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# Hedge Funds, Systemic Risk, and Dodd-Frank

The Road Ahead

Lloyd Dixon, Noreen Clancy, Krishna B. Kumar





RAND Center for Corporate Ethics and Governance

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## Preface

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On September 24, 2012, the RAND Corporation convened a symposium in Washington, D.C., to discuss the ways hedge funds might contribute to systemic risk and the extent to which recent financial reforms have addressed these potential risks. Invited participants included thought leaders from industry, government, and academia. Regulatory perspectives were represented by senior staff from the U.S. Department of the Treasury, the Federal Reserve Board of Governors, the Financial Crisis Inquiry Commission, and the House Financial Services Committee. Individuals involved in various aspects of the hedge-fund industry brought the private-sector perspective, and academics and RAND staff brought a policy analysis perspective. The symposium participants are listed in Appendix A.

These proceedings summarize the major themes and issues raised during the symposium. The goal of the symposium was to inform the discussion on the issues that should be addressed regarding the potential for hedge funds to increase systemic risk and the appropriate policy response. To enhance the free flow of ideas, participants were promised that the symposium proceedings would not attribute comments and observations to individuals or their organizations.

Readers of these proceedings may also be interested in the following RAND document, which was used to help structure the dialogue during the symposium:

Lloyd Dixon, Noreen Clancy, Krishna B. Kumar, *Hedge Funds and Systemic Risk*, Santa Monica, Calif.: RAND Corporation, MG-1236-CCEG, 2012.<sup>1</sup>

## RAND Center for Corporate Ethics and Governance

The RAND Center for Corporate Ethics and Governance is committed to improving public understanding of corporate ethics, law, and governance and to identifying specific ways in which businesses can operate ethically, legally, and profitably. The center's work is supported by contributions from private-sector organizations and individuals with interests in research on these topics.

The center is part of RAND Justice, Infrastructure, and Environment, a division of the RAND Corporation dedicated to improving policy and decisionmaking in a wide range of policy domains, including civil and criminal justice, infrastructure protection and homeland security, transportation and energy policy, and environmental and natural resources policy.

Questions or comments about this report should be sent to the project leader, Lloyd Dixon (Lloyd\_Dixon@rand.org). For more information on the Center for Corporate Ethics, see <http://www.rand.org/jie/cceg> or contact the director (cceg@rand.org).

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<sup>1</sup> Available at <http://www.rand.org/pubs/monographs/MG1236.html>



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## Acknowledgments

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Jamie Morikawa, Director of Development and Strategic Relationships, did a tremendous job helping set the agenda and coordinating the outreach and invitation process. Michael Greenberg, Director of the RAND Center for Corporate Ethics and Governance, provided valuable advice on format and agenda and also helped identify and recruit participants. Stephanie Shedd did a superb job handling the many logistical aspects of the symposium.



## Abbreviations

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Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
Fed	Board of Governors of the Federal Reserve System
SEC	U.S. Securities and Exchange Commission
SIFI	systemically important financial institution
SRO	self-regulatory organization



## Key Issues and Themes Raised During the Symposium

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To better understand how hedge funds might contribute to systemic risk and how the ongoing financial reforms address these potential risks, the symposium was divided into two panel discussions. The first panel discussed the role hedge funds played in the financial crisis of 2008 and the potential contributions of hedge funds to systemic risk. The issues for this panel were framed by a presentation of findings from the recent RAND report on the topic.<sup>2</sup> Three panelists then presented their analyses and views on the issues, followed by a discussion with symposium participants. The symposium agenda is provided in Appendix A.

The second panel discussed whether and how the ongoing regulatory reforms—primarily the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)—address the potential systemic risks posed by hedge funds. RAND’s recent findings were summarized, followed by presentations by four panelists and general discussion.

The main themes that arose in the panelist presentations and discussion that followed are summarized below. To avoid repetition of material in the RAND report, the findings from the RAND study are not repeated below. The comments fell into the following general categories:

- Approach to regulating hedge funds
- Leverage and liquidity of hedge fund portfolios
- Herding in the hedge fund industry
- Issues related to reporting by hedge funds
- Costs of regulation
- Risks posed by big banks
- Topics for further research.

