

Hedge fund regulation: current trends in the industry

Michael S. Lukaj and Girard M. Healy

Michael S. Lukaj is the Director of Compliance at International Fund Services (N.A.), LLC in New York. Girard M. Healy is a Managing Associate with Beacon Consulting Group in Boston, MA, USA.

Abstract

Purpose – *This paper aims to provide an analysis and report on the current regulatory environment for US hedge funds and explore the latest actions from governmental groups and the private sector.*

Design/methodology/approach – *A compilation of the most recent government communications, legislative proposals, industry newsletters and seminars, and other related sources.*

Findings – *US regulation surrounding hedge funds is in a state of flux. Substantially more pension money being invested in hedge funds has become a very important factor in the discussions. Hedge funds that are already registered are staying so in the vast majority of cases. The consensus is that more regulation is likely; however, what form that regulation will take is still unsettled at this point.*

Originality/value – *Based on first-hand experience working with hedge funds, the authors have endeavored to present and outline the most up-to-date information on this hot-button issue.*

Keywords *Hedging, Legislation, Pensions, United States of America*

Paper type *Research paper*

Introduction

Before he established the first hedge fund in 1949, Alfred Winslow Jones was a freelance journalist for *Fortune* magazine. In an article that laid the groundwork for the first hedge fund, he observed that investment advisers intrepidly collect and analyze macroeconomic facts and figures under the assumption that the data will accurately predict the future direction of individual stock prices, but then he cautioned that “in the meantime, awkward things get in the way” (Jones, 1949).

It may be a slight overstatement, but in 2006, a year in which hedge funds turned in another year of significant growth, some awkward things did get in the way. First, there was the short-lived requirement that hedge fund managers register with the Securities and Exchange Commission (SEC) as investment advisers by 1 February 2006[1]. Then, at mid-year, came the reversal of the requirement by the D.C. Circuit Court of Appeals in the Goldstein case[2]. After that, administrative transition rules issued by the SEC to facilitate compliance with registration requirements were in, out, and then in again. In the court decision’s wake, many hedge fund managers pondered the benefits of remaining registered and considered deregistering. Finally, in the midst of all the awkwardness, SEC Chairman Cox reported that even after Goldstein, many more hedge fund managers registered for the first time as investment advisers than deregistered.

Where, then, does this leave the US hedge fund industry in terms of regulatory oversight? The short answer, if we consider a recent *Wall Street Journal* survey of economists where more than half of respondents believe regulation and supervision of hedge funds is too light, is probably more regulation (Izzo, 2006). To help the reader understand what this additional regulation might consist of requires that we examine the current hedge fund landscape and a few of the drivers behind the important regulatory proposals being circulated. It is also

helpful to characterize some of these proposals as impulsive reactions to Goldstein. This means we need to know who the key players involved in this regulation quandary are. The groups principally concerned are Congress, the SEC, individual states, the President's Working Group on Financial Services (PWG), and the private sector itself.

This article will aim to specifically review the state of the hedge fund industry prior to Goldstein, the extraordinary growth of the industry, various other forms of regulatory oversight already in place, the private sector's own efforts at self-review and supervision, potential legislation under the new Democratic Congress, individual state actions (Connecticut, in particular), and alternatives to more regulation.

State of affairs in the industry prior to Goldstein

The state of affairs in the hedge fund industry before Goldstein can be characterized by a single word: growth. During and despite the important debate taking place about the scope and depth of hedge fund regulation, the industry continued its growth by any measure. It was primarily this growth, multidimensional in nature, that triggered the SEC's effort to regulate the industry in 2005 and 2006.

Several factors were of concern to the SEC and led to the promulgation of the regulations. They included:

- the industry's explosive growth in assets under management;
- the highly publicized failure of long term capital management in 1998;
- a plausible and growing concern over hedge funds' influence in capital markets;
- a growing appetite for hedge funds by institutional investors and the potential impact on retail investors;
- the highly leveraged nature of the trading strategy of many hedge funds; and
- the increase in fraud actions by the SEC against hedge fund advisors.

Further frustrating the SEC was the relative lack of hard data and transparency concerning the true impact and reach of hedge funds. These concerns, especially the burgeoning of the industry, prompted the SEC to issue rules that would require hedge fund managers to register with the SEC as investment advisers.

