

# *Implications of the Growth of Hedge Funds*



Staff Report to the  
United States Securities and Exchange Commission

September 2003

This is a staff report to the Commission. The Commission has expressed no view regarding the analysis, findings or conclusions herein.



THE CHAIRMAN

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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Hedge funds, while representing a relatively small portion of the U.S. financial markets, have grown significantly in size and influence in recent years. In June 2002, the staff of the Commission's Division of Investment Management and Office of Compliance Inspections and Examinations undertook a fact-finding mission aimed at reviewing the operations and practices of hedge funds.

After last spring's two-day roundtable on the hedge fund industry, I asked the staff to summarize its findings in a report to the Commission. I also asked the staff to include recommendations about actions that, in the judgment of the staff, the Commission might consider when addressing issues that the staff raised in its report. The substance and the language of the report represent the views of the staff. They do not represent the views of the Commission or of any individual Commissioner.

I look forward to reviewing the staff's report and accompanying recommendations with my fellow Commissioners. The staff has raised important issues for the Commission's consideration. I anticipate that we will hear strong views both in support of and in opposition to the staff's recommendations. We intend to consider these comments carefully as we continue to deliberate the appropriate extent of Commission oversight of the hedge fund industry.

William H. Donaldson

## ACKNOWLEDGEMENTS

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# TABLE OF CONTENTS

## IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS

EXECUTIVE SUMMARY.....	vii
I. Investigation by the Staff of the Commission.....	1
II. Legal Structure and Benefits of Hedge Funds .....	3
A. What is a Hedge Fund.....	3
B. Market Benefits of Hedge Funds .....	4
C. Pooled Investment Vehicles that Are Not Hedge Funds .....	5
1. Registered Investment Companies .....	5
2. Private Equity Funds .....	7
3. Venture Capital Funds.....	8
4. Commodity Pools .....	8
D. Domestic and Offshore Hedge Funds.....	9
1. Domestic Hedge Funds.....	9
2. Offshore Hedge Funds.....	10
III. The Regulation of Hedge Funds and Their Advisers.....	11
A. Hedge Funds and the Investment Company Act of 1940 .....	11
1. Section 3(c)(1).....	11
2. Section 3(c)(7).....	12

B.	Hedge Funds and the Securities Act of 1933.....	13
1.	The Private Offering Exemption of the Securities Act.....	14
2.	Regulation D.....	14
C.	Hedge Funds and the Securities Exchange Act of 1934.....	18
1.	Definition of “Broker” and “Dealer”.....	18
2.	Exchange Act Registration Under Section 12.....	18
3.	Beneficial Ownership Reporting under Sections 13 and 16 of the Exchange Act	19
D.	Hedge Fund Advisers and the Investment Advisers Act of 1940.....	20
E.	Certain Other Regulatory Requirements.....	23
1.	Regulation under the CEA.....	23
2.	NASD Regulation.....	25
3.	Regulation under ERISA.....	28
4.	Treasury Department Regulations.....	29
5.	State Regulation.....	31
IV.	Operations of Hedge Funds.....	33
A.	Hedge Fund Investment Strategies.....	33
1.	Overview.....	33
2.	Hedge Funds Strategies.....	34
3.	Hedge Fund Investment Activities Compared to those of Registered Investment Companies.....	36
4.	Leverage.....	37

5. Short Selling .....	39
B. Nature of Hedge Fund Investors .....	43
C. Hedge Fund Marketing .....	44
D. Disclosure by Hedge Funds to Investors and Prospective Investors .....	46
1. Private Placement Memoranda.....	47
2. Limited Partnership Agreements.....	49
3. Transparency .....	49
4. Periodic Reporting.....	50
5. Additional Sources of Hedge Fund Information .....	51
E. Hedge Fund Service Providers.....	52
1. Hedge Fund Investment Advisers .....	52
2. Broker-Dealers/Prime Brokers .....	53
3. Offshore Administrators.....	55
4. Auditors .....	57
5. Consultants and Other Finders .....	59
F. Hedge Fund Advisory Fees.....	61
G. Hedge Fund Valuation Practices.....	64
H. Audit Reports .....	65
I. Risk Management .....	66
J. Funds of Hedge Funds .....	67

1. Background.....	67
2. Registered FOHFs .....	68
3. Repurchases.....	71
4. Content of Registered FOHF Disclosure.....	71
V. Hedge Fund Enforcement Actions .....	72
A. Commission Actions.....	72
B. State and SRO Enforcement Activities.....	74
VI. Concerns .....	76
A. Lack of Commission Regulatory Oversight .....	76
1. Inability to Detect Fraud and Other Misconduct at Early Stages.....	76
2. Lack of Meaningful Information about Hedge Funds and Hedge Fund Advisers	77
B. Valuation of Hedge Fund Portfolio Securities.....	79
C. Retailization.....	80
1. Direct Investment in Hedge Funds.....	80
2. Registered Funds of Hedge Funds.....	81
3. Pension Plan and Other Institutional Investment in Hedge Funds.....	82
D. Disclosure .....	83
E. Conflicts of Interests.....	83
1. Side-by-Side Management of Client Accounts .....	83
2. Relationships with Prime Brokers.....	85



F.	Concerns about General Solicitation .....	86
G.	Concerns about Whether the Federal Securities Laws and Regulations Are Impairing the Investment Activities of Registered Investment Companies .....	87
VII.	Recommendations.....	88
A.	The Commission Should Consider Requiring Hedge Fund Advisers to Register as Investment Advisers under the Advisers Act, Taking into Account Whether the Benefits Outweigh the Burdens of Registration .....	89
1.	Benefits of Mandatory Registration .....	92
2.	Concerns about Mandatory Registration .....	96
B.	The Commission Should Consider Revising its Regulations Under the Advisers Act to Require Advisers to Provide a Brochure Specifically Designed for Hedge Funds.....	97
C.	The Commission Should Consider Requiring Certain Registered Investment Companies to Follow Board Adopted Valuation Procedures .....	99
D.	The Commission Should Consider Requiring Additional Disclosure to be Provided About Layered Fees of “Funds of Funds” .....	99
E.	Regulators Should Continue to Monitor Whether Suitability Obligations Are Being Met.....	100
F.	The Commission Should Consider Permitting General Solicitation in Section 3(c)(7) Hedge Fund Offerings .....	100
G.	Monitor Capital Introduction Services Provided by Prime Brokers.....	101
H.	Encourage the Hedge Fund Industry to Embrace and Further Develop Best Practices .....	101
I.	Investor Education .....	103
VIII.	The Commission Should Consider Issuing a Concept Release for Examining Wider Use of Hedge Fund Investment Strategies in Registered Investment Companies.....	103

A.	Different Registered Investment Company Structures Provide Various Benefits and Challenges in the Deployment of Absolute Return Strategies.....	104
B.	Registered Investment Companies are Subject to Restrictions on Leverage and Short Selling that Hedge Funds Avoid .....	107
C.	Alignment of the Investment Adviser’s Interests with Investors.....	109
D.	Absolute Return Strategies May Challenge Traditional Investor Expectations ..	110
Appendix A -- Summary of the Commission’s Previous Studies or Investigations of Hedge funds		

## EXECUTIVE SUMMARY

### I. Background on Report of the Implications of the Growth of Hedge Funds

At the request of the Commission, the staff has conducted a study of hedge funds, including their investment advisers and other service providers and their investors. The Commission's decision to study the hedge fund industry was based, in large part, on the growth of hedge fund assets coupled with the Commission's lack of information about these investment pools. The hedge fund industry recently has experienced significant growth in both the number of hedge funds and the amount of assets under management. Based on current estimates, 6,000 to 7,000 hedge funds operate in the United States managing approximately \$600 to \$650 billion in assets. In the next five to ten years, hedge fund assets have been predicted to exceed \$1 trillion.

The growth in hedge funds has been fueled primarily by the increased interest of institutional investors such as pension plans, endowments and foundations seeking to diversify their portfolios with investments in vehicles that feature absolute return strategies – flexible investment strategies which hedge fund advisers use to pursue positive returns in both declining and rising securities markets, while generally attempting to protect investment principal. In addition, funds of hedge funds (“FOHF”), which invest substantially all of their assets in other hedge funds, have also fueled this growth.

The study focused on a number of key areas of staff concern, including the recent increase in the number of hedge fund enforcement cases, the role that hedge funds play in our financial markets and the implications of the Commission's limited ability to obtain basic information about hedge funds. The staff also examined the emergence of registered FOHFs – FOHFs that register under the Investment Company Act of 1940 (“Investment Company Act”) so that they may offer and sell their securities to a larger number of investors and FOHFs that register under the Investment Company Act and the Securities Act of 1933 (“Securities Act”) so that they may offer and sell their securities in the public market. Finally, the staff reviewed hedge fund disclosure and marketing practices, valuation practices and conflicts of interest.

The study commenced with the staff's review of 65 hedge fund advisers (both registered and unregistered) managing approximately 650 different hedge funds with over \$160 billion of assets. This phase of the study included a number of on-site visits to hedge fund advisers, which were selected to provide a representative cross-section of the industry. The staff also visited several broker-dealers offering prime brokerage services to hedge funds and conducted a separate series of on-site examinations focused on the operations of registered FOHFs. In addition, the staff met with hedge fund advisers, investors, regulators and industry observers willing to share information about hedge funds.

Complementing the study, the Commission held a Hedge Fund Roundtable on May 14 and 15, 2003, and invited a broad spectrum of the hedge fund industry and interested persons to participate in a discussion of hedge fund issues. At the close of the Roundtable, Chairman

William H. Donaldson requested that the staff provide the Commission with a report of its findings and recommendations resulting from the hedge fund study. In response, the Division of Investment Management, with the assistance of the Divisions of Corporation Finance, Enforcement and Market Regulation, and the Offices of Compliance Inspections and Examinations, Economic Analysis, International Affairs and Investor Education and Assistance, has prepared this Report. The Chairman also requested public comment on the issues discussed in the Roundtable. The Commission received approximately 80 comment letters in response and those letters have been considered in preparing this Report.

The Report outlines the staff's factual findings, identifies concerns and recommends that the Commission should consider certain regulatory and other measures to improve the current system of hedge fund regulation and oversight. The views expressed in this Report are those of the staff and do not necessarily reflect the views of the Commission or the individual Commissioners.

## **A. Characteristics of Hedge Funds**

Although financial service providers, regulators and the media commonly refer to "hedge funds," the term has no precise legal or universally accepted definition. The term generally identifies an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act. Hedge funds are also characterized by their fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital appreciation. Hedge fund advisory personnel often invest significant amounts of their own money into the hedge funds that they manage. As discussed in the Report, although similar to hedge funds, there are other unregistered pools of investments, including venture capital funds, private equity funds and commodity pools that generally are not categorized as hedge funds.

The investment goals of hedge funds vary among funds, but many hedge funds seek to achieve a positive, absolute return rather than measuring their performance against a securities index or other benchmark. Hedge funds utilize a number of different investment styles and strategies and invest in a wide variety of financial instruments. Hedge funds invest in equity and fixed income securities, currencies, over-the-counter derivatives, futures contracts and other assets. Some hedge funds may take on substantial leverage, sell securities short and employ certain hedging and arbitrage strategies. Hedge funds typically engage one or more broker-dealers to provide a variety of services, including trade clearance and settlement, financing and custody services.

Hedge funds often provide markets and investors with substantial benefits. For example, based on our observations, many hedge funds take speculative, value-driven trading positions based on extensive research about the value of a security. These positions can enhance liquidity and contribute to market efficiency. In addition, hedge funds offer investors an important risk management tool by providing valuable portfolio diversification because hedge fund returns in many cases are not correlated to the broader debt and equity markets.

## **B. Hedge Fund Organization and Operations**

Hedge funds are typically organized by professional investment advisers that manage a hedge fund's investments. Hedge funds distribute securities in private offerings, traditionally "marketing" their interests through word of mouth and the personal relationships with the hedge fund's advisory personnel. Broader marketing, including use of the Internet, has become more frequent in recent years. Hedge funds generally do not have limited time horizons, although a number of factors, including an inability to consistently achieve positive returns, often contribute to a relatively shorter life span than that of other investment vehicles. Hedge fund advisers typically receive, as compensation, a management fee based on the amount of hedge fund assets (commonly 1-2 percent), plus a share of the capital gains and capital appreciation (commonly 20 percent) or some other allocation based on the fund's investment performance. Hedge funds typically agree to repurchase their own interests from investors on a limited, periodic basis, such as quarterly, often following an initial "lock-up period" during which time investors are not permitted to liquidate their investments.

Because hedge funds are not registered investment companies, they generally are not required to meet prescribed disclosure requirements. Hedge fund advisers, however, typically provide potential hedge fund investors with a private placement memorandum that discloses information about the investment strategies the hedge fund is permitted to use and an overview of how the hedge fund operates. The private placement memorandum also generally provides the adviser with the maximum flexibility in selecting, shifting and modifying its strategies. In addition, the private placement memorandum often provides the hedge fund adviser with broad discretion in valuing the hedge fund's assets. Hedge fund investors generally receive some ongoing performance information, risk analyses and portfolio profiles from their hedge fund advisers. Although not required, most hedge funds retain an auditor to conduct an annual independent audit, which, if certified, is prepared using generally accepted accounting principles.

For tax and other considerations, some hedge fund advisers create one or more "offshore" hedge funds that are organized in a foreign jurisdiction, in addition to maintaining U.S.-based hedge funds. In many cases, an offshore hedge fund is managed using trading strategies that are substantially similar to those used to manage an onshore hedge fund managed by the same adviser. These hedge funds are offered and sold to certain U.S. investors as well as foreign investors.

## **C. Principal Exclusions and Exemptions for Hedge Funds and Their Investment Advisers**

To avoid registration and substantive regulation under the Investment Company Act, hedge funds rely on one of two exclusions from the definition of investment company. The first exclusion is available to hedge funds that have 100 or fewer investors. The second exclusion applies to hedge funds that sell their interests only to highly sophisticated investors. To rely on either exclusion, the hedge fund must restrict its offerings so that they meet the requirements for non-public offerings.

Hedge funds do not register the offer and sale of their interests under the Securities Act. As such, hedge funds may not offer their securities publicly or engage in a public solicitation. Instead, hedge funds generally sell their interests in private offerings. To meet the most commonly used regulatory “safe harbor” for conducting private offerings, hedge funds may sell their interests to an unlimited number of “accredited investors.” Accredited investors include individuals with a minimum annual income of \$200,000 (\$300,000 with spouse) or \$1 million in net worth and most institutions with \$5 million in assets. Hedge funds that seek to rely on the sophisticated investor exclusion from Investment Company Act registration may sell their interests only to “qualified purchasers,” a standard with significantly higher financial requirements than those necessary for accredited investors. In practice, we understand that most hedge funds sell only to investors whose wealth exceeds that required to meet the standard established for accredited investor status.

Although some hedge fund advisers choose to register voluntarily, or are registered for another reason, most advisers to hedge funds do not register under the Investment Advisers Act of 1940 (“Advisers Act”). They often rely on the “*de minimis*” exemption from registration for investment advisers with 14 or fewer clients. Under Commission rules, each hedge fund counts as one client.

## **II. Concerns Relating to Hedge Fund Growth**

As noted above, our study was, in large part, the result of the Commission’s recognition that it lacks information about hedge fund advisers that are not registered under the Advisers Act and the hedge funds that they manage. Although this recognition is not new, the Commission’s attention was focused again on the hedge fund industry as a result of the recent growth of the industry and the increase of investments in hedge funds by institutions. Although hedge fund investment advisers are subject to the antifraud provisions of the federal securities laws, they are not subject to any reporting or standardized disclosure requirements, nor are they subject to Commission examination. Consequently, the Commission has only indirect information about these entities and their trading practices and, we believe, is hampered in its ability to develop regulatory policy as hedge funds become more important participants in our financial markets. We are concerned about our inability to examine hedge fund advisers and evaluate the effect of the strategies used in managing hedge funds on our financial markets. We also are concerned about the lack of applicable regulatory measures necessary to ensure that material information to assist investors in making fully informed investment decisions is available.

The Commission’s inability to examine hedge fund advisers has the direct effect of putting the Commission in a “wait and see” posture vis-à-vis fraud and other misconduct. The Commission typically is able to take action with respect to such fraud and other misconduct only after it receives relevant information from third parties (for example, investors or service providers), and frequently only after significant losses have occurred. In contrast, we believe that our examination program not only allows the Commission to identify misconduct by registered investment advisers earlier, but it also assists in identifying and possibly preventing certain misconduct from developing into fraud.

We also are concerned that some hedge fund investors may not always receive useful information about the investment adviser and its management of the fund. In addition, we believe that disclosure to some hedge fund investors could be improved to address conflicts of interests of hedge fund advisers.

One of our key concerns relates to the manner by which hedge fund advisers value hedge fund assets. The broad discretion that these advisers have to value assets and the lack of independent review over that activity gives rise to questions about whether some hedge funds' portfolio holdings are accurately valued. Our concern not only reflects our recognition of the incentives that may cause an adviser to inaccurately value hedge fund assets, but it also reflects our concern that registered funds that invest their assets in hedge funds may lack access to information that enables them to "fair value" their interests in hedge funds and therefore accurately calculate their net asset value.

In addition, we have observed various uses of the Internet by hedge fund advisers to communicate with investors. We are taking the opportunity in this Report to reiterate the Commission's statement that the analysis historically applied to determine whether an offering is part of a general solicitation or public offering has not changed in the context of offerings made through electronic sources. Separately, however, we recommend to the Commission that additional consideration be given to whether hedge funds that offer and sell their securities solely to "qualified purchasers," as defined under the Investment Company Act, should be subject to the limitation that such funds only make private offerings of their securities.

### **III. Staff Recommendations Relating to Hedge Fund Advisers, Funds of Hedge Funds and Hedge Funds**

#### **A. The Commission Should Consider Requiring Hedge Fund Advisers To Register as Investment Advisers under the Advisers Act, Taking into Account Whether the Benefits Outweigh the Burdens of Registration**

The staff recommends that the Commission consider revising its rules under the Advisers Act to require hedge fund advisers to register as investment advisers. Amending the rules under the Advisers Act would require hedge fund advisers to "look through" any hedge funds under their management and count each investor in each hedge fund as a separate client of the adviser. In practical terms, this would result in the registration of most large hedge fund advisers. The staff further recommends that the Commission consider amending its rules to require that registered hedge fund advisers file with the Commission, and deliver to investors, a disclosure statement specifically designed for hedge fund investors.

Registration of hedge fund advisers would have several benefits. First, registered hedge fund advisers would become subject to the Commission's regular inspections and examinations program. Effective Commission oversight could lead to earlier detection of actual and potential misconduct, help to deter fraud and encourage a culture of compliance and controls. Second, the Commission would be authorized to collect basic and meaningful information about the activities of hedge fund advisers and hedge funds, which are becoming increasingly influential participants

in the U.S. financial markets. Third, Advisers Act registration would enable the Commission to require hedge fund advisers to disclose information about issues important to investors, such as conflicts arising from side-by-side management of hedge funds and other client accounts and hedge fund advisers' relationships with prime brokers. Fourth, registration of hedge fund advisers under the Advisers Act would effectively increase the minimum investment requirement for direct investments in certain hedge funds because registered advisers are generally prohibited from charging performance fees unless investors have \$750,000 invested with the adviser or have a net worth of \$1.5 million.

Importantly, Advisers Act registration would not impede the manner in which a hedge fund adviser invests or operates a hedge fund. Registration would not place restrictions on a hedge fund adviser's ability to trade securities, use leverage, sell securities short or enter into derivative transactions. Registration would also not require the disclosure of hedge fund proprietary trading strategies and portfolio positions, nor would it result in the public identification of the hedge fund's investors.

**B. The Commission and its Staff Should Consider Addressing Certain Valuation, Suitability and Fee Disclosure Issues Relating to Registered FOHFs**

The Commission should consider requiring, through rulemaking, that all registered investment companies that invest their assets in hedge funds, including registered FOHFs, have policies and procedures designed to ensure that funds and their boards value their interests in hedge funds in a manner consistent with the requirements of the Investment Company Act. To address concerns that registered FOHF investors do not understand the impact of multiple layers of fees, the Commission should adopt its proposed rulemaking to require all registered investment companies, including registered FOHFs, to disclose in their prospectus fee tables the estimated expenses of the company's underlying fund interests. To address concerns about registered FOHFs exposing investors to levels and types of risks that are not appropriate for those investors, the Commission should continue to encourage the examination staffs of the Commission and the NASD to be vigilant in identifying violations of broker-dealer suitability obligations with respect to the sale of all registered FOHFs.

**C. The Commission Should Consider Permitting General Solicitation in Fund Offerings Limited to Qualified Purchasers**

The staff recommends that the Commission consider eliminating the prohibition on general solicitation or advertising in offerings by hedge funds that rely on the exclusion from the definition of an investment company for hedge funds that permit investments only by highly sophisticated investors. Permitting pooled investment vehicles, including hedge funds, which limit their investors to this higher standard to engage in a general solicitation could facilitate capital formation, without raising significant investor protection concerns.



**D. The Staffs of the Commission and the NASD Should Monitor Closely Capital Introduction Services Provided by Broker-Dealers**

Commission and NASD examiners should continue to monitor prime brokers' capital introduction practices. In addition, the staff should consider whether broker-dealers' suitability and other regulatory obligations are being met in connection with the offering of hedge funds interests.

**E. The Commission Should Encourage the Hedge Fund Industry To Embrace and Further Develop Best Practices**

The Commission should encourage those involved in the hedge fund industry to embrace existing "best practices" and refine and improve these best practices to supplement current conflict management practices.

**F. The Commission Should Continue Its Efforts To Improve Investor Education Regarding Hedge Funds**

In light of the publicity surrounding hedge funds, as well as the advent of registered FOHFs, there is a greater need to promote investor education regarding hedge funds, their investment strategies and their operations. In addition to making investors aware of the potential for fraud in hedge funds, we are also concerned that many investors may not realize the correlation between risk and return – that higher risk inevitably accompanies potentially higher returns.

**IV. The Commission Should Consider Issuing a Concept Release To Examine the Wider Use of Hedge Fund Investment Strategies in Registered Funds**

Some commenters have asserted that retail investors could benefit from greater access to absolute return strategies and hedge fund investment techniques. The Commission should consider issuing a concept release requesting comment on this topic generally and focusing on issues such as whether: (1) current restrictions placed on registered funds' use of leverage and short selling should be relaxed; (2) an absolute return strategy, especially in connection with a performance fee tied to achieving an absolute return, has a positive effect on aligning the interests of hedge fund advisers and investors; and (3) additional investor education initiatives would be necessary to educate investors about absolute return strategies and risks.

## Staff Report

### I. Investigation by the Staff of the Commission

Over the past 35 years, the Commission and the staff have periodically conducted or participated in a number of studies about hedge funds.<sup>1</sup> While some of these studies were prompted by particular events, others were part of a program of Commission surveillance to review aspects of the securities markets. Previous studies often focused on the impact of hedge fund operations on the stability of the financial markets. These studies examined, among other things, trading and brokerage practices, including the use of short selling and leverage by hedge funds, the systemic risks posed by hedge funds and the exposure of banks and other counterparties to hedge funds and other highly-leveraged institutions.

The considerable growth of the hedge fund industry in recent years prompted the Commission to authorize the staff to examine hedge funds once again.<sup>2</sup> Although hedge funds remain a relatively small portion of the U.S. financial markets,<sup>3</sup> the rate of growth of hedge funds has been substantially greater than that of other sectors.<sup>4</sup> In addition, hedge funds have a growing role in our securities markets as large and frequent traders of securities.

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<sup>1</sup> See Appendix A for a chronological discussion of the Commission's major studies or investigations of hedge funds.

<sup>2</sup> Consistent with previous hedge fund studies, the staff has no reliable data on the number of hedge funds in existence or the amount of hedge fund assets under management. Participants at the Commission's May 14-15, 2003 Hedge Fund Roundtable ("Roundtable") estimated that there are approximately 6,000 hedge funds currently operating in the United States, with approximately \$600 billion in assets under management. Other estimates vary greatly. The Commission estimated in 1992, based on media reports, that there were approximately 400 hedge funds in existence. See Letter from Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (June 12, 1992) ("Breeden Letter").

<sup>3</sup> For example, the total market value of corporate equities in the U.S. stock market at the end of 2002 was \$11.8 trillion. Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States - Flows and Outstanding*, available at <http://www.federalreserve.gov/releases/Z1/20030605/>.

<sup>4</sup> According to a Roundtable participant, hedge fund assets grew from \$50 billion in 1993 to \$592 billion in 2003, an increase of 1084 percent. Comment submitted by Roundtable Panelist Charles J. Gradante on behalf of the Hennessee Group LLC at 4-5 ("Hennessee Group Comment Letter"). By contrast, over the decade from December 1992 to December 2002, the number of mutual fund portfolios increased by 116 percent, from 3,824 to 8,256, and their assets increased by 289

As more fully discussed below, the concerns that prompted the Commission's current examination of hedge funds involve not simply the growth in the number of hedge funds and their assets under management, but more importantly, the causes and implications of that growth. They also reflect the Commission's interest in determining whether the recent increase in the number of hedge fund frauds is a result of this growth, and whether certain types of offenses are endemic to hedge funds. Finally, the Commission was concerned about the potential impact that the growth in hedge fund assets and activities may have on our financial markets.<sup>5</sup>

Our examination began in June 2002, and included reviews of both registered and unregistered investment advisers that manage hedge funds. The staff also had on-site discussions with a number of hedge fund advisers.<sup>6</sup> In addition, the staff met or spoke with a variety of experts in their respective fields to get their perspectives on the hedge fund industry. This group included legal and accounting experts, chief investment officers, risk managers, prime brokers, trade industry representatives, hedge fund consultants and representatives from foreign and domestic regulators.

In May 2003, the Commission hosted a Roundtable to provide a public forum for discussion and debate about the implications of hedge fund growth. The Roundtable brought together representatives from the hedge fund industry and other interested persons to discuss issues relating to hedge funds, and to offer their recommendations.<sup>7</sup> In addition, the Commission

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percent from \$1.6 trillion to \$6.4 trillion. See The Investment Company Institute, *2003 Mutual Fund Fact Book: A Guide to Trends and Statistics in the Mutual Fund Industry* 63 (43rd ed. 2003). In that same period, assets of insurance companies increased by 110 percent (from \$1.6 trillion to \$3.3 trillion), assets of commercial banks grew by 100 percent (from \$3.5 trillion to \$7 trillion), and deposits of commercial banks increased by 79 percent (from \$2.5 trillion to \$4.5 trillion). See Federal Reserve Statistical Release Z.1, *supra* note 3; Federal Reserve Statistical Release H.8, *Assets and Liabilities of Commercial Banks in the United States*, available at <http://www.federalreserve.gov/releases/Z1/20030605/>; <http://www.federalreserve.gov/releases/z1/current/data.htm>.

<sup>5</sup> The Commission recognized over 30 years ago that hedge fund trading raises special concerns with respect to their impact on the securities markets. See *35th Annual Report*, U.S. Securities and Exchange Commission 18 (1969) (“[b]ecause hedge funds are so strongly performance-oriented, they may have a greater impact on the securities markets than their asset size would indicate”).

<sup>6</sup> The staff selected hedge fund investment advisers based on their: (1) hedge fund assets under management; (2) number of hedge funds under management; (3) hedge fund investment objectives; (4) status and length of operations; (5) Commission registration status; and (6) additional advisory services provided.

<sup>7</sup> A wide range of persons involved in the hedge fund industry participated in the Roundtable, including hedge fund advisers, consultants, service providers (such as prime brokers, auditors and

invited the public to submit written comments to the Commission relating to the growth and investor protection implications of hedge funds. The Commission received approximately 80 comment letters addressing these topics, which the staff considered in connection with the preparation of this Report.<sup>8</sup>

## II. Legal Structure and Benefits of Hedge Funds

### A. What is a Hedge Fund

Although there is no universally accepted definition of the term “hedge fund,”<sup>9</sup> the term generally is used to refer to an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act. Alfred Winslow Jones is credited with establishing one of the first hedge funds as a private partnership in 1949. That hedge fund invested in equities and used leverage and short selling to “hedge” the portfolio’s exposure to movements of the corporate equity markets.<sup>10</sup> Over time, hedge funds began to diversify their investment portfolios to include other financial instruments and engage in a wider variety of investment strategies. Today, in addition to trading equities, hedge funds may trade fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options and other non-securities investments. Furthermore, hedge funds today may or may not utilize the hedging and arbitrage strategies that

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attorneys), investment bankers and hedge fund investors. Academics and foreign and U.S. regulators also participated in the Roundtable. A copy of the webcast and a transcript of the Roundtable discussions are available on the Commission’s website. See <http://www.connectlive.com/events/sechedgefunds/>; <http://www.sec.gov/spotlight/hedgefunds/hedge1trans.txt> and <http://www.sec.gov/spotlight/hedgefunds/hedge2trans.txt>.

<sup>8</sup> See *Notice of Roundtable Discussions; Request for Comment*, Advisers Act Release No. 2117 (Mar. 26, 2003). All comments received in response to the request are available from SEC public reference by calling (202) 942-8090, or by writing to: [publicinfo@sec.gov](mailto:publicinfo@sec.gov). In addition, comments submitted by Roundtable panelists are available at <http://www.sec.gov/spotlight/hedgefunds/hedge-parts.htm>.

<sup>9</sup> One Roundtable participant submitted a selection of definitions and descriptions of the term “hedge fund” that illustrates the diversity of views about that term. See Comment submitted by Roundtable Panelist David A. Vaughan.

<sup>10</sup> Carol Loomis, *Hard Times Come to Hedge Funds* (“Loomis”), *Fortune* 100, 101 (Jan. 1970). One commenter suggested that the first hedge funds were merely implementing investment strategies first used by the proprietary trading desks of investment banks. See Hennessee Group Comment Letter, *supra* note 4, at 2.

hedge funds historically employed, and many engage in relatively traditional, long-only equity strategies.

