INSTITUTE FOR LAW AND FINANCE

MARCIA L. MACHARG

WAKING UP TO HEDGE FUNDS:

IS U.S. REGULATION TAKING A NEW DIRECTION?

INSTITUTE FOR LAW AND FINANCE
JOHANN WOLFGANG GOETHE-UNIVERSITÄT FRANKFURT

WORKING PAPER SERIES NO. 11

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Waking Up to Hedge Funds: Is U.S. Regulation Really Taking a New Direction?

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I. Introduction

In response to recent developments in the financial markets and the stunning growth of the hedge fund industry in the United States, policy makers, most notably the Securities and Exchange Commission ("SEC"), are turning their attention to the regulation, or lack thereof, of hedge funds. U.S. regulators have scrutinized the hedge fund industry on several occasions in the recent past without imposing substantial regulatory constraints. Will this time be any different?

The focus of the regulators' interest has shifted. Traditionally, they approached the hedge fund industry by focusing on systemic risk to and integrity of the financial markets.[1] The current inquiry is almost exclusively driven by investor protection concerns. What has changed?

First, since 2000, new kinds of investors have poured capital into hedge funds in the United States, facilitated by the "retailization" of hedge funds through the development of funds of hedge funds and the dismal performance of the stock market. Second, in a post-Enron era, regulators and policy makers are increasingly sensitive to investor protection concerns.

On May 14 and 15, 2003, the SEC held for the first time a public roundtable discussion on the single topic of hedge funds. Among the investor protection concerns highlighted were: an increase in incidents of fraud, inadequate suitability determinations by brokers who market hedge fund interests to individual investors, conflicts of interest of managers who manage mutual funds and hedge funds side-by-side, a lack of transparency that hinders investors from making informed investment decisions, layering of fees, and unbounded discretion by managers in pricing private hedge fund securities.

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Although there has been discussion about imposing wide-ranging restrictions on hedge funds, such as reining in short selling, requiring disclosure of long/short positions and limiting leverage, such a response would be heavy-handed and probably unnecessary. The existing regulatory regime is largely adequate to address the most flagrant abuses. Moreover, as the hedge fund market further matures, it is likely that institutional investors will continue to weed out weak performers and mediocre or dishonest hedge fund managers.

What is likely to emerge from the newest regulatory focus on investor protection is a measured response that would enhance the SEC's enforcement and inspection authority, while leaving hedge funds' inherent investment flexibility largely unfettered. A likely scenario, for example, might be a requirement that some, or possibly all, hedge fund sponsors register with the SEC as investment advisers. Today, most are exempt from registration, although more and more are registering to provide advice to public hedge funds and attract institutions. Registration would make it easier for the SEC to ferret out potential fraudsters in advance by reviewing the professional history of hedge fund operators, allow the SEC to bring administrative proceedings against hedge fund advisers for statutory violations and give the agency access to books and records that it does not have today. Other possible initiatives, including additional disclosure requirements for publicly offered hedge funds, are discussed below.

This article addresses the question whether U.S. regulation of hedge funds is really taking a new direction. It (*i*) provides a brief overview of the current U.S. regulatory scheme, from which hedge funds are generally exempt, (*ii*) describes recent events in the United States that have contributed to regulators' anxiety, (*iii*) examines the investor protection rationale for hedge fund regulation and considers whether these concerns do, in fact, merit increased regulation of hedge funds at this time, and (*iv*) considers the likelihood and possible scope of a potential regulatory response, principally by the SEC.

II. The Hedge Fund Market

Hedge funds have existed in the United States for more than 50 years as unregulated investment pools. Typically structured as private limited partnerships or limited liability companies to provide flow-through tax treatment for investors, hedge funds have drawn scant regulatory attention.

The primary reason for the latest regulatory offensive is the SEC's belief that unsupervised and unregulated hedge fund managers pose a threat to the investing public as a result of "retailization" of the hedge fund market. Hedge fund sponsors and broker-dealers have exploited the present regulatory scheme to make hedge funds more broadly available to investors who would not otherwise have qualified to invest in such funds.

Recently, U.S. regulators have voiced this concern loudly, and the financial press has picked up the drumbeat.[2]

Another factor, some regulators have suggested, is that hedge funds are contributing to, or unfairly profiting from, falling stock markets. The shroud of secrecy that generally surrounds hedge funds has exacerbated these concerns. As expressed by Senator Richard Shelby, Chairman of the Senate Committee on Banking, Housing and Urban Affairs: "These investment pools have been, to borrow Winston Churchill's words regarding Russia, 'a riddle wrapped in a mystery inside an enigma.'"[3]

The term "hedge fund" is frequently used in the United States to identify a broad range of private investment vehicles that actively trade a variety of securities and commodities through a multitude of investment strategies, with an almost unbounded range of risk and return objectives. These strategies include, among others, market neutral strategies, where managers aim to produce almost the same profit regardless of market circumstances (***e.g.***, capitalizing on pricing inefficiencies with respect to particular securities or commodities or between related instruments while remaining neutral with respect to directional price movements in relevant markets) and event driven strategies (***e.g.***, capitalizing on the price spread between the current market price and the value of a security upon successful completion of a merger and acquisition transaction).

Hedge fund managers employ different techniques in pursuing these strategies, including: arbitrage, where managers seek to exploit pricing anomalies of identical or similar financial instruments on different markets or in different forms (***e.g.***, fixed income arbitrage, merger arbitrage, derivatives arbitrage); hedging through long/short[4] strategies, where managers invest in equity and/or fixed income instruments and combine long investments with short investments to reduce market exposure; and market timing, where managers attempt to predict the short-term movements of various markets and, based on those predictions, move capital from one asset class to another in order to secure market gains and avoid market losses. These strategies and techniques involve the use of varying levels of leverage, that is, utilizing borrowed money in making investments. Because hedge fund managers generally can use these different strategies and techniques as they wish, the performance of a hedge fund may be considered less predictable than the performance of an investment vehicle, such as a mutual fund, managed according to stricter guidelines. There are other studies tending to demonstrate the capital preservation strengths of certain hedge fund strategies.

Hedge funds have seen a marked rise in capital infusion since the start of the bear market in 2000. It is estimated that currently there are close to 6,000 U.S. hedge funds controlling approximately $600 billion of total assets.[5] As the equity mutual fund markets lost their lustre, financial firms viewed hedge funds as vehicles to attract or retain affluent clients, as well as institutions, looking for diversification and alternative investments, and to retain talented portfolio managers who might benefit from the incentive fees charged by hedge funds. Some investors view hedge funds as a way to escape from, or at least balance, the dismal performance they have experienced recently with more traditional investments.

The recent phenomenon of registered funds of hedge funds — in which an umbrella fund is registered under the Investment Company Act of 1940 (the "1940 Act") and offered in a private placement to individual investors — has raised some regulators' hackles. Funds of hedge funds are indeed becoming more mainstream. According to AdvisorBenchmarking.com, more than 15% of advisers allocated a portion of their client's assets to funds of hedge funds, up from 4% in 2000. It is estimated, however, that only about 60 U.S. hedge funds are registered investment companies.[6] These 1940 Act funds theoretically are subject to a panoply of investor protection regulations, but the underlying hedge funds in which they invest are totally unregulated. Such funds are proving to be a critical test of the underlying premises justifying hedge funds' freedom from regulation. The proponents of increased regulation argue essentially that investors in funds of hedge funds are precisely the investors who need regulatory protections, additional disclosure and more transparency.

