A REGULATOR LOOKS AT SOME UNREGULATED INVESTMENT COMPANIES

THE EXOTIC FUNDS

Address by

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As a result of my experience as a State administrator and member of the Securities and Exchange Commission, it is clear to me that there must be cooperation between all agencies charged with the prevention of fraud in the sale of securities. It is also clear to me that a meaningful dialogue between State securities administrators, the Commission and industry spokesmen is a necessary part of any cooperative effort in the securities industry. This morning I will review some significant developments in the securities industry in the hope that the discussion will promote the kind of dialogue which will benefit our mutual goals.

One of the most interesting developments that has recently come to the Commission's attention is the formation of a spate of unique and exotic investment vehicles generally known as hedge funds. This phenomenon is properly categorized as a problem confronting the Commission only insofar as the discharge of our public trust requires us to look ahead to anticipate steps necessary for investor protection.

The term "hedge fund" has been used broadly to describe registered or unregistered investment companies which employ special speculative investment techniques. The words "hedge fund" have been applied generally, however, to the so-called private investment partnerships which employ the investment techniques of leveraging and hedging. In the interest of clarity, therefore, I will refer to the private investment partnerships as hedge funds.

The primary thrust of this discussion will be developments in the hedge fund area; to a lesser degree, this discussion will also touch on related developments in regard to offshore funds.

To those familiar with Wall Street lexicon, to hedge means simply to sell short to protect a long position. It is reported, however, that most hedge funds, in addition to selling short, depend to a significant extent upon the use of margin accounts, bank loans, and the writing and buying of options. Some hedge funds also invest in restricted securities, but it has been said that the resulting lack of liquidity is considered a drawback by some hedge fund managers.

Conventional wisdom has it that the dominant investment technique of a hedge fund is to leverage its assets as much as is possible; that is, it borrows on some securities and buys others on margin. This

leveraging is utilized to establish a long position in the fund's portfolio, then hedging, or selling short, is used to protect partially the fund's long position in the event management has misjudged the market trend. I am limited to relying on conventional wisdom because the Commission does not presently have sufficient information on which to base unqualified statements on the nature of the hedge funds' investment techniques. It is more or less an open secret, however, that this lack of information will soon be remedied, since the staff has gathered data on hedge funds and is in the process of analyzing this data. Our Institutional Study will also have a look at hedge funds. I will have more to say on the subject of the Study in a moment.

The lack of information on hedge funds is explained in part, of course, by the fact that we have no registration data to refer to because of claimed exemptions or exceptions by the funds from the registration requirements of the various federal securities laws. Hedge funds fit the definition of investment companies in Section 3(a)(1) of the Investment Company Act of 1940. That section defines an investment company as any issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities . . . ." Section 3(c)(1) of the Investment Company Act excepts, however, from the definition of an investment company an issuer whose outstanding securities are owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. Most hedge funds, in order to come within this exception, are structured to avoid a public offering and to limit the number of partners to less than one hundred persons. In this regard, it is sufficient to note that the exception exists; it may or may not be applicable to a specific hedge fund partnership.

It becomes pertinent to mention here that certain Commission staff members when asked have stated they believe hedge funds are within the purview of the registration provisions of the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934. It is, of course, quite clear that the antifraud provisions of the federal securities laws do apply to hedge funds whether registration provisions do or do not apply. There is no need to belabor this discussion with a detailed analysis of the status of hedge funds under the registration provisions of the federal securities laws; however, a brief analysis of the staff's view may be helpful at this point.

The prevailing type of hedge fund partnership agreement which provides for remuneration of the operating partner in an amount greater than he would realize on a pro rata basis from his capital contribution

may give rise to several questions with respect to that partner under the Investment Advisers Act of 1940. Our staff has expressed the view that under Section 202(a)(11), as well as the last paragraph of Section 205 of the Advisers Act, the operating partner of such an investment partnership is an "investment adviser" within the meaning of the Advisers Act who may have to take into account the registration requirements of the Act, as well as other pertinent provisions.

Section 203(b) of the Advisers Act provides certain limited exemptions from registration. Of general interest to hedge funds is the exemption contained in paragraph (3) of Section 203(b) for those investment advisers who during the course of the preceding 12 months have had fewer than 15 clients; that is, 14 clients or less, and who do not hold themselves out generally to the public. The exemption would not be available unless both conditions are met.

As to the effect of registration, the provisions most often referred to in inquiries involving hedge funds relate to Section 205(1) which prohibits a fee arrangement based, directly or indirectly, upon capital gains or capital appreciation of the funds or any portion of the funds of any clients. This, of course, precludes profit-sharing agreements. In addition, the staff views the section as prohibiting performance fees. These generally involve an arrangement by which compensation, otherwise fixed, may be increased or decreased depending upon a comparison of the funds of a client under the investment adviser's management with a specific standard or yardstick such as the Dow-Jones or Standard & Poors averages. The staff stresses that the prohibitions under Section 205(1) apply to an investment adviser who is required to be registered even though he has failed to do so.

