. Jones Model" the demand for stock borrows would likely exceed supply, creating a need to rethink the A.W. Jones model to successfully achieve the targeted hedging objective. If the supply of stock to borrow could not meet demand, then the industry would hit a "ceiling" in growth unless the industry accepted larger net long exposure or adopted the use of derivatives to replace stock shorting. Neither condition (larger net long positions or greater use of derivatives to simulate short hedging) would be desirable.

L. ***The elasticity of the long only industry to manage new assets is far greater than the hedge fund industry. Concerns that the hedge fund industry will overtake the long only industry is without merit.***

V. HEDGE FUND FRAUD AND THE ROLE OF "GATE KEEPERS" IN THE PREVENTION OF FRAUD

A. The hedge fund industry is not in a crisis. Misdeeds of a few have resulted in a backlash against the industry.

B. SEC registration and audits will help reduce fraud but "gate keepers" need to step up their respective roles to complement the SEC's efforts.

C. The SEC Roundtable of May 2003 stated that the incidence of fraud is no more prevalent in hedge funds than other investment management pools.

D. Most frauds could have been curtailed by the "gate keepers" of the industry with improved "best practices":

- **Administrators**: only accept third party marks (i.e., no "trader marks"). Administrators perform **monthly NAV calculations** for offshore funds. If done for onshore hedge funds, it would reduce valuation fraud. ***Most frauds have involved valuation deception.***

- **Accountants**: only accept third party marks. K-1 statements and annual audits should be **mailed directly to limited partners by the accountant**, not the general partner who can commit document fraud. ***Valuation fraud invariably involves either document fraud with respect to K-1s and the annual audit or lack of testing of valuations by the auditor (i.e., accepting manager's valuations).***

- **Lawyers**: perform background check and disclose criminal or regulatory infractions in the hedge fund offering memorandum.

- **Prime Broker**: highlight unusual DVP (Delivery Versus Payment) activity to SEC.

E. In the case of the **SEC vs. House Asset Management, LLC**, the manager made false statements about his background in the offering memorandum.

F. In the case of the **SEC vs. Manhattan Capital Management, Inc.**, the manager hid fund losses from the auditor, fund administrator, and investor by creating phony account statements which were mailed to investors.

G. In the case of the **SEC vs. Edward Strafaci (Lipper Convertibles, L.P.)**, the auditor's apparent acceptance of "manager marks" for several years led to sizable losses.

VI. PORTFOLIO RISK TRANSPARENCY

A. The need for more balance sheet transparency in annual audits

- Counterparty exposures
- Off balance sheet exposures
- Concentration exposures
- Illiquidity exposure (i.e., private placements, excessive "trade days," etc.)

VII. SYSTEMIC RISK MONITORING

A. Monitoring leverage being employed by the hedge fund industry through reporting by prime brokers and commercial banks to the appropriate government agency.

B. Monitoring off balance sheet and counterparty risk exposures through reporting by accountants to appropriate government agency.

VIII. OTHER FUTURE REGISTRATION ISSUES

A. Registered representatives (Series 7) registration for those who market/sell hedge funds and fund of hedge funds.

- Increased sensitivity to regulations regarding the sale of "securities."
- An investor may meet accredited investor rules but hedge funds may not be "suitable." Registered representatives are educated to be sensitive to the nuances in their responsibility and accountability to investors in securities.

IX. OTHER FUTURE DISCLOSURE ISSUES

A. Availability to investors of SEC audit reports for hedge funds and fund of hedge funds.

B. Disclosure of regulatory infractions to limited partners of monetary penalties paid by registered advisers of hedge fund limited partnerships.