Several of these funds of hedge funds are also registered under the Securities Act of 1933 (the "1933 Act") and are therefore not restricted to selling their securities only to sophisticated investors through private placements. These 1933 Act registered funds of hedge funds are permitted to market to any investor; many require minimum investments of only $25,000. In the summer of 2002, the first U.S. fund of hedge funds became eligible to sell its securities to the public. There are about 18 of such "public" funds currently in existence.[7] The staff of the SEC has expressed concern about the suitability of such funds for retail investors:

> While hedge funds have long been a product for wealthy investors, funds of hedge funds are now being made available to a broader investor base because the original investment is placed in a registered investment company. These funds could thus pool smaller investors together to meet the high minimum investments [the underlying] hedge funds require. However, these types of funds are suitable only for certain investors given the nature of their investments. We have been carefully scrutinizing these funds for appropriate disclosure and we are particularly interested in how these funds value their investments in the underlying hedge funds in determining their own net asset values.[8]

William Donaldson, recently confirmed Chairman of the SEC, announced in his confirmation hearings that he would encourage the continued investigation of hedge funds. He stated his belief that "there is a tremendous growth in hedge funds, pretty much totally unregulated, a lot of money, a distressing move towards 'retailization' of hedge funds, and making them available to smaller and smaller investors and aggregating their money."[9] Donaldson also noted that the SEC's Division of Investment Management had seen a "boom" in funds of hedge funds, all of which currently are subject to at least a $25,000 minimum investment. Donaldson expressed concern, however, that there is no legal requirement to maintain a $25,000 minimum. Funds could decide to lower the required investment, further compelling the SEC to focus on suitability issues and hedge fund marketing practices.[10]

III. The Current Regulatory Scheme

Hedge funds and other "private" pooled investment vehicles, and often their managers, generally seek to minimize the extent to which they are regulated in the United States. They typically rely on exemptions from registration under the major U.S. securities and commodities laws applicable to pooled investment vehicles and their sponsors. The following is a brief overview of the current regulatory regime and how hedge funds and their investment managers are presently exempt from regulation:

A. The 1940 Act

The 1940 Act is the principal U.S. securities statute governing investment companies. The 1940 Act regulates virtually every aspect of an investment company's operations, including its governance and structure, leveraging by issuance of debt and other senior securities, investment and concentration limits, sales and redemptions of shares, and dealings with service providers and other affiliates.[11]

Private hedge funds, unlike regulated investment companies such as mutual funds, are exempt from 1940 Act restrictions on engaging in investment strategies such as leverage, short selling, or taking concentrated positions in a single industry, firm, or sector. Further, hedge funds are not subject to valuation requirements applicable to registered investment companies, which must price their portfolio securities daily at market value or, if market values are not available, at fair market value.

The exemptions under the federal securities laws including the 1940 Act for private funds, such as private hedge funds, are premised on one or both of two theories. First, investors in such funds are sufficiently sophisticated that they do not need all of the statutory protections. Second, the private nature of the fund, the limited number of investors and, in certain cases, their "personal, familial and similar" ties suggest that federal oversight of the investment pool is impractical or unnecessary.[12]

These two theories are embodied in exceptions to the definition of "investment company" in the 1940 Act: Section 3(c)(1) and Section 3(c)(7). Section 3(c)(1) is available to an issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and that is not making and does not presently propose to make a public offering of its securities.

Section 3(c)(7) is available to an issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers," and that is not making and does not at that time propose to make a public offering of such securities. Qualified purchasers, for purposes of Section 3(c)(7), must meet a higher standard than that for "accredited investors" under the 1933 Act (see below), and generally include natural persons owning at least $5 million in investments and entities owning at least $25 million in investments. It is important to note here that, in order for a fund to rely on either the 3(c)(1) or 3(c)(7) exception, the fund's securities must be sold in a "private placement" under the 1933 Act.

Section 3(c)(1) was amended to reflect the current fewer than 100 beneficial owner exception, and Section 3(c)(7) was added to the 1940 Act recently, pursuant to the National Securities Markets Improvement Act of 1996 ("NSMIA").[13] Prior to the enactment of NSMIA, private investment pools such as hedge funds were limited to fewer than 100 investors. The SEC considered this limitation to be arbitrarily restrictive in size and unresponsive to a perceived increase in investor financial sophistication about private fund investment.[14] Accordingly, the new Section 3(c)(7) exception was adopted. The recent launch of funds of hedge funds was facilitated by these mid-1990s developments and subsequent SEC rulemaking.

Regulators have expressed concern that the recent trend toward the fund of hedge funds structure amounts to exploitation of a regulatory loophole under the 1940 Act. Investors in funds of hedge funds, by pooling their capital, can invest indirectly in the very hedge funds in which they would be unable to invest directly. For example, a registered fund that invests in an underlying 3(c)(7) hedge fund meets the "qualified purchaser" requirements for the underlying fund. A registered fund that invests in an underlying 3(c)(1) hedge fund will have pooled a sufficient amount of assets from its various investors to invest a significant amount in the 3(c)(1) fund.[15] In reality, an individual investing in a fund of hedge funds could not invest directly in a 3(c)(1) hedge fund because such a fund, limited to fewer than 100 investors, would probably be unable to attract a critical mass of capital from individuals. Similarly, most investors in a fund of hedge funds could not invest directly in a 3(c)(7) fund, as to which each investor must meet the "qualified purchaser" investor standard, a much higher standard than the "accredited investor" standard (see III.B. below).

B. The 1933 Act

The essential purpose of the 1933 Act is to protect investors; it is concerned primarily with the initial distribution of securities, rather than subsequent trading.[16] This is achieved by requiring registration with the SEC and dissemination of certain information concerning the securities before they are publicly offered for sale.

Most private funds, including hedge funds, rely on the private placement exemption in Section 4(2) of the 1933 Act to avoid registering their securities under that Act. Section 4(2) exempts "transactions by an issuer not involving any public offering" from the 1933 Act's registration provisions. The basic thrust of Section 4(2)'s interpretative history is that the statutory exemption from registration is available in situations where the 1933 Act's protection is not needed because the potential investors can "fend for themselves."

Regulation D under the 1933 Act provides a means of establishing that an issuer is not making a public offering for purposes of Section 4(2). Most hedge funds rely on Rule 506 under Regulation D to meet the "no public offering" exemption. Under this rule, no public offering is deemed to have taken place if the issuer has not engaged in a general solicitation of its securities and if securities are offered to no more than 35 non-accredited investors. The rule permits offering to an unlimited number of "accredited investors," which include, among others, most financial institutions, any natural person who, individually or together with such person's spouse, has at the time of purchase of securities a net worth in excess of $1,000,000, and any natural person who during the preceding two years had, and reasonably expects in the current year to have, an individual income exceeding $200,000 or, together with such person's spouse, $300,000.

At the conclusion of the SEC roundtable, SEC officials signaled that they would be considering increasing these thresholds, which have not changed since Regulation D was adopted in 1982, to discourage less sophisticated investors from putting money into complex hedge fund vehicles. It is worth noting that regulators, wary of the retailization of hedge funds, are most troubled by the handful of funds of hedge funds that have registered under the 1933 Act and are thus publicly available. Investors in these vehicles are not legally required to meet even the "accredited investor" standard under the 1933 Act.

Hedge funds that rely on an exemption from registration under the 1933 Act remain fully subject to the antifraud provisions in Section 17(a)[17] and the regulations thereunder.

C. <u>The 1934 Act</u>

While the 1933 Act regulates primarily the initial distribution of securities, the Securities Exchange Act of 1934 (the "<u>1934 Act</u>") governs subsequent trading, serving four main purposes: (*i*) to afford a measure of disclosure to people who buy and sell securities; (*ii*) to prevent, and afford remedies for, fraud in securities trading and manipulation of the markets; (*iii*) to regulate the securities markets; and (*iv*) to control the amount of credit that goes into those markets.[18]

Among other things, the 1934 Act empowers the SEC to require registration and periodic reporting of information by issuers of publicly traded securities. Section 12(g) of the 1934 Act requires an issuer having 500 or more holders of a class of equity securities and more than $10,000,000 in assets to register the class of equity securities.[19] Under Rule 12h-3 of the 1934 Act, an issuer with over $10,000,000 in assets, that would otherwise be subject to the reporting requirements required by Section 15(d) of the 1934 Act, is exempt from providing reports if its securities are held of record by fewer than 500 persons.[20] Hedge funds generally seek to limit the number of record owners of their securities to fewer than 500 persons in order to avoid becoming subject to these registration and reporting requirements.

As with the 1933 Act, even if a hedge fund can rely on an exemption under the 1934 Act, the antifraud provisions of Section 10(b) and Rule 10b-5 under the 1934 Act still apply to these funds.[21]

D. The Advisers Act

The Investment Advisers Act of 1940 (the "Advisers Act") requires investment advisers with at least $25 million in assets under management, as well as investment advisers of any registered investment companies, including 1940 Act registered hedge funds, to register with the SEC. Registered investment advisers must comply with significant substantive regulations, including extensive books and records requirements and disclosure through the Form ADV. Additionally, registered investment advisers are limited in their ability to charge performance-based fees of the kind often utilized in the hedge fund industry.

Most sponsors or investment advisers of hedge funds rely on the exemption from registration under Section 203(b)(3) of the Advisers Act. Section 203(b)(3) exempts from registration any adviser that during the course of the preceding 12 months has had fewer than 15 clients and that does not hold itself out generally to the public as an adviser or act as an adviser to a fund registered under the 1940 Act. Under Rule 203(b)(3)-1 promulgated by the SEC, a limited partnership (such as a hedge fund) generally is a single client of any general partner or other person acting as an investment adviser to the partnership. An adviser may count a limited partnership as a single client as long as the adviser provides advice based on the partnership's investment objectives, and not the individual objectives of the limited partners. An investment adviser that has its principal office and place of business outside the United States must count only clients that are U.S. residents; an investment adviser that has its principal office and place of business in the United States must count all clients.