Finally, on the subject of the Investment Advisers Act, anyone who comes within the term "investment adviser" as defined in the Act is a fiduciary who owes his clients undivided loyalty. An important point to observe in this connection is that in the staff's view it would be a violation of Section 206 of the Act for an investment adviser to contract for and receive a fee which is so excessive as to be unconscionable as this would constitute a breach of the adviser's fiduciary obligation to his client. Of course, under Section 206 and other applicable antifraud provisions of the federal securities laws, an investment adviser is prohibited from making false or misleading statements or from otherwise transgressing those provisions in relation to any client or prospective client.

With respect to the Securities Exchange Act of 1934, the staff claims that a hedge fund is by its nature a business organization whose business is to invest, reinvest and trade in securities -- that is, to

purchase and sell securities for its own account -- and that such an organization comes within the definition of "dealer" as that term is defined in Section 3(a)(5) of the Securities Exchange Act of 1934. The fact that it utilizes another broker-dealer to execute its transactions for it and effect transactions with it does not, according to the staff, serve to take an investment partnership out of the definition, since a person is a "dealer" if he is engaged in the business of buying and selling securities for his own account, through a broker or otherwise. The staff further reasons that since there is no exemption provided for such a dealer in Section 15(a)(1) of the Exchange Act from the registration requirements of that section, the partnership is subject to registration. In addition, the staff asserts, since the partnership is a broker-dealer subject to registration, all other regulatory provisions applicable to such a dealer must be complied with, including, for example, compliance with the net capital requirements of Rule 15c3-1 under the Act, the maintenance and preservation of books and records as required by Section 17(a) and the regulations thereunder, and the financial reporting requirements under Section 17(a) and the rules and regulations thereunder.

Hedge funds are a relatively recent phenomenon; this accounts for the apparent novelty of the foregoing theories and also provides an additional reason for the information gap on hedge funds. Possibly more than ninety per cent of the existing hedge funds were formed since 1963. Moreover, more than half -- possibly as many as three-fourths -- reportedly were formed in 1968. Their exact number is presently an unknown, but there may be more than one hundred and fifty. Most estimates that have come to my attention place their number between one hundred and two hundred.

Undoubtedly the striking growth in the number of hedge funds is due to a number of factors. Probably the most important element in the growth factor is the quest for performance, for, as The Institutional Investor stated succinctly, hedge funds are "the logical extension of the cult of success." We have been witnessing an unprecedented demand for performance. It has been said that we have been experiencing a fad of sorts, and that in time the fad would go the way of all fads. The demand for performance seems insatiable, however, and it would not be surprising if the reported outstanding performance records of some hedge funds have spurred the demand for more hedge funds.

High on the list of factors underlying the proliferation of hedge funds must be the emoluments which may be earned by hedge fund managers and broker-dealers. Hedge fund managers have been receiving up to twenty per cent of the gain realized by their funds in the form

of performance fees. Clearly, fees in the neighborhood of twenty per cent of the fund's gains could far exceed fees to be earned managing other capital pools. Thus, it is possible that the proliferation of hedge funds is due in some degree to the desire of some money managers to benefit from performance fees.

A further reason for the multiplication of hedge funds may be the brokerage generated by the investment techniques of hedge fund managers. Once again, we are faced with the non-existence of information -- this time on the portfolio turnover of hedge funds -- but I would be greatly surprised if these performance oriented vehicles did not have substantial portfolio turnover; furthermore, I would be as equally surprised if broker-dealers did not promote the formation of affiliated hedge funds so as to benefit from the allocation of hedge fund brokerage commissions.

Before referring to the possible significance of the growth in the number of hedge funds, let me set the scene by illustrating the effect of that growth to date in terms of the assets and purchasing power of hedge funds. It is estimated that the assets of hedge funds were approximately $1.5 billion at the end of 1968. During the fourth quarter of 1968, purchases and sales of common stocks by hedge funds may have amounted to as much as $1.4 billion. Contrast this figure with the $12.1 billion of common stock purchased in the same quarter by open-end investment companies whose assets are at least 40 times as large as those of hedge funds. Or, to put it another way, if these estimates are correct, open-end investment companies, whose assets are at least 40 times larger than hedge funds, have purchased only about nine times as much common stock as the hedge funds in the last quarter of 1968.