### Approach to Regulating Hedge Funds

Symposium participants discussed whether market discipline was enough to restrain hedge fund leverage and to ensure adequate portfolio liquidity. One participant was confident that the best practices for hedge fund managers and counterparties promulgated by the President’s Working Group on Financial Markets in 2009<sup>3</sup> are still being followed by larger hedge funds. Another participant commented that one downside of only having a guide for best practices—rather than a requirement—is that memories of the last financial crisis will fade over time, and that the pendulum will again swing to focus on making profits. Given this tendency, the participant felt that institutionalized rules to prevent excessive risk-taking are appropriate.

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<sup>2</sup> Dixon, Lloyd, Noreen Clancy, Krishna B. Kumar, *Hedge Funds and Systemic Risk*, RAND Corporation, MG-1236-CCEG, 2012.

<sup>3</sup> That report can be found at <http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf>

According to several participants, regulators focus on activities and markets rather than the legal structure of the parties participating in the market. Dodd-Frank's provisions on the derivatives markets, for example, will affect how hedge funds operate, but are not directly targeted at hedge funds. Other participants commented that even though the designation of systemically important financial institutions (SIFIs) is a central part of the new regulatory regime, regulating markets seems like a more effective approach. This might involve examining illiquid markets where there might be concentration risks and looking for correlation between markets. Several participants believed that using bank-like regulations for hedge funds would be inappropriate, due to the different functions the two perform and the difference in client base.

Dodd-Frank's direct regulation of financial institutions focuses on the largest institutions. This is appropriate according to one of the participants. In his view, systemic risks do not exist in the equity markets, in which margin requirements are well-defined. Rather, they exist in credit-derivative markets and other types of derivative markets. But only the largest hedge funds participate in these markets; therefore, there is no point in putting substantial regulatory burden on the smaller funds.<sup>4</sup> One participant noted that there are as many as 500 new rules that affect the hedge fund industry.

Participants also described some of the organizational changes that are being made in government in response to the new regulations and regulatory priorities. The Board of Governors of the Federal Reserve System (Fed) has established the Office of Financial Stability, which cuts across divisions within the Fed to prevent systemic risk regulation from becoming siloed. The Fed's Large Institutions Coordinating Committee focuses on the "macroprudential" issues of the largest bank holding companies, and a similar body has been set up for financial market infrastructure. Stress-testing of banks and other financial institutions is an enormous undertaking at the Fed, and efforts are being made to make stress tests more reproducible (meaning that independent stress tests of the same organization would produce similar results) and transparent. The Fed and the Financial Stability Oversight Council are focusing on structural vulnerabilities. They realize that they cannot foresee and protect against every potential financial shock. Rather, they need to create institutions and markets that are less susceptible to shocks.

## Leverage and Liquidity of Hedge Fund Portfolios

Highly leveraged and illiquid hedge fund portfolios can, in principle, pose a systemic risk to the financial system. It should be noted that, in practice, it appears that hedge funds typically have a much lower rate of leverage on average (two to three times leveraged) than other segments of the financial sector (investment banks are often leveraged between 14 and 40 times). There was discussion at the symposium about the extent to which the new financial regulations address the potential for hedge funds to build highly leveraged and illiquid portfolios. Several

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<sup>4</sup> See the section below, however, on the possibility of herd behavior by the smaller hedge funds.

participants observed that reforms in the derivatives markets limit opportunities for hedge funds to build high leverage (for example, Title VII of Dodd-Frank requires that derivatives trades be cleared through central clearing houses and that adequate margin be posted). Some observed that the regulations are still in process and that some types of derivatives may be exempted from clearing requirements. However, the regulatory gap in the derivatives market is in the process of being plugged.

Although the new regulations address, at least to some extent, opportunities to build excessive leverage, there was a general sense among symposium participants that Dodd-Frank and other recent reforms do not adequately address the liquidity issue. Some believe that the rapid evaporation of liquidity during periods of financial stress remains an important concern. Some commented that we will soon see proposals in Europe that call for better matching the maturities of assets and liabilities (short-term versus long-term). The Financial Stability Oversight Council is also examining this issue. A symposium participant pointed out that studies by Britain's Financial Services Authority have shown that the maturity profiles of assets and liabilities held by British hedge funds are similar. These studies suggest that liquidity is not currently a concern for hedge funds. The data that are now being collected from U.S. hedge funds (discussed below) will hopefully allow regulators to identify emerging liquidity risks.

## Herding in the Hedge Fund Industry

There was a good deal of discussion at the symposium about the potential systemic risks posed by large numbers of hedge funds following similar strategies. Direct regulation of hedge funds under Dodd-Frank is focused on the largest hedge funds, and the risk posed by herding does not appear well addressed.