The SEC staff has historically interpreted the "holding out to the public" element of Section 203(b)(3) broadly to include, for example, using letterhead or business cards that refer to advisory activities and maintaining a publicly accessible website that provides information about advisory services. The SEC staff has, however, allowed an adviser that posts hedge fund information on a website to rely on Section 203(b)(3) where access to the website was limited to certain accredited investors.[22]

Under Advisers Act Rule 205-3, registered investment advisers may charge performance-based fees (carried interest) without significant constraints only to "qualified clients," as defined in that Rule. Qualified clients include: (*i*) persons with at least $750,000 under management with the adviser; (*ii*) persons with a net worth (together with spouse) of more than $1.5 million; (*iii*) "qualified purchasers" as defined under the 1940 Act; and (*iv*) executive officers, directors or general partners of the adviser or employees who participate in the adviser's investment activities. Accordingly, investment advisers to registered hedge funds, in order to take advantage of the special performance fee exceptions under Rule 205-3, require investors to meet these standards.

Similar to the other U.S. federal securities laws, the Advisers Act contains an antifraud provision (Section 206) that is applicable to all investment advisers, whether or not registered.[23]

E. The Commodity Exchange Act

Hedge funds that trade in futures, options on futures, or commodities options are deemed "commodity pools" for purposes of the Commodity Exchange Act ("CEA") and are subject to regulation by the Commodity Futures Trading Commission (the "CFTC"). Hedge funds whose interests are offered exclusively to "qualified eligible participants" ("QEPs") may qualify under CFTC Rule 4.7 as "exempt pools." The definition of QEP is quite flexible and includes most institutional investors that are subject to other regulatory schemes (***i.e.*** banks, insurance companies, ERISA plans) as well as investment professionals, knowledgeable employees, qualified purchasers under the 1940 Act (see above in III.A.), non-U.S. persons, and accredited investors under Regulation D who have securities portfolios of at least $2 million. The commodity pool operator ("CPO") and commodity trading adviser ("CTA") (see below) of a hedge fund that is sold in a non-public offering under Section 4(2) of the 1933 Act and that qualifies as an exempt pool under CFTC Rule 4.7 is subject to reduced reporting, recordkeeping, and disclosure requirements with respect to such hedge fund.

In November 2002, the CFTC published an Advance Notice of Proposed Rulemaking ("ANPR")[24] intended to facilitate investments in commodities by operators of collective investment vehicles. The ANPR proposed to exempt from CPO registration commodity pool operators that commit a limited amount of pool assets (***i.e.*** not more than 5% of liquidation value) to establish commodity interest trading positions, that do not market participations in the pool to the public, and that restrict pool participation to "accredited investors," as defined in Regulation D under the 1933 Act. Pool operators would be required to file a notice of exemption with the CFTC before relying on the proposed rule. In the ANPR, the CFTC also proposed to exempt from CPO registration pool operators that operate pools exempt from registration under the 1933 Act and that restrict participation to, in the case of individual investors, QEPs, and in the case of entities, "accredited investors" as defined in Regulation D[25] or QEPs. Certain other requirements would also apply, including that the CPO would be required to file a notice of eligibility with the CFTC. In the ANPR, the CFTC issued no-action relief pursuant to which it will not pursue enforcement action during the rulemaking process against a CPO for failure to register where each pool for which the CPO claims relief meets certain criteria consistent with the rule proposals. A CPO must file a claim with the CFTC and the National Futures Association ("NFA") in order to rely on the no-action relief.

The adviser to a hedge fund is generally a CTA for purposes of the CEA and, absent an available exemption, must register as such with the CFTC. In the November 2002 ANPR, the CFTC also proposed to exempt from CTA registration those persons that provide advice only to pools operated by persons that are eligible for, and have claimed exemption under, the proposed CPO exemption described above, and whose commodity trading advice is solely incidental to the business of providing advice to such pools in instruments not subject to CFTC regulation. Persons claiming such exemption would not be permitted to hold themselves out as CTAs, and would be required to file a notice of exemption with the CFTC. The ANPR also included no-action relief for CTAs if they comply with certain criteria consistent with the proposed rule and file a claim with the CFTC and NFA in order to rely on the no-action relief.

F. Anti-Money Laundering Regulation

Hedge funds must be aware of U.S. anti-money laundering ("AML") regulation. In October 2001, the USA PATRIOT Act[26] made significant changes to the Bank Secrecy Act (the "BSA"), the major U.S. civil statute on money laundering. On September 18, 2002, the U.S. Department of the Treasury ("Treasury") proposed a new rule under the BSA, which would establish the minimum requirements for AML programs for certain unregistered investment companies, including hedge funds, commodity pools and real estate funds.[27] A hedge fund will be subject to the proposed rules if it (*i*) gives investors a right to redeem their ownership interests within two years after purchase and (*ii*) has total assets of at least $1,000,000 at the end of the most recent calendar quarter. An offshore hedge fund meeting these criteria will be subject to the rule if it (*i*) sells ownership interests to a U.S. person or (*ii*) is organized, operated or sponsored by a U.S. person (***e.g.***, a fund sponsor or manager located in the United States).[28] Although it is unclear when and in what form this rule will be adopted, hedge funds will have to comply with the final rule 90 days after it is published in the Federal Register.

Under the proposed rule, a hedge fund's AML program has to be reasonably designed to prevent the fund from being used for money laundering or the financing of terrorist activities and to achieve and monitor compliance with the applicable provisions of the BSA. The program must: (*i*) establish and implement policies, procedures and internal controls reasonably designed to achieve these objectives; (*ii*) provide for independent testing for compliance; (*iii*) designate one or more persons responsible for implementing and monitoring the AML program; and (*iv*) provide for ongoing AML training for appropriate persons. The proposed rule also would require a hedge fund to file a notice with Treasury's Financial Crimes Enforcement Network, including contact information for the fund, its sponsors, and its AML compliance officer, the amount of the fund's assets under management, and the number of fund security holders. Treasury further encouraged hedge funds to adopt procedures for voluntarily filing reports relating to suspected money laundering.

In addition, Section 356(a) of the USA PATRIOT Act mandated that Treasury, the Board of Governors of the Federal Reserve System, and the SEC submit a joint report to Congress with recommendations for effective AML regulation of investment companies, including hedge funds. The December 31, 2002 report to Congress ("Joint Report") noted that hedge funds may be the most susceptible type of unregistered investment companies open to abuse by money launderers because of the relative liquidity of their interests and their structure. It stated that "[t]he potential availability of 'anonymous' investment and the inability of law enforcement to obtain information about the beneficial ownership of corporate entities in certain jurisdictions make this type of hedge fund particularly attractive to money launderers." Regulators made two recommendations for AML regulation of hedge funds: hedge funds should (*i*) establish AML programs and (*ii*) implement customer identification and verification programs ("CIPs").[29]

Treasury has not yet issued proposed rules outlining its recommendations for CIPs for hedge funds, but the requirements might bear some resemblance to the final rules on CIPs that Treasury has issued for mutual funds and registered broker-dealers. In its broadest outlines, a CIP requires that a financial institution implement procedures to verify the identity of any person or entity seeking to open an account, to the extent reasonable and practicable, including making a determination as to whether the potential customer appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency, and to maintain records of the information used to verify the identity of such person or entity.

G. Consumer Privacy Regulations

The Gramm-Leach-Bliley Act of 1999 (the "GLB Act") required the SEC and other federal agencies to adopt regulations restricting the ability of financial institutions, including hedge funds, to disclose an individual's nonpublic personal financial information to non-affiliated third parties.

Registered investment advisers are required to comply with the SEC's Regulation S-P (Privacy of Consumer Financial Information). Hedge fund sponsors and other advisers that are not registered with the SEC are subject to the privacy regulations promulgated by the Federal Trade Commission (the "FTC") under the GLB Act, which are substantially similar to Regulation S-P.

Both the SEC's and the FTC's privacy schemes generally require that a sponsor and hedge fund notify their "consumers" and "customers" (as defined in the regulations) of their policies and practices regarding nonpublic personal information. If the sponsor or hedge fund intends to share nonpublic personal information about consumers and customers with certain non-affiliated third parties, the customers must be permitted to opt out of such information sharing. Permitted disclosure of nonpublic personal information to third parties is limited, and safeguards must be adopted to maintain the security of customer information. Importantly, these requirements apply only to individuals (as opposed to entities such as trusts or pension plans) who are consumers or customers of the sponsor or the hedge fund. The schemes also include a number of important exceptions to the notice, information sharing, and opt out provisions (*e.g.*, to permit information sharing with service providers and to protect against fraud).

