

# SECURITIES INDUSTRY **NEWS**

## Advisers May Find Themselves Targets in Hedge Fund Regulation

### Reed: Hedge funds escape oversight

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In a bellwether hearing Wednesday, members of the Senate were told that regulation of hedge fund advisers--an approach already tried by the Securities and Exchange Commission--is the cornerstone to crafting a regime for hedge fund oversight.

"The adviser approach is the minimum that is necessary," said Andrew Donohue, director of the SEC's Division of Investment Management, at a hearing on hedge fund regulation called by the Senate securities subcommittee, chaired by U.S. Senator Jack Reed (D-RI).

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Donohue spoke of a "regulatory gap" under which hedge funds continue to escape federal oversight despite the fact that they manage \$1.4 trillion in assets and account for 18 to 22 percent of all trading on the New York Stock Exchange.

He supports the adviser approach over its main rival, regulation of the hedge fund itself. That alternative would be achieved through the Investment Company Act, a 1940 law defining and regulating investment companies of various types, including mutual funds, and largely aimed at protecting retail investors.

A concern if this statute is used for hedge funds, which are designed for wealthy investors and institutions, is that it might open the door to heavier, mutual-fund-like regulation.

"The Investment Company Act is really intended for retail investors," Donohue told the subcommittee. "Investment adviser registration is appropriate for any adviser managing \$30 million or more."

Since the financial crisis erupted last year, there has been general agreement that greater oversight of hedge funds is inevitable. Now, as Wednesday's hearing made clear, there also appears to be agreement on what type of oversight that should be. "There absolutely will be registration of hedge funds under the Investment Advisers Act," said one prominent industry figure, signaling a shift in stance that puts the hedge fund industry on the same page as many of the key Congressional players in the hedge fund arena.

At the July 15 hearing, the hedge fund industry's support for adviser registration was voiced by witness Dinakar Singh, founder and CEO of TPG Axon Capital and a member of the Managed Funds Assn. (MFA) the main hedge fund trade association. Speaking for the MFA, Singh said "We believe mandatory registration of investment advisers is the right approach" to hedge fund regulation. Singh added that MFA supports this type of registration not only because many hedge fund advisers are already registered voluntarily with the SEC, but also because the Investment Advisers Act "provides a meaningful regulatory framework for investment advisers."

Central to the emerging consensus is a bill introduced by Reed that appears to have the blessing of the industry as well as the Obama Administration, whose own proposal it resembles. "The bill represents an intelligent approach to tackling financial regulatory reform," said Richard H. Baker, president and CEO of the MFA, the day after Reed

introduced the bill on June 16.

That represents a significant shift. Before the near-collapse of global financial markets last year caused severe damage to the hedge fund industry, the industry was staunchly against any type of increased hedge fund oversight by the SEC. Now, acknowledging that regulation is inevitable, the industry, via the MFA, has chosen to throw its weight behind the least objectionable form of registration, represented by the Reed bill.

It may be the best the industry can expect. The bill requires that advisers file Form ADV with the SEC, which includes such disclosures as basic information about the applicant, scope of business, nature of the clientele, and fees. Sensitive information, such as levels of leverage and institutional interconnectivity, would remain confidential. Significantly, as Singh noted, many hedge fund advisers have chosen on their own to register with the SEC, and so are already in compliance with any new registration requirement.

### **Focus on the Adviser**

The favored Reed bill, the Private Fund Transparency Act of 2009, amends the Investment Advisers Act of 1940 to require advisers to hedge funds, private equity funds, venture capital funds and other private investment pools to register with the SEC. Among other things, advisers managing over \$30 million in assets would be required to fill in a detailed disclosure form, and give the SEC authority to collect information from the industry and other investment pools (see table). Advisers can be used as proxies because they sponsor and control the fund.

The bill is similar to an earlier effort that the SEC tried on its own to beef up hedge fund regulation. The rule took effect in February 2006, and was struck down on June 23 2006 when the U.S. Court of Appeals for the District of Columbia vacated it on the grounds that it was not compatible with the Investment Advisers Act. The decision said that the SEC had improperly extended its authority to redefine the term "client" in a way that could require hedge fund advisers to register.

There are some differences from the SEC's earlier attempt. One is a broader scope. In 2004, the SEC had an exception for funds with a two-year lockup or more, specifically designed to eliminate advisers to private equity funds and venture capital funds.

Private equity funds and venture capital funds are specifically included in the Reed bill. "I am not hearing anyone talk about a carve-out," says one industry expert.