## **B. Market Benefits of Hedge Funds**

Hedge funds seek to achieve positive investment returns, often with less volatility than traditional asset classes such as stocks and bonds. Hedge funds engage in a wide variety of investment strategies, such as investing in distressed securities, illiquid securities, securities of companies in emerging markets and derivatives, as well as pursue arbitrage opportunities, such as those arising from possible mergers or acquisitions. They typically are managed by entrepreneurs who employ more complicated, flexible investment strategies than advisers at mutual funds, brokerage firms and bank trust departments.

Hedge funds can provide benefits to financial markets by contributing to market efficiency and enhancing liquidity. Many hedge fund advisers take speculative trading positions on behalf of their managed hedge funds based on extensive research about the true value or future value of a security. They may also use short-term trading strategies to exploit perceived mispricings of securities. Because securities markets are dynamic, the result of such trading is that market prices of securities will move toward their true value. Trading on behalf of hedge funds can thus bring price information to the securities markets, which can translate into market price efficiencies.<sup>11</sup> Hedge funds also provide liquidity to the capital markets by participating in the market.

Hedge funds play an important role in a financial system where various risks are distributed across a variety of innovative financial instruments. They often assume risks by serving as ready counterparties to entities that wish to hedge risk. For example, hedge funds are buyers and sellers of certain derivatives, such as securitized financial instruments, that provide a mechanism for banks and other creditors to un-bundle the risks involved in real economic activity. By actively participating in the secondary market for these instruments, hedge funds can help such entities to reduce or manage their own risks because a portion of the financial risks are shifted to investors in the form of these tradable financial instruments. By reallocating financial risk, this market activity provides the added benefit of lowering the financing costs

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<sup>11</sup> “[M]any of the things which [hedge funds] do . . . tend to refine the pricing system in the United States and elsewhere. And it is that really exceptionally and increasingly sophisticated pricing system which is one of the reasons why the use of capital in this country is so efficient . . . there is an economic value here which we should not merely dismiss . . . I do think it is important to remember that [hedge funds] . . . , by what they do, they do make a contribution to this country.” Testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, Before the House Committee on Banking and Financial Services (Oct. 1, 1998).

shouldered by other sectors of the economy. The absence of hedge funds from these markets could lead to fewer risk management choices and a higher cost of capital.

Hedge funds also can serve as an important risk management tool for investors by providing valuable portfolio diversification. Hedge fund investment strategies are typically designed to protect investment principal. Hedge funds frequently use financial instruments (e.g., derivatives) and techniques (e.g., short selling) to hedge against market risk and construct a conservative investment portfolio -- one designed to preserve wealth. In addition, hedge fund investment performance can exhibit low correlation to that of traditional investments in the equity and fixed-income markets.<sup>12</sup> Institutional investors have used hedge funds to diversify their investments based on this historic low correlation with overall market activity.

### **C. Pooled Investment Vehicles that Are Not Hedge Funds**

Hedge funds are often compared to registered investment companies. In addition, unregistered investment pools, such as venture capital funds, private equity funds and commodity pools, are sometimes referred to as hedge funds. Although all of these investment vehicles are similar in that they accept investors' money and generally invest it on a collective basis,<sup>13</sup> they also have characteristics that distinguish them from hedge funds.

#### *1. Registered Investment Companies*

As a practical matter, hedge funds are similar to registered investment companies in a number of respects. Both are entities that issue securities to investors and hold pools of securities and perhaps other assets through which investors can obtain, among other things, investment diversification and professional asset management by an investment adviser who typically organizes the pool. Hedge funds and registered investment companies may invest in similar types of securities and may even share similar investment strategies.

Registered investment companies, however, also differ from hedge funds in a number of significant respects, including the extent to which they are regulated. Registered investment companies are registered with the Commission and are subject to the provisions of the Investment Company Act. Their securities offerings are almost always registered with the Commission and they are subject to the disclosure and reporting requirements of the federal

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<sup>12</sup> See, e.g., Mark J.P. Anson, *Handbook of Alternative Assets* 37-40 (2002) ("*Handbook of Alternative Assets*").

<sup>13</sup> But for certain exclusions set forth in the Investment Company Act, all of these vehicles would meet the definition of investment company in Section 3(a) of the Investment Company Act. See infra Part III.A.1. and 2.

securities laws. Finally, investment advisers to registered investment companies are required to register with the Commission under the Advisers Act.

Registered investment companies, which register their securities offerings under the Securities Act, generally may offer and sell their securities to any investor,<sup>14</sup> including investors who are not financially sophisticated. Most registered investment companies have a board of directors, a majority of whom are independent of the investment companies' investment adviser.<sup>15</sup> The board is responsible for selecting and overseeing the activities of the company's investment adviser and other service providers and for generally overseeing the company's operations.

In addition, registered investment companies are subject to extensive operational restrictions designed to prevent the potential for abuse that exists when an investment adviser has control of the assets of other persons who do not actively oversee the management of those assets. For example, registered investment companies are subject to regulations concerning the computation of the fund's net asset value,<sup>16</sup> as well as regulations designed to protect against

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<sup>14</sup> Recently, a number of hedge funds that invest all or substantially all of their assets in other hedge funds have begun registering under the Investment Company Act as closed-end investment companies, and many have also registered their securities offerings under the Securities Act. See infra Part IV.J. (discussing funds of hedge funds).

<sup>15</sup> See *Interpretive Matters Concerning Independent Directors of Investment Companies*, Investment Company Act Release No. 24083 text accompanying n. 4 (Oct. 14, 1999) ("Congress intended to place independent directors in the role of 'independent watchdogs,' who would furnish an independent check upon the management of funds and provide a means for the representation of shareholder interests in fund affairs.") (citations omitted).

<sup>16</sup> Under the Investment Company Act, a registered investment company must value its portfolio securities using market quotations or, if market quotations are not readily available, fair value as determined in good faith by the company's board of directors. See Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder. See also Accounting Series Release No. 118, Financial Reporting Codification (CCH) §404.03 (Dec. 23, 1970) ("ASR No. 118"); Accounting Series Release No. 113, Financial Reporting Codification (CCH) §404.04 (Oct. 21, 1969); Letters to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management (Dec. 8, 1999; Apr. 30, 2001). Most boards fulfill their obligations by approving and monitoring the implementation of valuation procedures and methodologies. Boards of registered investment companies are also required to continuously review the appropriateness of their valuation methodologies. See ASR No. 118.

conflicts of interest and limit leverage (and consequently certain trading strategies).<sup>17</sup> They also are subject to regulations requiring shareholder reports.<sup>18</sup>

## 2. *Private Equity Funds*

A private equity fund, like a hedge fund, is an unregistered investment vehicle in which investors pool money to invest in securities. Private equity funds concentrate their investments in unregistered (and typically illiquid) securities. Both private equity funds and domestic hedge funds are typically organized as limited partnerships.<sup>19</sup> Because these entities rely on an exemption from registration of the offer and sale of their securities, the managers/sponsors of both private equity funds and hedge funds solicit investors directly, or through a registered broker-dealer, rather than through general solicitation, general advertising or a public offering of the securities. The investors in private equity funds and hedge funds typically include high net worth individuals and families, pension funds, endowments, banks and insurance companies.<sup>20</sup> Like hedge funds, many private equity funds establish offshore “mirror” funds that are typically managed by the general partner of the companion U.S. fund and have similar investments.

Private equity funds, however, differ from hedge funds in a number of significant ways. Private equity investors typically commit to invest a certain amount of money with the fund over the life of the fund, and make their contributions in response to “capital calls” from the fund’s general partner. Because private equity funds typically do not retain a pool of uninvested capital, their general partners make a capital call when they have identified or expect to identify a portfolio company in which the private equity fund will invest.<sup>21</sup> Private equity funds are long-

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<sup>17</sup> See Investment Company Act Sections 10(f); 17 (conflicts of interest) and 18 (leverage).

<sup>18</sup> See Investment Company Act Section 30(e) and Rule 30e-1 thereunder.

<sup>19</sup> See George W. Fenn, Nellie Lang and Stephen Prowse, *The Economics of the Private Equity Market*, Staff Study of the Board of Governors of the Federal Reserve System 41 (1995). Like domestic hedge funds, some private equity funds are organized as limited liability companies and, occasionally, corporations.

<sup>20</sup> “[I]ndividuals and families account for less than 10 percent of the assets invested in private equity funds, pension funds account for about 30 percent, endowments account for about 20 percent, and banks and insurance companies account for about 40 percent.” Secretary of the Treasury, Board of Governors of the Federal Reserve System, and Securities and Exchange Commission, *A Report to Congress in Accordance with § 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* n. 95 (Dec. 31, 2002) (“Patriot Act Report”).

<sup>21</sup> A hedge fund investor, by contrast, generally can decide when and how much to invest in the fund.



term investments, provide for liquidation at the end of the term specified in the fund's governing documents, and offer little, if any, opportunity for investors to redeem their investments.<sup>22</sup> A private equity fund, however, may distribute cash to its investors when it sells its portfolio investment, or it may distribute the securities of a portfolio company (assuming the portfolio company has complied with the registration requirements of the Securities Act in connection with the distribution) to its investors.

### 3. *Venture Capital Funds*

Venture capital funds are unregistered investment vehicles, which are structurally similar to hedge funds and attract similar types of investors.<sup>23</sup> Venture capital pools are generally organized, however, to invest in the start-up or early stages of a company.

Venture capital funds have the same features that distinguish private equity funds generally from hedge funds, such as mandatory capital contributions over the life of the fund and the long-term nature of the investment. In addition, unlike hedge fund advisers, general partners of venture capital funds often play an active role in the companies in which the funds invest, either by sitting on the board of directors or becoming involved in the day-to-day management of these companies. In contrast to a hedge fund, which may hold an investment in a portfolio security for an indefinite period based on market events and conditions, a venture capital fund typically seeks to liquidate its investment once the value of the company increases above the value of the investments.

### 4. *Commodity Pools*

Commodity pools are investment trusts, syndicates or similar enterprises that are operated for the purpose of trading commodity futures. The investment concentration in commodity futures distinguishes commodity pools from hedge funds and the other investment vehicles

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<sup>22</sup> There is typically no formal secondary market for shares in a private equity fund, although there may be a small informal secondary market comprised of private equity funds that buy interests in other established private equity funds. In 1999, five private equity funds raised \$1.6 billion for purchases of secondary interests in other private equity funds. See Patriot Act Report, supra note 20, at n. 99 (citation omitted). See also David M. Toll, *Private Equity Primer*, in *Galante's Venture Capital & Private Equity Directory*.

<sup>23</sup> See National Venture Capital Association, *2003 National Venture Capital Association Yearbook* 9 (2003). The National Venture Capital Association estimates that 1,798 venture capital funds were in existence in 2002, with \$253 billion in capital under management. It also estimates that, in 2002, individuals and families accounted for approximately nine percent of the invested assets in venture capital funds; pension funds accounted for 42 percent; endowments accounted for 21 percent; and banks, insurance companies and corporations accounted for 28 percent. Id. at 10.

discussed above.<sup>24</sup> Commodity pool operators, which manage commodity pools, are subject to oversight by the Commodity Futures Trading Commission (“CFTC”). The CFTC has recently adopted rules which sharpen the distinction between hedge funds and commodity pools.<sup>25</sup>

## **D. Domestic and Offshore Hedge Funds**

The corporate structure of a hedge fund depends primarily on whether the fund is organized under U.S. law (“domestic hedge fund”) or under foreign law and located outside of the United States (“offshore hedge fund”). The investment adviser of a domestic hedge fund often operates a related offshore hedge fund, either as a separate hedge fund or often by employing a “master-feeder” structure that allows for the unified management of multiple pools of assets for investors in different taxable categories.<sup>26</sup>

### *1. Domestic Hedge Funds*

Domestic hedge funds are usually organized as limited partnerships to accommodate investors that are subject to U.S. income taxation.<sup>27</sup> The fund’s sponsor typically is the general partner and investment adviser. The sponsor also typically handles marketing and investor services. Domestic hedge funds typically maintain contractual relationships with one or more broker-dealers, which provide clearance and settlement and financing services and may provide a

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<sup>24</sup> Commodity pools also differ from hedge funds, private equity funds and venture capital funds in that commodity pools frequently rely on Section 3(b)(1) of the Investment Company Act to exclude them from the definition of investment company. Section 3(b)(1) excludes from that definition any issuer that is directly or indirectly primarily engaged in a business other than investing or trading in securities.

<sup>25</sup> See *infra* Part III.E.1 (discussing the regulation of commodity pools).

<sup>26</sup> The master fund is usually organized as a corporation, such as an international business company, under non-U.S. law. It offers shares to one or more domestic feeder funds and one or more offshore corporate feeder funds, all of which share common investment strategies and objectives. See Gerald T. Lins (“Lins”), *Hedge Fund Organization*, in *Hedge Fund Strategies: A Global Outlook* 98, 100-101 (Brian R. Bruce, ed., 2002).

<sup>27</sup> Hedge funds may also take the form of limited liability companies (“LLCs”) or business trusts. Limited partnerships, LLCs and business trusts are generally not separately taxed and, as a result, income is taxed only at the level of the individual investor. Each of the three forms also limits investor liability. LLCs offer the additional benefit of limited liability for fund advisers, but some states and foreign countries tax LLCs as corporations. See David A. Vaughan and Margaret A. Bancroft, *Structuring Issues for Hedge Funds*, in *The Capital Guide to Starting a Hedge Fund – A U.S. Perspective* 31, 32 (2001).

variety of incidental services.<sup>28</sup> A domestic hedge fund also may employ executing brokers, accountants, lawyers, custodians, administrators, placement agents, registrars and transfer agents. Domestic hedge funds typically do not have a board of directors or any oversight body analogous to the board of directors of a registered investment company.

## 2. *Offshore Hedge Funds*

Offshore hedge funds are typically organized as corporations in countries such as the Cayman Islands, British Virgin Islands, the Bahamas, Panama, the Netherlands Antilles or Bermuda. Offshore funds generally attract investment of U.S. tax-exempt entities, such as pension funds, charitable trusts, foundations and endowments, as well as non-U.S. residents. U.S. tax-exempt investors favor investments in offshore hedge funds because they may be subject to taxation if they invest in domestic limited partnership hedge funds.<sup>29</sup> Offshore hedge funds may be organized by foreign financial institutions or by U.S. financial institutions or their affiliates. Sales of interests in the United States in offshore hedge funds are subject to the registration and antifraud provisions of the federal securities laws.

Offshore hedge funds typically contract with an investment adviser, which may employ a U.S. entity to serve as subadviser.<sup>30</sup> An offshore hedge fund often has an independent fund administrator, also located offshore, that may assist the hedge fund's adviser to value securities and calculate the fund's net asset value, maintain fund records, process investor transactions, handle fund accounting and perform other services.<sup>31</sup> An offshore hedge fund sponsor typically appoints a board of directors to provide oversight activities for the fund. These funds, especially those formed more recently, may have directors who are independent of the investment adviser.

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<sup>28</sup> See Roundtable Transcript, May 14 (statement of Richard Lindsey). See *infra* Part IV.E.2 (discussing the role of broker-dealers/prime brokers).

<sup>29</sup> Under U.S. income tax laws, a tax-exempt organization (such as an ERISA plan, a foundation or an endowment) engaging in an investment strategy that involves borrowing money is liable for a tax on "unrelated business taxable income" ("UBTI"), notwithstanding its tax-exempt status. The UBTI tax can be avoided by the tax-exempt entity by investing in non-U.S. corporate structures (*i.e.*, offshore hedge funds). See <http://www.greencompany.com/HedgeFunds/OffDocOffshore.shtml>.

<sup>30</sup> Lins, *supra* note 26 at 100.

<sup>31</sup> According to one Roundtable participant, there is a "trend towards more independent administration for domestic [hedge] funds, which traditionally have handled administration through fund affiliates." Roundtable Transcript, May 14 (statement of William Keunen). See also Roundtable Transcript, May 14 (statement of Joel Press). See *infra* Part IV.E.3 (discussing the role of offshore administrators).

### III. The Regulation of Hedge Funds and Their Advisers

#### A. Hedge Funds and the Investment Company Act of 1940

Most hedge funds have substantial investments in securities that would cause them to fall within the definition of investment company under the Investment Company Act.<sup>32</sup> Hedge funds, however, typically rely on one of two statutory exclusions from the definition of investment company, which enables them to avoid the regulatory provisions of that Act.

##### 1. Section 3(c)(1)

Section 3(c)(1) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and which is not making and does not presently propose to make a public offering of its securities.<sup>33</sup> In general, ownership by a corporate investor is counted as one investor in testing compliance with the 100-investor limitation of Section 3(c)(1).<sup>34</sup> Section 3(c)(1) reflects Congress's view that privately placed

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<sup>32</sup> Section 3(a)(1)(A) of the Investment Company Act defines an investment company as an 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(a)(1)(C) of that Act defines an investment company as an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. Many hedge funds meet both of these definitions.

<sup>33</sup> Notwithstanding the 100-investor limitation, a hedge fund that is incorporated offshore, but relies on Section 3(c)(1) in order to offer its securities privately to U.S. residents, may have more than 100 investors. The staff of the Division of Investment Management takes the position that an offshore hedge fund that relies on Section 3(c)(1) may exclude non-U.S. investors in determining whether it is in compliance with the 100-investor limitation of Section 3(c)(1). *See Touche, Remnant & Co.* (pub. avail. Aug. 27, 1984); *Investment Funds Institute of Canada* (pub. avail. Mar. 4, 1996) (staff states that it would not recommend enforcement action if an offshore hedge fund relying on Section 3(c)(1) exceeds the 100-investor limit because investors who purchased securities outside the United States have relocated to the United States). In practice, many offshore hedge funds relying on Section 3(c)(1) have more than 100 investors.

<sup>34</sup> If a corporate investor that is a registered investment company, or a company relying on Section 3(c)(1) or Section 3(c)(7), beneficially owns ten percent or more of the outstanding voting securities of the Section 3(c)(1) fund, the Section 3(c)(1) fund must "look-through" that corporate investor and count each of its investors as a beneficial owner of the Section 3(c)(1) fund for purposes of the 100-investor limitation. A hedge fund that relies on Section 3(c)(1) and that accepts investments from registered investment companies or entities relying on Section 3(c)(1)

investment companies owned by a limited number of investors do not rise to the level of federal interest under the Investment Company Act.<sup>35</sup>

Hedge funds relying on Section 3(c)(1) may not be making or proposing to make a public offering. As discussed further below, these hedge funds must comply with Section 4(2) of the Securities Act, and frequently do so by relying on the safe harbor available under Regulation D under that Act, as discussed below.<sup>36</sup> Consequently, hedge funds may offer their securities only to “accredited investors,” and may not engage in any general solicitation or general advertising of their shares, as discussed below.

## 2. Section 3(c)(7)

Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are “qualified purchasers,”<sup>37</sup> and which is not

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or Section 3(c)(7), therefore, must ensure that those investors do not acquire more than ten percent of the hedge fund’s outstanding voting securities so that the hedge fund may continue to rely on Section 3(c)(1).

<sup>35</sup> See *Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency, 76<sup>th</sup> Cong., 3d Sess. 179 (1940).*

<sup>36</sup> See *infra* Part III.B.2 (discussing Regulation D). The staff of the Division of Investment Management generally interprets the non-public offering requirement of Section 3(c)(1) consistently with the non-public offering exemptions under Section 4(2) of the Securities Act and the rules thereunder. See, e.g., *Santa Barbara Securities* (pub. avail. Apr. 8, 1983). See also *Lamp Technologies* (pub. avail. May 29, 1997; May 29, 1998) (“*Lamp*”).

<sup>37</sup> Section 2(a)(51) of the Investment Company Act generally defines “qualified purchaser” to be: (1) any natural person who owns not less than \$5 million in investments; (2) any family-owned company (as described in that section) that owns not less than \$5 million in investments; (3) any other trust the trustee and settlor(s) of which are qualified purchasers that was not formed for the specific purpose of acquiring the securities of the Section 3(c)(7) fund; and (4) any person acting for its own account or the accounts of other qualified purchasers, that owns and invests on a discretionary basis not less than \$25 million in investments. Rule 2a51-1 under the Investment Company Act defines the term “investments” for purposes of Section 2(a)(51), and details how the value of a qualified purchaser’s investments should be calculated. Rule 2a51-3 under the Investment Company Act provides that any company may be deemed to be a qualified purchaser if each beneficial owner of the company’s securities is a qualified purchaser. The staff of the Division of Investment Management takes the position that a hedge fund that is incorporated offshore but relies on Section 3(c)(7) to offer its securities privately in the United States is not subject to the qualified purchaser requirements with respect to its investors who are non-U.S. residents. See *Goodwin Proctor & Hoar* (pub. avail. Feb. 28, 1997).

making and does not at that time propose to make a public offering of its securities.<sup>38</sup> This exclusion reflects Congress’s view that certain highly sophisticated investors do not need the protections of the Investment Company Act because those investors are in a position to appreciate the risks associated with pooled investment vehicles.<sup>39</sup>

A hedge fund relying on Section 3(c)(7) may accept an unlimited number of qualified purchasers for investment in the fund. As a practical matter, however, most funds relying on Section 3(c)(7) have no more than 499 investors in order to avoid the registration and reporting requirements of the Securities Exchange Act of 1934 (“Exchange Act”).<sup>40</sup> In addition, unlike Section 3(c)(1), Section 3(c)(7) does not have a “look-through” provision in the event that a registered investment company or a private investment company owns ten percent or more of the Section 3(c)(7) fund’s outstanding voting securities. A Section 3(c)(7) fund is only required to look through any company (investment company or otherwise) that invests in its shares to determine whether that company’s investors are qualified purchasers if the company was “formed for the purpose” of investing in the Section 3(c)(7) fund.<sup>41</sup>

## **B. Hedge Funds and the Securities Act of 1933**

One of the Securities Act’s primary objectives is to provide full and fair disclosure in securities transactions. To accomplish this objective, Section 5 of the Securities Act mandates the registration with the Commission of public securities offerings and the delivery to purchasers of a prospectus containing specified categories of information about the issuer and the securities being offered, unless there is an available exemption from the registration requirements. Since limited partnership, LLC and other interests offered to investors in the case of a typical hedge fund fall within the definition of the term “securities” for purposes of the federal securities laws, the hedge funds must either register the offer and sale of the securities or rely on an exemption

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<sup>38</sup> As with respect to a Section 3(c)(1) fund, the Commission has stated that the non-public offering requirement of Section 3(c)(7) should be interpreted consistently with the non-public offering exemptions under Section 4(2) of the Securities Act and the rules thereunder. *Privately Offered Investment Companies*, Investment Company Act Release No. 22597 n. 5 (Apr. 3, 1997). See supra note 36.

<sup>39</sup> S. Rep. No. 293, 104<sup>th</sup> Cong., 2d. Sess. 10 (1996) (“Generally, these investors can evaluate on their own behalf matters such as the level of a fund’s management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.”).

<sup>40</sup> See infra Part III.C.2 (discussing Exchange Act registration under Section 12).

<sup>41</sup> Rule 2a51-3 generally provides, in relevant part, that an entity may not be deemed to be a qualified purchaser if it was formed for the specific purpose of acquiring the securities offered by a Section 3(c)(7) fund unless each beneficial owner of an entity’s securities is a qualified purchaser.

from registration. Offerings of hedge fund securities in the United States generally rely on the private offering exemption in Section 4(2) of the Securities Act or Rule 506 promulgated under that Section to avoid the registration and prospectus delivery requirements of Section 5.

### *1. The Private Offering Exemption of the Securities Act*

Section 4(2) of the Securities Act exempts from the registration and prospectus delivery requirements of Section 5 any “transactions by an issuer not involving any public offering.” The Section 4(2) exemption, commonly known as the “private offering” or “private placement” exemption, requires no notice or other filing or regulatory approval as a prerequisite for its availability.

The procedures appropriate to establish the availability of an exemption under Section 4(2) have evolved over time based upon judicial decisions, Commission interpretive guidance and shared experience. The Supreme Court in *Ralston Purina* stated that a private offering is an “offering to those who are shown to be able to fend for themselves” and that the availability of the exemption “turns on the knowledge of the offerees” and is limited to situations where the offerees have access to the kind of information afforded by registration under Section 5 of the Securities Act.<sup>42</sup>

### *2. Regulation D*

#### *a. Rule 506*

Rule 506 of Regulation D under the Securities Act is a set of requirements promulgated by the Commission to govern private offerings. Although compliance with the Rule 506 requirements is not required to establish the availability of a private offering exemption, satisfaction of the conditions of the rule entitles an issuer to claim the Section 4(2) exemption. In this sense, Rule 506 establishes “safe harbor” criteria for the private offering exemption, but is not the exclusive means of establishing entitlement to the exemption. Because of a degree of uncertainty as to the availability of the Section 4(2) exemption, many hedge funds tailor their offering and sale procedures to the criteria specified in Rule 506.

#### *b. Offerings to “Accredited Investors”*

The safe harbor protection most often relied upon by hedge funds under Rule 506 exempts offerings that are made exclusively to “accredited investors.”<sup>43</sup> Issuers are permitted

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<sup>42</sup> SEC v. Ralston Purina Co., 346 U.S. 119, 125, 126-27 (1953).

<sup>43</sup> While Rule 506(b)(2)(i) limits the number of purchasers in a Rule 506 transaction to 35, this numerical limitation becomes irrelevant if the offering is made only to “accredited investors”

under these provisions to sell securities to an unlimited number of “accredited investors.”<sup>44</sup> In addition, if the offering is made only to accredited investors, no specific information is required to be provided to prospective investors.

The term “accredited investors” is defined to include:

Individuals who have a net worth, or joint worth with their spouse, above \$1,000,000, or have income above \$200,000 in the last two years (or joint income with their spouse above \$300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and

Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than \$5,000,000 in assets; and many, if not most, employee benefit plans and trusts with more than \$5,000,000 in assets.<sup>45</sup>

Although most of these thresholds were initially established in 1982, the Commission has modified the definition of accredited investor since then and has had the opportunity to reevaluate the thresholds.<sup>46</sup> Most recently, the Commission, in December 2001, proposed that the term “qualified purchaser” be defined under the Securities Act to mean “accredited investor” as defined in Rule 501(a) of Regulation D under the Securities Act.<sup>47</sup> At that time, the

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because Rule 501(e)(1)(iv) provides that “accredited investors” are not counted for purposes of determining whether the issuer has exceeded the 35-purchaser limit.

<sup>44</sup> On its face, Rule 506 appears to permit offerings to hundreds of investors, as long as no more than 35 purchasers are not accredited investors. In the original proposing release for Regulation D, the Commission indicated that it was aware of this potential and issued this warning:

The Commission cautions issuers . . . that depending on the actual circumstances, offerings made to such large numbers of purchasers may involve a violation of the prohibitions against general solicitation and general advertising.

*Proposed Revisions of Certain Exemptions*, Securities Act Release No. 6339 n. 30 (Aug. 7, 1981).

<sup>45</sup> See Rule 501 under the Securities Act.

<sup>46</sup> See *Defining the Term “Qualified Purchaser” Under the Securities Act of 1933*, Securities Act Release No. 8041 (Dec. 19, 2001) (history of accredited investor concept).

<sup>47</sup> Id.



Commission stated in the proposing release that the existing “accredited investor” standard struck the appropriate balance between investor protection and capital formation needs and did not propose changes to the definition.

*c. General Solicitation and General Advertising*

Offers and sales under Rule 506 cannot be made using any form of “general solicitation or general advertising.” The current parameters of prohibited and permissible activities are set out in Rule 502(c) under the Securities Act, Commission staff no action letters, Commission releases and enforcement and private actions. The restrictions on general solicitation and general advertising in finding investors for private offerings mean that issuers and persons acting on their behalf cannot find investors through, among other things, advertisements, articles, notices or other communications published in a newspaper, magazine or similar media, cold mass mailings, broadcasts over television or radio, material contained on a web site available to the public or an e-mail message sent to a large number of previously unknown persons.<sup>48</sup> The restrictions also apply to any meeting or seminar where the participants have been invited by general solicitation or general advertising.

One central principle in the interpretations is that general solicitation is not present when there is a pre-existing, substantive relationship between an issuer or its broker-dealer, and the offeree. The relationship must be established at a time prior to the commencement of the private offering or, in the case of a hedge fund, 30 days before the investor can make an investment.<sup>49</sup> The existence of a pre-existing, substantive relationship is not the only way to avoid a general solicitation. The presence or absence of a general solicitation depends on the facts and circumstances of each particular case.

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<sup>48</sup> See Rule 506 under the Securities Act; *SEC v. Inorganic Recycling Corp.*, Litigation Release No. 16322 (Sept. 30, 1999); *In the Matter of CGI Capital, Inc.*, Securities Act Release No. 7904 (Sept. 29, 2000); *In the Matter of Harry Harootunian and Professional Planning & Technologies, Inc. and In the Matter of Robert Testa*, Exchange Act Release No. 32981 (Sept. 29, 1993); *In the Matter of Kenman Corp.*, Exchange Act Release No. 21962 (Apr. 19, 1985); *In the Matter of PriorityAccess, Inc.*, Securities Act Release No. 8021 (Oct. 3, 2001); *Circle Creek Aquaculture V, L.P.* (pub. avail. Mar. 26, 1993); *H.B. Shaine & Co.* (pub. avail. May 1, 1987); *Ovation Cosmetics, Inc.* (pub. avail. Mar. 8, 1976); *Woodtrails-Seattle, Ltd.* (pub. avail. Aug. 9, 1982).

<sup>49</sup> Many of the interpretive letters that the staff of the Division of Corporation Finance has issued address the circumstances under which issuers and broker-dealers can establish the pre-existing substantive relationship without violating the restrictions on general solicitation and advertising. See, e.g., *Bateman Eichler, Hill Richards, Inc.* (pub. avail. Dec. 3, 1985); *E.F. Hutton Co.* (pub. avail. Dec. 3, 1985); *IPONET* (pub. avail. July 26, 1996) (“IPONET”); *Lamp*, supra note 36.