H. State Regulation

Under NSMIA, states are preempted from regulating securities offering or investment advisers that are subject to registration under, or exempt from registration by, the federal securities laws. Thus, hedge funds and their sponsors are generally free from regulation under state law. States may, however, require notice filings by hedge funds and their sponsors and may also collect fees.

Although state regulators are preempted from much regulation in the hedge fund area, one area in which they retain authority is in broker-dealer regulation. Brokers may be required to make certain filings before offering hedge funds in a state, and states can act to protect consumers from "unsuitable" investments. Importantly, state regulators could effectively make it impossible for certain hedge funds to be marketed in a state if they determined that such investments were "unsuitable" for investors in that state. Certain activities (such as acting as adviser to both a private and public fund and funneling opportunities between them in an inappropriate manner) could also trigger state-law antifraud provisions. In a recent speech to the Wall Street Hedge Fund Forum, New York Attorney General Eliot Spitzer expressed his belief that, although the hedge fund industry did not require fundamental change, the use of leverage and other techniques should be examined.[30]

IV. Yesterday's Regulatory Mantra: Systemic Risk

A. Prelude to the Prelude

The first hedge fund is thought to date to 1949.[31] In 1968, the SEC conducted a survey reporting 140 hedge funds operating at that time.[32] Regulatory interest in hedge funds increased for the first time in the recent past following the market break of October 1987 when the Dow Jones Industrial Average declined by nearly one-third. In response to the market break, President Reagan created the Task Force on Market Mechanisms ("Task Force") to determine what happened and to provide guidance to prevent it from happening again. The Task Force was specifically commissioned to examine the current and long-term financial condition of the U.S. securities markets; identify problems that threaten the short-term liquidity or long- term solvency of such markets; analyze potential solutions to such problems that would both assure the continued smooth functioning of free, fair, and competitive securities markets and maintain investor confidence in such markets; and provide appropriate recommendations.[33]

The Task Force determined that the market break was triggered by a number of events, including an initial decline in the market that stimulated the aggressive selling by hedge funds in anticipation of further market declines, which, in turn, set off further selling in the market. Rather than propose specific regulation for hedge funds, the Task Force focused on the need for the different market segments (***e.g.***, stocks, stock index futures, options) to act as one market. Its recommendation included that clearing systems and margin regulations be made consistent across marketplaces to reduce financial risk and control speculation and financial leverage. Traditional hedge fund activities were, of course, captured in these recommendations.

Congress proposed legislation to implement many of the Task Force's recommendations and eventually the Market Reform Act of 1990[34] was enacted into law. The Market Reform Act of 1990 amended the 1934 Act and authorized additional power for the SEC in emergency situations, established reporting and disclosure requirements for market participants, and directed the SEC to facilitate the establishment of a national system for clearance and settlement of securities transactions.

B. Long-Term Capital Management

The next major incident in the hedge fund industry, and corresponding regulatory focus, occurred almost ten years after the recommendations issued by the Task Force, with the near collapse of Long Term Capital Management ("LTCM").[35] LTCM, founded in early 1994, operated a hedge fund (the "LTCM Fund") led by a team of highly respected and experienced individuals, including two Nobel laureates. LTCM sought to profit from a number of trading strategies, including convergence trades[36] and dynamic hedging.[37] At the end of 1997, LTCM had a capital base of $4.8 billion.

However, by leveraging its investments, it controlled significantly larger positions. By August 1998, it held over $125 billion of assets.

In a well-documented fiasco, the LTCM Fund ran into a significant problem following Russia's devaluation of the ruble in 1998 and other market events. During August and September 1998, the LTCM Fund suffered substantial losses and encountered major liquidity pressure. A number of major banks and other financial institutions that were trading counterparties and lenders to LTCM would have been exposed to an LTCM default. The actual number and identity of participants in the liquidity chain could not be determined. Fourteen financial services firms agreed to participate in a consortium to recapitalize LCTM, which had the effect of providing these firms with a 90% equity stake in LTCM's portfolio and operational control of the LTCM Fund. The Federal Reserve Bank of New York provided the facilities for these discussions and encouraged the firms to "seek the least disruptive solution that they believed was in their own collective self interest."

In the wake of the LTCM incident, hedge fund practices were closely examined by regulators and received much attention from the press. President Clinton commissioned The President's Working Group on Financial Markets ("PWG"), comprised of representatives of the Department of the Treasury, the Board of Governors of the Federal Reserve System, the SEC, and the CFTC. The PWG conducted a study that explored the policy implications of the LTCM incident, culminating in a report entitled, "***Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management***" (the "PWG Report"). The PWG Report included the following recommendations: (*i*) more frequent and meaningful information on hedge funds should be made public; (*ii*) public companies should publicly disclose additional information about their material financial exposures to significantly leveraged institutions; (*iii*) financial institutions should enhance their practices for counterparty risk management; (*iv*) regulators should encourage improvements in the risk-management systems of regulated entities and take other actions to promote risk management by regulated entities; and (*v*) regulators should consider stronger incentives to encourage non-U.S. financial centers to comply with international standards.

The PWG's concerns, like those of the Task Force ten years earlier, were related to investor confidence in and operations of the markets rather than investor protection. The PWG Report focused on systemic risks in the market, including the implications of the use of leverage and "determining the proper balance between the benefit that leverage confers to markets and the potential systemic risk posed by high levels of leverage." Significantly, the PWG Report expressly dismissed the notion that hedge funds raised significant investor protection issues that warranted changes to the various securities laws exemptions that hedge funds rely upon:

> Although hedge funds may present certain risks, these vehicles generally have not been associated with traditional investor protection issues (such as self-dealing by the fund's manger). Investors in private funds typically receive disclosure concerning the risks presented by these funds. The antifraud provisions of the [securities laws] also apply to the sale of a private fund's securities, whether or not the private fund is registered under the Investment Company Act.[38]

In addition, the PWG Report observed that modifying the exemptions under the federal securities laws to address the perceived risks presented by hedge funds could be overreaching because such an approach "may also impose unwarranted burdens on other types of private investment pools . . . that may not raise the same concerns as hedge funds."[39]

C. Proposed Legislation

In response to the LTCM incident and the PWG Report, public disclosure-based legislative initiatives were introduced – including the "Hedge Fund Disclosure Act" (H.R. 2924). This legislation, if enacted, would have required unregulated hedge funds to submit quarterly reports for public dissemination to the Board of Governors of the Federal Reserve System, including: (*i*) total assets and notional amount of derivatives position; (*ii*) the balance sheet leverage ratio of assets to liabilities; (*iii*) meaningful, comprehensive measures of market risk; and (*iv*) such other information as selected regulatory agencies required. Only those unregulated hedge funds with capital of $3 billion or more, or total net assets of at least $1 billion would have been subject to the proposed regulation. It is interesting to note that, while this initiative would have severely impeded the freedom of certain large hedge funds, the majority of hedge funds would not have been captured by the proposed regime because their assets failed to meet the proposed thresholds. Conversely, many other private funds would have been swept in.

Other disclosure-based initiatives surfaced as well. In November 1999, the "Derivatives Market Reform Act of 1999" (H.R. 3483) was introduced in the House of Representatives. This legislation proposed to amend the 1940 Act to require unregistered hedge funds to submit quarterly status reports to the SEC, including a statement of the financial condition of the fund, income or losses, cash flows, changes in equity, and a description of the models and methodologies used to calculate, assess, and evaluate market risks.

These legislative initiatives were never enacted. The principal responses to the LTCM incident appeared in the regulatory and private arenas – enhanced focus on risk management and assessments of counterparty risks.[40] Perhaps because most hedge fund investors have traditionally been institutions, legislation or regulatory initiatives to further limit the sale of hedge funds to certain investors were not proposed. Importantly, the legislative proposals that followed the LTCM incident focused on disclosure issues that would have permitted better monitoring by regulators and market participants, but may not have resulted in meaningful disclosure to investors.

V. Today's Regulatory Mantra: Investor Protection

A. The SEC Fact-Finding Investigation

As discussed above, the SEC's recent discomfort with hedge funds is a direct result of the growth in the number of hedge funds, total assets under management, and seemingly increased accessibility for individual investors, together with its lack of understanding of the industry. Because hedge funds are typically not registered with the SEC, they are not directly subject to examination and inspection by the SEC, and the SEC is thus "limited in [its] ability to detect problems *before* they result in harm to investors or the securities markets"[41] (emphasis added). This lack of oversight ability, coupled with a perceived boom in the retailization of hedge funds, was the driving force behind the SEC's formal fact-finding investigation announced in May 2002.