As you know, in 1968 Congress directed the Commission to study the impact of institutional investors of all types on the securities markets. Pursuant to this Congressional mandate, the Commission's Institutional Study is now underway. That Study will direct its attention to the market impact of institutional trades, and since hedge funds are reportedly very active traders the Study will examine their trading and its effect on the securities markets. It may develop that the major implication flowing from the growth in the number of hedge funds stems, in large part, from the "go-go" investment techniques utilized by hedge fund managers and that hedge funds may have an impact on the securities markets far out of proportion to their size.

The Study will also direct its attention to the relationships between institutions of all types -- including hedge funds -- and the companies whose securities are held in their portfolios. Specifically, the Study will examine the role of institutions in the transfers of corporate control.

Finally, the Study will also examine the extent to which information flows between hedge funds and companies in their portfolios, the extent to which information flows between broker-dealers and hedge funds, and the extent to which the flow of information to hedge funds leads to parallel trading. The flow of information between broker-dealers and hedge funds takes on special significance, since hedge funds reportedly operate with small or no internal research staffs and rely almost exclusively on "The Street" for information. The Study has a special interest in this characteristic of hedge funds since its imitation by larger institutions may be of considerable significance to the securities industry.

If hedge funds are the "logical extension of the cult of success," so, too, offshore funds are the logical extension of the hedge fund concept. Freedom from United States capital gains tax liability has given the offshore fund portfolio managers an opportunity to seek maximum performance without concern for holding periods dictated by capital gains tax considerations. Furthermore, hedge funds must limit the number of investors to less than one hundred to support claimed exceptions from the registration requirements of the Investment Company Act, but offshore funds are under no such restrictions. Thus, offshore funds may be offered to many more investors.

Just what is an "offshore fund"? Broadly speaking, it is an investment company organized under the laws of a jurisdiction foreign to the United States, generally in a tax haven such as Panama, the Bahama Islands, the Cayman Islands or the Netherlands Antilles. Many offshore funds are managed by Americans, and the assets of the funds are held in the United States by a United States custodian bank. Fund shares are sold exclusively, however, outside the United States to non-United States citizens in order to support claimed exemptions and exceptions from certain provisions of the United States tax and securities laws. Naturally, not all offshore funds are managed by Americans; nor do all offshore funds invest in United States securities or engage in hedging techniques. There is variety in the make-up of offshore funds as there is variety in the make-up of our domestic investment company industry.

It has been estimated that four or five years ago there were less than a half dozen offshore funds. Today, one estimate places their number at closer to two hundred.

In all likelihood, a large part of this growth represents the entry of United States money managers into the offshore scene. A number of factors have brought about this circumstance. First, and perhaps most important, is the Foreign Investors Tax Act of 1966. In 1963, as part of a program to reduce the deficit in the United States balance of payments, President Kennedy formed a task force to examine ways and means of

promoting increased foreign investment in the securities of United States private companies. The report of that task force, known as the Fowler Report, contained a number of recommendations, including a recommendation which led to the Foreign Investors Tax Act of 1966. That Act, generally, permits the offshore fund and its shareholders to escape United States capital gains and estate taxes. I should mention that the offshore vehicle does not completely eliminate United States tax liability, since the offshore funds are subject to United States taxes on interest and dividends. In any event, the Foreign Investors Tax Act of 1966 was undoubtedly a tremendous boost to the popularity of the offshore funds.

Offshore funds have also capitalized on the increased interest of European investors in the United States securities market. Foreign investors are investing in our markets with zest. For example, in 1968 foreign investment in United States securities amounted to a total of $2,296,000,000 worth of United States shares. As Fortune put it: "Foreign investors have discovered Wall Street with the belated enthusiasm of a matron discovering sex." Of course, the rush to invest in United States securities by foreign investors is a phenomenon that has been aided, in part, by the salesmen for the overseas funds who have brought extensive advertising methods and aggressive selling methods such as door-to-door selling to the foreign investment scene.

The phenomenal growth of the sale of offshore funds in foreign countries has not been without its critics, and, generally, this criticism has focused on the selling and advertising methods employed by the offshore funds. In at least one instance, this criticism has led a foreign government to consider whether restrictions should be imposed on the operations of foreign funds. Recently, that foreign government requested the Commission to provide assistance in the drafting of laws applicable to the sale of offshore funds within its jurisdiction. We were pleased to dispatch the Chief Counsel of our Division of Corporate Regulation to assist this government with its review of proposed legislation concerning the regulation of offshore or foreign investment company shares.

The proliferation of the offshore funds has raised a number of questions concerning their activities within the United States. Since the offshore funds are less concerned with the tax effect of investment decisions than their domestic counterparts, the offshore fund managers may acquire portfolio securities, or dispose of them, with more rapidity than is the case with their domestic counterparts. Thus, the amount of trading done by the offshore funds may achieve sufficient proportions to have a substantial impact on the United States securities markets. In this regard, more than a year ago a leading financial magazine reported that on some days the purchases and sales on American markets by one offshore fund group alone equaled four per cent of all trading on the New York Stock Exchange.