The registration rule

In general, investment advisers are required to register with the SEC if, among other requirements, they meet certain thresholds with respect to assets under management and number of clients. Investment advisers are exempt from registering with the SEC if they provide investment management services to fewer than 15 clients. Determining how a client is defined was the crux of the Goldstein decision. The typical hedge fund manager provides services to fewer than 15 hedge funds. In 2005, however, the SEC issued Adviser Act Rule 203(b)(3)-2 requiring hedge fund managers to "look through" the hedge fund's legal entity and count the number of "shareholders, limited partners, member or beneficiaries of the funds" as clients. Previously, the definition of a client had been determined by reference to where the investment adviser's fiduciary responsibility lied – usually at the entity level. Since most hedge fund managers handle multiple funds with multiple investors, getting to the 15-client threshold was unavoidable. The new definition of client had the effect of requiring nearly all hedge fund managers to register as investment advisers, but only if they permitted investors to redeem their interests in a hedge fund within two years of investing. Registration meant that hedge fund managers would have to submit to SEC inspections, enhance their record keeping disciplines, adopt compliance procedures, and follow performance-reporting rules, among other obligations.

Opponents of hedge fund regulation had long argued that the previous level of regulatory oversight from the SEC and banking regulators was appropriate. They added that the two highly publicized hedge fund failures were caused by trading strategies and would not have been prevented by registration. They also believed that the demands and efficiencies of the

free market spurred the remarkable growth in the hedge fund industry and that any additional regulation that injected uncertainty and additional costs into the equation would place the US hedge fund industry at a significant competitive disadvantage.

Multi-dimensional growth

The hedge fund industry has benefited from investors' continued demand for alpha-generating investment opportunities and diversification. It is estimated that there are currently approximately 7,100 hedge funds operating with over \$1.337 trillion dollars in assets under management[3]. In the last five years, the number of hedge funds has doubled and assets under management have tripled.

Hedge funds have also achieved an important role in global capital markets by providing opportunities for capital formation, pricing, and liquidity. They are also a key part of risk management programs for counterparties. The Bank for International Settlements estimates that hedge funds now account for one-third of foreign currency exchange volume. Additionally, it is estimated that hedge funds account for 5 per cent of total assets under management and an impressive 30 per cent of all US equity market trading volume. In some cases, hedge funds are even using their substantial influence to affect a company's management and to force restructurings and strategic change at companies in which they invest.

The appeal of hedge funds has also grown among an increasingly diverse set of investors. According to the Bank of New York[4], the demand for hedge funds by public and private pensions and other institutions will increase from \$360 billion currently to more than \$1 trillion by 2010. Underscoring a broader acceptance of alternative investments' ability to deliver market-beating investment returns, the study also estimates that 25 per cent of institutions, up from 15 per cent today, will make hedge funds a part of their investment portfolios by 2010. "Retailization," or the offering of hedge funds to other than sophisticated investors, has been a major concern of the SEC. While most retail investors are not eligible to invest in hedge funds because they do not meet the definition of an "accredited investor," the growth in the appeal of hedge funds to large institutional investors, such as private and public pension plans, indirectly exposes retail investors to the risks associated with hedge fund investing.

The hedge fund market is beginning its transition to a "maturing" market, meaning that while the industry will continue to grow, the rate of growth will likely begin to slow. Growth will continue because hedge funds generally do not restrict their investment strategies and tend to seek innovative investment vehicles to create alpha-generating opportunities for their investors. Market maturity also means that start-ups will be fewer in number because they may find it increasingly difficult to compete with the ability of larger, established managers to attract new investors. There will probably be fewer, but larger funds as well-established managers become "asset gatherers" The profile of the typical hedge fund investor is changing, and that investor is placing requirements on hedge fund managers that play to the scale of larger funds. The growth in institutional investors means more controls and infrastructure must be in place and that a track record of market-beating performance takes on more importance.

Oversight

The perception among many in the public is that hedge funds are unregulated and not subject to oversight from anyone, not even their investors. The reality, however, is that while hedge funds are not regulated by virtue of their status as hedge funds, their investment activities and certain offering activities cause them to fall under the domain of several regulatory and industry standard-setting bodies. Even prior to Advisor Act Rule 203(b)(3)-2, the hedge fund industry was, and remains, subject to many elements of the SEC's broad civil liability and anti-fraud authority. Hedge funds (mostly funds of hedge funds) that are offered through brokers have to deal with extra scrutiny and comply with standards set by industry groups that oversee the offering of investment products.