Beginning in 2001, in a series of speeches, senior members of the SEC staff suggested that hedge funds raised investor protection issues. Interestingly, these speeches appear to have coincided with the first registrations of funds of hedge funds. In one speech, Paul Roye, Director of the SEC's Division of Investment Management, remarked:

> If one needs a reason to appreciate the regulatory framework governing the mutual fund industry, you need only look to the recent miniboom we have experienced in hedge fund fraud. The SEC has brought a number of cases this past year exposing schemes that siphoned hundreds of millions of dollars from investors in these largely unregulated funds. Some have mistakenly concluded that hedge funds are beyond our reach, because they are not subject to registration or reporting requirements. Nonetheless, hedge funds are subject to the antifraud provisions of the federal securities laws. While it is difficult to prevent those otherwise intent on engaging in fraudulent activity from doing so, I submit that the regulatory framework governing the mutual fund industry makes such types of fraud more difficult to commit and easier to detect.[42]

Based on these and similar statements by the SEC staff, the SEC is taking a proactive approach to address its investor protection concerns with respect to the hedge fund market, rather than reactively as it did in response to the market break in 1987 and the near collapse of LTCM. In May 2002, then-SEC Chairman Harvey Pitt explicitly raised the issue of hedge fund regulation:

> By all accounts, private investment funds have experienced a seismic boom in both number and total assets under management. But, since these entities are not subject to reporting requirements, the information we have about them is sketchy. We are concerned about the implications flowing from the growth in these private investment funds. Accordingly, we will seek a better understanding of the issues currently affecting these vehicles by commencing a formal fact-finding investigation to enlighten us about:
>
> - incidents of fraud that we have seen with certain of these vehicles, particularly hedge funds;
> - conflicts associated with managing these vehicles alongside mutual funds; and
> - marketing these vehicles directly and indirectly to retail investors.
>
> Our goal is to determine whether the present state of regulation – or perhaps more accurately the lack thereof – is in the public interest.[43]

Shortly after Chairman Pitt's remarks, the SEC issued a formal order of investigation authorizing a fact-finding inquiry into hedge funds and other private funds. The actual order has not been made public; there has, however, been a substantial amount of publicity concerning the inquiry, including an article on *The New York Times* editorial page.[44]

The SEC investigation began in the summer of 2002. The SEC staff conducted a number of meetings with private fund professionals, focusing on the following areas: (*i*) services (prime brokerage, advisory, capital introduction, etc.); (*ii*) marketing to obtain business; (*iii*) counterparty credit risks (margin, collateral, risk limits); (*iv*) market risks from hedge fund investments and lending; (*v*) selling and recommending hedge funds to investors; and (*vi*) guaranteed or other alternative products.

In addition, the SEC's Office of Compliance Inspections and Examinations conducted inspections of registered and unregistered private fund sponsors. The SEC staff requested a number of documents and information with respect to each fund, including, among other things, the following: (*i*) the means by which the sponsor identifies or solicits investors, including the methods used to pay for these introduction/referral services and lists of third-party consultants (and the services provided by the consultants); (*ii*) fund performance information (including a description of the methodology used in calculating performance); (*iii*) a description of the processes relied upon by the funds to make suitability determinations for sale of interests to investors; (*iv*) information concerning private fund brokerage and related arrangements; (*v)* a description of the valuation process used by each fund; (*vi*) the use of websites to disseminate information concerning the fund; (*vii*) information concerning independent audits of the fund; and (*viii*) copies of offering memoranda and other marketing information and reports provided to investors and prospective investors.

B. Scrutiny of Broker-Dealers and Their Hedge Fund Activities

The SEC is also interested in the activities of broker-dealers that are involved in the businesses and services related to hedge funds. The SEC has conducted examinations of such broker-dealers, and has considered their arrangements with hedge funds from both a financial risk perspective, as counterparties to broker-dealers, and from an investor protection perspective, as products sold by broker-dealers to investors.[45]

The SEC is particularly examining the practice of "capital introduction services" by prime brokers, which clear and finance trades on behalf of a customer. These services are aimed at bringing hedge fund managers together with potential investors. At the roundtable, Chairman Donaldson indicated the SEC is looking into these services, including the manner in which they are disclosed to investors.

The SEC staff has concluded that as a result of "the downturn in the stock market, and reduced broker-dealer revenues from traditional activities – M&A business, investment banking, trading, commissions, and others – some firms seem to be competing heavily in new areas, including for hedge fund business. In this environment, there is concern that firms could take greater credit or market risks or market aggressively to investors."[46]

C. Role of the National Association of Securities Dealers

Like the SEC, the National Association of Securities Dealers, Inc. (the "NASD"), the self-regulatory organization for broker-dealers, is hindered from detecting hedge-fund fraud early because most hedge fund sponsors are not brokers registered with the NASD. The NASD has therefore traditionally focused on registered broker-dealers that sell hedge funds to their clients.

Citing the surge in the popularity of hedge funds, in February 2003, the NASD issued a Notice to Members expressing concern that members that sell interests in hedge funds and funds of hedge funds may not be complying with sales practices requirements with respect to such sales.[47] The NASD is especially concerned about sales of hedge funds to retail investors, and has instructed members to consider the "desirability and suitability" of hedge funds for such investors in light of the fact that hedge fund investing has traditionally been available only to high net worth individuals and institutions.

In the Notice to Members, the NASD reminded its members that their sales practice obligations with respect to hedge fund and fund of hedge fund sales include: (*i*) providing balanced disclosure in promotional efforts; (*ii*) performing a reasonable-basis suitability determination as to the hedge fund product; (*iii*) performing a customer-specific suitability determination; (*iv*) supervising associated persons selling hedge funds and funds of hedge funds; and (*v*) training associated persons regarding the features, risks, and suitability of hedge funds.[48]

It can be expected that the NASD will use its authority to regulate broker-dealers to refine further its sales practice and suitability guidelines in the hedge fund area and bring additional enforcement proceedings where warranted.

D. Enforcement Activity

Cases of hedge fund fraud have probably contributed the most to regulators' investor protection concerns. In a speech in April 2002, a month before the announcement of the SEC investigation, the Director of the Division of Investment Management stated: "Hedge fund managers always must keep in mind that, even though they consider themselves to be 'unregulated,' they have a fiduciary duty to their clients. The [Securities and Exchange] Commission and others are watching to make sure that hedge fund managers meet their fiduciary obligations."[49]

There have been a number of enforcement actions since the beginning of 2001 that involve hedge funds and other private funds.[50] Many of them involve allegations of garden-variety fraud (*i.e.* misappropriations of funds, Ponzi schemes, misleading performance claims).[51] The SEC recently charged Beacon Hill Asset Management, a $1 billion fund, with fraud and reportedly is currently investigating the demise of Lipper Convertible Funds. The agency is also reportedly exploring the short-selling practices of several smaller hedge funds, including Gotham Partners, Greenlight Capital, Aquamarine Fund, and Tilson Capital Partners.[52] In the case of Gotham Partners, the firm unexpectedly closed its biggest funds after a disastrous real-estate investment. Regulators are said to be examining complaints that the firm, which analyzed stocks on its own website, may have colluded with other firms to manipulate stock prices.

Most enforcement cases have involved registered investment advisers; however, as noted above, the antifraud provisions of the Advisers Act on which these actions are based apply to all investment advisers, whether or not registered with the SEC. Most recently, cases have been brought for portfolio pumping, the departure from investment objectives, failure to obtain best execution, and breach of fiduciary duty.[53] Because hedge funds are subject to the antifraud provisions of the federal securities laws under the existing regulatory regime, it is fair to question whether further regulation would provide the SEC with useful enforcement tools that it does not already have.

Similar to actions brought by the SEC, in April 2003 the NASD brought its first enforcement action since it began its focus on hedge funds. The agency censured and levied a $175,000 fine against Altegris Investment, a California firm accused of marketing hedge funds to small investors while exaggerating the funds' prospects and without fully declaring their risks. The NASD also fined the firm's chief compliance officer $20,000 for failing to adequately supervise the firm's hedge-fund advertising practices.[54]

E. Current Legislative Focus

Perhaps prompted by renewed regulatory interest, hedge fund issues are once again on the legislative agenda. The U.S. House of Representatives Financial Services Committee announced in February 2003 that it will monitor the SEC's review of hedge fund regulation, consider the impact on U.S. markets if the hedge fund business moves offshore, and look into investors' access to hedge funds and the risk disclosure that investors receive.[55] In March, the Committee announced its intention of holding a series of hearings on the role that hedge funds play in the financial markets.