One participant with a research background noted that, although herding is a problem in theory, there is little empirical evidence to suggest that herding is currently a problem in reality. Correlations across the different hedge fund indices reported by Dow Jones Credit Suisse have been rising, but they are still not high enough to be of great concern. He also noted that higher correlations might be driven by correlations across the markets in which hedge funds invest, as opposed to hedge funds themselves taking on similar positions.

Another participant observed that even though herding does occur in some settings, it may pose only limited systemic risk. This participant noted that herding tends to happen among smaller firms in equity markets, which are typically not a major concern. Herding could be more of a problem in small or less liquid markets, such as some currency markets, than in larger, highly liquid markets.

Information that will be collected by the U.S. Securities and Exchange Commission (SEC) through Form 13H could give some insight into herding issues. The purpose of Form 13H is to provide the SEC with information on where firms are trading to ensure no manipulation. Although the resulting data will not be available to the public, regulators can use the information



to assess whether herding behavior is taking place and whether it is becoming an important issue in the hedge fund industry.

## Issues Related to Reporting by Hedge Funds

Dodd-Frank requires hedge funds to periodically report information about their operations, investment strategies, and positions to the SEC. In principle, this information can be of great help to regulators in assessing systemic risk, but a significant topic of discussion during the symposium was whether the information would actually be useful.

A key issue is whether hedge funds will use consistent definitions when reporting information. For example, leverage can be calculated in many different ways, potentially resulting in data that are not comparable or easily aggregated. Important considerations in calculating leverage include whether off-balance sheet positions and derivatives are included. Based on what he has seen so far, an industry observer commented that hedge funds are interpreting the data-reporting questions differently. Contributing to the problem is the fact that the information is not public, and thus one hedge fund is not able to see how other hedge funds are interpreting the questions. He and others commented that it would be a shame if both hedge funds and regulators spent a lot of time and money collecting information that turned out not to be useful for monitoring systemic risk, simply because the information was not standardized and therefore difficult to aggregate and compare.

Another participant said that one could expect the regulatory agencies to refine the data requests over time. Also, firms themselves will get better at reporting the data as time goes on. This has been a fairly common pattern with new regulations. Both the sender and the receiver get better at determining what information to provide and how to interpret the requirements.

There was considerable discussion at the symposium about alternative data collection approaches that could result in higher quality and more consistent data. In particular, some suggested that prime brokers report the data for their hedge fund clients. There are only about five major prime brokers, but thousands of hedge funds. Prime brokers already spend a great deal of time understanding the positions and risks posed by their hedge fund clients, and often use comparable measures across funds. Although putting the reporting burden on prime brokers was supported by several symposium participants, others pointed out possible disadvantages. First, prime brokers do not always use the same risk measures across hedge funds. Hedge funds vary greatly in investment strategy, and some measures might be relevant to one type of hedge fund but not others. Second, hedge funds often use multiple prime brokers, so a prime broker may see only part of a hedge fund's operation. Finally, if the reporting burden is placed on prime brokers, the cost of prime brokerage would, in the view of some participants, rise substantially. Prime brokers would have to bear the reporting costs as well as potential liability for inaccurate or incomplete reports, and it is not clear whether they are willing to take on such a role.

## Costs of Regulation

Several participants who work in the hedge fund industry or who provide legal and other services to the industry observed that it is costing hedge funds a great deal to comply with data reporting requirements. One participant described a fund that took about 2,000 hours to prepare its first Form PF filing. Another gave an example of a fund with about 140 employees, eight to ten of whom work full time on regulatory compliance. According to a symposium participant who interacts with hedge funds of varying sizes, compliance with data reporting requirements is especially burdensome for small firms, which can have ten or fewer employees. Compliance is very expensive for these firms because they either have to dedicate some of their small staff to compliance or pay to outsource the compliance to another firm. At the same time, these firms are pressured by their investors to reduce fee-related expenses. It also costs funds a great deal to comply with the new requirements for trades in derivatives (Title VII of Dodd-Frank). This type of “indirect regulation” has significant costs, according to those closely involved with the industry.

One participant observed that, based on his experience in the industry, many hedge funds are now subject to a huge amount of regulation, even if they are not designated as SIFIs. In his view, designation as a SIFI will impose considerable additional costs and will possibly affect the structure and business models of funds so designated.