Furthermore, the SEC has been increasingly active in disciplining hedge funds, issuing over 90 enforcement actions since 2000[5]. The SEC's Office of Compliance Inspections and Examinations (OCIE) has examined approximately 400 hedge fund managers who registered with the Commission prior to the registration requirement[6]. In fiscal year 2006, the SEC examined approximately 750 privately offered investment funds[7], and many of these reviews were performed under already existent authority. The OCIE has acknowledged that the volume of hedge fund reviews helped it make a quick ascent of the learning curve and build a body of knowledge that increased the effectiveness of subsequent exams. With each review, the OCIE refined the scope of activities it placed under review to target areas that the SEC deems to be of increased risk and concern for hedge fund investors. The funds are also subject to a number of reporting requirements, including the ownership reports under 13(d) and 13(f) of the Securities Exchange Act of 1934.

Retailization of hedge funds and the promotion of hedge funds, especially funds of hedge funds, to investors has been a major concern. The offering of funds of hedge funds by brokers represents a small portion of new investments in hedge funds and these activities fall under the jurisdiction of the National Association of Securities Dealers (the NASD), which sets standards regarding the sales-material content and distribution of all investment products by brokers. The NASD provides guidance regarding the required disclosures and representations that can be made when offering hedge funds. It stipulates controls over hedge fund distribution, including the requirement to explain the risks of investing in hedge funds, assessing the general suitability of an investment product to any investor, and assessing the suitability of an investment product to a specific investor. The NASD also mandates that internal controls must be appropriately designed and operating effectively and that those brokers are provided with training on the fundamentals of the product being offered.

The NASD can levy fines and impose sanctions against brokers and others who misrepresent the risks associated with investments in hedge funds or fail to perform due diligence on the background and experience of hedge fund managers.

Hedge funds must also follow other regulations, depending on their size and activities, including commodity-trading rules and state regulations. Exchange rules apply to hedge fund activities, including the use of leverage and margin requirements. Offshore funds must comply with local exchange requirements and local rules and regulations.

Market landscape – investors, creditors and counterparties

In general, hedge fund investors, creditors, counterparties, and market forces have shaped the environment in which hedge funds operate and have struck a balance among risk, transparency, and innovation. As former Federal Reserve Board Chairman Alan Greenspan once said, "Hedge funds are strongly regulated by those who lend the money."

Many hedge fund managers had already registered as investment advisers before the hedge fund rule was issued. Some performed investment advisory services that required them to comply with registration because perhaps they advised a separate account or provided services to 15 or more clients. In response to concerns by investors, especially institutional and foreign investors, other hedge fund managers voluntarily registered in order to take a potential sticking point off the table and streamline the due diligence process undertaken by potential new investors. Many institutions have investment policy statements, which stipulate that discretionary power with regard to buying, managing, and selling investment assets can only be granted to registered investment advisers. Other hedge fund managers have adopted registration as a best practice and provide their Form ADV even before being asked for it by the potential client. In addition, there is pressure on hedge fund managers to register from trustees of Employee Retirement Income Security Act (ERISA) plans who face more liability if they hand over money to unregistered managers than they would if they dealt with registered managers.

As hedge funds become an important part of creating investment returns for public pension funds, the experience and expertise of pension fund trustees and the related processes, policies and procedures under which they make investment decisions is sure to be subject to increased marketplace scrutiny. Investment and risk management expertise will be required to ensure that due diligence and continual oversight of funds invested in hedge funds occurs.

Counterparty risk management has been a primary focus of the industry in recent years. In response to the long term capital management (LTCM) failure in 1998, which many observers attribute to the aggressive extension of credit by banks with little regard for creditworthiness or collateral, many banks and other lending institutions have tightened their credit policies and procedures with respect to hedge funds.