Last month, the Senate Committee on Banking, Housing and Urban Affairs held a hearing on recent developments in hedge funds. SEC Chairman Donaldson was the sole witness at the hearing. The committee's main concerns that prompted the hearing were: (*i*) the potential that a very large, very leveraged hedge fund could blow up much like LTCM, creating systemic market risk; (*ii*) the retailization of hedge funds and the layering of fees in the fund of hedge funds structure; and (*iii*) conflicts of interest that arise when hedge funds are managed alongside mutual funds.

It remains to be seen whether this renewed interest by Congress will result in new proposed legislation.

F. The SEC's Hedge Fund Roundtable

The SEC's formal fact-finding investigation culminated in two days of public roundtable discussions on May 14 and 15, 2003. The roundtable discussions by a wide range of panelists, including fund managers, service providers, attorneys, accountants, investor advocates, and foreign and U.S. regulators, covered a number of topics including: (*i*) the structure, operation and compliance activities of hedge funds; (*ii*) marketing issues; (*iii*) investor protection issues; (*iv*) the current regulatory scheme; and (*v*) whether additional regulation is warranted.

The discussions focused mainly on the investor protection concerns discussed throughout this article. One prominent theme was the policy implication of funds of hedge funds for the U.S. retail market. Opinions varied greatly and the SEC's view on whether or not to further regulate accessibility to hedge funds by the retail market remains unclear. Other focal points included (*i*) the dated accredited investor standard in Regulation D, (*ii*) the current net-worth requirement as an appropriate proxy for financial sophistication, (*iii*) the registration of hedge fund sponsors as investment advisers, and (*iv*) the general institutionalization of hedge fund sponsors and hedge fund investors. The panelists were generally supporters of hedge funds and accessibility. The SEC made clear that it valued the role of hedge funds in the U.S. market. The SEC will publish its research and recommendations on the hedge fund market before the end of the year.

VI. What's Next?

It is difficult to assess whether and to what extent policy makers will seek to impose additional regulation on private funds, including hedge funds. In a recent hearing, Senator Paul Sarbanes stated: "We may have to close the door on some of those exceptions or exclusions, or redefine them in such a way to accomplish what needs to be accomplished but [cannot be] utilized or manipulated for other purposes that endanger the stability of our markets."[56] On the other hand, SEC Chairman Donaldson, although anxious to examine hedge funds, may not be ready to seek immediate regulation of their operations: "It's hard to make a universal rule about how to run a hedge fund because you'd defeat the purpose of having a hedge fund."[57]

Certainly, the SEC inquiry, including the discussion and the public report that will be issued, perhaps before the end of this year, will be the primary force shaping future regulation, if any.

A. Is There a Need for New Regulation?

There is a strong argument that further regulation is entirely unnecessary. The current concerns relating to hedge funds appear to be based more on incidents of fraud and the potential for increased fraud due to rapid growth and retailization of the industry rather than the potential for broader market dislocations (either from hedge fund trading activities or credit risks to major participants in the financial system). The antifraud provisions of the federal securities laws have provided the SEC with ample grounds to pursue private fund managers through enforcement actions, such as in instances where the fund managers fail to abide by the disclosures made in the offering memorandum.[58] The counter-argument is that the SEC could do more and be proactive rather than reactive if it had some authority to regulate market participants, principally advisers to hedge funds.

Arguably, additional disclosure requirements are unnecessary as well. Traditionally, most opponents of detailed disclosure obligations proceeded on the proposition that wealthy and sophisticated investors could demand enough disclosure to protect themselves. The competition among hedge funds has been considered enough of a motivating force for hedge funds to strike the right balance between protecting proprietary strategies and disclosing information to investors. These factors are undermined by the demonstrated retailization of the hedge fund market, the development of registered funds of hedge funds and the relatively complex nature of some kinds of hedge fund strategies.

Regulators can also protect investors by other means, for example, through education. On February 12, 2003, the SEC issued an alert (such alerts are issued infrequently) on its website warning investors of the special hazards involved with investing in hedge funds and funds of hedge funds.[59] In connection with this warning, the SEC launched a number of bogus websites to advertise fictitious hedge funds, including GRDI Select L.P. [60] ("greedy"), to warn investors of fraudulent hedge funds.

State regulators currently have the authority to severely restrict registered hedge fund sales through their regulation of brokers.

Finally, the institutional market will force out weak funds and managers. As the hedge fund industry matures, managers will have to respond to investor demands for transparency and risk disclosure in order to remain competitive.[61]

B. Where Regulation Is Unlikely

The regulatory approaches vented at last week's roundtable ran the gamut from *laissez faire* to heavy-handed. Several avenues will be duly considered and rejected by the SEC.

It is unlikely that fundamental hedge fund investment strategies will be subject to significant regulation. As discussed throughout this article, regulators and legislators have visited this issue repeatedly in the past, and have chosen to keep hedge funds free from such regulation. However, hedge fund strategies, including leverage and short selling, will not be free from scrutiny, particularly in the context of registered hedge funds. For example, Eliot Spitzer, the New York Attorney General famous for the recent landmark investigation of conflicts of interest in the investment banking industry, announced that although "hedge funds do not demand structural change," he believes that leverage and the manner in which illiquid securities are priced do require examination.[62]

Although the SEC might consider restrictions on certain types of short selling (such as where short-sellers have not borrowed stock to cover the shorts) or the shorting of less liquid stocks, it is unlikely to require the disclosure of individual short positions. Such disclosure requirements would allow competitors to take offsetting positions that would negatively affect a hedge fund. As in the United Kingdom, where the Financial Services Authority (the "FSA") has pronounced shorting to be a "legitimate investment activity," short selling itself is not considered a menace to the marketplace.[63] However, on the issue of potential manipulation through short selling, Chairman Donaldson announced that "the [SEC] will consider amendments to existing short sale regulation, as necessary, to curb potential manipulation by all market participants, including hedge funds, without unnecessarily restricting liquidity."[64]

Finally, there do not appear to be any efforts to impose a public disclosure obligation similar to those proposed following the LTCM blowup in the late 1990s. Notwithstanding recent news reports suggesting increased pressure for hedge fund disclosure based on market protection theories,[65] it is clear that any broad-based disclosure initiatives are likely to face regulators' skepticism, and vigorous opposition from the industry. The ability to shield investment decisions from other investors plays a large role in a hedge fund's strategy. If hedge fund managers were required to disclose publicly specific information regarding their strategies, they would risk third parties being able to use that information to the hedge fund's detriment. For example, an investor who knows that a hedge fund holds a large short position in a specific security could use that information to negatively affect the hedge fund by trading against the short position.

At the roundtable, the SEC staff did indicate that it would at least be examining related disclosure issues, including whether hedge fund performance calculations should be standardized. The SEC staff also appeared particularly concerned about the type of disclosure that investors in registered funds of hedge funds receive with respect to underlying funds, and the SEC examination staff's lack of access to information concerning the underlying unregistered funds.

C. Where Regulators Might Tread

Regulation through reporting requirements, monitoring of sales practices, or other amendments to the federal securities laws is possible. Changes to the basic private fund exemptions under the 1940 Act would require legislation. In enacting the Sarbanes-Oxley Act of 2002,[66] Congress has shown that it is capable of acting quickly on legislation in the face of a series of major scandals. Although there is no legislation pending that would alter the 1940 Act exemptions, the possibility of legislation cannot be ruled out.

Requiring hedge fund sponsors to register under the Advisers Act may be the most logical response to regulators' recent discomfort with hedge fund independence. As a registered investment adviser, a hedge fund sponsor would be subject to routine examinations by the SEC, perhaps easing concerns of undetected fraud. Subjecting fund sponsors to registration under the Advisers Act could bring: (*i*) a restriction on the types of retail investors who could be charged performance fees, (*ii*) the SEC ability to audit funds periodically, and (*iii*) limitations on certain investment techniques, such as leverage, employed by a hedge fund. The SEC can bring administrative proceedings, subpoena witnesses and documents, and issue cease and desist orders with respect to registered investment advisers.