With respect to online private offerings under Regulation D, the Commission has stated that “[b]road use of the Internet for exempt securities offerings under Regulation D is problematic because of the requirement that these offerings not involve a general solicitation or advertising.”<sup>50</sup> The Commission and staff, on numerous occasions, have made clear how the Internet can be used in private offerings of securities without running afoul of the prohibitions on general solicitation and general advertising.<sup>51</sup> The staff of the Division of Corporation Finance has granted no action relief where a broker-dealer, on behalf of other issuers, solicited, pre-qualified and made offers to potential investors via the Internet.<sup>52</sup> In a letter involving hedge funds, the staff of the Division of Corporation Finance determined that there was no general solicitation if investors were solicited, pre-qualified and able to access a password protected web site containing information on hedge funds to purchase hedge fund interests 30 days after the investor was qualified.<sup>53</sup>

*d. Resale Restrictions*

Hedge funds relying on Rule 506 must exercise reasonable care to assure that their investors are not investing with a view to distributing their interests in the fund to the public. Unrestricted resales of the interests can jeopardize the availability of Rule 506 protection even if the original sales qualify for the protection. Rule 506 provides safe harbor protection for issuers against the loss of Rule 506 protection because of resales.<sup>54</sup> The conditions for the safe harbor include “reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons” and “written disclosure . . . that the securities . . . cannot be resold unless they are registered under the [Securities] Act or unless an exemption from registration is available.”<sup>55</sup>

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<sup>50</sup> *Use of Electronic Media*, Securities Act Release No. 7856 (Apr. 28, 2000) (“2000 Electronic Release”).

<sup>51</sup> *Use of Electronic Media for Delivery Purposes*, Securities Act Release No. 7233 (Oct. 6, 1995); *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Securities Act Release No. 7516 (Mar. 23, 1998); 2000 Electronic Release, supra note 50; *IPONET*, supra note 49; *Lamp*, supra note 36.

<sup>52</sup> *IPONET*, supra note 49.

<sup>53</sup> *Lamp*, supra note 36. The staff of the Division of Corporation Finance also has addressed general solicitation issues in the context of other privately offered funds. See *Royce Exchange Fund, Quest Advisory Corp.* (pub. avail. Aug. 28, 1996).

<sup>54</sup> Rule 502 under the Securities Act is incorporated into Rule 506 under the Securities Act.

<sup>55</sup> Rule 502(d) under the Securities Act.

In addition, the safe harbor is conditioned upon the placement of a legend on the certificate or other document that evidences the securities.

These resale restrictions ordinarily do not present a problem for hedge funds. For a variety of business and legal reasons, the principals of hedge funds normally have no interest in encouraging resale of interests in their funds. In the usual case, therefore, transfers of the interests are prohibited without the written consent of the general partner or other manager, and there is limited liquidity of the interests through sales and redemptions by the hedge funds.

### **C. Hedge Funds and the Securities Exchange Act of 1934**

#### *1. Definition of “Broker” and “Dealer”*

Some hedge funds may need to register with the Commission as dealers. Section 3(a)(5) of the Exchange Act generally defines a dealer as a person that is engaged in the business of buying and selling securities for its own account. The Commission historically has distinguished “dealers” from “traders.” A trader is a person that buys and sells securities, either individually or in a trustee capacity, but not as part of a regular business. Entities that buy and sell securities for investment generally are considered traders, but not dealers. In contrast to dealers, which must register with the Commission in accordance with Section 15(b) of the Exchange Act, there is no registration requirement for traders.<sup>56</sup>

#### *2. Exchange Act Registration Under Section 12*

The Exchange Act contains registration and reporting provisions that may apply to hedge funds. Section 12 of the Exchange Act and the rules promulgated thereunder govern the registration of classes of equity securities traded on an exchange or meeting the holder of record and asset tests of Section 12(g) and related rules. Section 12(g) and Rule 12g-1 thereunder require that an issuer having 500 holders of record of a class of equity security (other than an exempted security) and assets in excess of \$10 million at the end of its most recently ended fiscal year register the equity security under the Exchange Act. Registration of a class of equity security subjects domestic registrants to the periodic reporting requirements of Section 13, proxy requirements of Section 14 and insider reporting and short swing profit provisions of Section 16 of the Exchange Act. Although hedge fund interests fall within the definition of equity security

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<sup>56</sup> See generally Testimony of Richard R. Lindsey, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, *Concerning Hedge Fund Activities in the U.S. Financial Markets*, Before the House Committee on Banking and Financial Services (Oct. 1, 1998); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, *Concerning Hedge Fund Activities in the U.S. Financial Markets*, Before the House Committee on Banking, Finance and Urban Affairs (Apr. 13, 1994). See also *Davenport Management, Inc.* (pub. avail. Apr. 13, 1993); *Louis Dreyfus Corp.* (pub. avail. July 23, 1987).

under the Exchange Act, most hedge funds seek to avoid Exchange Act registration by having fewer than 500 holders of record (which in the case of hedge funds are also generally the investors).

### 3. *Beneficial Ownership Reporting under Sections 13 and 16 of the Exchange Act*

The beneficial ownership reporting rules under Sections 13(d) and 13(g) of the Exchange Act generally require that any person who, after acquiring beneficial ownership of any equity securities registered under Section 12 of the Exchange Act, beneficially owns greater than five percent of the class of equity securities, file a beneficial ownership statement containing the information required by Schedule 13D or Schedule 13G.<sup>57</sup> Beneficial ownership is broadly defined by Rule 13d-3 under the Exchange Act to include the power to vote or dispose of any equity securities, or the power to direct the voting or disposition of those securities. Due to the power a hedge fund's adviser may exercise over the equity securities held by the fund, both the hedge fund and its adviser generally will be deemed to beneficially own any equity securities owned by the hedge fund.<sup>58</sup> In certain specified circumstances, the hedge fund and its advisers may file a short form Schedule 13G in lieu of filing a Schedule 13D.<sup>59</sup>

In addition to the amount of equity securities beneficially owned by the reporting person and the percentage of the subject class of equity securities this amount represents, Schedule 13D requires disclosure of certain other material information regarding the reporting person (e.g., identity and background) and the acquisition of the securities (e.g., source and amount of funds or other consideration used or to be used in making the purchase; the purpose of the acquisition; contracts, arrangements, understandings or other relationships between the reporting persons with respect to any securities of the issuer, etc.). The information required to be disclosed by Schedule 13G is more limited than the information required to be disclosed by Schedule 13D.<sup>60</sup> Once a hedge fund and its advisers are subject to the reporting obligations of Sections 13(d) or

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<sup>57</sup> See Rule 13d-1(a) under the Exchange Act.

<sup>58</sup> See Example 11 from *Adoption of Beneficial Ownership Disclosure Requirements*, Exchange Act Release No. 13291 (Feb. 24, 1977) (power over discretionary accounts represents beneficial ownership of the shares held in those accounts).

<sup>59</sup> See Rule 13d-1(b) under the Exchange Act.

<sup>60</sup> For example, Schedule 13G does not require as much disclosure on the background of the reporting person, does not require any disclosure as to the source of the funds used in the transaction, and does not require a statement as to the purpose of the transaction (other than a certification that the purpose is not to change or influence control over the issuer). See Instructions to Schedule 13G.

13(g), previously filed beneficial ownership statements must be amended as a result of certain changes in the information disclosed.<sup>61</sup>

In addition, hedge fund advisers also may be subject to the quarterly reporting obligations of Section 13(f) of the Exchange Act, which apply to any “institutional investment manager” exercising investment discretion with respect to accounts having an aggregate fair market value of at least \$100 million in equity securities. An “institutional investment manager” includes any person (other than a natural person) investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.<sup>62</sup>

Section 16 applies to every person who is the beneficial owner of more than ten percent of any class of equity security registered under Section 12 of the Exchange Act and each officer and director of the issuer of the security (collectively, “reporting persons” or “insiders”). Upon becoming a reporting person, a person is required by Section 16(a) to file an initial report with the Commission disclosing the amount of his or her beneficial ownership of all equity securities of the issuer. Section 16(a) also requires reporting persons to keep this information current by reporting to the Commission changes in ownership of these equity securities, or the purchase or sale of security-based swap agreements involving these securities.<sup>63</sup> Hedge funds are also subject to the short swing profit provisions of Section 16(b) of the Exchange Act.

#### **D. Hedge Fund Advisers and the Investment Advisers Act of 1940**

Virtually all hedge fund advisers meet the definition of “investment adviser” under the Advisers Act.<sup>64</sup> Under the Advisers Act, investment advisers must register with the Commission and comply with the provisions of that Act and Commission rules. Registered investment advisers must keep current a Form ADV that is filed with the Commission and provide a

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<sup>61</sup> See Rule 13d-2 under the Exchange Act.

<sup>62</sup> See Section 13(f)(5)(A) of the Exchange Act.

<sup>63</sup> See Section 16(a)(3)(B) of the Exchange Act.

<sup>64</sup> Section 202(a)(11) of the Advisers Act generally defines an investment adviser as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.” The Advisers Act contains certain limited exceptions from this definition for banks, certain professionals, including lawyers and accountants, broker-dealers, publishers and persons giving advice only about U.S. government securities.

disclosure statement that includes the information disclosed on Part II of Form ADV to clients.<sup>65</sup> These disclosures provide both the Commission and investors with current information about the adviser's business practices and disciplinary history, among other things. Registered advisers must maintain required books and records<sup>66</sup> and submit to periodic examinations by the Commission's staff. Advisers registered with the Commission also must comply with other requirements, including those relating to safeguarding client assets that are in the adviser's custody<sup>67</sup> and requiring that clients be told of an adviser's adverse financial condition.<sup>68</sup> Registered investment advisers must also inform clients of the adviser's proxy voting practices.<sup>69</sup> The Advisers Act also prohibits them from defrauding their clients.<sup>70</sup>

Many hedge fund advisers, however, avoid registering with the Commission by relying on the Advisers Act's *de minimis* exemption under Section 203(b) of that Act. That section excludes from registration investment advisers that have had fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered investment company.<sup>71</sup> For purposes of Section 203(b), current Commission rules provide that investment advisers may count a "legal organization," such as a hedge fund, as a single client.<sup>72</sup> Thus, an adviser may manage up to 14 hedge funds before being required to register with the Commission as an investment adviser, so long as it satisfies the "no holding out" condition. Investment advisers that are exempt from registration nevertheless are subject to the antifraud provisions of the Advisers Act.

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<sup>65</sup> See Rule 204-3 under the Advisers Act.

<sup>66</sup> See Rule 204-2 under the Advisers Act.

<sup>67</sup> See Rule 206(4)-2 under the Advisers Act.

<sup>68</sup> See Rule 206(4)-4 under the Advisers Act.

<sup>69</sup> See Rule 206(4)-6 under the Advisers Act.

<sup>70</sup> Section 206(1) of the Advisers Act prohibits investment advisers from employing "any device, scheme or artifice to defraud any client or prospective client." Section 206(2) of the Advisers Act prohibits an investment adviser from engaging "in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client."

<sup>71</sup> Section 203(b)(3) of the Advisers Act.

<sup>72</sup> Rule 203(b)(3)-1 under the Advisers Act provides that an adviser may count a legal organization as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual investment objectives of its owners.

Registered investment advisers are not required to indicate whether they manage hedge funds. They are also not required to state the amount of hedge fund assets under their management. A recent survey identifying the largest hedge fund firms accounts for slightly under half of the estimated \$600 billion in U.S. hedge fund assets.<sup>73</sup> Approximately 52 percent of the domestic advisers in this survey, managing some \$158 billion of hedge fund assets, are not registered with the Commission as investment advisers.<sup>74</sup> There is no comprehensive database or survey of the smaller firms managing the other half of U.S. hedge fund assets – approximately another \$300 billion. We expect that relatively fewer of these smaller advisers would be registered with the Commission, and that the proportion of hedge fund advisers not registered with us industry-wide may be approximately two-thirds.<sup>75</sup>

A number of hedge fund advisers, however, do register as investment advisers under the Advisers Act. Some are required to register because they have 15 or more advisory clients, or they advise one or more registered investment companies, and therefore are ineligible for the *de minimis* exemption. Others have registered with the Commission voluntarily because their investors demand it or for competitive reasons.<sup>76</sup>

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<sup>73</sup> See Institutional Investor, *The Hedge Fund 100* (June 2002) (“*The Hedge Fund 100*”) (The survey lists 86 U.S.-based and U.S.-registered firms managing \$298 billion in hedge fund assets. It also covered 14 internationally based firms managing approximately \$42 billion in hedge fund assets.).

<sup>74</sup> Forty-eight percent of the domestic hedge fund advisers listed in *The Hedge Fund 100* are registered with the Commission and manage a total of \$140 billion in hedge funds.

<sup>75</sup> This expectation is based on our assumption that smaller hedge fund advisers who are not named in *The Hedge Fund 100* are more likely to operate without registering with the Commission than larger hedge fund advisers. Larger hedge fund advisers are more likely to serve investors who demand registration, such as pension plans and many endowments, or to engage in other advisory activities such that the adviser is no longer eligible for the exception under Section 203(b)(3).

<sup>76</sup> Hennessee Group Comment Letter, *supra* note 4, at 14 (“Due to market forces predominantly driven by trust and ERISA fiduciaries, hedge funds are finding it necessary to become Registered Investment Advisers in order to attract capital from that market.”); Roundtable Transcript, May 15 (statement of Sandra Manzke) (institutional investors are requiring that hedge fund advisers register). See also *U.S. Hedge Fund Regulations Might Help Industry in Long Run*, Reuters English News Service (May 24, 2002) (“We registered with the SEC because it was simply easier to say that we were registered. A few fraud cases have gotten attention and when someone writes a \$10 million check, they want some assurances.” (Quoting Jerry Paul of Quixote Capital Management LLC)).

## **E. Certain Other Regulatory Requirements**

Depending upon their activities, in addition to complying with the federal securities laws, hedge funds and their advisers may have to comply with other laws including the Commodity Exchange Act (“CEA”), rules promulgated by the National Association of Securities Dealers (“NASD”) and/or provisions of the Employment Retirement Income Security Act (“ERISA”). In addition, hedge funds may be subject to certain regulations promulgated by the Department of the Treasury, including rules relating to the prevention of money laundering. Moreover, hedge fund advisers are subject to certain state laws.

### *1. Regulation under the CEA*

Generally, a hedge fund that engages in even a single commodity futures transaction will be deemed to be a “commodity pool” by the CFTC.<sup>77</sup> Similarly, the person that organizes and provides futures advice to such a hedge fund will typically fall within the statutory definitions of “Commodity Pool Operator” (“CPO”) and “Commodity Trading Advisor” (“CTA”), respectively.<sup>78</sup> An adviser to a hedge fund that uses commodity futures typically acts as both a CPO and a CTA to that hedge fund. However, as noted below, most hedge fund advisers can now claim an exemption from registration as a CPO and CTA pursuant to exemptions that were recently adopted by the CFTC.

Once an adviser falls within the definition of CPO or CTA, it generally must register as such with the CFTC.<sup>79</sup> Registered CPOs and CTAs must comply with CFTC rules that impose disclosure, record keeping and periodic reporting requirements.<sup>80</sup> In addition, registered CPOs and CTAs must complete an annual self-audit and must submit to periodic audits conducted by

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<sup>77</sup> See CFTC Interpretive Letter 98-18 (Mar. 12, 1998).

<sup>78</sup> See Section 1a(5) of the CEA (defining CPO); Section 1a(6)(A) of the CEA (defining CTA). A hedge fund adviser generally will not fall within the definition of CPO or CTA if it invests only in swaps, forward contracts or synthetic futures. These investments provide the same investment exposure as futures, but generally are not subject to regulation under the CEA.

<sup>79</sup> See Section 4m(1) of the CEA. A person generally registers with the CFTC as a CPO or a CTA by filing a completed Form 7-R and certain supporting materials with the National Futures Association (“NFA”), the self-regulatory organization governing the commodities markets. 17 C.F.R. Section 3.10.

<sup>80</sup> See Rules 4.21 through 4.26 under the CEA (rules applicable to CPOs), and Rules 4.31 through 4.36 under the CEA (rules applicable to CTAs).



the NFA.<sup>81</sup> All registered CPOs and CTAs are subject to the CEA's general antifraud rules,<sup>82</sup> as well as specific client protection, advertising and position reporting rules.<sup>83</sup>

As a result of recent CFTC rule adoptions, many hedge fund advisers can now qualify for exemptions from CPO and CTA registration. Regulations under the CEA provide an exemption from registration to CPOs operating pools that engage in limited commodity futures activities and sell interests solely to certain qualified individuals.<sup>84</sup> Regulations under the CEA also provide an exemption from registration to CPOs that operate pools that sell interests to certain highly sophisticated pool participants.<sup>85</sup> Investment advisers to hedge funds that operate in reliance upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act may be able to rely upon one of these CFTC exemptions.<sup>86</sup> In addition, the CEA provides a *de minimis*

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<sup>81</sup> See Interpretive Notice, NFA Compliance Rule 2-9 (July 4, 2000). Audits conducted by the NFA are designed to determine whether a firm is maintaining records in accordance with applicable CFTC and NFA rules, and to ensure that the firm is being operated in a manner that protects investors in the commodity futures markets. Although the NFA's audits may include a review of non-commodities, the emphasis of these audits is on reviewing commodities futures issues. See, e.g., Roundtable Transcript, May 15 (statement of Jane Thorpe) (stating that the NFA conducts its audits using "a risk-based approach [and] is going to focus on those areas that obviously it has the most and we have the most interest in.").

<sup>82</sup> See Section 4o of the CEA (general antifraud provision similar to Section 206(1) and Section 206(2) of the Advisers Act) and CFTC Rule 32.9 (prohibiting fraud in connection with commodity option transactions). See also Section 4b of the CEA (prohibiting fraudulent or misleading contracts) and CFTC Rule 4.15 (stating that Section 4o continues to apply to persons that are exempt from registration as a CTA or CPO).

<sup>83</sup> See Rules 4.20 and 4.30 under the CEA (governing segregation of pool assets and prohibited CTA activities, respectively); Rule 4.41 under the CEA (governing advertising by CPOs, CTAs and the principals thereof); Rule 18.04 under the CEA (requiring traders who hold or control reportable positions in futures, or options on futures, to file a "Statement of Reporting Trader" on Form 40 with the CFTC upon receipt of a special call by the CFTC).

<sup>84</sup> See CFTC Rule 4.13(a)(3) (exempting pools that privately place ownership interests to "accredited investors" as defined in Rule 501 of Regulation D of the Securities Act, and to certain other special groups of purchasers, provided that the pool, among other things, complies with certain limits on margin and notional value of the fund's commodity interests). This rule amendment took effect on August 8, 2003.

<sup>85</sup> See CFTC Rule 4.13(a)(4) (exempting pools that privately place ownership interests to certain highly sophisticated persons, including natural persons that are "qualified purchasers," as defined in Section 2(a)(51) of the Investment Company Act). This rule was recently adopted by the CFTC and became effective on August 8, 2003.

<sup>86</sup> Approximately 50 percent of the roughly 1,800 registered CPOs are eligible to deregister with the CFTC in reliance upon CFTC Rules 4.13(a)(3)-(4). See Roundtable Transcript, May 15

exemption from CTA registration that is similar to the Investment Advisers Act's *de minimis* exemption from investment adviser registration.<sup>87</sup> Consequently, hedge fund advisers that are exempt from registration as an investment adviser also are usually exempt from registration as a CTA.<sup>88</sup> Hedge fund advisers that meet the definition of CPO or CTA, but that are exempt from registration as such, are required to keep books and records, but are not subject to disclosure, periodic reporting or audit requirements that apply to a registered CPO or a registered CTA.<sup>89</sup>

## 2. NASD Regulation

### a. Suitability Determinations

Broker-dealers that sell interests in hedge funds are subject to the requirements of NASD rules, which regulates sales practices of its members, including certain suitability matters. The NASD recently issued a Notice to Members to remind them of their obligations when selling hedge funds and funds of hedge funds.<sup>90</sup> The Notice to Members was issued in response to the NASD's recent review of its broker-dealer members when recommending an investment in

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(statement of Jane Thorpe). As of May 2003, the CFTC had received 290 notices claiming the CFTC no action relief that was subsequently codified as CFTC Rule 4.13(a)(3). See id. It is difficult to ascertain whether these CPOs are new participants in the commodity markets or whether they are existing, registered CPOs that deregistered after claiming this relief.

<sup>87</sup> See Section 4m(1) of the CEA (providing exemption from registration for CTAs with 15 or fewer clients). See also CFTC Rule 4.14(a)(10) (counting certain business organizations as a single client for the purposes of the calculation required by Section 4m(1)). This rule amendment took effect on August 8, 2003.

<sup>88</sup> CPOs that are registered, or exempt from registration, as CPOs are specifically exempted from registration as CTAs. See CFTC Rules 4.14(a)(4) and 4.14(a)(5). As a result, only hedge fund advisers that are not CPOs, such as hedge fund sub-advisers, will typically need to rely upon the Section 4m(1) exemption.

<sup>89</sup> Certain CPOs and CTAs, although not exempt from registration, nevertheless enjoy relief from many of the requirements applicable to registered entities. See CFTC Rule 4.7 (exempting certain registered CPOs and CTAs from portions of the CEA's operational requirements). In order to obtain this relief, a CPO must sell interests in its commodity pool, and a CTA must provide advice, only to "qualified eligible persons," as defined in the rule (e.g., qualified purchasers, as defined by Section 2(a)(51) of the Investment Company Act), or individual accredited investors who meet a specific commodity portfolio requirement set forth in CFTC Rule 4.7(a)(1)(v).

<sup>90</sup> NASD Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds* (Feb. 2003).

hedge funds or FOHFs.<sup>91</sup> The NASD found that some broker-dealers may not be fulfilling their sales practice obligations under the NASD Rules, particularly when selling hedge funds and FOHFs to investors.

The Notice to Members reminded broker-dealers of their obligations in the following five areas:

- Promotion of Hedge Funds. Broker-dealers must balance sales material and oral presentations that promote hedge fund investing with disclosure of the risks and potential disadvantages that investing in these products may present.<sup>92</sup> Broker-dealers must give potential investors any prospectus or disclosure document, but providing such a document does not by itself satisfy the member's duty to provide balanced sales materials and oral presentations.
- Reasonable-Basis Suitability. A broker-dealer that recommends a hedge fund, directly or indirectly, must believe that the hedge fund is suitable for any investor. To satisfy this obligation broker-dealers must conduct due diligence regarding any hedge fund that they recommend to potential investors.<sup>93</sup>
- Customer-Specific Suitability. A broker-dealer must believe that its recommendation to invest in a hedge fund product is suitable for that particular investor. To reach this determination, a broker-dealer must, in accordance with NASD Rule 2310, examine the investor's financial status, tax status and investment objectives, as well as any other pertinent information.<sup>94</sup>

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<sup>91</sup> The NASD censured and fined a broker-dealer for failing to disclose the risks associated with hedge funds when marketing them to investors. See infra note 262 (discussing disciplinary action taken against Altegris Investments, Inc.).

<sup>92</sup> The NASD specifically stated, among other things, that broker-dealers “may not claim that hedge funds offer superior professional management with more investment flexibility [and] protection against declining markets . . . unless these statements are fair, accurate, and without exaggeration.” In addition, when disclosing the risks of hedge fund investing, the NASD stated that broker-dealers should specifically disclose (where applicable) that hedge funds can be illiquid, engage in leverage and other speculative practices, are not required to provide valuation information to investors, are not regulated like open-end investment companies, may raise complex tax issues and often charge high fees.

<sup>93</sup> This due diligence includes, but is not limited to, investigating the background of the hedge fund adviser, reviewing the offering memorandum and subscription agreements, examining references, and examining the relative performance of the fund.

<sup>94</sup> NASD Rule 2310.

Whether an investor is an accredited investor for purposes of Regulation D under the Securities Act does not, by itself, satisfy the NASD's suitability requirements.

- Internal Controls. A broker-dealer's internal controls, including those relating to compliance and supervision of associated persons, must ensure that the sale of hedge fund products comply with all NASD and Commission rules.
- Training. Broker-dealers must train all associated persons about the features, risks and suitability of hedge funds products before such persons may recommend investment in them.

*b. NASD Hot Issues Rule*

The NASD's Free-Riding and Withholding Interpretation, IM-2110-1, governs the allocation of so-called "hot issues."<sup>95</sup> IM-2110-1 does not directly restrict a hedge fund's ability to acquire shares of a hot issue. However, it does prohibit an investment adviser to a hedge fund from acquiring shares of a hot issue through a personal account. Hedge fund advisers often have significant interests in the funds that they manage and the investment adviser's interest in the hedge fund does not disqualify the fund itself from acquiring shares of a hot issue, provided that such acquisitions are part of the fund's "normal investment practice," and the notional *pro rata* amount of hot issues acquired by the investment adviser through the fund is "insubstantial and not disproportionate in amount as compared to sales to members of the public."<sup>96</sup>

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<sup>95</sup> NASD IM-2110-1 defines "hot issue" as a public offering that trades at a premium in the secondary market whenever such secondary market trading begins.

<sup>96</sup> NASD IM-2110-1(b)(5). The NASD has filed a proposed rule change with the Commission that would amend the Interpretation in several respects. Under the proposal, all portfolio managers, including investment advisers to hedge funds, would be "restricted persons." An account in which a restricted person had a beneficial interest generally would be prohibited from purchasing hot issues. Thus, a hedge fund adviser would be prohibited from purchasing a hot issue through a personal account as well as for the account of the hedge fund because the beneficial interest in the hedge fund of even a single restricted person might disqualify the entire fund from purchasing hot issues. The NASD is proposing a *de minimis* exemption whereby a collective investment vehicle (such as a hedge fund) would be permitted to purchase shares of a hot issue, provided that the participation of restricted persons in the fund (the adviser, plus any other restricted persons) does not, among other things, exceed ten percent. *Notice of Filing of Amendment Nos. 3 and 4 to a Proposed Rule Change by the National Association of Securities Dealers, Inc. Regarding Restrictions on the Purchase and Sale of Initial Public Offerings of Equity Securities*, Exchange Act Release No. 46942 (Dec. 4, 2002). The Commission has received comments from the hedge

### 3. Regulation under ERISA

An investment adviser to a hedge fund is an ERISA plan fiduciary if it exercises discretionary authority over the management of “plan assets.”<sup>97</sup> The assets of a hedge fund are deemed to be “plan assets” if an ERISA plan’s investment in that hedge fund is “significant.” An ERISA plan’s investment is deemed to be significant if, immediately after the most recent acquisition of any equity interest in the hedge fund, more than 25 percent of the value of any class of equity interests in the hedge fund is held collectively by the employee benefit plan investors.<sup>98</sup> Many hedge fund advisers take measures to ensure that employee benefit plan investments in hedge funds do not exceed this 25 percent threshold in order to avoid being subject to regulation as an ERISA fiduciary.<sup>99</sup>

Some hedge fund advisers, however, accept regulation under ERISA because they view ERISA plans as attractive investors for the hedge funds they advise. As a result, they permit the investment of significant amounts of employee plan assets in the hedge funds. Before investing plan assets in such a hedge fund, however, the non-adviser ERISA plan fiduciary typically will require assurances from the hedge fund adviser that it will not be liable under ERISA for any misconduct on the part of the hedge fund adviser in managing the plan assets. Generally, a hedge fund adviser can shield ERISA plan fiduciaries from liability for its misconduct by registering as an investment adviser under the Advisers Act, and by qualifying as an “investment manager” under ERISA.<sup>100</sup>

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fund industry strongly opposing this approach. It has not yet taken final action on the NASD’s proposal.

<sup>97</sup> See Section 3(21)(A) of ERISA. Once an investment adviser is deemed to be an ERISA fiduciary, it is subject to ERISA’s provisions governing, among other things, prohibited transactions, fiduciary obligations and liability for the acts of co-fiduciaries.

<sup>98</sup> See Rule 3-101 under ERISA.

<sup>99</sup> The fund adviser will monitor the percentage of equity held by employee benefit plan investors on every purchase, redemption or transfer. Among other things, hedge funds may disclose in the private placement memorandum delivered to investors that they may deny a subscription, forcibly redeem shares owned by benefit plan investors or refuse to recognize transfers that would cause the fund to reach the 25 percent limitation.

<sup>100</sup> An ERISA trustee generally will be insulated from co-trustee liability for actions taken by an “investment manager” that meets certain criteria established by the statute. See Section 405(d) of ERISA. In order to qualify as an “investment manager” for the purposes of ERISA, a hedge fund adviser generally must: (1) have the power to manage, acquire or dispose of plan assets; (2) be registered as an investment adviser under the Advisers Act; and (3) acknowledge in writing that it is a plan fiduciary. See Section 3(38) of ERISA. In lieu of being a federally registered

#### 4. Treasury Department Regulations

##### a. Treasury Securities Position Reports

Pursuant to authority granted by the Exchange Act, the Treasury Department has adopted rules that govern the reporting of large positions in U.S. Treasury securities by persons who participate in the government securities market, including registered investment advisers and hedge funds.<sup>101</sup> Pursuant to these rules, the Treasury Department periodically provides notices of Treasury security issues for which large position information must be reported (“reportable position”) and the applicable large position threshold for that issue.<sup>102</sup> Hedge funds that have a reportable position in a noticed government securities issue that is equal to or greater than the large position threshold must file a report with the Federal Reserve Bank of New York (“FRBNY”) containing certain prescribed information relating to that issue of securities.<sup>103</sup> Hedge funds may also be required to make and keep certain records related to their large position reports.<sup>104</sup>

##### b. Foreign Currency Position Reports

The Treasury Department also requires weekly, monthly or quarterly reports from hedge fund advisers and other institutions (e.g., U.S. banks, brokers, dealers and registered investment company advisers) that hold more than a designated dollar equivalent threshold of foreign exchange contracts.<sup>105</sup> Specifically, hedge funds that had more than the equivalent of \$50 billion

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investment adviser, a person also generally may qualify as an “investment manager” under ERISA if it is a bank, insurance company or state registered investment adviser that files a copy of its Form ADV with the Secretary of Labor each time it updates that document. *Id.*

<sup>101</sup> See Section 15C(f) of the Exchange Act (grant of rulemaking authority) and 17 C.F.R. pt. 420 (2003) (rules adopted pursuant to grant of authority).