Lenders have adopted stricter credit assessment guidelines and are demanding greater transparency into a hedge fund's portfolio composition, especially the details regarding other debt obligations. A significant side business has developed in the industry where service providers offer risk analytics to help counterparties assess creditworthiness. Other initiatives have been launched to test and enhance the controls and methods around assessing the quality of the counterparties' data and processes. Lenders now combine the scale that risk management systems offer with analytical testing that includes stress tests, scenario analyses, and liquidity-adjusted metrics. Increased training and investment in staff have also strengthened the level of judgment utilized in extending credit.

The counterparty controls that the industry has implemented have coincided with increased scrutiny of hedge fund activity by banking regulators. Bank regulators are targeting known risk areas during their reviews. One issue that bank examiners have reviewed with success involved the explosive growth of the credit derivatives market. The practice of assigning trades of over-the-counter derivatives is common and contributes to credit market liquidity. According to the Federal Reserve, the assignment of trades from one counterparty without the consent of the other, even when the trade documentation called for consent by all parties, was formerly widespread. However, the Federal Reserve believes that the practice of unauthorized assignments is now rare. Under another bank examiner initiative in New York, total credit derivative confirmations outstanding for more than 30 days fell 70 per cent between September 2005 and March 2006[8]. This facilitates the creation of a paper trail in the event of a failure and strengthens operational confidence among counterparties.

More recently, the focus on enhancing hedge fund transparency and counterparty risk management has prompted a number of marketplace innovations aimed at helping hedge fund managers, investors, and creditors monitor risk. Moody's, for example, has launched a quality ratings service that assesses a hedge fund's operational risk. The agency assesses key components of operations, including valuation processes and third party service providers. They also perform manager background checks. The rating also includes an evaluation of the autonomy of the risk management reporting structure and an assessment of its independence from portfolio management responsibilities. For some hedge funds, a strong operational risk rating could prove to be a useful competitive tool in attracting and maintaining investment funds.

Morningstar has also expanded its mutual fund monitoring brand and now offers a similar rating formula to track the performance of hedge funds. It provides performance data, risk measurements, and manager profiles that can help investors evaluate their portfolios more effectively. Morningstar expects investor demand to persuade traditionally tight-lipped hedge funds to divulge more performance and other data.

Changing of the guard and potential hedge fund legislation

As power in US Congress shifts from the Republicans to the Democrats, the question for many is whether that power shift increases the likelihood of legislative change or increases the potential for gridlock. What both political parties do appear to agree on is that any final rules must not affect the investment strategies of hedge funds and should not be too costly to implement.

When reading tea leaves, it is helpful to start with key facts. Both parties were the beneficiaries of substantial campaign contributions by the hedge fund industry. Interestingly, Democrats garnered two-thirds of campaign contributions made by the 100 largest hedge funds[9]. Has this fact affected policymaking? Well, before the November 2006 election, Representative Barney Frank (D-Mass.) introduced the SEC Authority Restoration Act of 2006 (H.R. 5712) to the House of Representatives, which seeks to restore the SEC's authority to require hedge fund managers to register as investment advisers by counting investors in funds as clients. The legislation was an impulsive reaction to Goldstein to reinstate the hedge fund registration rule. Now that the election is over, Frank is Chairman of the House Financial Services Committee and is establishing his legislative priorities, which according to Bloomberg News, will be pointing in "a more working-family and consumer-friendly direction." Frank noted that hedge funds are marketed to wealthy individuals and as such, he will not seek "overall regulation of hedge funds". Furthermore, John Gaine, president of the Managed Funds Association (MFA), a Washington, DC-based membership organization and the industry's main trade group, added, "I think (Frank) is going to do a careful examination of the industry, working with his counterparts on the committee" (Vekshin, 2006). In the end, if Washington's focus is the working-family and the consumer, it seems that Wal-Mart's managers may have more to worry about than hedge fund managers will.

It is, nevertheless, likely that some form of hedge fund manager regulation will take place. Democrats and the SEC have expressed anxiety about the retailization of hedge funds. The Bank of New York study cited above indicated that most of the growth in institutional hedge fund investment would be from US corporate and public retirement funds. Given the recent highly publicized failure of Amaranth Advisors, widespread interest in reducing the exposure of retail investors to hedge funds will increase the odds that some legislation will pass. This means that hedge fund managers who take in money from pension funds will likely have to contend with some form of registration requirement. Senator Arlen Specter, the Chairman of the Senate Judiciary Committee, has recently distributed a legislative proposal that would require hedge funds that accept pension-fund money to register (Westbrook and Bilodeau, 2006).