There was concern that increased costs of doing business in the United States would induce start-up hedge funds to move their base of operations overseas to places such as Asia, where the compliance burden is less. Capital will find the cheapest place to do business. Others did not believe that potential migration was a significant concern or that new funds would choose to set up overseas rather than in the United States. In the view of some, regulations in Europe are even more onerous than in the United States, and some parts of Asia are considering regulations more like those in Europe than in the United States. Some participants believed that difficulty in raising capital is a bigger obstacle to hedge fund growth than regulation.

One participant observed that regulations are making life more difficult for smaller hedge fund managers in particular (even though reporting burdens are less on smaller funds than on larger funds). He did not think it appropriate to impose substantial costs on the part of industry that creates little potential systemic risk. He was concerned that the rationale for reporting by smaller funds conflated investor protection and market integrity concerns with systemic risk regulation. It should be noted, however, that from a systemic risk perspective, it may still be important to collect information on smaller firms to address potential herding behavior.

## Risks Posed by Big Banks

Hedge funds rely on big banks for prime brokerage services and to be counterparties for many of their trades. Several symposium participants pointed out that hedge funds were not worried about the risks posed by big banks prior to the 2007–2008 financial crisis. The failure of

Lehman Brothers in 2008 changed that, and now hedge funds are carefully evaluating the risk of trading with every one of their counterparties. One participant noted that a particular symptom of this concern is that hedge funds are now typically using multiple prime brokers, whereas it was not uncommon to use only one before the financial crisis.

Many symposium participants believed that big banks pose far greater systemic financial risks than hedge funds. JP Morgan Chase, for example, is now, in effect, the nation's counterparty for derivatives trades. Its exposure in the derivative markets is so large that it has no place to transfer risk. Once the market recognizes such a situation, the bank can become vulnerable. By implication, systemic risk regulation should focus less on identifying the hedge funds that might be systemically important and more on identifying hedge fund counterparties that are systemically important.

## Topics for Further Research

Symposium participants suggested a number of areas for future research and policy analysis.

- **Alternative Approaches to Hedge Fund Regulation**
  - **The Potential Use of Self-Regulatory Organizations (SROs).** The Financial Industry Regulatory Authority (FINRA) model has worked well in many regards for broker dealers, and some symposium participants wondered if an SRO for hedge funds could reduce the regulatory burden while maintaining effectiveness. Widespread voluntary participation in an SRO could, for example, reduce incentives for hedge funds to leave the United States or for new funds to start overseas; facilitate cross-border compliance; and result in a single, global industry standard rather than rules that vary by country. What are the disadvantages and limitations of an SRO for hedge funds?
  - **Requiring Independent Boards of Directors.** Many hedge funds have a board of directors, but there is disagreement about whether these boards provide effective oversight of management decisions. Some symposium participants wondered if increasing the independence of hedge fund boards might reduce the need for more stringent regulation. Increasing the independence of boards has had benefits in the mutual fund industry, and some participants postulated that doing so for hedge funds might improve oversight in the hedge fund industry. How might the independence of hedge fund boards be increased and what would be the advantages and disadvantages of doing so?
- **Unintended Consequences of the Volker Rule.** Dodd-Frank's Volker Rule limits the amount of proprietary trading by banks. A new set of institutions will presumably take on these activities. What might these institutions look like and what types of systemic risk might they create? How should regulators respond?

- **Options for Increasing the Usefulness and Reducing the Costs of Collecting Hedge Fund Data.** As discussed above, complying with the data reporting requirements is costly, and the ultimate usefulness of the data for identifying systemic risk is an open question. What types of information should be collected from hedge funds, what are the options for collecting it most efficiently (for example, via prime brokers) and how might that information be used?
- **Alternatives for Mitigating Systemic Risks for Organizations That Are Too Big to Fail.** The big banks have become focal counterparties that have few places to transfer risk. Such large counterparties can become vulnerable if market participants become aware of the counterparties' own risk. Does the regulatory structure set up by Dodd-Frank adequately address the risks of banks that are too big to fail? How can systemic risks of such organizations be addressed without reinstating Glass-Steagall? Or should separating the major functions provided by big banks into different organizations be reconsidered?



# Appendix A. Symposium Agenda and Participants

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## **HEDGE FUNDS AND SYSTEMIC RISK**

Symposium  
September 24, 2012  
Washington, DC

### **AGENDA**

**1:00 p.m.** Welcome and Introduction of Participants

*Michael Greenberg, Director, RAND Center for Corporate Ethics and Governance*

**1:15 p.m.** PANEL 1: Role of Hedge Funds in the Financial Crisis and the Contribution of Hedge Funds to Systemic Risk

Questions to be addressed include: "Were hedge funds caught up in the financial storm, did they actively contribute to the storm, or both?" "Even if few hedge funds are large enough to create systemic risk by themselves, is there enough herd behavior in the industry to increase systemic risk?" "In what ways might hedge funds contribute to systemic risk moving forward?"