<sup>102</sup> See 17 C.F.R. § 420.3(a) (2003). To date, the Treasury has only issued test notices. See, e.g., *Government Securities Act Regulations: Large Position Rules*, 67 Fed. Reg. 77411 (Dec. 18, 2002) (stating “[s]ince the rules became effective in 1997, we have conducted annual calls for reports to test the accuracy and reliability of large position reporting systems.”). The large position threshold is a dollar amount set by Treasury that is no less than \$2 billion. See 17 C.F.R. § 420.2(d) (2003).

<sup>103</sup> See 17 C.F.R. § 420.3 (2003).

<sup>104</sup> See 17 C.F.R. § 420.4 (2003).

<sup>105</sup> See 31 U.S.C. § 5315 (reports on foreign currency transactions); 31 C.F.R. § 128 (reporting of international capital and foreign currency transactions and positions). The value of the contracts

in foreign exchange contracts on the last business day of any calendar quarter during the previous year must file Form FC-1 on a weekly basis and Form FC-2 on a monthly basis with the FRBNY.<sup>106</sup> The foreign currency reporting provisions provide information on the nature and source of flows of mobile capital with respect to six “specified currencies” (*i.e.*, U.S. dollars, Euros, Swiss francs, U.K. pounds, Japanese yen and Canadian dollars). The reports collect consolidated data of foreign exchange contracts and positions and include, among other things, all foreign exchange contracts involving specified currencies that are used for hedging. The reported data is not publicly disclosed in a manner that will reveal the information reported by any individual entity.<sup>107</sup>

*c. Recent Anti-Money Laundering Regulations*

Section 352 of the USA Patriot Act requires every “financial institution” to establish an anti-money laundering program that meets certain minimum requirements.<sup>108</sup> In connection with Section 352, the Treasury has proposed a rule that would require hedge funds, among other entities, to adopt anti-money laundering procedures.<sup>109</sup> In addition to adopting an anti-money

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is calculated using the prevailing exchange rates at the end of each quarter. *See, e.g.*, Treasury Foreign Currency Form FC-1, General Instructions Section B (Who Must Report).

<sup>106</sup> Hedge funds that have more than the equivalent of \$5 billion in foreign exchange contracts on the last business day of any calendar quarter during the previous year and that do not file Form FC-2 must file Form FC-3 on a quarterly basis with the FRBNY.

<sup>107</sup> *See* 31 C.F.R. § 128.3 (permitting only the publishing or disclosure of aggregate data).

<sup>108</sup> *See* Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56 (Oct. 26, 2001) (“USA Patriot Act”). These requirements include: (1) the development of internal policies, procedures and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test the program.

<sup>109</sup> *See* *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 60617 (Sept. 26, 2002) (“Treasury Anti-Money Laundering Proposal”). The term “financial institution” includes “investment companies.” The Treasury rule would define “investment company” to include entities operating in reliance on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, commodity pools and companies investing primarily in real estate or interests in real estate. These entities would be included in the definition of “investment company,” provided that they: permit owners to redeem ownership interests within two years of purchase; have total assets, as of the most recently completed calendar quarter, of \$1 million or more; and are organized under the laws of a state or the United States, are organized, operated or sponsored by a U.S. person or sell their ownership interests to U.S. persons. The rule excludes from its requirements family companies, employee benefit plans, employees’ securities companies (as defined in Section 2(a)(13) of the Investment Company Act) or persons that are otherwise required to have anti-money laundering plans. *Id.*

laundering program, these entities would be required to provide a written notice to the Treasury within 90 days of becoming subject to the rule.<sup>110</sup>

## 5. *State Regulation*

### a. *State Regulation of Hedge Funds*

Unlike the Investment Company Act, state securities laws do not regulate the operations of pooled investment vehicles such as investment companies or hedge funds. Although states do not regulate hedge funds directly, they may regulate them indirectly through the fund's investment adviser or by regulating the offer and sale of interests in the hedge fund. Because of federal preemption and the availability of exemptions from adviser registration, only some states exercise regulatory authority over some hedge fund advisers, and most do not regulate the offer and sale of interests in hedge funds.

### b. *State Regulation of Offers and Sales of Hedge Fund Securities*

The adoption of the National Securities Markets Improvements Act of 1996 (“NSMIA”)<sup>111</sup> also greatly reduced state regulation of offers and sales of hedge fund securities. Most hedge funds issue securities in offerings that are exempt from registration under the Securities Act in reliance upon Rule 506 of Regulation D, and are therefore deemed to be “covered securities” under Section 18 of the Securities Act.<sup>112</sup> Under Section 18, covered securities are exempt from state regulations that: (1) require the registration or qualification of securities or securities transactions; (2) impose any requirements related to disclosure documents used in an offering; or (3) impose any merit regulation of such offerings. The states, however,

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<sup>110</sup> The form of the proposed notice would require the filing entity to provide identifying information, a statement of the assets held by the “investment company” at the end of the preceding fiscal year and a disclosure of the number of participants, interest holders or securities holders of the “investment companies.” See id. If adopted, the form of notice filed by a hedge fund would be a partial source of information about that hedge fund.

<sup>111</sup> Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

<sup>112</sup> See Section 18(b)(4)(D) of the Securities Act.



retain their antifraud jurisdiction.<sup>113</sup> They may also impose notice filing requirements and notice filing fees.<sup>114</sup>

*c. State Regulation of Hedge Fund Advisers*

Hedge fund advisers registered with the Commission under the Advisers Act are not required to register with the state securities authorities and are exempt from most substantive provisions of state investment adviser laws. Moreover, hedge fund advisers not registered with the Commission may also be eligible for exemptions from state registration and regulatory requirements.<sup>115</sup> State exemptions can be found in a number of states where hedge fund advisers are concentrated, including California, Connecticut and New York.<sup>116</sup> As a result, it is not uncommon for a hedge fund adviser to be exempt from registration under both state and federal investment adviser laws.

A hedge fund adviser that is subject to state investment adviser laws is likely to face regulations similar to the Commission's, as state regulation of investment advisers is generally similar to the Advisers Act. Broadly speaking, the investment adviser must register with authorities and must provide certain disclosures to clients. The adviser is also subject to rules designed to protect investors and prevent fraud, and may be subject to periodic examination by regulators.<sup>117</sup>

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<sup>113</sup> See Section 18(c)(1) of the Securities Act. See also, e.g., *In the Matter of James Pangione, Timothy Rassias, Hercules Capital Management, LLC, Hercules Hedgehog Fund, LP* No. E-2003-56 (Mass. Sec. Div. filed Aug. 13, 2003).

<sup>114</sup> See Section 18(c)(2) of the Securities Act.

<sup>115</sup> The preemption of state investment adviser laws applies only to those investment advisers that are registered with the Commission. Advisers that rely on an exemption from registration with the Commission may therefore be subject to state investment adviser laws. See Section 203A(b)(1) of the Advisers Act.

<sup>116</sup> See California Code of Regulations Title 10, Section 260.204.9; *Order Governing Certain Federally Exempt Investment Advisers*, Connecticut Department of Banking Order (Oct. 14, 1997) (each, in pertinent part, granting an exemption from state registration to any investment adviser that relies on the exemption from Commission registration in Section 203(b)(3) of the Advisers Act). See also NY Gen. Bus. Law Section 359-eee(a)(5) and Codes, Rules and Regulations of the State of New York Part 11.12(a) (respectively, providing an exclusion from the definition of adviser if an adviser has fewer than six clients, and counting limited partnerships, and other legal organizations, as single clients).

<sup>117</sup> Both the Commission and states retain antifraud jurisdiction to bring enforcement actions against all investment advisers, whether registered or not.

## IV. Operations of Hedge Funds

### A. Hedge Fund Investment Strategies

#### *1. Overview*

Hedge funds generally employ an absolute return approach to investing through which they seek to make money in a variety of market environments. Registered investment companies, in contrast, tend to favor a relative return approach. These funds attempt to duplicate or exceed the performance of a selected asset class or securities index.

Because an absolute return approach places a premium on flexibility (a successful bull market strategy is unlikely to produce positive returns during bear markets), many hedge funds tend to be opportunistic in seeking positive returns while avoiding loss of principal. The organizational documents of most hedge funds establish broad objectives and authorize multiple strategies in order to provide flexibility to take advantage of changing market conditions.<sup>118</sup>

Some hedge funds use traditional tools of fundamental or technical analysis to purchase or sell short individual stocks and bonds. Others take a directional view on a particular stock, bond or currency market. Still others engage in arbitrage in order to exploit perceived inefficiencies in the markets or to make money from particular expected events, such as mergers or bankruptcies. Certain hedge funds take large, concentrated positions in securities. Others invest across diverse asset classes and types of securities. When market conditions turn negative, many hedge funds sell short, utilize derivatives that increase in value as security values fall or take positions that are less dependent on the price movements of broad market averages. Many hedge funds use some or all of these strategies from time to time, based on their view of what strategy is most favored by current market conditions.<sup>119</sup> Finally, a number of hedge funds eschew all of these techniques and adopt traditional, long-only strategies similar to those used by most registered investment companies.

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<sup>118</sup> See Roundtable Transcript, May 14 (statement of Robert Schulman) (“The hedge fund industry has avoided, in large measure, the catastrophic impacts of the market by having enough flexibility in the [private placement] document and using it to react to what you would call changing market conditions.”).

The flexibility of some hedge fund advisers appears to be restricted only by the presence of investors who have invested in a hedge fund because of its use of a particular investment strategy and their expectation, communicated to the hedge fund adviser, that the fund will only invest in accordance with that strategy. See Alexander M. Ineichen, *Absolute Returns: The Risk and Opportunities of Hedge Fund Investing* 123 (2003) (“Ineichen”).

<sup>119</sup> See *Hedge Funds: A Guide*, *The Economist* 82 (Oct. 3, 1998).

## 2. Hedge Funds Strategies

Hedge funds use a wide variety of investment styles and strategies.<sup>120</sup> Even among hedge funds that purport to use the same investment strategy or invest within the same asset class, there is a wide range of investment activities, performance and risk levels.<sup>121</sup> Because the investment activities of hedge funds are so diverse, the hedge funds assigned to a particular investment category are likely to exhibit less similarity than more traditional investment vehicles, such as registered investment companies.

Although classification systems vary, hedge funds may generally be classified according to broad style and strategy categories, including:

- **Market Trend (Directional/Tactical) Strategies**

(These strategies exploit broad market trends in equities, interest rates or commodity prices.)

- **Macro:** These funds may take positions in currencies (often unhedged) based on their opinion of various countries' macroeconomic fundamentals. For example, if a country's economic policies look inconsistent and its ability to sustain its exchange rate appears questionable, macro funds may take positions designed to profit from devaluation, usually by selling the currency short.
- **Long/Short:** (includes sector and market neutral/relative value funds): These funds try to exploit perceived anomalies in the prices of securities. For example, a hedge fund may buy bonds that it believes to be underpriced and sell short bonds that it believes to be overpriced. No matter what happens to overall interest rates, as long as the spread between the two narrows, the fund profits. Conversely, if spreads widen,

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<sup>120</sup> One commenter classifies hedge fund investment strategies into more than 25 categories. Comment submitted by Roundtable Panelist John G. Gaine on behalf of the Managed Funds Association, at 2 (“Managed Funds Association Comment Letter”).

<sup>121</sup> See Roundtable Transcript, May 14 (statement of Michael Neus) (“When speaking about hedge funds [whether] the average hedge fund is less risky or more risky, I think that misses the point. It's not a monolithic institution. Hedge funds, by and large, are incredibly entrepreneurial; are constantly innovating and mutating.”).

gains can turn quickly into losses. Long/short equity is the most frequently used strategy among hedge funds.<sup>122</sup>

- **Event-Driven Strategies**

(These strategies attempt to exploit discrete events such as bankruptcies, mergers, and takeovers.)

- **Distressed Securities:** These funds may take long and/or short positions to attempt to profit from pricing anomalies among securities issued by companies going through bankruptcy or reorganization.
- **Risk/Merger Arbitrage:** These funds attempt to profit from pending merger transactions by, for example, taking a long position in the stock of the company to be acquired in a merger, leverage buyout or takeover and simultaneously taking a short position in the stock of the acquiring company.

- **Arbitrage Strategies**<sup>123</sup>

(These strategies, which exploit pricing discrepancies between closely related securities, are designed to be among the less risky hedge fund strategies. Arbitrage also may be a significant strategy component for funds in the event-driven and long/short categories.)

- **Convertible Arbitrage:** This strategy involves taking long positions in a company's convertible bonds, preferred stock, or warrants that are deemed to be undervalued while taking short positions in the company's common stock.

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<sup>122</sup> The actual percentage varies according to different commenters, probably because commenters often define investment strategies differently. One commenter claimed that over 60 percent of hedge fund assets were managed using this strategy. Hennessee Group Comment Letter, supra note 4 at 3. Another commenter stated that, as of the third quarter of 2001, approximately 45 percent of hedge fund assets were managed using this strategy. Ineichen, supra note 118 at 42-43.

<sup>123</sup> Many arbitrage strategies contribute substantial benefits to the U.S. financial markets by exploiting mispricings and inefficiencies. These efforts often result in enhanced liquidity and improved market efficiency. As was recently demonstrated, however, some abusive strategies used by hedge fund advisers such as mutual fund “market timing” activities provide no benefits to the securities markets. See State of New York v. Canary Capital Partners, LLC, (N.Y. Sup. Ct., complaint filed Sept. 3, 2003), available at: [http://www.oag.state.ny.us/press/2003/sep/canary\\_complaint.pdf](http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf) (“Canary Capital Partners”).

- **Fixed Income Arbitrage:** Hedge funds in this category seek to provide stable, positive returns by exploiting the relatively small pricing inefficiencies of fixed income instruments. For example, a newly issued (“on the run”) 10-year Treasury bond may trade at a slightly higher price than a similar previously issued (“off-the-run”) 10-year Treasury bond. A hedge fund may seek to profit from this disparity by purchasing off-the-run Treasuries and selling on-the-run Treasuries short.
- **Statistical Arbitrage:** Funds in this category attempt to profit from pricing inefficiencies identified through the use of mathematical models. Statistical arbitrage attempts to profit from the likelihood that prices will trend toward a historical norm.

### *3. Hedge Fund Investment Activities Compared to those of Registered Investment Companies*

As discussed above, registered investment companies typically seek positive returns compared to the performance of a particular asset class or index (“benchmark”). Thus, in a declining market, a registered investment company may be considered successful even if it loses money, so long as the company outperforms its benchmark (*i.e.*, its relative return is positive). In a rising market the registered investment company may be considered unsuccessful if the company, though profitable, underperforms the benchmark (*i.e.*, its relative return is negative). In brief, in the relative return paradigm, downside risk means the risk of failing to perform as well as the benchmark. In contrast, a hedge fund that utilizes an absolute return strategy may be considered successful only if it is profitable in both rising and declining markets.<sup>124</sup> In the absolute return paradigm, downside risk means the risk of failing to make money.

Registered investment companies generally have less flexibility to change their investment objectives than do most hedge funds. As a result, these funds provide investors with greater certainty of the risks their advisers will take, but provide their advisers with a diminished ability to take alternative investment approaches when market conditions change. Most of the restrictions on registered investment companies are self imposed, and are designed to assure investors that the fund will be managed in a manner consistent with their expectations.<sup>125</sup>

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<sup>124</sup> As discussed in Part IV.F. *infra*, compensation arrangements for hedge fund advisers are typically structured to reinforce the incentive to produce positive returns, irrespective of the direction of the market.

<sup>125</sup> The Investment Company Act does not require registered investment companies to restrict the flexibility of fund advisers. Section 13(a)(3) of the Investment Company Act requires registered investment companies to obtain the consent of their shareholders before deviating from their fundamental policies, including concentration in certain industries, but does not require registered investment companies to have policies restricting investments. Similarly, Section 13(a)(2) of the Investment Company Act requires registered investment companies to seek the approval of their

#### 4. Leverage

##### a. Background

Leverage is an important component of many hedge fund investment strategies. Leverage can be defined in numerous ways. As a general matter, however, leverage, can be viewed as a means of potentially increasing an investment's value or return without increasing the amount invested. Although leverage historically was obtained primarily by purchasing securities with borrowed money, today futures, options and other derivative contracts may be a major source of leverage. The use of leverage may have a significant impact on investment results because, while it may enhance investment gains, it may also magnify investment losses. Leverage also may increase the risk caused by holding assets that are illiquid or whose full value cannot be realized in a quick sale.<sup>126</sup>

##### b. Use of Leverage by Hedge Funds

The degree to which a hedge fund uses leverage depends largely on its investment strategy. Macro funds and funds that attempt to capitalize on small inefficiencies in relative values (e.g., fixed income arbitrage and statistical arbitrage) are more likely to engage in leverage and to take more highly leveraged positions<sup>127</sup> than are hedge funds that use other investment strategies, such as investing in distressed securities situations.<sup>128</sup>

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shareholders before they deviate from their policies regarding borrowing money, issuing senior securities, underwriting certain securities, purchasing or selling real estate or commodities or making loans, but does not preclude registered investment companies from having policies permitting all such activities to the extent permitted by law.

<sup>126</sup> *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management - Report of The President's Working Group on Financial Markets* 5 (Apr. 1999) ("LTCM Report").

<sup>127</sup> For example, according to hedge fund data consultants, approximately 89 percent of macro funds use leverage. Of those macro funds, 52 percent have leverage ratios greater than 2 to 1. (Here, a leverage ratio is defined as the ratio of total absolute dollars invested to total dollars of equity. A leverage ratio of greater than 2 to 1 is considered high; while a ratio of less than or equal to 2 to 1 is considered low.) This information is based on a sample of funds and may not be representative of all hedge funds. See Van Hedge Fund Advisors International, Inc., *Global Hedge Funds - Use of Leverage As of December 2002* (2003).

<sup>128</sup> Slightly over half (52 percent) of hedge funds that employ a distressed securities strategy use leverage. Of hedge funds using distressed securities strategies that use leverage, only six percent have leverage ratios greater than 2 to 1. *Id.*

A hedge fund's limitation on its use of leverage is often dictated by any margin or collateral requirements imposed on lenders or on others (e.g., broker-dealers), and the willingness of lenders or other counterparties to provide it with credit. For example, a broker-dealer extending credit to a hedge fund in connection with a short sale would have to comply with Regulation T issued by the Board of Governors of the Federal Reserve System.<sup>129</sup> The hedge fund could also be required to provide additional "maintenance margin" for transactions in short sales under margin requirements imposed by self-regulatory organizations.<sup>130</sup>

*c. Use of Leverage by Registered Investment Companies*

Although registered investment companies may use leverage and sell short, their ability to use these tools is more limited than is the case with hedge funds. For example, the Investment Company Act generally allows open-end investment companies to leverage themselves only by borrowing from a bank, and provided that the borrowing is subject to 300 percent asset coverage.<sup>131</sup> Closed-end investment companies are subject to less restrictive limits.<sup>132</sup> The Commission and staff have applied the Investment Company Act provisions governing use of leverage to permit registered investment companies to engage in certain transactions involving leverage ("senior security transactions"), generally, however, only if the registered fund "covers" the transaction by setting aside liquid assets in an amount equal to the potential liability or exposure created by the transaction.<sup>133</sup> A registered investment company's board of directors has

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<sup>129</sup> 12 C.F.R. § 220.12. This could require the hedge fund to provide margin for a short sale of a "nonexempted security," such as a security registered on a national securities exchange, of 150 percent of the current market value of the security. 12 C.F.R. § 220.12(c)(1).

<sup>130</sup> See NASD Rule 2520(c) and NYSE Rule 431(c). See also NASD Rule 2520(d) and NYSE Rule 431(d), which permit broker-dealers to institute higher short-sale margin requirements than those imposed by self-regulatory organizations rules.

<sup>131</sup> Section 18(f)(1) of the Investment Company Act. The Investment Company Act also allows registered investment companies to engage in certain private and temporary borrowings without 300 percent asset coverage, and from non-bank lenders. See Section 18(g) of the Investment Company Act.

<sup>132</sup> See Sections 18(a) - (e) of the Investment Company Act.

<sup>133</sup> See, e.g., *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979) ("Release 10666") (discussing Section 18 regulation of reverse repurchase agreements, firm commitment agreements, standby agreements and other transactions having similar effects on the capital structure of an investment company). See also, e.g., *Dreyfus Strategic Investing & Dreyfus Strategic Income* (pub. avail. June 22, 1987) ("*Dreyfus*") (short selling transactions and certain derivatives transactions such as: purchasing and selling futures contracts; purchasing and selling options on specific securities, stock indexes,

certain responsibilities in connection with the company's use of leverage,<sup>134</sup> and information about the characteristics and risks of permitted leverage transactions must be disclosed to investors in fund prospectuses.<sup>135</sup>

## 5. *Short Selling*

### a. *Background*

A short sale is the sale of a security that the seller does not own or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.<sup>136</sup> In order to deliver the security to the purchaser, the short seller borrows the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by returning the security to the lender, typically by purchasing equivalent securities on the open market, or by using an equivalent security that it already owns. In general, short selling is

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or interest rate futures contracts; and purchasing and selling forward contracts on currencies “involve potential leveraging.”).

The requirement that registered investment companies set aside liquid assets to cover senior security transactions is also referred to as the “segregated account” obligation. The purpose of this requirement is to limit the amount of leverage in which a registered investment company may engage, and to ensure the availability of adequate funds to meet the obligations arising under the senior security transactions. See, e.g., Release 10666, as modified by *Dreyfus and Merrill Lynch Asset Management, L.P.* (pub. avail. July 2, 1996) (“*MLAM*”). This requirement applies in addition to any margin requirements, which apply to investment companies just as they do to hedge funds and other brokerage customers engaging in margin transactions. The assets set aside to cover the senior security transactions are considered frozen and unavailable for sale or any other purpose. See, e.g., Release 10666; *MLAM*.

<sup>134</sup> Specifically, the board must conclude that senior security transactions are consistent with the policies recited in its registration statement pursuant to Section 8(b) of the Investment Company Act, and must also make sure that the level of senior security transactions will not impair the investment company's ability: to meet current obligations; to honor requests for redemption (for open-end investment companies); and to manage properly the investment portfolio in a manner consistent with the investment company's stated investment objectives. See Release 10666, supra note 133.

<sup>135</sup> See Form N-1A, Items 4(b)(1) (requiring a description of the fund's principal investment strategies) and 4(c) (requiring a description of the principal risks of investing in the fund, including circumstances reasonably likely to affect adversely the fund's net asset value, yield or total return). See also Release 10666, supra note 133.

<sup>136</sup> See Rule 3b-3 under the Exchange Act.



utilized to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand or to hedge the risk of a long position in the same or a related security.

Short selling can provide the market with important benefits, including market liquidity and pricing efficiency. Market liquidity is provided through short selling by market professionals, such as market makers (including specialists) and block positioners, who offset temporary imbalances in the supply and demand for securities. Short sales effected in the market by securities professionals add to the trading supply of stock available to purchasers and thus may reduce the risk that the price paid by investors is artificially high.

Short selling also can contribute to the pricing efficiency of the markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on or hedges against a downward movement in a security, the transaction is a mirror image of the person's who purchases the security based upon speculation that the security's price will rise or in order to hedge against such an increase. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.<sup>137</sup>

Although short selling serves useful market purposes, it also may be used to manipulate stock prices. One example is the "bear raid" where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest.<sup>138</sup> Unrestricted short selling can also exacerbate a declining market in a security by eliminating bids and causing a further reduction in the price of a security by creating an appearance that the price is falling for fundamental reasons.

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<sup>137</sup> Arbitrageurs also contribute to pricing efficiency by utilizing short sales to profit from price disparities between a stock and a related security, such as a convertible security or an option on that stock. For example, an arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions.

<sup>138</sup> Many people blamed "bear raids" for the 1929 stock market crash and the market's prolonged inability to recover from the crash. See 7 Louis Loss and Joel Seligman, *Securities Regulation* 3203-04, n. 213 (3d ed. 1989).

*b. Regulatory Restrictions on Short Selling*

The Commission has traditionally held the belief that protections against abusive short selling are important for issuer and investor confidence, and has enacted prophylactic rules designed to curb manipulative behavior. Rule 10a-1 under the Exchange Act was adopted in 1938 after several years of considering the effects of short selling in a declining market.<sup>139</sup> The core requirement of Rule 10a-1 is commonly referred to as the “tick test.” The tick test provides that, subject to certain exceptions, an exchange-listed security may only be sold short: (1) at a price above the immediately preceding reported price (“plus tick”); or (2) at the last sale price if it is higher than the last different reported price (“zero-plus tick”). Subsection (c) and (d) of Rule 10a-1 also require broker-dealers effecting sell orders for exchange-listed securities to mark such orders “long” or “short.” The Commission has also approved a price test for certain Nasdaq securities.<sup>140</sup>

There are other requirements that apply to short selling. For example, the self-regulatory organizations (“SROs”) have adopted rules generally requiring that, prior to effecting short sales, member firms must “locate” stock available for borrowing, so that the short seller may effect delivery to the purchaser.<sup>141</sup> In addition, short sale transactions are subject to margin requirements,<sup>142</sup> and may impact a broker-dealer’s net capital.<sup>143</sup> Other securities market

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<sup>139</sup> By adopting Rule 10a-1, the Commission sought to achieve three objectives: (1) allow relatively unrestricted short selling in an advancing market; (2) prevent short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and (3) prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers. See *Short Sales of Securities*, Exchange Act Release No. 13091 (Dec. 21, 1976).

<sup>140</sup> NASD Rule 3350 uses a “bid test” that prohibits NASD members from effecting short sales in NASDAQ National Market System Securities at or below the best bid when the best bid displayed is below the preceding best bid in a security.

<sup>141</sup> See, e.g., NASD Rule 3370; NYSE Rule 440C.

<sup>142</sup> See, e.g., Section 220.12(c)(1) of Regulation T of the Board of Governors of the Federal Reserve System, which requires margin for a short sale of a nonexempted equity security of 150 percent of the current market value of the security. An investor may be required to deposit additional “maintenance margin” for transactions in short sales under margin requirements imposed by SROs. See, e.g., NASD Rule 2520(c) and NYSE 431(c). Further, broker-dealers may institute higher short sale margin requirements than those imposed by self-regulatory organization rules. See, e.g., NASD Rule 2520(d); NYSE Rule 431(d).

<sup>143</sup> For example, a broker-dealer with a proprietary short position in an equity security may be required to deduct a percentage of the market value of the position when computing net capital under Exchange Act Rule 15c3-1. See Rule 15c3-1(c)(2)(vi)(J) under the Exchange Act. There may also be net capital implications for a broker-dealer executing short sale transactions for

participants, such as registered clearing agencies, may also establish requirements for firms engaging in short sale transactions.<sup>144</sup>

The SROs also have rules requiring members to report monthly aggregate short positions in all customer and proprietary accounts in securities listed on such exchanges or traded on NASDAQ.<sup>145</sup> This information is publicly available from a number of different sources, including Barrons, the Wall Street Journal and some financial websites.

*c. Short Selling by Hedge Funds*

Many hedge funds regularly engage in short selling as a major component of their investment strategy. For example, hedge funds may engage in long/short strategies that consist of buying higher-expected-return securities and selling short lower-expected-return securities. Hedge funds also may sell short in connection with arbitrage activities. A risk arbitrage position would consist of buying the target company securities coupled with simultaneous shorting of the securities of the acquiring company. Convertible arbitrage involves taking long positions in convertible securities while shorting the underlying securities, thereby taking advantage of a difference between the prices. Statistical arbitrage involves attempting to profit from pricing differentials between statistically related securities identified through the use of mathematical models.

The use of short selling by hedge funds has led to allegations that some hedge funds may be engaging in short selling as part of a manipulative scheme. Issuers have alleged that the hedge funds accumulated bearish positions in their stocks (*i.e.*, sold securities short or purchased put options and credit-default swaps) and subsequently issued critical reports regarding the issuers in an attempt to drive down their security prices.<sup>146</sup>

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customers. For example, a broker-dealer may be required to deduct the amount of cash required in a customer's account to meet maintenance margin requirements arising from the customer's short sale transactions. See Rule 15c3-1(c)(2)(xii) under the Exchange Act.

<sup>144</sup> There are capital and risk management standards established by the National Securities Clearing Corporation, which generally acts as the guarantor of trades between broker-dealers. See National Securities Clearing Corporation Rules of Procedures, Addendum K (effective Aug. 11, 2003).

<sup>145</sup> See, e.g., NASD Rule 3360; NYSE Rule 421.10.

<sup>146</sup> See, e.g., Randall Smith, *Regulators Review Complaints About Hedge Funds*, Wall Street Journal, (Jan. 22, 2003).

*d. Short Selling by Registered Investment Companies*

Registered investment companies have less flexibility than hedge funds to engage in short selling. While there are registered investment companies that actively sell short, registered investment companies are constrained by requirements of the Investment Company Act. Registered investment companies that sell short need to ensure that their prospectuses and other disclosure documents adequately inform shareholders about the risks associated with short selling.<sup>147</sup> Registered investment advisers and directors of registered investment companies should consider the consistency of such risks with the companies' disclosures and (for open-end investment companies) with the duty to have sufficient liquid assets to meet redemption requests in a timely manner.<sup>148</sup>

**B. Nature of Hedge Fund Investors**

Historically, hedge funds were sold primarily to high net worth individuals and families. Individual investors and families continue to represent a large portion of the hedge fund investor population today.<sup>149</sup> Much of the recent growth in the hedge fund industry, however, can be attributed to the investments of institutional investors.<sup>150</sup> Institutional investors such as pension

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<sup>147</sup> See Form N-1A, Items 4, 12. Registered investment companies are required to disclose their short sale activity in their financial statements that accompany their annual reports and semi-annual reports. For example, open- and closed-end investment companies must provide a Schedule of Securities Sold Short along with their financial statements, which schedule specifically lists the securities sold short during the relevant reporting period. See Regulation S-X, Rules 6-10 and 12-12A. In addition, all registered investment companies must disclose: (1) the amount held by others in connection with short sales in the asset section of the balance sheet; (2) the amount payable for securities sold short in the liability section of the balance sheet; and (3) the gain or loss on closed short positions in securities in the statement of operations. See Regulation S-X, Rules 6-04, 6-07.