It is not clear at present whether the peculiarities of offshore funds will require special examination by the Institutional Study or by the Commission's staff, but assuming for the sake of further discussion that the Institutional Study or some future study reveals problems in the offshore area which must be dealt with because of their impact within the United States, the Commission's path will by no means be well defined. First, the Commission will be faced with the question of jurisdiction over foreign corporations. It has been urged that, assuming the offshore fund is organized outside the United States and that it does not make use of the jurisdictional devices as defined in the Investment Company Act, the offshore fund is free from the registration requirements of the Investment Company Act. Speaking generally, notwithstanding the purported exemption from the registration requirements of the Investment Company Act, if the activities of any offshore funds result in abuses within the United States, I venture to say that such activities will subject those funds to Commission jurisdiction under some provisions of the federal securities laws. That is, it would seem impossible to conduct such activities without creating a jurisdictional nexus as defined in the federal securities laws.

The question of the applicability of the federal securities laws to the activities of offshore funds is broad enough to consume more time than your patience would permit this morning. It is sufficient to mention that there is a growing body of case law dealing with the extra-territorial application of the provisions of the federal securities laws. Of particular relevance to our discussion is the case of Roth v. Fund of Funds 1/ decided in the United States Court of Appeals for the Second Circuit in December 1968. In that case, Section 16(b) of the Securities Exchange Act of 1934 was found to apply to securities transactions within the United States by a foreign based investment company.

Even where the jurisdictional question is resolved satisfactorily, there will still be other weighty problems; for example, it is clear that the activities of the offshore funds will certainly give rise to questions of international diplomacy. Furthermore, the commitment of the United States government to reduce its balance of payments deficit and to maintain the strength of the dollar will have to be considered.

Before concluding, I should like to add a brief comment about advisory fees tied to performance. As stated earlier, performance fees are very much a part of the hedge fund scene. In addition, performance fees are on the increase among registered investment companies. With few exceptions, performance fees have been adopted by funds with objectives of capital appreciation. Frequently, the funds adopting such arrangements are the registered investment companies which engage in various speculative and high-risk investment activities.

1/ 405 F.2d 421 (C.A. 2, 1968), cert. denied, 394 U.S. 975 (1969).

Basically, two types of performance fee arrangements have been adopted by registered investment companies. The first variety provides that the investment adviser receives a fee (which may or may not be in addition to a basic management fee) based on a certain percentage of the fund's net realized capital gains and net unrealized capital appreciation. Where there is a basic management fee, it generally amounts to from 1/4 to 1/2 of 1% of the net assets of the fund during the year. In some cases, there is no contractual limit to the dollar amount of the fee which may be payable to the adviser.

The other, and more frequently used, type of arrangement also provides for a basic advisory fee of a percentage of the fund's net assets. The basic fee is payable if the performance of the fund is the same as that of a specified securities index or, in some cases, regardless of how poorly the fund's performance has been when compared with the index. If the investment company outperforms the index by a certain percentage, a so-called performance bonus of an additional percentage of the fund's net assets is paid. By this method, the total annual advisory fee may be as high as six per cent of the fund's net assets. Recently, a number of funds have adopted arrangements which provide for decreases in compensation in the event the fund underperforms the index. In many cases, however, the percentage of decrease is disproportionately less than the possible percentage of increase.

In the Commission's 1966 Mutual Fund Report to the Congress we recommended that performance fees be prohibited. While we would prefer the flat prohibition, after discussions with the industry we are not objecting to a provision contained in the Bill recently passed by the Senate (S. 2224) which would permit a limited type of performance fee. Under that provision, the advisory contract with a registered investment company may provide for compensation based on the net asset value of the investment company averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company in relation to the investment record of an appropriate index of securities prices.

I should also add that the fee would also be subject to the new proposed standard in Section 36(b) which provides that the investment adviser of a fund shall be deemed to have a fiduciary duty with respect to advisory fees and permits a suit for breach of the fiduciary duty in respect of such fees.

Finally, it may be well to indicate that my remarks this morning were not intended to be a barely veiled hint that the Commission may soon take steps which will effect any of the funds that we have considered;

rather, my intention was merely to promote a worthwhile dialogue and to point up problem areas rather than to point out intended remedies. Those who invest through the media discussed this morning should not look upon Commission scrutiny with trepidation. After all, the Commission is by law the guardian of the market place and is, consequently, responsible for supplying the protections of the securities laws to persons who invest in an entity which itself invests in securities. Suffice it to say, therefore, that the Commission is taking a long and hard look at such investing vehicles in this light.