*Framing of the Issues: Lloyd Dixon, RAND*

*Panelists:*

- Wendy Edelberg, Macroeconomic Analysis Division, Congressional Budget Office and former executive director of the Financial Crisis Inquiry Commission
- David Hsieh, Fuqua School of Business, Duke University
- Paul N. Roth, Founding Partner, Schulte Roth & Zabel International

*Moderator: Krishna Kumar, RAND*

**2:45 p.m.** Break

**3:00 p.m.** PANEL 2: Effectiveness of On-going Reforms in Addressing Systemic Risks Posed by Hedge Funds

Questions to be addressed include: "How do the recent reforms address the liquidity and leverage of hedge-fund portfolios?" "What gaps in the regulations remain?" "Will regulators have enough information to detect the build-up of systemic risk?" "Will new regulations compromise the services hedge funds provide to individual investors and to the economy as a whole?"

*Framing of the Issues: Noreen Clancy, RAND*

## **AGENDA (Continued...)**

*Panelists:*

- Benjamin Allensworth, Managed Funds Association
- Chris Petitt, Founder, Blue Haystack Inc.
- Beth Kiser, Assistant Director of the Office of Financial Stability, Board of Governors of the Federal Reserve System
- Patrick Pinschmidt, Senior Policy Advisor, Financial Stability Oversight Council, U.S. Department of the Treasury

*Moderator:* Lloyd Dixon, RAND

**5:00 p.m.** Closing Remarks

*Michael Greenberg, Director, RAND Center for Corporate Ethics and Governance*

**5:15 p.m.** Reception  
*fyve Lounge, Ritz Carlton, Pentagon City*

## HEDGE FUNDS AND SYSTEMIC RISK

RAND Policy Symposium

SEPTEMBER 24, 2012

### SYMPOSIUM PARTICIPANT LIST

**Benjamin Allensworth**

*Associate General Counsel,  
Managed Funds Association*

**David Brooks**

*General Counsel,  
Fortress Investment Group*

**Noreen Clancy**

*Policy Sciences Project  
Associate,  
RAND Corporation*

**Susanne Clark**

*General Counsel and Senior  
Managing Director,  
Centerbridge Partners*

**Glenn Davis**

*Senior Research Associate,  
Council of Institutional Investors*

**Lloyd Dixon**

*Senior Economist,  
RAND Corporation*

**Wendy Edelberg**

*Assistant Director,  
Congressional Budget Office;  
former executive director,  
Financial Crisis Inquiry  
Commission*

**Alex Ehrlich**

*Head of Prime Brokerage,  
Morgan Stanley*

**Michael Greenberg**

*Director,  
RAND Center for Corporate  
Ethics and Governance*

**Elliot Grossman**

*Managing Director,  
Dinosaur Securities*

**David Hsieh**

*Professor,  
Fuqua School of Business, Duke  
University*

**James Jayko**

*Portfolio Manager,  
Dock Street Capital*

**Jin Gil Jeong**

*Professor of Finance,  
Howard University School of  
Business*

**Beth Kiser**

*Assistant Director of the Office  
of Financial Stability,  
Federal Reserve Board of  
Governors*

**Krishna Kumar**

*Senior Economist,  
RAND Corporation*

**Jeff Nason**

*Managing Director,  
Butterfield Fulcrum Group*

**Christopher Pettit**

*Founder,  
Blue Haystack, Inc.*

**Patrick Pinschmidt**

*Senior Policy Advisor,  
U.S. Department of the Treasury*

**Christo Pirinsky**

*Finance Professor,  
Washington University*

**Nela Richardson**

*Senior Economic Analyst,  
Bloomberg*

**Paul Roth**

*Founding Partner,  
Schulte Roth & Zabel  
International*

**Megan Rowley**

*Associate,  
Goldman Sachs & Co.*

**Lawranne Stewart**

*Minority Counsel,  
House Financial Services  
Committee*

**Arthur Tully**

*Partner, Financial Services and  
Global Hedge Fund Services Co-  
Leader,  
Ernst & Young*

**Tim Webb**

*Senior Engineer,  
RAND Corporation;  
Managing Director,  
Inflection Point Ventures*





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