<sup>148</sup> See, e.g., Release 10666, *supra* note 133; *MLAM*, *supra* note 133.

<sup>149</sup> According to one commenter, as of January 1, 2003, individuals and families invested \$249 billion in hedge funds, representing approximately 42 percent of industry assets. Over the past several years, however, these investments, as a percentage of all hedge fund assets, have been declining. Hennessee Group Comment Letter, *supra* note 4 at 7-9.

<sup>150</sup> See e.g., Roundtable Transcript, May 14 (statement of Robert Schulman) (“[T]he vast majority of . . . [the] growth [in the hedge fund industry] is coming institutionally. So although there’s been a lot of talk about the retailization of the business . . . the reality is it is large commitments from big public plans . . . , like CALPERS and Texas Teachers, that is leading the way towards the growth in this asset.”).

plans, endowments and foundations are increasingly considering investments in hedge funds, and those who are already investing are devoting a larger portion of their portfolios to these funds.<sup>151</sup> These institutional investors are shifting portions of their portfolios away from more traditional investments to investment vehicles employing absolute return strategies.<sup>152</sup> According to one commenter, the catalyst for this shift was the performance of these vehicles during the recent 3-year bear market.<sup>153</sup> These investors are also increasingly investing in FOHFs.<sup>154</sup>

### C. Hedge Fund Marketing

Typically, hedge fund advisers market and distribute hedge funds to investors directly,<sup>155</sup> as compared to registered investment companies, which often are sold through broker-dealers.<sup>156</sup> Hedge funds rely heavily on investors' pre-existing relationships with the hedge fund's advisory personnel (either on a personal basis or through a prior advisory relationship) and existing investors' recommendations. In addition, some hedge fund advisers have staff dedicated to

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According to one commenter, institutional investors in the aggregate invested \$175 billion in hedge funds in 2002, compared to \$53 billion four years earlier. Hennessee Group Comment Letter, *supra* note 4, at 14.

<sup>151</sup> See, e.g., Chris Clair, *A Growing Role: Institutional Investors Jumping Big into the Hedge Fund Market*, Pensions and Investments 3 (Feb. 18, 2002); Gregory Zuckerman, *Hedge Funds May Give Colleges Painful Lesson*, WSJ.com (Oct. 7, 2002); Andy Serwer, *Where the Money's Really Made*, Fortune 106 (Mar. 31, 2003).

<sup>152</sup> Hedge funds are only one of the alternative investments that institutional investors are exploring as part of an overall diversification strategy. Other alternative investments include real estate, timberland and oil and gas. See *Foundations, Endowments Try Real Assets*, Fundfire (Aug. 25, 2003).

<sup>153</sup> See Roundtable Transcript, May 14 (statement of Charles Gradante).

<sup>154</sup> According to one commenter, as of January 1, 2003, FOHFs represented approximately 27 percent of hedge fund assets, compared to 20 percent the year before. Hennessee Group Comment Letter, *supra* note 4, at 8-9.

<sup>155</sup> One commenter stated that, as of January 1, 2003, hedge funds raised approximately 88 percent of their capital as a result of in-house marketing efforts. *Id.*, at 10. Close to half (43 percent) of this capital, however, came from the hedge fund's general partners and employees. *Id.*

<sup>156</sup> Some hedge funds, however, use the services of a broker-dealer as a placement agent for their securities. Broker-dealers often may place hedge fund shares with wealthy clients through divisions of broker-dealers dedicated to providing services to "high net worth" customers. We note, however, that for most broker-dealers that sell hedge funds, these sales account for a minimum amount of total revenue.

marketing the fund, which may include identifying new investors, holding seminars for potential investors and assisting potential investors in understanding the products and completing the subscription documents.

Many hedge fund advisers also operate Internet websites through which they communicate with investors. As sponsors of securities offerings by hedge funds, the advisers are required to limit both the content of their websites and the persons who may access them in order to avoid general solicitation and general advertising concerns in connection with the hedge fund securities offering.<sup>157</sup> Many hedge fund advisers provide information about themselves, but typically do not mention to the general public that they manage hedge funds. Some hedge fund advisers follow the staff and the Commission's guidance on using password protected websites to communicate with existing investors and investors with whom they or persons acting on their behalf have substantive, pre-existing relationships.

Hedge fund advisers using the Internet and other medium of electronic communications are subject to the constraints of the exemptions from the applicable registration requirements that they are relying on in selling the hedge fund securities or engaging in advisory activities. Moreover, if advisers and hedge funds do not follow the Commission's guidance on the use of the Internet in engaging in private offerings, they run a risk of not being able to rely on an exemption from the registration requirements of the Securities and Investment Company Acts. Purchasers of securities sold in violation of these registration requirements have the right to rescind their purchase and obtain the amount of their investment plus interest.

In addition to obtaining marketing information directly from hedge fund advisers, prospective investors and financial professionals also may receive information about potential investment opportunities in hedge funds through third-party intermediaries. Many potential investors are introduced to hedge funds through capital introduction services that are provided by

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<sup>157</sup> See supra Part III.B.2.c. (discussing permissible and prohibited solicitation activities in connection with securities offerings).

broker-dealers.<sup>158</sup> Also, many investors hire consultants to advise them about investing in hedge funds.<sup>159</sup> Hedge funds also hire consultants as “marketers” to introduce investors to the fund.<sup>160</sup>

#### **D. Disclosure by Hedge Funds to Investors and Prospective Investors**

Hedge fund advisers typically provide information to investors during an investor’s initial due diligence review of the fund, although some, more proprietary, information may not be provided until after the investor has made a capital commitment to the fund, if at all. Most hedge funds provide written information to their investors in the form of a private offering memorandum or private placement memorandum (“PPM”).<sup>161</sup> This reflects market practice and the expectations of the sophisticated investors who typically invest in hedge funds. It also reflects the realization of the sponsors and their attorneys that the exemptions from the registration and prospectus delivery provisions of Section 5 of the Securities Act available under Section 4(2) of the Securities Act and Rule 506 thereunder do not extend to the antifraud provisions of the federal securities laws. The disclosures furnished to investors serve as protection to the principals against liability under the antifraud provisions. Some of the information may be disclosed less formally in one-on-one conversations between investors and the hedge fund adviser.

Hedge fund advisers may also provide information to hedge fund investors in the form of letters, conference calls and financial statements. In addition, some hedge fund advisers may provide prospective investors with access to their prime brokers and other service providers, such

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<sup>158</sup> See *infra* Part IV.E.2. (discussing broker-dealers/prime brokers). According to one survey, capital introduction services sponsored by broker-dealers are the second most popular method by which investors are introduced to hedge fund advisers, following networking. Deutsche Bank, *Equity Prime Services Alternative Investment Survey Results Part 2: Inside the Mind of the Hedge Fund Investor* 22 (Mar. 2003) (the “Deutsche Bank Survey”).

<sup>159</sup> See *infra* Part IV.E.5. (discussing consultants and other finders). See also *Investors Jump Long-Only Ship for Hedge Funds*, Fundfire (Jan. 30, 2003); *Plans Seek Sound Advice on Hedge Funds*, Fundfire (May 29, 2002).

<sup>160</sup> See *infra* Part IV.E.5. (discussing consultants and other finders).

<sup>161</sup> Rule 506 does not require that issuers provide any specific written information to accredited investors. This reflects the Commission’s view that accredited investors are sophisticated enough and have enough bargaining power to obtain any information they need from an issuer in making an investment decision. If the offering is extended to anyone who is not an accredited investor, the issuer must provide extensive written information to the investors who are not accredited. See Rule 502(b) under the Securities Act.

as administrators, both during the investor's initial due diligence of the hedge fund and subsequently.

Hedge fund investors must often spend significant resources, frequently hiring a consultant or a private investigation firm, to discover or verify information about the background and reputation of a hedge fund adviser.<sup>162</sup> In practice, even very large and sophisticated investors often have little leverage in setting terms of their investment and accessing information about hedge funds and their advisers.<sup>163</sup>

### *1. Private Placement Memoranda*

As a matter of practice, hedge funds generally provide investors with a PPM before an investment is made. As with any other offering solely to accredited investors, there are no specific disclosure requirements that pertain to the PPM under Section 4(2) or Rule 506.<sup>164</sup> While we are not passing on the adequacy and content of PPM disclosure generally, we note that certain basic information about the hedge fund's adviser and the hedge fund is typically disclosed. The information disclosed in PPMs varies from adviser to adviser, however, and often is general in scope. PPMs generally discuss in broad terms the fund's investment strategies and practices. They also typically disclose that the hedge fund's investment adviser may invest fund assets in illiquid, difficult-to-value securities and that the adviser reserves the discretion to value

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<sup>162</sup> Roundtable Transcript, May 14 (statement of Michael Neus) (“Whether they do it internally or whether they hire a consultant, they do more than kick the tires. They audit. Sometimes they audit results, they do background checks, they do a huge amount of legal work internally, as well as externally -- talking to other investors.”); Roundtable Transcript, May 15 (statement of Sandra Manzke) (“[I]t’s very difficult to get answers out of managers, and they hold all the keys right now. If you want to get into a good fund, and you ask some difficult questions, you may not get that answer. Sure, there is a lot of access, to get online and do background checks, and hire firms . . . . But that’s expensive. And can the retail investor do it? No. Firms like ours, we spend a lot of money, we have a lot more people working for us now to uncover these types of situations.”).

<sup>163</sup> Roundtable Transcript, May 15 (statement of Mark Anson) (“[t]he power remains with the hedge fund managers . . . . [T]here are far more attorneys out there representing hedge fund managers than representing investors in hedge funds. So when you get down to negotiating the nitty gritty, generally you’re sitting across the table from a hedge fund manager who has better legal representation than you do as an investor. . . . The best hedge fund managers close their hedge funds. Or, if they open them for a small period of time, . . . it’s basically a take it or leave it. ‘You want into my fund? Here are the terms that you get.’ The bargaining and leverage remains with the best hedge fund managers.”).

<sup>164</sup> Hedge fund advisers that are registered investment advisers, however, are required to provide investors with a disclosure statement that includes information required under Part II of Form ADV. See *supra* Part III.D. (discussing hedge fund advisers and the Advisers Act). This may be satisfied by providing a copy of the PPM that includes the appropriate disclosure to an investor.



such securities as it believes appropriate under the circumstances.<sup>165</sup> The PPM also may disclose that the adviser may exercise its discretion to invest fund assets outside the stated strategy or strategies.

PPMs also generally discuss qualifications and procedures for a prospective investor to become a limited partner, as well as provide information about the hedge fund's operations.<sup>166</sup> For example, PPMs generally discuss fund expenses, allocations of gains and losses, tax aspects of investing in the fund and may incorporate the hedge fund's financial statements. PPMs disclose any lock-up period that new investors must observe, as well as laying out the specifics for when investors will be able to redeem some or all of their investments out of the hedge fund. PPMs also may name frequently used service providers to the fund.

PPMs may generally disclose potential conflicts of interest to investors, frequently under the heading of "risk factors." A hedge fund's PPM may note that the fund's valuation practices give rise to an inherent conflict of interest because the level of fees that the investment adviser earns is based on the value of the fund's portfolio holdings as determined by the fund's adviser. PPMs also may discuss potential conflicts arising from the adviser's "side-by-side management" of multiple accounts, including the hedge fund, private accounts, proprietary accounts and registered investment companies.<sup>167</sup> A hedge fund's PPM may also disclose the investment adviser's conflicts in allocating its time and certain investment opportunities among its clients. Some PPMs spell out allocation policies with respect to limited investment opportunities in great detail, while others may list, and only briefly discuss, the factors on which such allocations will be decided.

PPMs also often provide information concerning the use of affiliated services providers, including affiliated broker-dealers. Some PPMs also may note that the hedge fund may direct brokerage business to, and use other services of, firms that introduce investors to the fund. PPMs may disclose that the adviser may use soft dollars to pay for research and other services used by the adviser to benefit other accounts that it manages, and may further disclose that soft

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<sup>165</sup> See *infra* Part IV.B. (discussing concerns relating to valuation practices of hedge funds).

<sup>166</sup> Alternatively, the information may be detailed in the fund's limited partnership and/or subscription agreement.

<sup>167</sup> A registered investment adviser, including a registered adviser managing a hedge fund, is generally required to provide this disclosure. See *infra* Part VI.E. (discussing conflicts of interest).

dollar arrangements could give the adviser an incentive to place trades more actively than it might otherwise in order to generate additional credits with executing broker-dealers.<sup>168</sup>

## 2. *Limited Partnership Agreements*

Investors in a hedge fund structured as a limited partnership enter into a limited partnership agreement. These agreements specify the respective rights and responsibilities of the limited partners and the general partner (usually the investment adviser). For example, these documents frequently list any restrictions on the percentage of an investor's assets invested in the hedge fund that a hedge fund will repurchase at any one time.

## 3. *Transparency*

Hedge fund advisers may provide investors with a list of hedge fund securities positions and holdings (position transparency) or information about the risks associated with the hedge fund's market positions (risk transparency).<sup>169</sup> The information may be provided in full or in part and on a current or delayed basis.

Position transparency may help investors monitor whether a hedge fund adviser is following the fund's stated strategies. For example, an investor who receives a month-end aggregated position report by industry can see whether the hedge fund adviser is drifting away from earlier statements about the fund's industry concentrations.<sup>170</sup> Many hedge funds, however, decline to share specific position transparency citing, among other reasons, the need to keep such

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<sup>168</sup> The Commission has defined soft dollar practices as arrangements under which an adviser obtains products or services other than execution of securities transactions from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer. *See Disclosure by Investment Advisers Regarding Soft Dollar Practices*, Advisers Act Release No. 1469 (Feb. 14, 1995) (proposing amendments to Form ADV).

<sup>169</sup> There are divergent views as to the utility of position transparency. *See, e.g., Consultants Demand Hedge Fund Transparency*, Fundfire (Mar. 27, 2003). Many experts believe that position transparency is of little value to most investors because hedge fund advisers tend to engage in complex strategies beyond the understanding of those investors. *See, e.g., Roundtable Transcript*, May 14 (statement of George Hall) ("position level transparency is basically meaningless . . . to most investors.").

<sup>170</sup> In one survey, 75 percent of institutional investors named monitoring strategy drift as one of their primary reasons for requiring additional transparency and 57 percent of those polled said that monitoring sector concentration was important to them. Deutsche Bank Survey, *supra* note 158, at 15.

proprietary information confidential.<sup>171</sup> For example, many worry that such disclosure might permit other market participants to take advantage of short positions that the hedge fund might hold, to the detriment of the fund and its investors. Moreover, position transparency with respect to a hedge fund implementing a merger arbitrage strategy, for example, will reveal little about the risks involved because it reveals nothing about the likelihood of certain events occurring and it does not disclose what leverage, if any, the investment adviser is using.<sup>172</sup>

The financial press has reported increased investor interest in risk transparency, and has ascribed this trend primarily to institutional investor demand as hedge funds become a component of mainstream investing programs for pension plans, endowments, foundations and other non-private institutional investors.<sup>173</sup> Proponents of increased risk transparency assert that it provides a more meaningful measure of the risks associated with an ongoing hedge fund investment than position transparency.<sup>174</sup>

#### 4. *Periodic Reporting*

Many hedge fund advisers provide periodic reports to their investors, although they are not specifically required under the federal securities laws.<sup>175</sup> The information in such reports varies widely among hedge fund advisers in terms of the types of information shared and the quality of the disclosure. Some hedge fund advisers report only the hedge fund's overall performance during the most recent period, while other reports disclose each individual

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<sup>171</sup> See Roundtable Transcript, May 15 (statement of Mark Anson) (“If there is a public disclosure of the hedge fund manager's trading positions, well, that may reveal that hedge fund manager's competitive advantage. And as an investor, that doesn't help me, that's just going to erode my returns.”).

<sup>172</sup> Roundtable Transcript, May 14 (statement of George Hall) (“[I]f you look at most of the well-known blowups and problems that have happened, . . . [position] transparency wouldn't have made investors get out of those investments.”).

<sup>173</sup> See Alison Bisbey Colter, *Hedge-Fund Investors Seek Detailed Data, Survey Finds*, Wall Street Journal (Apr. 1, 2003); *Hedge Funds Seen Upping Risk Transparency*, Fundfire (Mar. 10, 2003).

<sup>174</sup> Leslie Rahl, *Hedge Fund Transparency: Unraveling the Complex and Controversial Debate* 31-32 (2003); Comment submitted by Price Meadows Inc. at 3.

<sup>175</sup> Hedge fund advisers are not required to provide investors with semiannual or any other reports containing information about their investments under the federal securities laws. In contrast, a registered investment company is required to provide shareholders with semiannual reports containing, among other information, a balance sheet and income statement within 60 days after the close of the reporting period. These reports also typically include a discussion of management's explanation of the investment company's performance. See Section 30(e) of the Investment Company Act and Rule 30e-1 thereunder.

investor's performance. Periodic reports may include detailed information about the fund, its investments, including whether the adviser has diverged from the fund's primary investment strategies, its performance history and relevant market commentary. Hedge fund advisers also may provide investors with account statements reporting their capital account balances with these periodic reports.

### 5. *Additional Sources of Hedge Fund Information*

Hedge fund databases and indices are an additional source of information about hedge funds.<sup>176</sup> Hedge fund indices are statistical composites that measure and report value changes in hedge fund groupings based on information contained in various databases. Various commenters, however, have questioned the accuracy and utility of these sources of information.<sup>177</sup> Among the complaints is the concern that, because there is no known universe of hedge funds, it is impossible to determine if all hedge funds that meet the qualifications of a particular index or database are actually represented in that index or database. In addition, there is no requirement for hedge funds to report their performance, and those that do may choose to stop providing the information at any time.<sup>178</sup> Studies also suggest that databases reflect a survivorship bias in that they may include only hedge funds currently in operation, and may exclude funds that close down as a result of poor performance and for other reasons.<sup>179</sup> Finally, the accuracy of hedge fund performance data provided by hedge fund advisers cannot be verified because of the lack of independent oversight of a hedge fund adviser's valuation of a hedge fund's portfolio securities and the fact that hedge fund performance results are not required to be reported using a uniform or standardized performance measure.

Information about hedge funds is also available through third-party websites (*i.e.*, websites sponsored by persons not connected to any hedge fund). Generally these websites provide in one central location descriptive and performance-related information about a number

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<sup>176</sup> Bloomberg posts the results of over 100 hedge fund indices. The data for the indices is compiled by several database repositories/consultants, including: Credit Suisse First Boston/Tremont Partners; Evaluation Associates Capital Markets; Lehman Brothers; Hedge Fund Research, Inc.; Hennessee Hedge Fund Group; and Standard & Poor's.

<sup>177</sup> See, e.g., Comment submitted by Craig S. Tyle on behalf of the Investment Company Institute; Bing Liang, *Hedge Funds: The Living and the Dead*, 35 *Journal of Financial and Quantitative Analysis* 309 (Sept. 2000); Harry M. Kat, *10 Things That Investors Should Know About Hedge Funds*, *The Journal of Wealth Management* 72 (Spring 2003).

<sup>178</sup> For example, a successful hedge fund that has reached its capacity limits may close the fund to new investors and stop reporting altogether.

<sup>179</sup> See, e.g., Liang, supra note 177 at 309; Kat, supra note 177 at 72, 73.

of hedge funds. Subscribers who are pre-qualified as accredited investors may, for a fee, receive a password permitting them access to this information.<sup>180</sup>

Finally, some information about hedge funds can be obtained from institutional reporting services such as Bloomberg and from financial newsletters. In addition, consistent with the growth of hedge funds, members of the press and other forms of media actively cover the hedge fund industry.<sup>181</sup>

## **E. Hedge Fund Service Providers**

### *1. Hedge Fund Investment Advisers*

A hedge fund typically is sponsored, organized and managed by its investment adviser. Many hedge fund investment advisers were founded by former traders, analysts or portfolio managers who left investment banks, investment management firms and other large financial institutions to establish their own hedge funds. Many of these individuals were attracted by the entrepreneurial aspects of starting their own business and managing assets using investment strategies in which they may have a particular expertise.<sup>182</sup> They also often are lured to establish their firms by the potential compensation that can be earned by managing hedge funds.

A hedge fund's investment adviser usually is responsible for establishing the hedge fund and overseeing the preparation of the hedge fund's PPM and subscription agreement, as well as the applicable limited partnership or limited liability company agreements (for domestic funds).<sup>183</sup> The investment adviser negotiates the hedge fund's arrangements with various service

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<sup>180</sup> See *Lamp*, *supra* note 36.

<sup>181</sup> As discussed below, some of these practices lead to questions regarding the sources of hedge fund information and more importantly, whether hedge fund advisory personnel that provide information through these sources or that respond to inquiries from the media are engaged in a general solicitation or in a general advertising for purposes of the federal securities laws. See *infra* Part VI.F. (discussing concerns relating to general solicitation).

<sup>182</sup> See Roundtable Transcript, May 14 (statement of Joel Press) (“It really is a business of people wanting to create their own culture, their own environment, . . . creating their way of earning dollars in a way that’s unique to them, in their own strategy, their own people, their own compensation environment, and allowing them to exist in today’s technology wherever they choose to set up their organization and just work and trade and do their research. It’s a very unique entrepreneur.”).

<sup>183</sup> If the fund is a limited partnership, the investment adviser typically serves as the fund’s general partner. If the fund is a limited liability company, the investment adviser typically serves as the

providers, including broker-dealers providing prime brokerage services. The investment adviser also generally is responsible, at least in the early stages of the hedge fund's existence, for marketing and distributing the fund's securities to investors. Finally, the investment adviser often is responsible for investor relations, including providing periodic reports to investors about fund performance.

The nature and capabilities of hedge fund investment advisers vary greatly. Some hedge fund advisers are exceedingly sophisticated entities that manage billions of dollars in investment assets. These advisers employ multiple portfolio managers, analysts, brokers and compliance, risk management, legal and other operational personnel. These advisers also have the ability to install sophisticated systems and procedures to assist in complying with the advisers' fiduciary duties. At the opposite end of the spectrum are smaller, typically recently established investment advisers where one individual serves as marketer, portfolio manager, trader, operations officer and risk manager. Many of these types of advisers have few, if any, formal procedures.

## 2. *Broker-Dealers/Prime Brokers*

Full service broker-dealers frequently offer prime brokerage services, in addition to typical brokerage services, to hedge fund advisers. Prime brokerage is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades and to provide other services for substantial retail and institutional customers, including hedge funds.<sup>184</sup> Hedge fund advisers often select prime brokers by matching the hedge fund's strategies with the specific services and areas of expertise offered by one or more different full-service broker-dealers.<sup>185</sup> Among the key services that may be offered by broker-dealers are:

- Streamlined Trading. Prime brokers clear and settle hedge funds' trades executed by other broker-dealers ("executing brokers") upon instructions from hedge fund advisers.<sup>186</sup> The hedge fund maintains its funds and securities in an account with the

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fund's managing member. Terrance J. O'Malley, *The Regulation of Hedge Fund Managers by the SEC 2* (2003).

<sup>184</sup> See Testimony of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, Before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (May 22, 2003) ("Chairman Donaldson Testimony").

<sup>185</sup> Less established hedge funds tend to have arrangements with a single prime broker, which is often the firm that assisted in the hedge fund's start-up. More established hedge funds and those with more complex investment strategies are more likely to use multiple prime brokers. Hedge fund advisers may also use multiple broker-dealers in order to ensure only limited exposure of their investment strategies and portfolio holdings to any one broker-dealer.

<sup>186</sup> See *Prime Broker Committee* (pub. avail. Jan. 25, 1994).

prime broker. Transactions placed with executing brokers are effected through accounts with those brokers in the name of the prime broker for the benefit of the hedge fund. After executing a trade, the executing broker and the hedge fund adviser report the details to the prime broker, who clears the trade and provides custody of the securities.

- Securities Lending. Many hedge funds' investment strategies involve short selling. A broker-dealer's securities loan capability plays a critical role in this process. Prime brokers use their relationships in the banking and brokerage communities to locate and acquire securities to lend to their customers for short selling purposes. Hedge funds often choose prime brokers who have the largest inventories of securities available for loans, or those who are able, through relationships and market clout, to easily acquire the securities.
- Margin Lending. Broker-dealers maintain margin accounts and provide loans and other services in connection with facilitating transactions for their customers. Prime brokers are generally required to maintain collateral to secure margin loans to hedge funds as a result of regulatory requirements and internal limits on risk exposure, which are constantly monitored for changes.
- Capital Introduction. These services are designed to introduce hedge fund advisers to potential hedge fund investors. Prime brokers may sponsor seminars for consultants and institutional investors seeking exposure to hedge funds. Prime brokers may also set up one-on-one meetings and prepare marketing materials to introduce potential investors to hedge fund advisers.
- Hedge Fund Start-up Services. Broker-dealers may offer new hedge fund advisers with the means of operating a hedge fund through introductions or referrals to lawyers, accountants and other service providers. In addition to assisting these hedge fund advisers with back office support, the broker-dealer may provide the hedge fund adviser with office space.
- Customized Reporting. Some broker-dealers offer to provide hedge fund advisers with customized periodic reports, including: (1) reports that reflect end of day pricing of securities; (2) reports that provide risk management to investment advisers, such as value-at-risk, liquidity and stress testing; and (3) reports that allow fund advisers to provide investors with some limited transparency information.
- Research. Most broker-dealers offer to provide proprietary and third-party research and other soft dollar arrangements related to individual securities and particular market sectors of interest to the hedge fund's investment adviser.
- Valuation. Some broker-dealers may function as a source of prices for certain types of (or individual) securities.

- Technology. Some broker-dealers facilitate the start-up of new hedge funds by offering technology services, including reporting systems, software, trading systems, connections to ECNs, fixed connectivity and risk management systems. Other broker-dealer firms offer advice in these areas and may arrange for these services to be provided by a third-party.
- Operations Services. Broker-dealers may offer to provide persons seeking to start a hedge fund with: (1) advice regarding minimum and maximum amounts of investor subscriptions required to be raised and rates of returns expected by investors; (2) services such as the preparation of offering materials and reports to investors; (3) information on strategies to assist in obtaining investments; (4) advice as to appropriate investment alternatives for excess cash; and (5) referrals of requests for information from potential investors.

Compensation for prime brokers varies based on the nature of the services that they provide to their customers. While some broker-dealer firms have guidelines for fees, most will negotiate final fees on a case-by-case basis.<sup>187</sup> To determine fees, prime brokers evaluate each hedge fund adviser on an overall risk/return basis and on the business done at the broker-dealer firm. Prime brokers generate revenue on hedge fund business from commissions, spreads, administrative fees, ticket charges, stock loans and credit interest earned from providing position financing and arranging securities loans.<sup>188</sup> The prime broker will generally assess the package of services required by the hedge fund and suggest a price on that basis.

### 3. *Offshore Administrators*

Investment advisers of offshore hedge funds typically rely on offshore administrators to provide various types of operational support.<sup>189</sup> These administrators provide offshore hedge funds with a number of services, many of which were initially offered to assist offshore hedge

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<sup>187</sup> Fee arrangements for prime brokerage services generally take the form of undocumented, verbal agreements.

<sup>188</sup> For example, prime brokers that finance margin transactions receive income based on the spread between the prime broker's cost of borrowing and the rate charged to the hedge fund for the loan. In short sale arrangements handled by the prime broker, the prime broker generally retains the spread between the interest earned on collateral (*i.e.*, cash) posted by the borrower and the rebate paid to the borrower. In addition, prime brokers may receive income by charging a "ticket charge" for each transaction processed through the prime broker.

<sup>189</sup> *Outsourcing the Administration of Alternative Investment and Hedge Funds* – Presentation by Dermot S.L. Butler to the Mastering Investments and Offshore Funds Conference in Dublin, Ireland (Nov. 28, 2001), available at [www.customhousegroup.com/outsourcing.htm](http://www.customhousegroup.com/outsourcing.htm).



funds in addressing certain U.S. tax provisions.<sup>190</sup> Notwithstanding the repeal of these provisions, many offshore funds continue to maintain their relationships with offshore administrators as a matter of convenience and investor preference.

Hedge fund advisers contract with offshore administrators for specific services that the administrator will provide their offshore hedge funds.<sup>191</sup> Offshore administrators may assist a hedge fund adviser to set up an offshore hedge fund in accordance with applicable foreign laws and also may assist the fund in complying with such laws on an ongoing basis. Offshore administrators also may assist hedge fund advisers by organizing meetings of investors and directors. They also may provide accounting, record keeping and reporting services, as well as assist in calculating fees and accruals. Offshore administrators may provide offshore hedge fund advisers with some oversight of their activities, particularly with respect to hedge fund finances.<sup>192</sup>

One of the more important tasks an offshore administrator may provide to an offshore hedge fund adviser is to assist it in pricing the fund's portfolio securities. The scope of this service frequently depends on the nature of the agreement with the offshore administrator, as well as the investment strategies used by a particular fund and whether prices are easily obtainable for the securities in which the hedge fund invests. In some cases, the administrator will not provide independent prices of specific securities, but may generally defer to the valuations provided to it by the hedge fund adviser and calculate the offshore hedge fund's net asset value based on that information.<sup>193</sup>

Certain offshore jurisdictions regulate offshore hedge fund administrators operating within their borders. Such regulation may subject the administrators to licensing, auditing and record keeping requirements. For example, many offshore hedge funds are domiciled in The

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<sup>190</sup> Prior to 1998, if an offshore hedge fund performed a set of specific services (called the "Ten Commandments") from offices outside of the United States, the IRS would not consider the fund to have its principal office in the United States, and generally would not subject the hedge fund to U.S. taxation. The Taxpayer Relief Act of 1997 eliminated the need for offshore hedge funds to comply with the Ten Commandments. Pub. L. No. 105-34, 111 Stat. 788 (1997).

<sup>191</sup> For a discussion of the range of possible services provided by an offshore third-party hedge fund administrator, see Roundtable Transcript, May 14 (statement of William Keunen).