Still, the impact on the industry is likely to be minimal. "Hedge funds were prepared to do this before," says Monica Arora, a partner at White & Case, a global law firm based in New York. "The more established players are either prepared for it, or have required systems in place already."

"I don't think the impact [on operations] will be very dramatic," adds Richard Goldman, a securities partner in the Boston office of law firm Bingham McCutchen LLP. "Most hedge funds--even if they are not registered--are acting as if they are."

### **Focus on the Fund**

Not so with the approach taken in the other major Senate bill, the Hedge Fund Transparency Act of 2009, introduced on January 29 by Senators Carl Levin, D-MI, and Charles Grassley, R-Iowa. It focuses on the hedge fund itself, rather than the adviser, and accomplishes regulation by closing exemptions in the Investment Company Act of 1940, the same vehicle used for comprehensive regulation of mutual funds.

While many of its requirements are similar to those in the Reed bill-- it would, for example, require funds with \$50 million or more in assets to register with the SEC, file an annual disclosure form, and maintain books and records as required by the SEC--it also spells out specific information to be made available to the public, including the names of companies and individuals who are the "beneficial owners" of the hedge fund, along with an explanation of the ownership structure.

"The entity would not be the adviser, but the fund," says Anita Krug, a partner specializing in hedge funds at law firm Howard Rice in San Francisco, and a research fellow at the Berkeley Center for Law, Business and the

Economy. "The Reed bill eliminates the exemption for registered investment advisers. It gives the SEC authority to request information from advisers to private funds."

The industry is concerned that the Levin bill focuses on reporting requirements, including the identities of "beneficial owners," which most experts construe as investors in hedge funds. While Levin later clarified this as referring to the identities of people entitled to a piece of the fees coming off the hedge fund, "it reads how it reads," says Krug.

Another problem with the bill in the eyes of the industry is that it contains a laundry list of things that have to be provided that could be made public (see table). Reed's bill doesn't specifically contain these types of things, and sensitive information would be treated confidentially.

### **Mutually Exclusive?**

An additional worry is that regulation under the Levin measure falls under the Investment Company Act, the same statute as mutual funds. While the Levin bill would subject private funds to less regulation than mutual funds, "There is concern that it could be a slippery slope leading to the mutual fund level of regulation," says Goldman "The concern is--because of the limits on who can be in a private fund--there is no need to subject them to all of the regulations that a mutual fund is subject to."

Otherwise, as Krug notes, whether the focus is on the fund or the adviser, it is the adviser who would be coordinating it. As to her prognosis, "the industry is behind investment adviser regulation," she says. "It is manifest in the Reed bill. The industry is saying that it is okay with us, and so is the Obama Administration. This seems to be where the minds are meeting."

## **Two Approaches to Hedge Fund Regulation**

### **Private Fund Transparency Act of 2009**

Introduced by: Senator Jack Reed. D-RI, on June 16

#### **Main provisions:**

- \* Requires all hedge fund advisers and other investment pool advisers managing more than \$30 million to register with the SEC under the Investment Advisers Act.
- \* Provides the SEC with authority to collect information from the hedge fund industry and other investment pools, including risks they may pose to the financial system.
- \* Authorizes the SEC to require hedge fund advisers to maintain and share with other federal agencies information, such as levels of leverage and institutional interconnectivity on a confidential basis, to calculate systemic risk.
- \* Clarifies other aspects of the SEC's authority to strengthen its ability to oversee registered investment advisers.

#### **Advantages:**

In line with the Obama administration's proposal. Also has the support of the hedge fund industry, which will not lobby against it.

#### **Disadvantages:**

Seen by some as little more than a business-as-usual rerun of the SEC's 2006 effort. Many of the disclosures to regulators would remain confidential.

**Chances of passage:**

Good

**Hedge Fund Transparency Act of 2009**

Introduced by: Senator Carl Levin, D-MI, and Senator Charles Grassley, R-Iowa, on January 29

**Main provisions:**

\* Requires all hedge funds with \$50 million or more in assets to register with the SEC under the Investment Company Act.

\* Requires filing of an annual disclosure form with the SEC basic information that will be made publicly available, including names of beneficial owners of the hedge fund, explanation of the ownership structure, names of any financial institutions with which the hedge fund is affiliated, minimum investment commitment, total number of investors, primary accountant and broker, and the current value of assets.

\* Authorizes the SEC to seek additional information that it deems appropriate.

**Advantages:**

Gives the public access to a wide variety of hedge fund information.

**Disadvantages:**

Lacks a broad base of support; employs untried focus on hedge fund and Investment Company Act; staunchly opposed by the industry.

**Chances of passage:**

Uncertain.

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