Senator Charles Grassley (R-Iowa), believes hedge funds are a serious danger to the country's pension funds and is calling for much more transparency in the industry. He stated in a letter, "I am deeply concerned about the lack of information regarding hedge funds . . . the potential for significant losses at our nation's pension funds due to hedge fund investments could put the retirement security of America's workers in jeopardy" (*Daily Institutional Investor*, 2006a).

Another proposal involves The President's Working Group, which includes the US Treasury Secretary and the Chairs of the Federal Reserve Board, the SEC, and the Commodity Futures Trading Commission. The Hedge Fund Study Act (H.R. 6079), which passed in the House on 27 September 2006, requires the group to study how hedge funds are affecting financial markets. It must then report back with recommendations to Congress on the following specific areas:

- Any proposed legislation relating to appropriate disclosure requirements for hedge funds.
- The type of information hedge funds should disclose to regulators and to the public.
- Any efforts the hedge fund industry or regulators of financial institutions should undertake to improve practices or provide examples of successful industry initiatives.
- Any oversight responsibilities that members of the PWG should have over the hedge fund industry, and the degree and scope of such oversight[10].

A key driving force behind H.R. 6079 is the amount of pension money coming into the hands of hedge funds. This has increased concerns on the part of Congress that more and more middle-income investors will be exposed to higher-risk investments in hedge funds.

Representative Scott Garrett (R-New Jersey), who co-sponsored the act, stated the following before a House assembly:

Hedge funds . . . can be a high-risk, high-stake investment. While they are usually targeted to wealthy investors, hedge funds are increasingly tied to pension plans and, consequently, to the financial earnings of millions of middle-class Americans. For that reason, I think it is necessary that we further explore hedge funds and the potential impact and benefits that they offer to the financial markets and investors as well.

Another stated reason for the creation of the study group is the perceived fear of having another large hedge fund collapse that could have serious consequences to the US financial system.

The PWG's recommendations should dramatically steer the direction of hedge fund regulation if the study group is authorized to move forward.

Individual states

While there has been significant interest on the part of particular states to get involved in filling in any perceived regulatory void in the hedge fund industry, none has probably been more concerned than the State of Connecticut (or more accurately, Fairfield County), which is considered by many to be a hub for hedge fund managers.

Connecticut's Attorney General, Richard Blumenthal, has taken considerable interest in the perceived regulatory void around hedge funds. The driving impetus behind Blumenthal's special focus on hedge funds would be the collapse of Amaranth, which just happened to be based in Stamford, CT. The Attorney General has jumpstarted his review by organizing a separate state task force to examine the need for additional regulation of hedge funds.

Blumenthal declared in his closing statement during a "60 Minutes" interview in March of 2006:

Joe Mainstreet can be impacted nowadays by hedge funds as never before. They control more money. They have more power. They're the elephant in the room that is unacknowledged a lot of the time. But they can hold huge market sway, and that's the reason why we need to know more about them, and I'm investigating so that hopefully there is more disclosure and transparency (Blumenthal, 2006).

State-level regulators' involvement in hedge fund regulation has not been welcomed by hedge fund managers. Hedge funds are not receptive to the idea of having to contend with separate state rules or what some have referred to as the "Balkanization" of hedge fund regulation, preferring instead to deal primarily with one federal regulatory body, like the SEC. States that are bent on strengthening hedge fund regulation will need to overcome two "minor" obstacles:

1. prevail in a likely constitutional challenge; and
2. invalidate each hedge fund's option to terminate its current lease and move to a more hedge-fund-friendly state.

Alternatives to heavier regulation

In an effort to devise some interim solutions to protect investors, the SEC announced in mid-December of 2006 that it would consider two new measures. The first measure entails raising the minimum "accredited investor" standards. Currently, the thresholds require a \$1 million dollar net worth (with one's real estate equity allowed to be included in the calculation) and a \$200,000 (\$300,000 if one includes a spouse) minimum annual salary for the previous two years. The current standards have been unchanged since 1982. The new proposal raises the minimum net worth level to \$2.5 million (without counting one's home) and increases the minimum salary requirements. Most current hedge fund investors would undoubtedly meet these higher thresholds. The second new measure would further strengthen the current anti-fraud statute for hedge funds (*The New York Times*, 2006).