<sup>192</sup> See *Ready to Take Advantage*, International Fund Services Review Dublin 40 (2001). See also Roundtable Transcript, May 14 (statement of William Keunen).

<sup>193</sup> Hedge fund PPMs typically state that the general partner/managing member has ultimate authority in the valuation of securities.

Bahamas, Bermuda, the British Virgin Islands and the Cayman Islands.<sup>194</sup> These jurisdictions generally apply certain laws regulating the operations and conduct of investment pools and investment pool administrators to hedge funds and hedge fund administrators. These laws generally require fund administrators to be licensed, and three of the four jurisdictions require licensed fund administrators to have their accounts audited by an auditor approved by the regulator.<sup>195</sup> With respect to record keeping, each of these jurisdictions also subjects licensed fund administrators to anti-money laundering provisions. These provisions set forth client identification and record keeping requirements in addition to obligations to report any suspicious activity with respect to the funds they administer to the relevant authority in that jurisdiction.<sup>196</sup>

#### 4. Auditors

Unlike registered investment companies, there is no statutory or regulatory requirement that a hedge fund have its financial statements audited.<sup>197</sup> Whether a hedge fund undergoes an annual audit of its financial statements is a contractual matter between the hedge fund and its investors. The auditors of hedge funds that provide audited financial statements to their investors generally conduct independent audits of hedge funds pursuant to Generally Accepted Auditing Standards in the United States (“GAAS”),<sup>198</sup> and generally render an opinion on

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<sup>194</sup> See generally The Bahamas Mutual Funds Act, 1995 (June 2001 Revision); Bermuda Monetary Authority Act 1969; Bermuda Companies Act 1981, Part XIIA (Mutual Fund Companies); Bermuda Monetary Authority (Collective Investment Scheme Classification) Regulations 1998; British Virgin Islands Mutual Funds Act, 1996 (as amended 1997); and Cayman Islands Mutual Funds Law (2003 Revision).

<sup>195</sup> We understand that the fourth jurisdiction, Bermuda, has legislation pending that would require such audits.

<sup>196</sup> See generally Bermuda Proceeds of Crime (Money Laundering) Regulations Sections 4-6 (1998); British Virgin Islands Anti-Money Laundering Code of Practice (1999); Cayman Islands Proceeds of Criminal Conduct Law (Money Laundering Regulations) (2000); The Bahamas Financial Transactions Reporting Act (2001 Revision).

<sup>197</sup> Generally, the federal securities laws effectively prohibit any issuer, including registered investment companies, from offering or selling its securities publicly unless the issuer has filed a registration statement with the Commission which is required to include the issuer’s financial statements and an opinion from an independent accountant. This prohibition, however, does not apply to hedge funds because they do not publicly offer or sell their securities. See Sections 5 and 7 of the Securities Act.

<sup>198</sup> GAAS is generally comprised of the professional standards established by the American Institute of Certified Public Accountants (“AICPA”), including the industry audit and accounting guides. See *Implementation of Section 10A of the Securities Exchange Act of 1934*, Exchange Act Release No. 38387 (Mar. 12, 1997) (citing AU Section 150.02, AICPA Codification of Statements on Auditing Standards).

whether a hedge fund's financial statements are materially consistent with Generally Accepted Accounting Principles in the United States ("GAAP")<sup>199</sup> Depending on its agreement with its investors, the investment adviser may forward the independent accountant's report and the hedge fund's financial statements to investors upon the completion of the audit.<sup>200</sup>

A domestic hedge fund's engagement of an independent accountant to audit its financial statements is normally the responsibility of the fund's investment adviser. The selection of an independent accountant by domestic hedge funds, because they are typically organized as limited partnerships, is not subject to ratification or approval by a board of directors or other representative body of the investors in the hedge fund.<sup>201</sup>

The qualifications of an independent accountant that may be used by a hedge fund are not as stringent as those used for registered investment companies. A hedge fund's independent accountant must comply with the general independence standards of the AICPA or of the individual State Boards of Accountancy where the independent accountant practices. In contrast, a registered investment company independent accountant must comply with the requirements of the Investment Company Act of 1940 and is required to follow certain regulations established under the Sarbanes-Oxley Act of 2002 and various Commission rules to ensure the independence

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<sup>199</sup> A minority of domestic hedge funds and many offshore hedge funds prepare financial statements on a different comprehensive basis of accounting (e.g., tax accounting standards, international accounting standards (IAS) or local country generally accepted accounting principles (foreign GAAP)). If the financial statements are prepared in accordance with another comprehensive basis of accounting instead of GAAP, an audit may still be conducted under GAAS.

<sup>200</sup> There are no time constraints on delivering the hedge fund's audited financial statements to investors unless specifically stated in the PPM or partnership agreement. But see Rule 206(4)-2 of the Advisers Act (registered investment adviser with custody of client assets is required to provide all limited partners or beneficial owners of the hedge fund with audited financial statements within 120 days in certain circumstances). In contrast, registered investment companies must transmit to shareholders audited financial statements within 60 days of their fiscal year end. See Rule 30e-1(c) under the Investment Company Act.

<sup>201</sup> The selection process used by domestic hedge funds contrasts with the selection of an independent accountant by a registered investment company. The Investment Company Act regulates both the selection process of the fund's accountant and the continuing oversight of a registered investment company's auditing processes by requiring an independent accountant to be approved by either a majority vote of the disinterested board members or the approval by the board's audit committee. See Section 32(a) of the Investment Company Act and Rule 32a-4 thereunder. There may be some oversight of the selection of the independent accountants by offshore hedge funds, because they are typically organized as corporations.

of auditors.<sup>202</sup> In addition, a hedge fund’s independent accountant is not required to register with the Public Company Accounting Oversight Board (“PCAOB”) unless if it also serves as the independent auditor for a public company.<sup>203</sup> A hedge fund’s independent auditor is not otherwise required to register with PCAOB, nor are its audits with respect to private issuers subject to PCAOB examination. As a result, the audits of hedge fund financial statements will not be subject to the examination process of the PCAOB in its oversight of registered accounting firms.<sup>204</sup>

### 5. *Consultants and Other Finders*

Hedge fund consultants are generally third parties who perform services for hedge fund investors and the hedge funds. Consultants offer investors educational and due diligence services to assist them in navigating the complexities of hedge fund investing.<sup>205</sup> They also may provide hedge fund advisers with services, such as assisting those advisers to determine the eligibility of new investors. Many consultants manage their own proprietary hedge fund products for sale to investors.

Hedge fund consultants educate investors with respect to the type of information that should be sought in connection with any hedge fund investment.<sup>206</sup> They may assess the

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<sup>202</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (“Sarbanes-Oxley Act”). See also Article 2 of Regulation S-X (qualifications and reports of accountants).

<sup>203</sup> PCAOB has jurisdiction over entities that are issuers pursuant to Section 3(a)(8) of the Exchange Act. PCAOB oversees the audits of financial statements of such public companies through registration, standard setting, inspection and disciplinary programs. See Sarbanes-Oxley Act, Sections 102-105, 108.

<sup>204</sup> The independent audits of public companies, including registered investment companies, will be subject to PCAOB examination. PCAOB is in the process of establishing auditing, quality control and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports. The implementation of these standards may indirectly benefit audits of hedge funds to the extent that PCAOB-registered firms also perform audits of hedge funds and draw on the standards applicable with respect to public companies.

<sup>205</sup> Hedge fund investors also frequently hire private investigator services to assist them in verifying the information provided by the investment adviser and its personnel. For example, these services may be called upon to verify a portfolio manager’s educational or employment background as well as to confirm reported investment performance assertions. See Roundtable Transcript, May 15 (statement of Sandra Manzke), supra note 162.

<sup>206</sup> Most hedge fund investors perform extensive due diligence prior to making initial and subsequent investments. According to a survey of institutional investors, 60 percent of institutional investors take between two to six months to complete due diligence on a hedge fund. Deutsche Bank Survey, supra note 158, at 7.

suitability of a hedge fund investment in light of the investor's investment objectives and risk tolerance and may assist with asset allocation decisions.<sup>207</sup>

Consultants often provide investors with due diligence services relating to specific hedge fund investments, such as analyzing the hedge fund's offering and partnership documents, compiling historic return information and checking background information about the hedge fund adviser. Consultants may also make an assessment of the operational capabilities of a particular hedge fund by visiting the adviser. After an investment is made, consultants assist investors' monitoring of hedge fund investments and management through regular communications with the hedge fund adviser and tracking of the fund's performance against other funds that utilize the same investment strategy.

The intermediary role of hedge fund consultants may present certain conflicts of interest. A conflict of interest may exist when a hedge fund consultant provides an advisory service to investors, but also offers or recommends its own proprietary hedge fund products. A conflict of interest may also arise when the consultant essentially acts as a "marketer" for the hedge fund and receives a "rebate" or fee (e.g., a percentage of the hedge fund's management and performance fees) from the hedge fund.<sup>208</sup> This contrasts with other arrangements where the

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<sup>207</sup> See, e.g., Hennessee Group Comment Letter, *supra* note 4, at 18-19. Consultants who, for compensation, recommend specific hedge funds to investors generally are serving as investment advisers under Section 202(a)(11) of the Advisers Act. A consultant that merely engages in solicitation activities for a registered investment adviser is deemed to be an associated person of that investment adviser. See *Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Advisers Act Release No. 688 (July 12, 1979).

<sup>208</sup> Generally, the obligation to disclose conflicts arises from the consultant's status as an investment adviser. Consultants that market hedge fund interests, however, may be acting as a broker and be required to register with the Commission as such under Section 15(b) of the Exchange Act. Section 3(a)(4) of the Exchange Act generally defines a "broker" as a person who is "engaged in the business of effecting transactions in securities for the account of others." "Regularity of participation" in securities transactions is primary indicia of being engaged in the business of effecting securities transactions. *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1, 12-13 (D.D.C. 1998). A person may be found to be acting as a broker if he participates in securities transactions "at key points in the chain of distribution." *Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass.), *aff'd*, 545 F.2d 754 (1<sup>st</sup> Cir. 1976), *cert. denied*, 431 U.S. 904 (1977). Key factors indicating that a person may be acting as a broker -- and, thus would need to register with the Commission -- are solicitation of investors to purchase securities, involvement in negotiations between the issuer and the investor, and receipt of transaction-related compensation. See, e.g., *SEC v. Hansen*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) 91,426 (S.D.N.Y. 1984). It is not necessary to prove scienter to establish a violation of Section 15(a)(1). *SEC v. National Executive Planners, Ltd.*, 503 F. Supp. 1066, 1073 (M.D.N.C. 1980).

consultant receives a fee from the investor, in the form of either a retainer, or a flat or asset-based fee.<sup>209</sup>

## F. Hedge Fund Advisory Fees

An investment adviser to a hedge fund generally receives compensation composed of an investment management fee and an incentive allocation.<sup>210</sup> The investment management fee is an asset-based fee that is similar to the advisory fee charged by advisers to registered investment companies and is designed to provide the investment adviser with current cash flow to maintain operations. The investment management fee is generally one to two percent of net assets.<sup>211</sup>

The incentive allocation is not a fee paid to the investment adviser, but instead, is an allocation of partnership earnings and profits to the general partner of the partnership. Unlike the management fee, the incentive allocation is usually calculated as a percentage of the hedge fund's net investment income, realized capital gains and unrealized capital appreciation. Incentive allocations for hedge funds tend to be 20 percent of realized and unrealized gains.<sup>212</sup>

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<sup>209</sup> Hedge fund advisers that are registered investment advisers that have referral/solicitation arrangements with various consultants or broker-dealers are specifically required to disclose, among other things, the compensation that they pay to solicitors. See Rule 206(4)-3 under the Investment Advisers Act and Form ADV, Part II, Item 13. Any conflicts of interest surrounding the referral arrangement (e.g., when the solicitor is also an investor in the hedge fund) must also be disclosed.

<sup>210</sup> The nature of a hedge fund's fees and the tax implications are intertwined with the fund's domicile and organizational structure.

<sup>211</sup> According to Van Hedge Fund Advisers ("VHFA"), as of the first quarter of 2003, the median hedge fund had a management fee of one percent. VHFA tracks over 4,000 hedge funds. See Van Hedge Fund Advisers International, Inc., *Global Hedge Funds*, characteristics as of the first quarter of 2003 ("Global Hedge Funds Characteristics"). See also *Clinton Group Hikes Fees on Macro Fund*, Alternative Investment News (July 1, 2003) (noting that the fund increased its management fee to three percent).

<sup>212</sup> Section 205 of the Advisers Act and Rule 205-3 thereunder address the assessment of fees based upon a share of capital gains and capital appreciation. These provisions generally prohibit registered investment advisers from charging performance-based fees to most clients that are not "qualified clients," as defined in Rule 205-3. This prohibition does not apply to advisory relationships with hedge funds that rely on Section 3(c)(7). See Section 205(b)(4) of the Advisers Act.

Rule 205-3 generally defines a qualified client as one of the following: (1) a natural person or company that has \$750,000 under the management of the adviser; or (2) a natural person or company whom the adviser believes has (a) a net worth of \$1.5 million or (b) is a qualified

In comparison with the asset-based fees typically charged by registered investment companies, the incentive allocations, or performance fees typically charged by hedge fund advisers, are often perceived as creating incentives for investment advisers to take greater risks with client assets.<sup>213</sup>

Hedge fund advisers often agree to certain conditions that are designed to align the adviser's interests with those of the hedge fund investors. For example, investors often require the investment adviser to have a significant financial investment in the hedge fund. Investors rely on this requirement to serve a number of purposes, including curbing any temptation for the adviser to take undue risks.

The partnership agreement may also contain other provisions that protect investors from paying incentive allocations for poor performance, such as high water marks and hurdle rates. High water marks are thresholds that the investment adviser must achieve before an incentive allocation can be assessed.<sup>214</sup> Generally, a high water mark varies for each limited partner based on the maximum value of the limited partner's interest in the partnership since its initial investment in the fund. The investment adviser must generate investment returns beyond the "high water mark" before the investment adviser can assess an incentive allocation. In essence, the hedge fund's performance must surpass its previous high point before additional incentive allocations can be assessed. This prohibits an adviser from collecting an incentive allocation twice for the same performance.<sup>215</sup>

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purchaser as defined in Section 2(a)(51)(A) of the Investment Company Act. Rule 205-3(b) requires a registered investment adviser intending to charge a hedge fund relying on Section 3(c)(1) a performance fee to look through the hedge fund to ensure that each of its equity owners is also a qualified client. *See Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Advisers Act Release No. 1731 at text accompanying nn.28-32 (July 15, 1998).

<sup>213</sup> *See* H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940). Performance fees have been characterized as "heads I win, tails you lose" arrangements in which the adviser had everything to gain if successful and little, if anything, to lose if not. S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940). *See also* Investment Trusts and Investment Companies, H.R. Doc. No. 477, 76th Cong., 3d Sess. 30 (1939); *Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*. Advisers Act Release No. 996 (Nov. 26, 1985); *Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Advisers Act Release No. 1682 (Nov. 13, 1997).

<sup>214</sup> According to VHFA, of those funds with performance fee arrangements, 89 percent have a high water mark. *See* Global Hedge Funds Characteristics, *supra* note 211.

<sup>215</sup> For example, assuming an initial investment of \$10,000, a 20 percent performance fee, and a first year return of ten percent, the first year's performance fee would be \$200:  $[(\$10,000 * 1.10 =$

Hurdle rates are also used to guarantee that the hedge fund achieves a minimum investment performance before the fund's adviser may receive any incentive allocation.<sup>216</sup> A hurdle rate establishes a performance floor that the investment adviser must exceed in order to obtain the incentive allocation.<sup>217</sup>

Hedge funds that cannot consistently achieve positive performance are likely to exit the business. Because the incentive allocation provides the majority of an investment adviser's income from its hedge fund, failure to produce positive returns will prevent a hedge fund from collecting the performance fee. If an adviser's performance allocation is subject to a high water mark, the hedge fund must surpass its previous high point before a performance allocation is paid. The failure to produce positive returns has other effects beyond denying the fund's adviser of profits. These may include the departure of the fund's key employees, as well as the redemption of investments. Of course, these factors are key determinants into whether the hedge fund will survive.<sup>218</sup>

When hedge funds do close, certain liquidation issues may be present. Hedge fund management contracts typically have provisions designed to protect the adviser and the remaining limited partners in the event of liquidation. "Holdback provisions" permit hedge funds to withhold specified fractions of redeeming limited partner's capital. These provisions

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\$11,000) and  $(\$11,000 - \$10,000) * 0.20 = \$200$ ]. If the second year's return is -20 percent  $[\$11,000 * 0.80 = \$8,800]$ , the adviser receives no performance fee since the \$8,800 is less than the high water mark of \$11,000. If in the third year the fund has a 30 percent return  $[\$8,800 * 1.30 = \$11,440]$ , the adviser receives a performance fee of \$88  $[\$11,440 - \$11,000 = \$440 * 0.20 = \$88]$ .

<sup>216</sup> According to VHFA, of those funds with performance fee arrangements, 18 percent have a hurdle rate. See Global Hedge Funds Characteristics, supra note 211.

<sup>217</sup> If a hedge fund investment adviser performance compensation plan is subject to a 10 percent hurdle rate provision, then the investment adviser must exceed a 10 percent return on the fund before an incentive allocation can be assessed. For example, assuming an initial investment of \$10,000, a hurdle rate of ten percent, a 20 percent performance fee and first year actual fund performance of 25 percent, then the adviser would earn \$300 in incentive allocation:  $[ \{ 10,000 * (1.25 - 1.10) \} * .20 = 300 ]$ . In other variations, a hurdle rate can be applied to all profits, but only after the net return has exceeded the hurdle rate (*i.e.*, the investment return after consideration of the incentive allocation is greater than the hurdle rate).

<sup>218</sup> The President's Working Group on Financial Markets report estimated that, based on a sample of 397 hedge funds from 1994 to 1998, the survival rate was less than 60 percent. LTCM Report, supra note 126, at A-4. VFHF reports that the median hedge fund age is only 5.5 years. See Global Hedge Funds Characteristics, supra note 211.



guard against the possibility that investors should have received less money than they received on the redemption dates.

### **G. Hedge Fund Valuation Practices**

Hedge funds that invest in liquid securities normally value their portfolio securities using market values for those securities when available. Hedge fund advisers generally “fair value” portfolio securities when market prices for those securities are not readily available.<sup>219</sup> Some hedge fund advisers fair value their portfolio securities by reference to an accounting industry standard, which standard generally equates fair value to the price that the fund might reasonably expect to receive for a security or other asset upon its current sale.<sup>220</sup>

The key difference between the valuation of a registered investment company’s portfolio securities and those of a hedge fund’s portfolio securities, is that a hedge fund investment adviser generally has complete discretion with respect to the valuations used to price the fund’s securities, whereas the board of directors of a registered investment company provides independent oversight of the adviser’s valuation activities.<sup>221</sup> For example, some hedge funds may value the securities of non-publicly traded companies at cost and may not revalue them until a public trading market for the securities develops or the issuer engages in a subsequent round of equity financing.

Third parties also may assist hedge funds in the valuation process. Many hedge funds obtain pricing information from independent pricing services to either ascertain the market values or assist the investment adviser in establishing fair values of the securities. Prime brokers, as well as third-party administrators to offshore hedge funds, often perform fund valuation services as part of the package of services they provide to hedge funds.<sup>222</sup> Whether

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<sup>219</sup> Illiquid securities, certain debt instruments and securities issued in private placements and other difficult-to-price securities are the types of securities a hedge fund would be expected to fair value.

<sup>220</sup> See Statement of Financial Accounting Standards No. 107, Financial Accounting Standards Bd. (1991); Statement of Financial Accounting Standards No. 115, Financial Accounting Standards Bd. (1993); and Statement of Financial Accounting Standards No 133, Financial Accounting Standards Bd. (1998).

<sup>221</sup> See supra note 16.

<sup>222</sup> See supra Part IV.E.2. (discussing role of broker-dealers/prime brokers) and Part IV.E.3. (discussing offshore administrators). Prime brokers and administrators may review the valuation of portfolio securities, provide independent prices and reconciliation of portfolios and calculate and report NAVs.

interposing a third-party into the fund's valuation process increases the accuracy of the reported NAV largely will depend on the relationship of the third party to the hedge fund adviser and on what responsibilities the third-party is required to perform under the service contract.<sup>223</sup> To assist in valuing particularly difficult securities, some hedge funds segregate these securities into "side pockets," and postpone including the value of those securities in the hedge fund's NAV calculation until the investment is liquidated.<sup>224</sup>

## H. Audit Reports

When conducting an audit of a hedge fund in accordance with GAAS, auditors are required to follow the AICPA's Investment Company Audit and Accounting Guide. Similar to an audit of a registered investment company, the auditor designs a series of tests, based upon an assessment of the hedge fund's internal control environment, that verify the validity of the assets, liabilities, income, expenses and capital transactions of the hedge fund. In addition, this audit testing typically verifies the accuracy of partner capital balances, management and incentive fee calculations and of NAV calculations at intervals when significant contributions and withdrawals are permitted by the fund.

A hedge fund audit, however, is not required to be identical to an audit of a registered investment company.<sup>225</sup> Unlike an audit of a registered investment company, a hedge fund audit generally utilizes a substantive test approach and does not rely on a strong, established internal control system.<sup>226</sup> The audit testing typically includes a sample confirmation of assets and

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<sup>223</sup> For example, the service contract may require a third party to simply transmit prices or check computations based on valuations provided by the hedge fund or its prime broker, without inquiry into the reasonableness of those prices.

<sup>224</sup> "Side pockets" protect investors against adverse timing of withdrawals. Since investment advisers tend to redeem more liquid assets first, as limited partners withdraw their money, the portion of the fund that is illiquid may increase significantly, leaving the remaining limited partners with an illiquid investment. The use of "side pocket" accounting effectively reduces the risk of illiquidity issues for limited partners that remain in the fund.

<sup>225</sup> The AICPA is in the process of revising its guidance to clarify the differences in accounting and auditing by registered investment companies and non-registered investment partnerships, such as hedge funds. See, e.g., AICPA Accounting Standards Executive Committee, Exposure Draft of a Proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnership* (July 15, 2003).

<sup>226</sup> A hedge fund auditor is not required to render a separate opinion on whether the internal control system contains any material weaknesses. See Form N-SAR, Item 77B.

liabilities with independent third-party service providers to the hedge fund. In addition, a hedge fund audit generally permits the use of sampling techniques (*i.e.*, less than 100 percent) in audit areas where the statutory provisions or regulatory rules applicable to registered investment companies require 100 percent verification, such as with respect to the existence and valuation of portfolio securities.<sup>227</sup>

When conducting an audit of a hedge fund in accordance with GAAS, auditors are required to review a hedge fund's fair valuation procedures for consistency with the fund's PPM or partnership agreement, as applicable, to determine the reasonableness of the procedures.<sup>228</sup> Although the audit procedures with respect to valuation also are similar to those used for registered investment companies, a hedge fund audit provides less assurance about the valuation process for two reasons.<sup>229</sup> First, a hedge fund audit evaluates a valuation determination that is made by the hedge fund's investment adviser, who both makes investment decisions for the hedge fund and typically has ultimate discretion for assigning a value to its portfolio securities. This valuation process contrasts with the delegation of duties in the registered investment company context, where the investment company's board of directors establishes valuation procedures and provides independent review of valuation determinations. Second, hedge fund auditors perform sample valuation tests of the hedge fund's portfolio securities that are less comprehensive than the 100 percent verification standard applicable to registered investment companies.<sup>230</sup>

## **I. Risk Management**

Hedge fund advisers are expected to achieve performance returns for investors by using strategies that are designed to assume or eliminate calculated risks consistent with the hedge fund's investment objective. The observation that some hedge funds are riskier than others

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<sup>227</sup> See Section 30(g) of the Investment Company Act (100 percent custody verification) and Accounting Series Release No. 118, Financial Reporting Codification (CCH) Section 404.03 (Dec. 23, 1970) (100 percent verification of pricing).

<sup>228</sup> Hedge fund auditors typically conduct substantive tests on the application of the procedures in pricing portfolio securities to ensure that the process is being consistently applied.

<sup>229</sup> See *infra* Part VI.B. (discussing concerns about valuation of hedge fund portfolio securities).

<sup>230</sup> Many hedge funds obtain pricing information from pricing/valuation services such as Bloomberg, Reuters and FT Interactive Data to either ascertain market values or assist the investment adviser in establishing fair values. As with registered investment companies, auditors of hedge funds confirm the accuracy of market-priced security valuations with an independent third party by comparing the portfolio values obtained from a pricing service to the valuations used in a hedge fund's financial statements.

reflects the wide latitude hedge fund advisers have to operate their funds and the potential that exists for some hedge funds to suffer significant losses. An effective risk management system, therefore, is important to a hedge fund's operations.

The risk management systems used by hedge funds vary by firm. Larger and more seasoned hedge funds often establish an internal risk management structure using their own resources and personnel. It is common for less established hedge fund advisers that usually have fewer financial and personnel resources to outsource the risk management function to their prime brokers or to other service providers. Some of the less established hedge fund advisers have little or no risk management controls.

Generally, risk management is a monitoring function that quantifies and tracks the risks involved after investments are acquired. Effective risk management systems require hedge fund advisers to identify, measure, monitor and manage the various dimensions of risk. These processes generally differ by firm because they are based on the resources and investment strategies of the hedge fund adviser. The risks that are associated with hedge funds generally may be divided into three broad areas of concern: portfolio risks; the effect of leverage on portfolio risks; and operational risks. Portfolio risks may be further divided into market risk, liquidity risk and credit risk.

As a general industry standard, hedge fund advisers uniformly review information about positions, transactions, orders and margin to identify and monitor exposures at the individual portfolio level and on an aggregate basis for portfolios with the same adviser and/or using the same strategy. This information is then used to identify any excessive concentration of holdings in any one market and any concentration of holdings with potential converging correlations.

## **J. Funds of Hedge Funds**

### *1. Background*

A FOHF is a hedge fund that utilizes a multi-manager, multi-strategy approach by investing all, or a significant portion, of its assets in hedge funds.<sup>231</sup> Although FOHFs can invest in as many underlying hedge funds as they choose, they typically invest in 15 to 25 funds. Institutional investors often choose to invest in FOHFs, rather than in single-manager hedge funds, in order to diversify against the risks associated with a particular hedge fund adviser. One

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<sup>231</sup> The Investment Company Act generally does not limit the investment in hedge funds by registered investment companies, including registered FOHFs. But see supra note 34 (look-through provision of Section 3(c)(1)) and supra note 41 (companies formed for the specific purpose of investing in a Section 3(c)(7) fund may not be a qualified purchaser).

article reports that during the first three quarters of 2002, the number of FOHFs grew from an estimated 510 to 675, an increase of 32 percent, and FOHF assets increased by 84 percent.<sup>232</sup>

Most FOHFs are not registered as investment companies under the Investment Company Act and privately place their securities generally with accredited investors or qualified purchasers. FOHFs employ a compensation structure similar to that of other hedge funds. FOHFs typically charge asset-based investment management fees that range from about one-half to two percent and a performance allocation that ranges up to 20 percent. These fees are levied in addition to the asset-based fees and performance allocations assessed by the underlying hedge funds.

## 2. Registered FOHFs

An increasing number of FOHFs are registering as investment companies with the Commission; as of early September 2003, 82 FOHFs had registered as closed-end investment companies under the Investment Company Act.<sup>233</sup> At the same time that a FOHF registers as an investment company under the Investment Company Act, it may also choose to register the offer and sale of its securities under the Securities Act (“Dual Registered FOHF”). Registration under the Securities Act allows a registered FOHF to, among other things publicly offer its securities. Dual Registered FOHFs must comply with the prospectus requirements of the Securities Act.

In contrast to Dual Registered FOHFs, registered FOHFs that do not register their offerings under the Securities Act must privately place their securities in reliance on an exemption from registration (“40 Act only Registered FOHF”).<sup>234</sup> More than two-thirds of the 82 registered FOHFs are Dual Registered FOHFs.<sup>235</sup> Registered FOHFs collectively have

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<sup>232</sup> Justin Dini, *The Fund of Hedge Fund*, Institutional Investor 50, 51 (Dec. 2002) (citing information from HFR, an organization that collects hedge fund data).

<sup>233</sup> In 1998, the first FOHF registered as an investment company under the Investment Company Act. See PW After Tax Equity Partners (SEC File No. 811-08803).

<sup>234</sup> See supra Part III.B.2 (discussing Regulation D).

<sup>235</sup> In October 2001, Oppenheimer Tremont Market Neutral Fund (SEC File No. 811-10537) and Oppenheimer Tremont Opportunity Fund (SEC File No. 811-10541) became the first FOHFs to register as investment companies under the Investment Company Act and to register the offering of their securities under the Securities Act.

approximately \$3.7 billion of assets under management. Investment advisers to registered FOHFs must register under the Advisers Act.<sup>236</sup>

To date, all operating registered FOHFs have imposed a minimum initial investment requirement on their investors ranging from \$25,000 up to \$1 million.<sup>237</sup> With respect to eligibility standards, registered FOHFs, including Dual Registered FOHFs, have restricted sales to investors that, at a minimum, satisfy the accredited investor standard.<sup>238</sup> Registered FOHFs, however, may lower or eliminate the investment minimum at any time because this investment qualification is not required by law.<sup>239</sup>

Importantly, other net worth-related, eligibility criteria may apply to investors in a registered FOHF, depending, in large part, on whether the fund intends to charge a performance fee. If the investment adviser wishes to charge a performance fee to the registered FOHF, all of the fund's investors must satisfy the definition of a "qualified client" under the Investment Advisers Act.<sup>240</sup>

Investors in a registered FOHF are directly subject to the fees and expenses charged at the registered FOHF level. They are also indirectly subject to the fees and expenses charged by the underlying hedge funds in which the registered FOHF invests.<sup>241</sup> Typically, a registered FOHF pays its investment adviser an asset-based management fee, generally equal to one to two percent of assets under management and, again provided that the fund's investors are all qualified clients, a performance allocation based on the capital gains and capital appreciation of

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<sup>236</sup> See Rule 203A-1 of the Advisers Act (requiring registration of advisers to registered investment companies).