Members of the staff of the SEC have suggested informally that the most seamless manner in which hedge fund sponsors would be subject to regulation under the Advisers Act would be to modify the basis for determining whether a sponsor can rely on the Section 203(b)(3)[67] registration exemption by, for example, counting each investor in a fund (instead of the fund itself) as a client. For example, under the SEC's present rules, an adviser to a hedge fund with 120 investors is deemed to have one client (the hedge fund). Under a proposed rule change, the adviser would have 120 clients (each investor in the hedge fund) and would therefore no longer qualify for the fewer than 15 client exemption from registration. This type of change, which would result in the registration of hedge fund sponsors, could be done by the SEC through rulemaking and would not require legislation.

Indeed, as noted at the roundtable, the United States is one of the few countries that does not require hedge fund sponsors to register. In the United Kingdom, where hedge fund sponsors are required to register in with the FSA, such regulation has not had a discernible adverse impact on the UK hedge fund industry. The SEC would, however, have to consider any unintended consequences of counting each investor, instead of the hedge fund itself, as a client. For example, would each investor then also be considered a client for purposes of making suitability determinations with respect to each fund investment? In addition, such measures would likely prompt challenges by other private fund sponsors.

Another initiative that has been proposed to increase investor protection is to revise the definition of "accredited investor" under the 1933 Act. Some advocates of tighter regulation have suggested that the bar to qualify as an accredited investor should be raised to reflect the economic trends and increased wealth accumulation of the last few decades. The SEC could accomplish this change by amending its own Regulation D. Industry trade groups such as the Association for Investment Management and Research strongly support the examination of what they have stated may be "obsolete" and "static regulatory yardsticks" for determining investor sophistication.[68] At the April 10 Senate hearing, Chairman Donaldson reflected on this point: "Although the [SEC] is not aware of any systemic investor losses or other failures caused by the current accredited investor standards, we could of course consider adjusting it, if appropriate."[69]

VII. Conclusion: Is U.S. Regulation Really Taking a New Direction?

After all has been said and done and the SEC issues its report on hedge funds, some regulatory changes are probably inevitable.

Many would argue that a key assumption underlying the current clamor for tighter regulation of the hedge fund industry – the emergence of a wave of unsophisticated retail investors – is wrong, and that the growth in the industry is actually being driven by institutional investors. Recent data seem to support this view.[70] If this is the case, we must ask, what has really caused the sudden surge in regulatory interest in hedge funds? The growing popularity of hedge funds is certainly a result of the bear market, and perhaps the increased scrutiny by regulators is also a result of the bear market. Regulators may have a psychological need to amplify the risk of retailization in order to play an active role in avoiding what they may perceive to be a potential financial disaster for many individual investors who may not have fully understood the risks involved in hedge fund investment.

There are signs that the SEC's interest in investor protection is not limited to protecting retail investors. In a 2001 speech, a senior SEC staff member discussed the increasing level of public pension plan investment in hedge funds and suggested that the risks in investing in hedge funds affect institutional investors as well:

> [I]t is harder for hedge fund investors to know how their funds are being managed, much less exert control over the manager. Managers can change investment strategies and their investors would never know. Moreover, it is more difficult for hedge fund investors to vote with their feet. Many hedge funds only allow investors to cash in their holdings on a few days a year. All of this can make it easier for a hedge fund manager to engage in fraud. . . . Clearly, the flow of billions of dollars into hedge funds creates opportunities for legitimate fund managers, but also for Ponzi scheme operators and swindlers.[71]

In the end, perhaps U.S. regulators will conclude that the principled basis for additional regulation will be to provide additional enforcement and inspection tools needed to forestall fraudulent practices in the industry, reset the bar for accredited investors eligible to invest in private placements, and encourage or mandate responsible hedge fund market participants to provide better disclosure about underlying funds and valuations to all investors.

[1] *See, e.g.*, Report of The President's Working Group on Financial Markets, "*Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*" (Apr. 1999) ("PWG Report"). The President's Working Group on Financial Markets ("PWG") consisted of the Department of the Treasury, the Board of Governors of the Federal Reserve System, the SEC and the CFTC.

[2] A collection of stories from *The Wall Street Journal* the week of January 20, 2003 illustrates this point: "Regulators Review Complaints About Hedge Funds' Research" (Jan. 22, 2003); "Hedge Funds for the Masses" (Jan. 23, 2003); "In 7 Days, a Hedge Fund Lost All Value" (Jan. 24, 2003); "Will Scrutiny of Hedge Funds Lead to Charges?" (Jan. 24, 2003); "Firms Must Disclose Hazards of Hedging, Regulators Warn" (Jan. 24, 2003).

[3] Opening Statement of Chair Richard Shelby (R-AL), Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).

[4] "Short selling" or "selling short" involves the borrowing of a security from a broker and selling it, with the understanding that it must later be bought back (hopefully at a lower price) and returned to the broker. This technique is used by investors who try to profit from anticipated declining stock prices.

[5] Testimony of William H. Donaldson, Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003); CNN Lou Dobbs Moneyline, Transcript # 021200CN.V19 (Feb. 12, 2003); "Hedge Funds May Face Crackdown" (*The Wall Street Journal*, Thursday, Jan. 30, 2003, page C1).

[6] Testimony of William H. Donaldson, Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).

[7] *Id*. Donaldson noted "In the summer of 2002, the first fund of hedge funds became eligible to sell its securities to the public. Subsequently, there have been 17 other funds of hedge funds cleared for the public market." Institutions that have raised registered funds of hedge funds include: Deutsche Bank AG, OppenheimerFunds and Montgomery Asset Management.

[8] P. Roye, "Priorities in Investment Management Regulation," Keynote Address at the Eighth Annual Advanced ALI-ABA Course of Study: Investment Management Regulation (Oct. 17, 2002). *See also* P. Roye, Keynote Address at the Twentieth Annual Advanced ALI-ABA Conference on Life Insurance Company Products (Nov. 14, 2002) (making similar remarks with respect to hedge funds being offered to broader segments

of the investing public through standardized variable products). All speeches by the SEC officials cited in this article are publicly available on the SEC web site (http://www.sec.gov).

[9] Hearing on the Nomination of William H. Donaldson to be a Commissioner of the SEC, U.S. Senate Committee on Banking, Housing and Urban Affairs (Feb. 5, 2003).

[10] Testimony of William H. Donaldson, Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).

[11] P. Roye, "The Genius of the Investment Company Act – A Framework for Adaptation to Change," Keynote address before the American Law Institute (June 15, 2000).

[12] *See* Division of Investment Management, U.S. Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (1992) at pp. 105-106.

[13] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290.

[14] *See* Division of Investment Management, U.S. Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (1992).

[15] Investment Company Act of 1940 § 3(c)(1)(A), 15 U.S.C. 80a-3(c)(1)(a) (2000). A Section 3(c)(1) fund may count an investing entity as a single investor, as long as the investing entity does not own greater than ten percent of the voting securities of the 3(c)(1) fund. If the investing entity owns greater than ten percent of the 3(c)(1) fund's voting securities, the 1940 Act requires that the fund count each beneficial owner of the investing entity as a beneficial owner of the fund, thereby likely destroying compliance with the 3(c)(1) exception.

[16] L. Loss, *Securities Regulation*, 83-84 (1951) (*hereinafter Loss*).

[17] Securities Act of 1933 § 17(a), 15 U.S.C. § 77(q)(a) (1988). Section 17(a) provides: "It shall be unlawful for any person in the offer or sale of any securities . . . to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . . ."

[18] Loss, at 84 (1951).

[19] Securities and Exchange Act of 1934 § 12(g), 15 U.S.C. § 78(l)(g) (requiring registration by issuers with more than 500 shareholders and more than $1,000,000 in

assets); *see also* Securities and Exchange Act of 1934 Rule 12g-1, 17 C.F.R. 240.12g-1 (2001) (exempting issuers with less than $10,000,000 in assets from registration under §12(g)).

[20] Securities and Exchange Act § 15(d), 15 U.S.C. § 78(o)(d); Suspension of Duty to File Reports Under Section 15(d), 17 C.F.R. 12h-3(b)(1)(ii); *see also* Certifications of Termination of Registration Under Section 12(g), 17 C.F.R. 12g-4(a)(2)(ii) (same exemption).

[21] Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(j); 17 C.F.R. 240.10b-5 (2001) Section 10(b) prohibits any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of any securities.

[22] *See Lamp Technologies, Inc.* (May 29, 1997).

[23] Investment Advisers Act of 1940 § 206, 15 U.S.C. 80b-6 (1994).

[24] *See Commodity Pool Operators and Commodity Trading Advisors; Exemption from Requirement to Register for CPOs of Certain Pools and CTAs Advising such Pools*, 67 Fed. Reg. 68785 (2002) (proposed Nov. 13, 2002).

[25] The ANPR restricts the "accredited investor" categories to those applying only to non-natural persons, but excludes private business development companies.

