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Has Hedge Fund Regulation Hit a Wall?

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By Carol E. Curtis

The hedge fund industry has largely accepted regulation as inevitable, and legislators have called it a priority, but despite the apparent momentum, there is little to indicate that federal oversight will become a reality anytime soon.

Prompted by risk concerns highlighted by scandals and the financial crisis, Congress has introduced several bills addressing hedge funds. While the two main measures each take different approaches, neither is given much chance without key players signing on. Yet to make their positions clear are Christopher Dodd, chairman of the Senate Finance Committee, and House Financial Services Committee chairman Barney Frank, who may do so by introducing bills of their own.



Meanwhile, state legislators are attempting to step into the breach. In Connecticut, three bills were introduced in January, each with a specific--if narrow--focus. One bill would require hedge funds to obtain a license, and another would mandate greater disclosure; a third seeks to restrict investors to individuals with more than \$2.5 million in assets and institutions with over \$5 million.

According to Monica Arora, a partner in law firm White & Case's investment funds group in New York, the Connecticut bills are a "patchwork" attempt to address issues that are being dealt with more comprehensively by two federal bills--the Hedge Fund Transparency Act in the Senate, and the Hedge Fund Adviser Registration Act in the House.

Focus on the Fund

The former, introduced by Senators Charles Grassley, R-Iowa, and Carl Levin, D-Mich., is a departure from previous attempts to regulate hedge funds because it focuses on the fund rather than the adviser to the fund. It would require hedge funds with more than \$50 million in assets to register under the Investment Company Act of 1940, provided that they meet certain requirements. Funds also would have to supply the Securities and Exchange Commission with information such as the identity of the fund's beneficial owners. All private funds, regardless of asset size, would be subject to certain anti-money-laundering requirements.

While hedge funds are the bill's primary target, it covers venture capital and other private equity finds, as well as special-purpose structured financial entities.

The rationale for looking at the fund rather than the adviser goes back to problems that surfaced around the time of the New Deal, when abuses were uncovered by mutual fund boards, according to Anita Krug, a partner in San Francisco-based law firm Howard Rice Nemerovski Canaday Falk & Rabkin. The Investment Company Act, which contains a broad array of investor protections, was intended to eliminate those abuses.

In the case of the hedge fund industry, the shift in focus may stem from the heightened concern among regulators about the systemic risk created by large funds, says Krug. With the financial markets becoming increasingly complex, counterparties and creditors need to know more about hedge funds' positions and concentrations, and the degree of leverage embodied in them.

While the Senate bill would bring hedge funds under the Investment Company Act, it would exempt them from the full panoply of requirements that mutual funds face. For example, hedge fund managers themselves would not need to register with the SEC.

The Investment Advisers Act of 1940, by contrast, addresses investment management professionals. "It was not as clear cut that the Investment Advisers Act was necessary," says Krug. Nevertheless, prior attempts to regulate hedge funds have centered on the adviser, and the act is the basis of the House's latest hedge fund oversight effort, a bill introduced in late January by Reps. Michael Capuano, D-Mass., and Michael Castle, R-Del.

That bill would require all investment advisers with U.S. clients to register with the SEC, eliminating the private adviser exemption that advisers to hedge funds commonly rely on. Advisers would have to file Form ADV with the SEC, which would be allowed to conduct compliance inspections. Other provisions include the establishment of compliance policies and procedures and the appointment of a chief compliance officer.

Of course, neither bill would be necessary had the SEC's hedge fund registration rule, which took effect in February 2006, not been struck down four months later by the U.S. Court of Appeals for the District of Columbia Circuit. That rule applied to hedge fund advisers.

Key Players Absent

For the legislation under consideration, the most significant factor may be the lack of key supporters. For a bill to gain traction, say experts, it is important that it have the sponsorship of a member sitting on the committee that must approve it, preferably the chairman. "The bill we are interested in seeing will come from Dodd, as chairman of Senate Banking," says a hedge fund executive who is a former Capitol Hill staffer. "Neither Grassley nor Levin are members of the committee of jurisdiction."

He says that the hedge fund industry strongly objects to the Senate bill. "What they are doing probably isn't the right approach," says the source. "It should be done through the adviser. What we believe is that Chris Dodd and Richard Shelby [the ranking Republican on the committee] will be driving regulatory reform. It is doubtful that Dodd will take this bill and make it his."

In the House, Barney Frank, D-Mass., is "the epicenter," according to the hedge fund executive. "He will determine what happens. The chairmen are going to be the ones driving this train."

The direction may not be clear, but observers agree that regulation is coming. "Something is going to happen," says White & Case's Arora, who feels that the Senate bill's chances are slim. "I don't think this will go through in its current form," she says. "One of the biggest issues is that the bill requires disclosure of ownership. Investors would be disclosed to the SEC. ... On its face, that would need to be clarified."

Nor does the bill address offshore issues. "The old approach was specifically tailored for hedge funds," she says. "This bill applies to all private funds." The proposal is also problematic, adds Arora, because it inadvertently captures "hedge funds in other statutes that are talking about registered investment companies."

Krug of Howard Rice sides with those who feel that the adviser should be the target: "I would not be surprised if something is enacted that requires larger managers to become registered under the Investment Advisers Act, plus measures requiring additional disclosure."

Robert Leonard, a partner and hedge fund attorney with Bingham McCutchen in New York, has a dim view of the Grassley-Levin measure. "The bill appears to have been written by someone in the mutual fund business," he says. "It is somewhat slapped together." Leonard suggests a return to what the SEC tried to do three years ago.

The industry's main trade group, the Managed Funds Association (MFA), has called regulation all but certain and is seeking to make the legislation that emerges as friendly to hedge funds as possible. But Roger Hollingsworth, EVP and managing director for government relations at the MFA, does not believe the House or Senate bills will become law. Beyond that, "We have heard Congressional leaders and the president indicate that a comprehensive examination of the financial regulatory system is an early priority," Hollingsworth says. "Part of this is taking a look at all financial market participants, including hedge funds."

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