<sup>237</sup> Notwithstanding the stated investment minimum, the offering documents of a registered FOHF (like those of hedge funds or unregistered FOHFs) may provide that the fund may reduce or waive the required minimum investment in limited circumstances, such as when the investor already is an existing client of the investment adviser with substantial assets under management, or when the investor is an officer or employee of the investment adviser.

<sup>238</sup> See supra Part III.B. (discussing accredited investor standard).

<sup>239</sup> But see infra note 250 (pending registration statement of FOHF that will offer and sell its securities without investor eligibility limitations).

<sup>240</sup> See supra note 212.

<sup>241</sup> The underlying hedge funds could also be FOHFs, which would further compound fees and affect the performance of an investor's investment in a registered FOHF.

the fund's portfolio.<sup>242</sup> The underlying hedge funds, in turn, pay similarly structured investment advisory fees to their investment advisers. In addition, operational expenses, including brokerage commissions, custody fees and transfer agent fees, may be incurred at both levels of a registered FOHF.

Registered FOHFs are structured as closed-end management investment companies. As a general matter, closed-end investment companies offer a fixed number of shares to investors during the initial offering period. Investors purchase registered FOHF shares either in the fund's initial offering or in any subsequent offerings.<sup>243</sup> Many registered FOHFs provide for subsequent offerings on a semi-annual or quarterly basis, but other registered FOHFs allow investors to purchase shares on a more frequent basis. The number and dates of any subsequent offerings are determined by the fund.

A registered FOHF uses the Form N-2 to register as a closed-end investment company under the Investment Company Act.<sup>244</sup> The prospectus portion of the registration statement discloses information about, among other things, the FOHF's investment objectives and strategies, risks, expenses and performance. Additional or more detailed information regarding the FOHF and its operations, such as: fund history and policies; officers, directors, and persons controlling the fund; advisory and other services; brokerage commissions; and tax and other matters are contained in the Statement of Additional Information portion of the registration statement.<sup>245</sup>

A 40 Act only Registered FOHF may commence offering and selling its shares immediately upon filing a registration statement with the Commission because such registration statements are deemed effective upon filing.<sup>246</sup> Because 40 Act only Registered FOHFs do not register their securities offerings under the Securities Act, the prospectus delivery requirements under the Securities Act do not apply. Accordingly, these funds typically provide a PPM to interested investors that may not necessarily provide all the information required to be included in the N-2 registration statement.

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<sup>242</sup> See supra note 212. See also supra Part IV.F. (discussing hedge fund advisory fees).

<sup>243</sup> Unlike open-end registered investment companies, closed-end funds do not continuously offer to sell and redeem fund shares.

<sup>244</sup> The Form N-2 is used by FOHFs that choose also to register their shares under the Securities Act.

<sup>245</sup> Registration statements on Form N-2 are available to the public on the Commission's website.

<sup>246</sup> See Section 8(a) of the Investment Company Act. The FOHF also would file a notice on Form D with the Commission no later than 15 days after the first sale of securities.

Under the Investment Company Act, shareholders in Dual Registered FOHFs and 40 Act only Registered FOHFs receive semiannual shareholder reports that are required to disclose, among other information, the fund's financial statements and portfolio holdings, during the relevant period.<sup>247</sup> Registered FOHFs may fulfill this disclosure obligation by listing the hedge funds in which the registered FOHF has invested, but they are not required to identify the securities in which the underlying hedge funds have invested.

### 3. Repurchases

Registered FOHFs generally provide limited liquidity to their shareholders by offering to repurchase their securities pursuant to tender offers structured to comply with Section 23(c)(2) of the Investment Company Act and Rule 13e-4 of the Exchange Act.<sup>248</sup> Many registered FOHFs provide for repurchases twice a year, but other registered FOHFs provide for repurchases on a quarterly or more frequent basis. The registered FOHF's adviser sets the terms of repurchase, which are disclosed to investors in the fund's offering documents.<sup>249</sup> Unlike most closed-end registered investment companies, shares of registered FOHFs have not been, to date, listed for trading in the United States on an exchange or NASDAQ.<sup>250</sup>

### 4. Content of Registered FOHF Disclosure.

Registered FOHFs provide in their registration statements on Form N-2 information that is required to be disclosed by all closed-end investment companies. In addition, they disclose information about the fund's unique strategies, operations and risks. Registration statements also provide information about the valuation of portfolio securities, certain risks involved in the investment and fees and expenses.

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<sup>247</sup> See Section 30(e) of the Investment Company Act and Rule 30e-1 thereunder.

<sup>248</sup> Under Section 23(c)(2) of the Investment Company Act, registered closed-end investment companies may repurchase their shares in tender offers. Generally, Rule 13e-4 under the Exchange Act governs issuer tender offers and prohibits fraudulent, deceptive and manipulative acts by an issuer or an affiliate in connection with an issuer tender offer, and prescribes filing, timing, disclosure, anti-discrimination provisions and other requirements.

<sup>249</sup> Registered FOHF prospectuses typically state that the fund "expects" to repurchase shares on a semi-annual, quarterly, or other basis. However, these funds do not qualify as "interval funds" for purposes of the Investment Company Act because they do not comply with all of the requirements of Rule 23c-3 under that Act. For example, registered FOHFs have not, to date, designated periodic repurchases as a fundamental policy.

<sup>250</sup> One Dual Registered FOHF that seeks to list its shares on the New York Stock Exchange has filed a registration statement with the Commission. That registration statement is currently under review. See CINTRA Select Fund (SEC File Nos. 811-21165 and 333-96821).



- Valuation. Many registered FOHFs disclose that, prior to investing in a hedge fund, the registered FOHF's adviser conducts due diligence reviews of the valuation methodologies used by each potential hedge fund investment. Most registered FOHFs disclose that one of the factors that they rely on to value their interests in hedge funds is valuation information provided to them by the advisers to the underlying hedge funds. They also typically disclose that they generally lack access to the information that would be needed to confirm independently the accuracy of valuation information provided by the underlying hedge funds.
- Risks. Registered FOHFs typically disclose that only those investors who can tolerate a high degree of risk, e.g., the loss of all or a portion of the investment, should invest in such funds. Some registered FOHFs also disclose that a potential investor should consider various factors (such as the investor's net worth, income, age, risk tolerance and liquidity needs) before deciding whether the particular registered FOHF is a suitable investment.
- Fees and Expenses. The fact that investors pay fees and expenses at both the registered FOHF and underlying hedge fund level is disclosed prominently to investors, as are the types of fees charged at the hedge fund level. Registered FOHFs generally do not, however, disclose the actual or estimated amount of fees indirectly incurred by the FOHF through its investment in the underlying hedge funds.<sup>251</sup>
- Investment Strategies. Registered FOHFs typically disclose the various investment strategies that the underlying hedge funds may employ, including, in some cases, the impact of style shifts in underlying hedge funds on the registered FOHF's ability to achieve its stated investment objective.

## V. Hedge Fund Enforcement Actions

### A. Commission Actions

Although hedge funds are not registered under the Investment Company Act, they and their advisers (regardless of whether the advisers are registered under the Advisers Act) are subject to the antifraud provisions of the federal securities laws. In recent years, the Commission

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<sup>251</sup> Form N-2 requires disclosure of the fees and expenses incurred by the registered FOHF, but does not encompass disclosure of fees and expenses incurred by the underlying hedge funds. See infra note 322.

has instituted a significant number of actions alleging hedge fund fraud.<sup>252</sup> Since 1999, the Commission has brought approximately 38 enforcement actions relating to hedge fund advisers and hedge funds, and, in the last few years, the Commission has seen a steady increase in actions. The Commission staff is currently investigating a number of additional matters involving possible fraud or other violations by hedge fund advisers and hedge funds.

There is no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity. However, the growth in the number of hedge fund fraud cases is likely attributable to a number of factors, including: the popularity of hedge fund investments and the large amounts of money they involve (and thus their attractiveness to perpetrators of fraud); the entrance to the industry of inexperienced, untested and, in some cases, unqualified individuals; and lack of adequate controls on the operations of some hedge fund advisers.

The fraud charged in Commission enforcement actions against hedge fund advisers has been similar to the types of fraud charged against other types of investment advisers. Examples include: misappropriation of assets;<sup>253</sup> misrepresentation of portfolio performance;<sup>254</sup> falsification of experience, credentials and past returns;<sup>255</sup> misleading disclosure regarding

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<sup>252</sup> In most cases involving hedge funds, the Commission institutes enforcement actions against the hedge fund adviser and/or the adviser's principals.

<sup>253</sup> See, e.g., *SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee*, Litigation Release No. 18216 (July 7, 2003); *SEC v. Peter W. Chabot, Chabot Investments, Inc. Sirens Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. David M. Mobley, Sr.*, Litigation Release No. 18150 (May 20, 2003); *SEC v. Vestron Financial Corp.*, Litigation Release No. 18065 (Apr. 2, 2003); *SEC v. Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17981 (Feb. 11, 2003).

<sup>254</sup> See, e.g., *SEC v. Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC*, Litigation Release No. 18247 (July 23, 2003); *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. David M. Mobley, Sr.*, Litigation Release No. 18150 (May 20, 2003); *In the Matter of Charles K. Seavey*, Advisers Act Release No. 2119 (Mar. 27, 2003); *SEC v. Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17981 (Feb. 11, 2003); *SEC v. Beacon Hill Asset Management LLC*, Litigation Release No. 17831 (Nov. 7, 2002); *SEC v. Edward Thomas Jung*, Litigation Release No. 17417 (Mar. 15, 2002); *SEC v. Jerry A. Womack*, Litigation Release No. 17293 (Jan. 2, 2002); *SEC v. Michael W. Berger, Manhattan Investment Fund, Ltd., Manhattan Capital Management Inc.*, Litigation Release No. 17193 (Oct. 16, 2001).

<sup>255</sup> See, e.g., *SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee*, Litigation Release No. 18216 (July 7, 2003); *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. Vestron Financial Corp.*, Litigation Release No. 18065 (Apr. 2, 2003); *SEC v.*

claimed trading strategies;<sup>256</sup> and improper valuation of assets.<sup>257</sup> The overwhelming majority of the cases the Commission has instituted involve charges under each of the Securities Act, the Exchange Act and the Investment Advisers Act.

There are a number of observations that can be made regarding hedge fund enforcement actions brought since 1999. Nearly a third of the hedge fund cases brought in the last four years involved criminal charges. Another characteristic, which appears common to hedge fund cases, is the lengths to which the violators go to conceal their fraud. In almost half of the enforcement actions brought since 1999, the defendants or respondents created false documentation in an effort to hide their fraud. These documents included account statements and other types of reports to customers, confirmations and pricing sheets. The third characteristic that is perhaps more common to hedge fund cases than the typical investment adviser's case is the greater frequency of outright theft, or misappropriation, of investor funds that occurs. Finally, based on the Commission's recent cases, both registered and unregistered investment advisers have engaged in hedge fund fraud. We have also found the same individual operating both registered and unregistered investment advisers while engaging in hedge fund fraud.<sup>258</sup>

## **B. State and SRO Enforcement Activities**

State attorneys general are using state antifraud statutes to pursue enforcement actions against hedge funds. For example, New York Attorney General Eliot Spitzer used a 1921 New York business statute, the Martin Act, in asserting fraudulent trading arrangements between a

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*House Asset Management, L.L.C., House Edge, L.P., Paul J. House, and Brandon R. Moore*, Litigation Release No. 17583 (June 24, 2002); *In the Matter of the Application of Brian Prendergast*, Exchange Act Release No. 44632 (Aug. 1, 2001).

<sup>256</sup> See, e.g., *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. David M. Mobley, Sr.*, Litigation Release No. 18150 (May 20, 2003); *SEC v. Edward Thomas Jung*, Litigation Release No. 17417 (Mar. 15, 2002); *SEC v. Jerry A. Womack*, Litigation Release No. 17293 (Jan. 2, 2002); *In the Matter of the Application of Brian Prendergast*, Exchange Act Release No. 44632 (Aug. 1, 2001).

<sup>257</sup> See, e.g., *SEC v. Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC*, Litigation Release No. 18247 (July 23, 2003); *SEC v. Beacon Hill Asset Management LLC*, Litigation Release No. 17831 (Nov. 7, 2002); *SEC v. Michael L. Smirlock and LASER Advisers, Inc.*, Litigation Release No. 17630 (July 24, 2002).

<sup>258</sup> *SEC v. Stevin R. Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17981 (Feb. 11, 2003).

hedge fund and four mutual fund companies.<sup>259</sup> Other state securities regulators are also investigating state securities law violations involving hedge funds.<sup>260</sup>

These state enforcement actions underscore the fact that the activities of hedge funds can have a material effect on both the securities markets and investors at large. The opaqueness of hedge funds, however, presents a significant obstacle in regulatory efforts to monitor hedge fund activities. For example, the fact that most hedge fund advisers are not registered with the Commission as investment advisers conceals not only the existence of advisers but also of hedge funds themselves. The states' efforts against hedge fund frauds assist the Commission in promoting fairness in the securities markets.

Self-regulatory organizations have also been active in instituting hedge fund related enforcement actions. The NASD recently censured and fined a firm for failing to disclose the risks associated with hedge funds when marketing them to investors, and for exaggerated and unwarranted statements made in sale literature.<sup>261</sup> The NASD also censured and fined the firm's

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<sup>259</sup> See Canary Capital Partners, *supra* note 123. See also Spitzer Alleges Mutual Funds Allowed Fraudulent Trading, Wall Street Journal (Sept. 4, 2003)

<sup>260</sup> For example, the Illinois Secretary of State's Office has launched an investigation in connection with the New York Attorney General's investigation of hedge fund trading in mutual fund shares. See, e.g., Illinois Probing Hedge Fund Samaritan, Reuters English News Service (Sept. 10, 2003). In August, Massachusetts securities regulators filed three complaints against hedge funds and their advisers for a variety of state securities law violations. See In the Matter of Rahul V. Singh, No. E-2003-55 (Mass. Sec. Div. filed Aug. 13, 2003) (alleging sales of hedge fund interests to non-accredited investors); In the Matter of Michael F. Payne, Futronix Trading, LTD, No. E-2003-55 (Mass. Sec. Div. filed Aug. 13, 2003) (alleging use of misleading performance claims and sales to non-accredited investors); In the Matter of James Pangione, Timothy Rassias, Hercules Capital Management, LLC, Hercules Hedgehog Fund, LP, No. E-2003-56 (Mass. Sec. Div. filed Aug. 13, 2003) (alleging use of misleading statements on adviser qualifications and experience, investment strategy and risk levels); In re Stonehouse, No. E-2003-52 (Mass. Sec. Div. filed Sept. 22, 2003) (alleging, among other things, fraud in the offering of hedge fund securities).

<sup>261</sup> See NASD Notice to Members 03-07 (June 16, 2003) (announcing disciplinary action taken against Altegris Investments, Inc.); see also In the Matter of the Application of Brian Prendergast, Exchange Act Release No. 44632 (Aug. 1, 2001) (Commission sustaining NASD bar and censure of hedge fund co-adviser for, among other things, using materially misleading PPM and sales literature).

Chief Compliance Officer for failing to adequately supervise the firm’s advertising practices in this area.<sup>262</sup>

## VI. Concerns

We have identified below a number of significant concerns in connection with the growth of hedge funds.

### A. Lack of Commission Regulatory Oversight

#### 1. *Inability to Detect Fraud and Other Misconduct at Early Stages*

As noted above, in the last five years, the Commission has instituted 38 enforcement actions involving hedge fund fraud, involving significant losses to investors. The Commission typically identifies frauds and other misconduct involving hedge funds only after fund investors or service providers suspect fraudulent activity and contact the Commission. Thus, the Commission often finds itself instituting enforcement action against an unregistered hedge fund adviser only after significant losses have occurred.<sup>263</sup> In contrast, the Commission has an advantage in identifying the misconduct of registered investment advisers because they are subject to periodic examinations by Commission staff. When fraudulent or other unlawful activity does occur, examinations can lead to earlier discovery – often before significant losses have resulted. Further, the Commission uses the potential for a surprise examination and

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<sup>262</sup> See *id.* Specifically, the NASD found that between October 2002 and February 2003, Altegris distributed 26 different pieces of hedge fund sales literature to its customers. Each of these marketing pieces failed to include important disclosures regarding specific risks of investing in hedge funds and made unbalanced presentations about the particular hedge funds that failed to provide investors with a sound basis for evaluating whether to invest in these hedge fund products.

<sup>263</sup> Roundtable Transcript, May 15 (statement of Stephen M. Cutler) (“[I]n the case of unregistered advisers, [the Commission’s Enforcement Division is] not going to be the beneficiar[y] of an examination that is going to have identified a problem, brought it to our attention in the form of an enforcement referral. So a lot of what we end up seeing in the hedge fund area is after the train wreck has already happened. We will get a complaint from an investor that finds that he’s been wiped out.”); Roundtable Transcript, May 15 (statement of Mark Anson) (“[W]hile the antifraud provisions can deter fraud, they really can't prevent it. [W]here hedge fund managers don't disclose their losses immediately . . . once the fraud is uncovered, and the antifraud provisions kick in, and action can be taken, well, by that time, the losses have already occurred. And it's difficult for investors to get their money back.”). See also Robert Lenzner and Michael Maiello, *The Money Vanishes*, *Forbes* 70 (Aug. 6, 2001) (“[I]f there is mischief [in unregulated hedge funds], the [Commission] will find out about it too late.”).

deficiency letters to encourage a culture of compliance at regulated entities. We believe that the prospect of Commission examination serves as a deterrent to fraud and other misconduct.

## 2. *Lack of Meaningful Information about Hedge Funds and Hedge Fund Advisers*

The Commission has long been concerned about the lack of information available about hedge funds and their investment advisers.<sup>264</sup> Despite the growth of the hedge fund industry in the last decade, we do not have accurate information about how many hedge funds operate in the United States, their assets or who controls them.<sup>265</sup> Instead, we must rely on information provided by private organizations, the accuracy of which information remains unclear.<sup>266</sup>

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<sup>264</sup> See Hugh F. Owens, *A Regulator Looks at Some Unregulated Investment Companies The Exotic Funds*, Address before the North American Securities Administrators Ass'n (Oct. 21, 1969) ("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 hedge funds' investment techniques. . . . 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."). See also Breeden Letter, *supra* note 2 (attaching staff memorandum stating that the Commission is unable to provide the House Subcommittee with statistics on the number of hedge funds, their managed assets, their investors, rates of return, leverage or investments in various classes of financial assets).

<sup>265</sup> For example, the Commission was unable to provide the Treasury Department with accurate information about the number of hedge funds for use in connection with its proposals to require hedge funds to adopt anti-money laundering programs. Treasury Anti-Money Laundering Proposal, *see supra* note 109. Because there is no government source of information to identify or locate hedge funds, the Treasury Department has proposed a rule under the USA Patriot Act that will require hedge funds, among others, to file a notice with the Department with certain information about their operations. *Id.* at p. 60622. See also *supra* Part III.E.4.c. (discussing Treasury Department Regulations). As noted, the proposed notice will only be a partial source of information about hedge funds and their advisers.

Chairman Donaldson Testimony, *supra* note 184 ("[T]here are no precise figures available regarding the number, size and assets of hedge funds. This is due, in part, to the fact that there is no industry-wide definition of hedge fund; in part, because those that track hedge fund data rely on self-reporting by hedge funds; and in part because hedge funds generally do not register with the SEC, so we cannot independently track the data."). See also *The President's Working Group Study on Hedge Funds: Hearing Before the House Comm. on Banking and Financial Services, 106th Cong. 5* (1999) (statement of Representative John LaFalce, Member, House Comm. on Banking and Financial Services) ("The message of LTCM is. . . that we can no longer doubt that we have a new powerful kind of financial institution in our midst, the hedge fund, and that we

The nature of hedge fund investors is changing. Although we did not observe an existing retail market for hedge funds, the potential for that market is clearly at hand. Investment advisers already have proposed to offer registered FOHFs to retail investors without sophistication or other wealth requirements.<sup>267</sup> Moreover, the amount of retirement assets directly invested in hedge funds is growing.<sup>268</sup> In our view, the Commission is impeded in its ability to formulate public policy that appropriately protects the interests of the U.S. investing public unless it also has access to accurate and current information about hedge funds and their advisers.

Also, hedge funds are becoming a significant participant in our financial markets. We are concerned about the incomplete nature of information we are able to compile about the trading practices of hedge fund advisers on behalf of hedge funds. Hedge funds are active and important participants in our securities markets. Among other things, hedge fund advisers can invest hedge

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know very little about them.”); LTCM Report, *supra* note 126, at 1 (“[I]t is difficult to estimate precisely the size of the [hedge fund] industry . . .”).

<sup>266</sup> See Liang, *supra* note 177, at 310 (study of statistical inconsistencies in two major hedge fund databases, noting that “the reliability of hedge fund data is an open question critical to hedge fund research and the investment community”). See also William Fung and David A. Hsieh, *Measuring the Market Impact of Hedge Funds*, 7 *Journal of Empirical Finance* 1, 3 (2000) (“There are varying estimates of the size of the hedge fund industry.”); and *Hedge-matics: How Many Funds Exist?*, *Wall Street Journal* C5 (May 22, 2003) (“Just how big is the hedge-fund industry? This simple question has been debated because the data on hedge funds are spotty.”).

<sup>267</sup> See *supra* note 250.

<sup>268</sup> See, e.g., *US Pension Plan Looks to Hedge Funds*, *Financial Times* (London), *Global Investing* 21 (June 26, 2003) (Virginia retirement system plans to invest \$1 billion in hedge funds); Michael P. Norton, *Changes to State Pension Sought; Hedge Funds Top Treasurer's Plan to Reduce Risks*, *The Patriot Ledger* (Quincy, MA), *Business* 24 (June 5, 2003) (proposal to invest up to five percent of pension fund assets in hedge funds); and *NYC Fund Eyes Maiden Hedge Fund of Funds Investment*, 4 *Alternative Investment News* 19 (June 1, 2003) (Manhattan & Bronx Surface Transit Operating Authority Retirement Fund considers investment in hedge funds). See also Chris Clair, *'Unprecedented Pressure': Public Plans Race to Embrace Hedge Funds; This Time They Are Leading, Not Following, Their Corporate Counterparts*, *Pensions and Investments* 2 (July 8, 2002); Susan L. Barreto, *Hedge Funds Become Saving Grace for Endowments in Tough Times*, *HedgeWorld Daily News* (Apr. 4, 2002); *Virginia Exposure Soars to 60%*, *Financial News* (Daily) (Apr. 27, 2003) (University of Virginia has invested 50 percent of its portfolio in hedge funds, and plans to increase its exposure to 60 percent of its total portfolio); *University of Wisconsin Searching for Hedge Funds*, 4 *Alternative Investment News* 20 (Feb. 1, 2003) (\$300 million University of Wisconsin endowment will allocate up to ten percent, or \$25-30 million, to a fund of funds adviser); and *Baylor University; Inside The Buyside; Increases Hedge Fund Activity by \$20-25 Million*, 4 *Alternative Investment News* 6 (Feb. 1, 2003).

fund assets in innovative, and sometimes aggressive, ways in order to effectuate their investment strategies.<sup>269</sup> The Commission's inability to examine unregistered investment advisers, however, inhibits its ability to familiarize itself with the types of trading and other investment activities taking place in hedge funds.

Moreover, because of the close relationships between hedge funds and broker-dealers, the failure of a large hedge fund could also impact those firms. Interactions between broker-dealers and hedge funds have long been a Commission concern and one that has been addressed in particular as part of the Commission's supervision of broker-dealers. Our concern is based both on the possible loss of customer assets held by broker-dealers, which the Commission has a mandate to protect in conjunction with the Securities Investors Protection Corporation, and the systemic risk implications for the broader financial system, should a large broker-dealer fail due to exposure to a hedge fund. The Commission may indirectly view certain limited aspects of hedge fund trading activities through its supervision of other market participants, *i.e.*, broker-dealers, SROs, etc. These avenues, however, present a fragmented view of the overall trading activity of hedge funds.

## **B. Valuation of Hedge Fund Portfolio Securities**

The lack of independent checks on a hedge fund adviser's valuation of a hedge fund's portfolio securities is among the most serious concerns we have identified in the course of our investigation of hedge funds. Hedge fund advisers have powerful incentives to achieve superior (and positive) performance. The requirement to achieve positive performance in order to receive a performance allocation (and to remain in business) is just one such incentive. The adviser's own investment in the hedge fund is another. Hedge fund advisers that perform well find it easier to retain investors and raise additional capital.

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<sup>269</sup> Among the most common trading practices used by hedge fund advisers is short selling. The staff makes no recommendations to the Commission regarding short selling at this time, but notes that it is currently considering recommending that the Commission propose rule amendments that would modernize short sale regulation designed to target areas of abuse, including naked short selling. ("Naked" short selling generally refers to a sale of securities when the seller does not own the securities sold and makes no arrangements to borrow the securities in order to make delivery on the sale.) The amendments would also be designed to ease regulatory restrictions where they are unnecessary or inhibit beneficial short selling.

Business Week recently reported that trading of a single hedge fund adviser routinely accounts for "as much as 3% of the New York Stock Exchange's average daily trading, plus up to 1% of the NASDAQ's -- a total of at least 20 million shares a day." See Marcia Vickers, *The Most Powerful Trader on Wall Street You've Never Heard Of*, Business Week 66 (July 21, 2003).



A hedge fund adviser has broad discretion to value these securities; hedge funds need only value its portfolio securities in a manner consistent with the valuation policies and guidelines they disclose to their investors.<sup>270</sup> Moreover, even when hedge fund advisers use an outside service provider such as an administrator or pricing service to assist in valuing securities, advisers may exercise their discretion to override such prices.

The absence of any form of independent oversight over hedge fund pricing raises significant questions about the quality and fairness of the prices at which investors buy or redeem interests in some hedge funds. Because many hedge funds invest in highly illiquid securities, these concerns are heightened. In addition, smaller hedge fund advisers often lack the resources to establish and install adequate pricing systems. Moreover, the Commission lacks the authority to examine many hedge fund advisers' books and records or conduct on-site inspections of hedge fund adviser operations, which could reveal instances of mispricing.

### **C. Retailization**

One of the primary objectives of the staff's investigation was to determine whether, as a result of the growth of hedge funds, or otherwise, significant numbers of less sophisticated investors were investing in hedge funds.

#### *1. Direct Investment in Hedge Funds*

Inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the "accredited investor" standard.<sup>271</sup> To date, however, the staff has not uncovered evidence of significant numbers of retail investors investing directly in hedge funds. A number of factors may account for this, including that most hedge funds maintain investment minimums that effectively limit the entry of minimally qualified investors into the funds.<sup>272</sup> Hedge fund sponsors also assert that they do not seek retail investors because such investors may not be suitable for the inherent risks that accompany some hedge funds and

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<sup>270</sup> See supra Part IV.G. (discussing hedge fund valuation practices).

<sup>271</sup> See supra Part III.B.2. (discussing Regulation D).

<sup>272</sup> The investment minimum for hedge funds typically ranges from \$50,000 to \$10 million. The staff, however, found that hedge funds may waive these minimums for pre-qualified investors and that these minimums have dropped in recent years.

that the effort required to ensure such suitability often outweighs the benefit of any investments that they might make.<sup>273</sup>

Nevertheless, the increased number of retail investors qualifying as accredited investors raises our concern that hedge funds and broker-dealers might begin to seek out these investors as a new source of capital for hedge funds. We have observed that the minimum qualifications required to invest in some hedge funds has decreased as newer entrants into the alternative investments market compete for investors. We remain concerned that less sophisticated investors, even those meeting the accredited investor standard, may not possess the understanding or market power to engage a hedge fund adviser to provide the necessary information to make an informed investment decision.

## *2. Registered Funds of Hedge Funds*

The staff's concerns about registered FOHFs mirror our concerns expressed in this Report about hedge funds generally. Our concerns are amplified, however, by the possibility that the retail public may be offered access to some of these investment opportunities without restriction in the future.

We are concerned about the reliability of registered FOHFs' calculations of net asset value ("NAV"). There are no readily available market prices for hedge fund securities. In addition, as discussed above, an adviser of a FOHF may find it difficult to independently verify the accuracy of the valuation provided by the underlying hedge funds because it does not have access to portfolio holdings of those hedge funds.<sup>274</sup> Despite disclosure that advisers to registered FOHFs will look to a variety of factors in valuing hedge fund securities, some advisers may still rely almost completely on a hedge fund adviser to provide it with the value of the hedge fund's securities.

The lack of hedge fund transparency presents other problems as well, including with respect to fees and expenses of the underlying hedge funds and evaluating overall investment diversification or risk exposures. Although a registered FOHF generally is required to disclose its fees and expenses in its registration statement, it is not required to disclose, and investors do not have specific information about, the fees and expenses of the hedge funds in which the

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<sup>273</sup> See Roundtable Transcript, May 14 (statement of James R. Hedges) ("[I]t is my sense that the lion's share of the hedge fund industry is actually not interested in the retail investor. More hedge fund managers that I talk to than not have no interest whatsoever in selling their product in a retail channel. They like being privately placed to accredited or qualified purchasers. They like the freedom that that enables them to have. And they are not interested in getting into a different type of construct in order to target the retail investor.").

<sup>274</sup> See *supra* Part IV.G. (discussing hedge fund valuation practices).

FOHF invests. In addition, the lack of transparency limits the ability of the registered FOHF adviser to ascertain the diversification of the registered FOHF's portfolio. Consequently, a registered FOHF adviser following a particular strategy may invest in a number of hedge funds executing similar strategies. Each of the underlying hedge funds could be taking similar positions in its portfolio. The potential for this to occur is particularly a concern for registered FOHFs executing convertible or merger arbitrage strategies. The registered FOHF adviser may have no way of knowing if it is, in fact, making duplicate investments, and possibly magnifying its risk. Significantly, retail investors seeking diversification by investing in a Dual Registered FOHF are also unable to ascertain this information, and may take on more risk than desired as a part of their overall portfolio.