Another idea floating around as an alternative to further government regulation of hedge funds involves establishing a peer-review style of regulation for hedge funds. The idea is not

a new concept in the financial services world, and would operate in a manner similar to the way in which public accounting firms were regulated before the creation of the Public Company Accounting Oversight Board. However, in light of all the government attention hedge funds have been receiving, the chances of the industry being permitted to oversee and review itself are slim at best.

Conclusion

It seems that not a week goes by without there being another story on the topic of hedge fund regulation, even at the international level, where Germany is said to have suggested that hedge funds be added to the agenda for the next G8 meeting.

The final scope and impact of the latest round of speculation on hedge fund regulation could prove, at the end of the day, to be far less consequential than the industry initially feared, especially considering the post-Goldstein hyperbolic reactions articulated by many. The marketplace is ahead of regulators in responding to counterparty risk concerns and investor requirements for transparency. Consider, for example, the latest Ernst & Young survey, which indicates that eight out of ten hedge funds that are registered with the SEC plan to stay registered. The topmost motivation for doing so, according to the survey: to satisfy current and prospective investor preference (*Daily Institutional Investor*, 2006b).

Congress is not likely to take hedge funds off its radar screen. Hedge funds' increasing share of pension fund investments, trading volume, and their increasingly prominent roles as activist shareholders ensures that they will be of continued interest. Large-scale regulation is not likely though. Raising the accredited investor standards and new rules for managers of pension funds are in progress.

Ultimately, the future drivers of hedge fund regulation will be the real or perceived influence that hedge funds exert on the financial markets, their contribution to market volatility, and their impact on the everyday investor. As Congress and the SEC continue to better understand that impact, the debate over the extent of regulation is likely to reignite.

Notes

1. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333, File No. S7-30-04 (10 December 2004).
2. *Goldstein v. Securities and Exchange Commission*, No. 04-1434 (D.C. Cir. June 23, 2006).
3. HFR Industry Report – 3Q 2006. Hedge Fund Research, Inc.
4. Institutional Demand for Hedge Funds 2: A Global Perspective. Bank of New York and Casey, Quirk and Associates LLC (October 2006).
5. Testimony Concerning the Regulation of Hedge Funds, SEC Commissioner Christopher Cox, July 25, 2006.
6. Remarks before the SIA Hedge Funds and Alternative Investments Conference, SEC Commissioner Roel Campos, 14 June 2006.
7. US Securities and Exchange Commission – 2006 Performance and Accountability Report. www.sec.gov/about/secpar2006.shtml
8. Testimony of Patrick M. Parkinson, Deputy Director, Division of Research and Statistics, Before the Subcommittee on Securities and Investment, Committee on Banking, Housing, and Urban Affairs, US Senate, 16 May 2006.
9. Federal Election Commission – Campaign Finance Report and Data. www.fec.gov/disclosure.shtml
10. See HR 6079, "To require the President's Working Group on Financial Markets to conduct a study on the hedge fund industry."

References

Blumenthal, R. (2006), "Betting on a fall: Lesley Stahl on one company's lawsuit against a hedge fund", 60 Minutes, 26 March.

Daily Institutional Investor (2006a), "Hedge funds face regulatory music", *Daily Institutional Investor*, 17 October.

Daily Institutional Investor (2006b), "Most hedge funds remain registered with SEC", *Daily Institutional Investor*, 5 December.

Izzo, P. (2006), "Getting a grip on hedge fund risk", *The Wall Street Journal*, 13 October.

Jones, A.W. (1949), "Fashion in forecasting", *Fortune*, March.

(The) New York Times (2006), "SEC delays weighing hedge rules", *The New York Times*, 2 December.

Vekshin, A. (2006), "Frank to push CEO pay curbs, wait on hedge-fund rules", *Bloomberg News*, 8 November.

Westbrook, J. and Bilodeau, O. (2006), "Republican Senator seeks to prevent insider trading tied to hedge funds", *International Herald Tribune*, 24 November.

To purchase reprints of this article please e-mail: reprints@emeraldinsight.com
Or visit our web site for further details: www.emeraldinsight.com/reprints