[26] Uniting and Strengthening America Act by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001, Pub. L. No. 101-57 (Oct. 26, 2001)) (the "USA PATRIOT Act"). Title III of this act is the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001.

[27] *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 60,617 (2002) (to be codified at 31 C.F.R. pt. 103).

[28] The proposed rule incorporates the definition of "U.S. person" from Regulation S under the 1933 Act. Under Regulation S, "U.S. persons" include, among others: natural persons resident in the United States; partnerships or corporations organized under U.S. law; estates administered by a U.S. person; trusts with a trustee that is a U.S. person; a U.S. agency or branch of a foreign entity; and a foreign partnership or corporation formed by a U.S. person principally for the purpose of investing in securities not registered under the 1933 Act, unless it is organized or incorporated and owned by "accredited investors" who are not natural persons, estates or trusts.

[29] On October 11, 2002, Treasury issued a press release advising all financial institutions (including hedge funds) that they will not be required to adopt CIPs until final regulations are adopted. Treasury noted, however, that such financial institutions "should already be taking basic steps to assure appropriate customer identification."

[30] Eliot Spitzer, speech to Wall Street Hedge Fund Forum (March 3, 2003).

[31] For a detailed history of hedge funds, see "*Hedge Funds: Investment and Portfolio Strategies for the Institutional Investor*," eds. Jess Lederman and Robert A. Klein (New York: Irwin Professional Publishing, 1995).

[32] PWG Report at 1.

[33] Executive Order 12614, Presidential Task Force on Market Mechanisms (November 5, 1987).

[34] Pub. L. No. 101-432, 104 Stat. 963 (1990) (codified at scattered sections of 15 U.S.C. and 12 U.S.C.).

[35] The facts surrounding LTCM are derived from the PWG Report.

[36] Convergence trading is generally regarded as bets on the relative price of two assets to narrow (or converge) and usually involves buying the cheaper asset and short-selling the more expensive asset. William Fund and David A. Hsieh, "The Risk in Hedge Fund Strategies: Theory and Evidence from Fixed Income Traders" (Oct. 2001).

[37] In general terms, dynamic hedging involves rebalancing hedge positions as market positions change.

[38] PWG Report at p. B-13.

[39] PWG Report at B-14.

[40] *See, e.g.*, Board of Governors of the Federal Reserve System, *Supervisory Guidance Regarding Counterparty Risk Management*, S.R. 99-3 (Feb. 1, 1999); SEC Office of Compliance Inspections and Examinations, New York Stock Exchange, NASD Regulation, Inc. Joint Statement: Broker-Dealer Risk Management Practices (July 29, 1999); The Counterparty Risk Management Policy Group, "Improving Counterparty Risk Management Practices" (June 1999); "Sound Practices for Hedge Fund Managers" (Feb. 2000). The Counterparty Risk Management Policy Group was formed by a group of international commercial and investment banks to promote enhanced strong practices in counterparty credit and market risk management. The last paper cited above was prepared by a group of prominent hedge fund sponsors in response to the PWG Report's

suggestion that a group of hedge funds publish "a set of sound practices for their risk management and internal controls."

[41] Testimony of William H. Donaldson, Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).

[42] P. Roye, "Mutual Funds and Investment Management," 2001 Mutual Funds and Investment Management Conference (Mar. 19, 2001).

[43] H. Pitt, Remarks before the Investment Company Institute, 2002 General Membership Meeting (May 24, 2002).

[44] *See, e.g.*, W. Safire, "Beware the Hedgehogs," *The New York Times*, Sept. 5, 2002.

[45] *See* M. Gadziala, "The SEC Examination Perspective," Keynote Address at Glasser Legalworks Broker-Dealer Compliance Conference, New York (May 6, 2003); M. Gadziala, "SEC Risk Management and Compliance Examinations," 2003 Fiduciary and Investment Risk Management Association Fiduciary and Risk Management Seminar (Feb. 26, 2003).

[46] *Id*.

[47] *See* NASD Notice to Members 03-07 (Feb. 2003).

[48] *Id*.

[49] P. Roye, Remarks Before the IA Compliance Summit and Best Practices Update (Apr. 8, 2002).

[50] The SEC staff brought 12 cases against private fund managers in 2002, up from five in 2001. *See* "Hedge Funds May Face Crackdown" (*The Wall Street Journal*, Thurs., Jan. 30, 2003, page C1).

[51] For recent examples of SEC complaints alleging such schemes, *see, e.g.*, *SEC v. House Asset Management L.L.C.*, Lit. Rel. No. 17583 (June 24, 2002) (alleging misleading performance claims, other misleading statements and undisclosed borrowing of client funds); *SEC Charges Ryan J. Fontaine and Signature Investments Hedge Fund With Fraud*, Lit. Rel. No. 17864 (Nov. 26, 2002) (alleging various misrepresentations by an unregistered investment adviser in connection with efforts to sell securities for a hedge fund, including misrepresentation with respect to past performance, amount of funds under management, relationships with auditors and other financial institutions; the principal was a 22-year-old college student who lived with his parents).

[52] *See* "Hedge Funds: The U.S. Securities and Exchange Commission is preparing the rules to rein in short-selling of stocks. More scrutiny likely to follow." *Financial Times* (Feb. 28, 2003, page 17).

[53] *See, e.g.*, *SEC v. Burton G. Friedlander*, Civil Action No. 01 Civ. 4658 (S.D.N.Y.), Lit. Rel. No. 17021 (June 1, 2001); *SEC v. Burton G. Friedlander*, Civil Action No. 01 Civ. 4683 (S.D.N.Y.), Lit. Rel. No. 17315 (Jan. 15, 2002); *In the Matter of Guillermo Wydler*, Investment Advisers Act Rel. No. 2093 (Dec. 23, 2002); *In the Matter of Luis Martinez*, Investment Advisers Act Rel. No. 2094 (Dec. 23, 2002); *In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses*, Investment Advisers Act Rel. No. 2038 (June 20, 2002); *In the Matter of Schwendiman Partners, LLC, et al.*, Investment Advisers Act Rel. No. 2043 (July 11, 2002).

[54] NASD Action (April 2003).

[55] *See* Oversight Plan of the Committee on Financial Services for the One Hundred Eighth Congress (Feb. 5, 2003).

[56] Statement of Ranking Member Paul Sarbanes (D-MD), Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).

[57] Testimony of William H. Donaldson, Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).

[58] *See* P. Roye, Remarks Before the IA Compliance Summit and Best Practices Update (Apr. 8, 2002) ("Hedge fund managers sell their hedge fund shares through private placements. Therefore, they must follow the disclosure and anti-fraud standards of the [1933] Act and the [1934] Act. As part of these standards, hedge fund managers must prepare a private placement offering document, which in many ways is similar to a mutual fund prospectus. Most importantly, hedge fund managers must live by the disclosures made in their offering documents, just as mutual fund managers are bound by the language of their prospectuses.").

[59] *See* "Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds" (www.sec.gov/answers/hedge.htm).

[60] www.growthventure.com/grdi.

[61] *See* Putnam Lovell NBF, "Institutional or Institutionalized – Are Hedge Funds Crazy?" (December 2002).

[62] Eliot Spitzer, speech to Wall Street Hedge Fund Forum (March 3, 2003).

[63] "Hedge Funds: The U.S. Securities and Exchange Commission is preparing the rules to rein in short-selling of stocks. More scrutiny likely to follow." *Financial Times* (Feb. 28, 2003, page 17).

[64] Testimony of William H. Donaldson, Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).

[65] *See, e.g.*, "Short Sellers Are People, Too!," *Wall Street Journal*, Wednesday, Jan. 29, 2003, page A19; "Regulators Review Complaints About Hedge Funds' Research," *Wall Street Journal*, Wednesday, Jan. 22, 2003, page C1.

[66] Pub. L. No. 107-204, 116 Stat. 804 (2002).

[67] Investment Advisers Act of 1940 § 203(b)(3), 15 U.S.C. 80b-3(b)(3).

[68] AIMR Comments on SEC Hedge Funds Discussion, http://www.sec.gov/spotlight/aimrhedgeletter.htm (April 17, 2003).

[69] Testimony of William H. Donaldson, Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).

[70] *See* Putnam Lovell NBF, "Institutional or Institutionalized – Are Hedge Funds Crazy?" (December 2002, page 8); *see also* Greenwich Associates Report "Asset Allocation: U.S. Portfolios Adjust to Difficult Markets in 2002" (April 23, 2003).

[71] P. Roye, "Risks and Opportunities for Public Pension Plans," Keynote Address Before the Public Funds Symposium (July 17, 2001).