### 3. *Pension Plan and Other Institutional Investment in Hedge Funds*

Perhaps the greatest change in terms of indirect exposure of individual investments in hedge funds has been the frequency with which pension plans, universities, endowments, foundations and other charitable organizations are investing in hedge funds. Pension plans were among the earliest hedge fund investors.<sup>275</sup> The pace of these investments, however, has increased over the past few years.<sup>276</sup>

The staff is concerned that recent infusions of funds from public and private pension plans, universities, endowments, foundations and other charitable organizations into hedge funds may raise public policy considerations that heretofore have not been examined. These concerns do not relate to the ability or propriety of pension plan sponsors or trustees making investment decisions to place plan assets into hedge funds. Indeed, many trustees may believe that hedge fund investments are critical parts of a prudent investment strategy.

Instead, our immediate concern stems from the increasing presence of these investors in hedge funds over which neither the Commission nor any other regulatory authority exercises meaningful oversight. Although these institutions typically qualify as "accredited investors" or "qualified purchasers," these institutions, by investing in hedge funds, expose their participants or other beneficiaries to hedge funds. Thus, for example, a pension plan that experiences substantial losses as a result of hedge fund fraud may be unable to meet its obligations to pensioners. The collective indirect investment of the assets of less sophisticated individuals into vehicles that are managed by entities that are not examined by the Commission leaves open the

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<sup>275</sup> See, e.g., Loomis, *supra* note 10, at 103.

<sup>276</sup> See generally <http://www.ialternatives.com/home.asp>; *Hedge Funds Gaining Acceptance Among Pension Funds*, *supra* note 268; Lewis Knox, *The Hedge Fund: Institutional Money is Swelling the Coffers of the World's Largest Hedge Fund Managers*, 28 *Institutional Investor* (International Edition) 53 (June 1, 2003); and Dan Neel, *Michigan Preps For Hedge, Real Estate*, *Investment Management Weekly* (Apr. 28, 2003). See also *supra* note 268.

possibility that the Commission will be unable to anticipate problems involving hedge funds that may invest on behalf of these institutions.

#### **D. Disclosure**

As discussed above, hedge funds are not subject to any minimum disclosure requirements.<sup>277</sup> Although hedge fund advisers generally provide investors with a PPM, and while we acknowledge that there are often a range of other communications between hedge fund advisers and hedge fund investors, we are concerned that investors may not always receive disclosure about certain fundamental information relating to the investment adviser and its management of a hedge fund. We are also concerned that investors may not receive information about material changes to an adviser's management of a hedge fund on an ongoing and regular basis.

#### **E. Conflicts of Interests**

An investment adviser must act solely in the best interests of its clients consistent with its fiduciary obligations owed to clients. Hedge fund advisers often have substantial conflicts of interest, both with the hedge fund and with other non-hedge fund investors. In recognition that certain conflicts may be unavoidable, an investment adviser may discharge its fiduciary obligation only by disclosing conflicts of interest to its client.<sup>278</sup> We are concerned, however, that disclosure currently being provided to some hedge fund investors could be improved to address the level of the conflict.

##### *1. Side-by-Side Management of Client Accounts*

Conflicts of interest between investment advisers and their clients are not new. As one commenter at the Hedge Fund Roundtable noted, "conflicts exist any time a manager has two clients."<sup>279</sup> Unique facts, however, including the nature of the fees paid, the interests of the

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<sup>277</sup> See supra Part IV.D (discussing disclosure by hedge funds).

<sup>278</sup> See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963) ("Capital Gains") ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a Congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested" (citations omitted)). Undisclosed, such conflicts may constitute fraud by an investment adviser.

<sup>279</sup> Roundtable Transcript, May 14 (statement of Richard Phillips). See also *Institutional Investor Study Report of the Securities and Exchange Commission*, H.R. Rep. 92-64, Vol. 2, pt. 2, at 348 (1971) (noting that advisers might give preferential treatment to accounts in which they have a

adviser and the nature of hedge fund investment strategies themselves, distinguish hedge funds from other pooled investment vehicles offered by investment advisers, and bring these conflicts into even sharper focus.

The relationship between a hedge fund and its investment adviser incorporates a number of significant incentives that have the potential to motivate an adviser to favor its hedge fund client over other clients. Performance fees, which often are 20 percent or more of the realized capital gains and capital appreciation of the hedge fund, are significantly higher than the asset-based fees paid on traditional accounts, including registered investment companies. In addition, many investment advisers have significant investments in hedge funds that they manage.<sup>280</sup> As a result, the investment adviser has additional incentives to favor the hedge fund client over other clients by allocating investment opportunities to the hedge fund.<sup>281</sup>

The very nature of the investment strategies used by hedge funds may put them at odds with other, more traditional investment products and thus, may raise additional conflicts of interest for the adviser. For example, an investment adviser that manages a mutual fund using a long-only strategy may, at the same time, manage a hedge fund using a different strategy. The investment adviser may determine that an equity security that the mutual fund holds long is appropriate for the hedge fund to sell short.<sup>282</sup> The short sale may have a negative effect on the price of the security and therefore also have a negative effect on the mutual fund's performance. Similarly, a model-driven statistical arbitrage fund may be engaging in short-term buying while

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greater self-interest) and *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, pt. 1, at 373 (1963).

<sup>280</sup> Hedge fund investors generally insist on hedge fund advisers and their principals investing a significant percentage of their net worth alongside the limited partners' investments to ensure that a hedge fund adviser's interests are aligned with theirs. See, e.g., Roundtable Transcript, May 14 (statement of David Swensen).

<sup>281</sup> See *In the Matter of Nevis Capital Management, LLC, David R. Wilmerding, III and Jon C. Baker*, Advisers Act Release No. 2154 (July 31, 2003) (alleged unfair allocations of "hot issues" to two clients, including a hedge fund). See also *In the Matter of F.W. Thompson Co. and Frederick W. Thompson*, Advisers Act Release No. 1895 (Sept. 7, 2000) (undisclosed preferential allocation of hot issues to certain clients); and *In the Matter of McKenzie Walker Investment Management, Inc. and Richard C. McKenzie Jr.*, Advisers Act Release No. 1571 (July 16, 1996) (undisclosed favoritism of performance-fee paying clients).

<sup>282</sup> For example, a registered investment company may have a focus on a particular industry or sector and must choose (and remain fully invested in) those securities that the adviser believes represent the best opportunities within that universe. Nonetheless, that adviser may simultaneously be quite bearish on the same industry and may choose to short sell certain representative securities, including those held long in the registered investment company.

the investment adviser is selling the same securities in another account that follows a different strategy. Both strategies may be used for legitimate business reasons, but the conflicting nature of the strategies may affect certain clients negatively.

## 2. *Relationships with Prime Brokers*

Services provided by prime brokers can be very important to a hedge fund's operations. The nature of the services provided by a prime broker to a hedge fund adviser varies, depending upon its stage of development, organization and structure and investment strategy. Notwithstanding the importance of these services to the hedge funds, we found that the quality of disclosure typically provided to hedge fund investors about advisers' relationships with their prime broker(s) is minimal. Hedge fund advisers rarely disclose the nature of the services that they receive from a prime broker, nor is there clear disclosure regarding how they compensate the prime broker for these services.

We are concerned that hedge fund advisers may not be disclosing that fees paid to prime brokers may include amounts for services that do not benefit investors. For example, the provision of, and payment for, capital introduction services to a hedge fund's adviser presents a conflict of interest in that the introduction of new investors to the hedge fund may occur because the adviser used (and used fund assets to pay for) certain of the prime broker's services.<sup>283</sup> The provision of office space to the hedge fund adviser as part of the package of services provided to the adviser and paid for by the hedge fund creates a similar conflict of interest.

There are other potential conflicts of interest that may raise disclosure issues. For example, accepting "seed capital" investments by prime brokers without disclosing the potential conflicts inherent in such arrangements may raise concerns. The acceptance of such capital may, for example, negate any flexibility that the hedge fund adviser would have to freely choose its prime broker, or negotiate more attractive fees. As another example, there may be a *quid pro quo* for the inclusion of a hedge fund on a prime broker's "preferred" list of hedge funds, or its inclusion in a proprietary fund of hedge funds, which would essentially wed the hedge fund to the prime broker. These conflicts of interest also raise a concern that a hedge fund may pay more than is usual for core services (such as fees relating to securities borrowing) provided by the prime broker, or may satisfy pre-determined minimum targets for services, such as margin or brokerage, that are established prior to the delivery of services.

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<sup>283</sup> Broker-dealer firms typically do not charge separately for capital introduction services. Moreover, they assert that this service, like others, is provided "gratis" as an accommodation to the hedge fund. We are not persuaded that these services are free. Although they do not receive separate compensation, broker-dealers are compensated for such services, albeit indirectly, through the fees that they negotiate and receive for the entire package of services provided to the hedge fund.

## F. Concerns about General Solicitation

We also have concerns about the proliferation of public information about hedge funds that has accompanied the growth of the hedge fund industry. We believe that questions exist whether some participants in the hedge fund industry may not be complying with the prohibition on general solicitation and general advertising in privately offering and selling the hedge fund securities. As discussed above, as a condition to the availability of the safe harbor of Rule 506, hedge funds may not engage in any form of general solicitation or general advertising in finding investors.<sup>284</sup> The hedge fund has the burden of proving the availability of the exemption from registration. If the hedge fund, its adviser or other persons acting on its behalf uses general solicitation or general advertising to sell the hedge fund interests, the hedge fund will not be able to rely on the safe harbor.

Current marketing practices by some hedge fund advisers raise questions as to whether the hedge fund is engaging in a general solicitation or general advertising. For example, information contained in newsletters, press articles and even institutional reporting services about a specific hedge fund raises concerns about whether the hedge fund is engaged in a general solicitation or general advertising if that information is provided by the hedge fund's adviser or at their behest.<sup>285</sup> The extensive use of the Internet by hedge fund advisers has exacerbated this concern. Given the public nature of the Internet, issues arise as to how to sufficiently target information to eligible investors without running afoul of the general solicitation or advertising prohibition.<sup>286</sup> Although the Commission has been clear in its interpretive releases about the ways in which the Internet can be used in private offerings, questions exist as to whether some hedge fund advisers and sponsors have not followed the Commission's and staff's guidance. In fact, the Commission, in its 2000 Interpretive Release on the Use of Electronic Media, recognized that parties are not following staff guidance on when web sites may constitute general

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<sup>284</sup> See supra Part III.B. (discussing hedge funds and the Securities Act). See also Roundtable Transcript, May 14 (statement of Alan Beller) (“You can’t put up a billboard on Times Square and say, ‘We have a new hedge fund but please understand that unless you are an accredited investor, don’t call.’”).

<sup>285</sup> The staff has found numerous media reports quoting hedge fund advisory personnel discussing the “rollout” of new hedge funds.

<sup>286</sup> See supra Part III.B. See also Roundtable Transcript, May 14 (statement of Alan Beller) (“Even targeted means of publicity to offer to persons to whom or with whom the adviser or the other intermediary seller does not have a pre-existing relationship can also raise general solicitation questions, especially as that targeting becomes less targeted, if you will. You send out an e-mail or make a website generally available and say, ‘You can buy this but only if you are an accredited investor, and people with whom you don’t have a preexisting relationship have access to that page, that itself can be problematic under our current rules.’”).

solicitation for particular offerings and again reminded market participants of the permissible types of activities.

Although the restrictions on general solicitation and general advertising apply only to activities that are used to offer and sell securities, for hedge fund advisers using the Internet, questions arise as to whether information about their services and their activities would be outside the scope of the restriction on general solicitation and general advertising. In addition to the implications of the use of the Internet for the hedge fund offering itself, the Commission has also made clear that if an unregistered adviser uses a publicly available web site to provide information about its services, it would not qualify for the exemption from registration in Section 203(b)(3) of the Advisers Act because it would be considered to be holding itself out generally to the public as an investment adviser.<sup>287</sup>

The use of the Internet by hedge fund advisers in marketing their products has sharpened the question as to whether, at least with respect to a certain category of sophisticated investors, the prohibition on general advertising and general solicitation continues to be necessary. While it may not be appropriate to revisit the limitations on general solicitation, including those resulting from the use of electronic media, in the context of private offerings generally or even hedge funds specifically, it may be worthwhile to consider the need for such limitations for funds whose owners are limited to investors that clearly meet a higher standard or may be presumed to be able to “fend for themselves” such as, for example, the “qualified purchaser” standard of Section 3(c)(7).

#### **G. Concerns about Whether the Federal Securities Laws and Regulations Are Impairing the Investment Activities of Registered Investment Companies**

The staff’s investigation of hedge funds revealed the broad investment flexibility that most hedge fund advisers find necessary in order to effectuate their absolute return strategies. The staff believes that this flexibility may have contributed to hedge funds avoiding some of the losses sustained by investors in registered investment companies during the 2000-2002 bear market.<sup>288</sup> One investor advocate for individual investors who participated in the Roundtable

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<sup>287</sup> *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940*, Exchange Act Release No. 37182 (May 9, 1996).

<sup>288</sup> One Roundtable participant cited data that registered open-end investment companies lost approximately \$1.4 trillion from 2000-2002. See Comment submitted by Roundtable Panelist Frederick C. “Rick” Lake.



expressed the view that these types of investment vehicles should be made available to a broader array of investors.<sup>289</sup>

A very small percentage of registered investment companies currently use certain hedge fund investment strategies, including long/short, market neutral and merger arbitrage. The registered investment companies that pursue such investment strategies represent, in our estimation, less than one half of one percent of the investment company industry's assets under management as of June 30, 2003.<sup>290</sup> It is unclear why so few registered investment companies pursue these types of strategies, although the restrictions placed on investment companies and investment advisers to such companies may be at least partially responsible.

## **VII. Recommendations**

We recommend that the Commission consider making several changes to the regulatory framework relating to hedge funds and their investment advisers. We believe that these changes will address the concerns that we have identified above. The adoption of our recommendations would result in a shift in the federal securities laws' approach to the regulation of the hedge fund industry, but would add a greater level of investor protection to investors in hedge funds and FOHFs. It would also provide greater insight into this growing segment of the investment management industry without constraining the legitimate investment activities of hedge funds and their advisers.

Our recommendations are intended to address, on a going forward basis, existing and emerging issues that flow from the growth in the number of hedge funds and the assets under management at those funds. The adoption of our primary recommendation, that the Commission consider mandating federal registration of hedge fund investment advisers under the Advisers Act, would mean that hedge fund investors would receive important information regarding the funds and their advisers. We believe that these measures will also foster stronger compliance programs and provide the Commission with the ability to: identify important participants in the U.S. financial markets; examine the activities of investment advisers to assist in evaluating issues relating to market movements; and deter fraud and wrongdoing.

We have recommended changes to the regulatory framework with a view toward minimizing any impediments that these changes may have on the manner in which advisers

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<sup>289</sup> See Roundtable Transcript, May 15 (statement of John Markese) (expressing the view that with registration and appropriate information, hedge fund-type products may be useful in assisting investors in diversifying their investment portfolios).

<sup>290</sup> According to the staff's estimate, companies with a market neutral or merger arbitrage investment style had approximately \$2.1 billion under management at the end of June 2003.

manage hedge funds to achieve their investment goals. Indeed, in making these recommendations we recognize the beneficial role that hedge funds play in our financial markets. We also suggest that the hedge fund industry observe and continue to develop best practices guidelines that will result in better investor protection and healthier financial markets.

Finally, we ask the Commission to consider a number of recommendations that apply to registered investment companies. Some of these recommendations are designed to provide additional protections to investors in registered FOHFs. Other recommendations suggest that the Commission reconsider certain of the restrictions generally applicable to registered investment companies and their investment advisers. For example, we recommend that the Commission take steps to determine if hedge fund-type strategies can be made available to less sophisticated investors in a manner that both achieves investment goals and protects investors.

**A. The Commission Should Consider Requiring Hedge Fund Advisers to Register as Investment Advisers under the Advisers Act, Taking into Account Whether the Benefits Outweigh the Burdens of Registration**

We recommend that the Commission consider amending Rule 203(b)(3)-1 under the Advisers Act to require hedge fund advisers to “look through” any hedge funds that they manage and count each separate investor as a client.<sup>291</sup> By amending Rule 203(b)(3)-1 to redefine “client,” the Commission would shift the regulatory emphasis away from counting the number of hedge funds advised by the investment adviser and refocus it so that it reflects a determination of whether an investment adviser is of a size to merit federal regulation. In our view, the result of the recommendation to amend Rule 203(b)(3)-1 would be consistent with the underlying purpose of Section 203(b)(3), which was designed to exempt advisers whose advisory business is so limited that it does not warrant federal attention.<sup>292</sup> We also recommend that the Commission

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<sup>291</sup> See supra Part III.D. (discussing hedge fund advisers and the Advisers Act).

<sup>292</sup> There is no legislative history explaining the *de minimis* exception of Section 203(b)(3). That provision appears to reflect Congress’s view that investment advisers with only a handful of clients that do not hold themselves out to the public are presumably “private” and therefore do not raise issues of federal interest and need not register. Yet an investment adviser that manages client assets through hedge funds could have thousands of clients. For example, one hedge fund that relies on Section 3(c)(7) of the Investment Company Act could have 499 investors, one short of the threshold number at which an issuer must register its securities and comply with certain reporting requirements of the Exchange Act. An adviser that managed 14 such hedge funds would then manage the assets of 6,986 clients. In addition, if any of those clients were also hedge funds that the adviser managed, the number of clients would increase by the number of investors in those hedge funds.

consider incorporating into any such amendment a threshold for Commission registration based upon the aggregate amount of assets managed by the hedge fund adviser.<sup>293</sup>

In the course of the staff's investigation of hedge funds, we frequently raised, with industry participants and others, the question of whether the Commission should require all hedge fund advisers to register as investment advisers. Some supported required registration as a means of obtaining needed oversight of the hedge fund industry and providing appropriate transparency<sup>294</sup> and background information about the adviser for investors,<sup>295</sup> without impeding the functioning of hedge funds.<sup>296</sup> Some felt that required registration would benefit a maturing hedge fund industry by helping reduce fraudulent activities that diminish all members' reputations. One thought that it would provide a basis for permitting greater retail participation in hedge funds.<sup>297</sup>

Many of those opposing required registration expressed a strong preference for leaving the hedge fund industry "unregulated." They argued that the incidence of fraud among hedge fund advisers is low, and that hedge funds are adequately supervised by prime brokers, auditors and lenders.<sup>298</sup> Some asserted that there would be no purpose in requiring registration, arguing that the types of clients investing in hedge funds are able to take steps to protect themselves without the assistance of the Commission.<sup>299</sup>

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<sup>293</sup> Such a threshold would maintain the registration exemption for advisers to very small hedge funds whose investors are likely to have personal relationships with the hedge fund adviser. It would also be consistent with the approach taken by Congress when it amended the Advisers Act in NSMIA to divide oversight of advisers between the states (for advisers with less than \$25 million in assets under management) and the Commission (for advisers with assets under management of \$25 million or more). We note, however, that even with such a threshold, our recommendation would require most hedge fund advisers to register under the Advisers Act.

<sup>294</sup> Roundtable Transcript, May 15 (statement of Mark Anson).

<sup>295</sup> Roundtable Transcript, May 15 (statement of Sandra Manzke).

<sup>296</sup> Roundtable Transcript, May 14 (statement of Richard Phillips).

<sup>297</sup> Roundtable Transcript, May 15 (statement of John Markese).

<sup>298</sup> Roundtable Transcript, May 15 (statement of Paul Roth). See also, Managed Funds Association Comment Letter, supra note 120.

<sup>299</sup> Roundtable Transcript, May 15 (statement of Paul Roth). See also Gibson, *Is Hedge Fund Regulation Necessary?*, 73 Temple Law Review 713-14 (Summer 2000) (hedge fund investors' ability to privately assert rights under antifraud provisions of federal securities laws obviates need for SEC regulation). We note, however, that there are limited private rights of action under the

During the course of the staff's investigation of hedge funds, we also questioned whether mandating registration of investment advisers to hedge funds would impede the operations or investment activities of hedge fund advisers. No one identified any provision of the Advisers Act or Commission rules that, if applied to hedge fund advisers, would have this result.<sup>300</sup> Although industry participants had mixed reactions to mandatory registration of hedge fund advisers,<sup>301</sup> many hedge fund advisers register voluntarily. This belies any notion that

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Advisers Act. Hedge fund investors would be unable to bring a private action against a hedge fund adviser for monetary relief based on violations of the Advisers Act antifraud provisions. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

<sup>300</sup> Indeed, hedge fund lawyers indicated to us that the U.S. approach to excluding hedge fund advisers (or making registration optional, depending upon the other advisory activities of the adviser) appeared to be unique among countries with developed markets and regulatory systems, most of which regulate the activities of hedge fund advisers (and in some cases hedge funds themselves), or are in the process of changing their laws to add hedge funds and hedge fund advisers to the country's existing system of investment management regulation. See, e.g., Japanese Securities Investment Adviser Association website, *About the Industry in Japan* at [http://jsiaa.mediagalaxy.ne.jp/komon\\_e/index.html](http://jsiaa.mediagalaxy.ne.jp/komon_e/index.html); Securities and Futures Commission (Hong Kong), Securities and Futures Ordinance (Cap. 571, Sec. 114 and Sch. 5), at <http://www.hksfc.org.hk/eng/bills/html/index/index0.html>; Securities and Futures Commission (Hong Kong), Fund Managers Code of Conduct (April 2003), at <http://www.hksfc.org.hk/eng/bills/html/index/index0.html>. One author has suggested that the European approach to regulating hedge fund advisers has benefited the industry by establishing minimum standards of practice in which investors can have some confidence. Neil Wilson, *Why Regulation Can Be Good*, *Absolute Return* (Apr. 2003) (U.K. regulation of hedge fund advisers has not impeded growth, and encourages advisers to build professional operations before launching funds; many of the firms deterred by regulation probably should not be managing hedge funds).

<sup>301</sup> A few Roundtable panelists suggested that if the Commission requires mandatory registration for most hedge funds advisers, some of those advisers would move their operations to jurisdictions that did not have such a requirement. We believe that such concerns are unwarranted. A hedge fund adviser could not avoid application of the Advisers Act simply by moving its office to a non-U.S. location. In fact, an adviser moving offshore would be required to register if more than 14 U.S. investors owned interests in the hedge fund. See Rule 203(b)(3)-1(b)(5) under the Advisers Act. At least one hedge fund consultant has suggested that advisers foregoing U.S. investors is unlikely to occur. Ron Orol, *Firmly Rooted*, *Daily Deal* (July 14, 2003) (citing Arthur Bell of Arthur Bell & Associates as stating that U.S. investors would be "virtually impossible to replace.")

Several Roundtable panelists asserted that registration under the Advisers Act was unnecessary because hedge fund advisers are already registered with the CFTC as CPOs or CTAs and examined by the NFA. Roundtable Transcript, May 14 (statement of Anthony Artabane); Roundtable Transcript, May 15 (statements of Patrick McCarty and Armando Belly). As discussed above, however, the CFTC and the NFA necessarily focus their examinations more

registration of hedge fund advisers is detrimental to a hedge fund's legitimate investment activities.

Registration under the Advisers Act represents the least intrusive form of regulation available to address many of the concerns identified in this Report. Our recommendation that hedge fund advisers register with the Commission under the Advisers Act would not result in any changes with respect to those advisers' ability to effectuate their investment strategies. Registration would not place any restrictions on hedge fund advisers' ability to trade securities, use leverage, sell securities short or enter into derivatives transactions. Nor would registration under the Act require the disclosure of any proprietary trading strategy. In addition, registration would not result in hedge funds and hedge fund advisers being subject to any additional portfolio disclosure requirements.

Our recommendation would not result in hedge funds having to register the offerings of their interests with the Commission, nor would it require that they modify their organizational structures. Advisers would be able to maintain their existing lock-up and repurchase schedules. Adviser registration would not result in public disclosure of the identities of advisers' clients. Finally, registration would not restrict the amount of fees that hedge fund advisers may charge hedge funds, although an adviser to a hedge fund relying on Section 3(c)(1) of the Investment Company Act would be permitted to charge that fund a performance fee only if each of the investors in the fund are qualified clients under Rule 205-3 under the Advisers Act.<sup>302</sup>

### *1. Benefits of Mandatory Registration*

#### *a. Registration of Hedge Fund Advisers Would Serve as a Deterrent to Fraud*

Our examination experience with registered investment advisers demonstrates that examinations can lead to earlier discovery of actual and potential misconduct and frequently reduces the possibility that such misconduct will occur.<sup>303</sup> Periodic examination of hedge fund advisers can be expected to have the same result. We concede, however, that Commission examinations cannot assure that frauds do not occur. Indeed, a number of our enforcement actions involving hedge fund frauds have been against hedge fund advisers that are registered

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closely on futures trading. Moreover, the CFTC recently adopted rules that may permit most hedge fund advisers, including those currently able to avoid investment adviser registration, to avoid registering as CPOs or CTAs.

<sup>302</sup> See supra note 212. Hedge fund advisers to funds relying on Section 3(c)(7) under the Investment Company Act would not be subject to any such limitation.

<sup>303</sup> See supra Part VI.A. (discussing concerns about lack of Commission oversight).

with us.<sup>304</sup> Nevertheless, the prospect of Commission examination may discourage persons from using hedge funds to engage in fraud. Moreover, we believe that the lack of regulatory oversight of hedge funds may contribute to the belief on the part of hedge fund advisers that fraud will not be exposed.

*b. Registration of Hedge Fund Advisers Would Provide the Commission with Examination Authority and Foster Strong Compliance Practices*

Advisers, including hedge fund advisers, are fiduciaries that must avoid conflicts of interest with their clients, or fully disclose those conflicts.<sup>305</sup> To protect against the adverse consequences of these conflicts, hedge fund advisers should adopt a “culture of compliance,” which involves making compliance considerations a part of an adviser’s business plan.

Our investigation revealed that many unregistered hedge fund advisers already have adopted sound compliance practices, which would need little modification to address registration requirements. Those unregistered advisers, however, tended to be larger firms that have substantial reputational risk at stake. Several participants in the hedge fund industry with whom we met during the course of our investigation, however, expressed concern that newer industry participants had not adopted compliance controls adequate for the amount of assets under their control.

While some new entrants to the hedge fund industry brought with them – from their previous employment with a money management or brokerage firm – an understanding of their obligations to fund investors, other new entrants may have little such experience. Our examinations confirmed that in many cases controls at some hedge fund advisers are very informal. We believe that the prospect of a compliance examination by the Commission staff will result in the adoption of procedures and controls designed to fulfill the hedge fund adviser’s fiduciary responsibilities to the hedge fund and its investors.<sup>306</sup>

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<sup>304</sup> See, e.g., *Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17981 (Feb. 11, 2003); *SEC v. Michael L. Smirlock and LASER Advisers, Inc.*, Litigation Release No. 17630 (July 24, 2002); *In the Matter of William F. Branston*, Advisers Act Release No. 2040 (June 26, 2002); *In the Matter of Abraham and Sons Capital, Inc. and Brett G. Brubaker*, Advisers Act Release No. 1956 (July 31, 2001).

<sup>305</sup> *Capital Gains*, *supra* note 278, at 191, 194.

<sup>306</sup> See Neil Wilson, *Why Regulation Can Be Good*, Absolute Return (Apr. 2003) (U.K. regulation of hedge fund advisers establishes minimum standards of practice; the process of registration encourages advisers to build professional operations before launching a fund “rather than scrambling to put them together after launch.”).

Earlier this year, the Commission proposed a new rule that, if adopted, would require all registered investment advisers to adopt written compliance procedures, review them at least annually and appoint a chief compliance officer.<sup>307</sup> Application of this rule to hedge fund advisers would, in our view, be particularly useful.

As registered investment advisers, hedge fund advisers would be required to make certain prescribed disclosures to the Commission and investors, including disclosure regarding the advisers' business practices and disciplinary history, and to maintain required books and records and safeguard client assets. The Commission could conduct periodic compliance examinations of these advisers and monitor whether they conduct their operations (as well as those of hedge funds that they manage) so as to avoid the concerns identified in this report. We anticipate that the prospect of a staff compliance examination will serve to support business decisions to allocate resources necessary to ensure the implementation of strong compliance controls and the satisfaction of hedge fund advisers' fiduciary responsibilities to their clients.

*c. Registration Would Provide the Commission with Important Information about a Segment of the U.S. Financial System that Is Growing in Significance*

Hedge fund adviser registration under the Advisers Act would permit the Commission to collect basic information about virtually all hedge fund advisers, including the number of hedge funds that they manage, the amount of assets of those hedge funds and the identity of persons controlling the hedge fund advisers.<sup>308</sup> This requirement also would enable the Commission to more comprehensively and effectively observe the trading activities of the funds managed by such advisers. Currently, the Commission generally has access to records of trading on behalf of hedge funds through the books and records maintained by the brokers that the hedge fund advisers use and the markets on which they trade. These records, however, are dispersed and it could be difficult to detect improper trading activities conducted by a particular hedge fund if such activities were effected through orders placed with multiple brokers and traded on multiple markets. The ability to directly examine the trading activities of hedge fund advisers would

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<sup>307</sup> *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2107 (Feb. 5, 2003).

<sup>308</sup> Roundtable panelists suggested that it would be valuable for the Commission to gather information about hedge funds. Roundtable Transcript, May 15 (statement of Thomas Fedorek) (“[T]here's a real opportunity here for the SEC to be not just a cop but to be what it is, actually, to a large extent already, an information provider. [N]ot a day that goes by that I don't dial into one of the SEC's databases to get information to help me in the research that I do in my investigations.”); Roundtable Transcript, May 15 (statement of Andrew Lo) (suggesting that the Commission is in a unique position to gather hedge fund data that are not generally and publicly available, and noting that an understanding of risks involved in hedge funds begins with data.).

provide a more complete picture of their trading activities and make it easier to detect improper or illegal trading practices.

Much of this information currently can be collected from hedge fund advisers that are registered with the Commission.<sup>309</sup> Using the Commission’s existing authority under the Advisers Act to obtain information about hedge fund advisers is particularly appropriate because, as originally enacted, the Advisers Act was designed to be “a continuing census of the Nation’s investment advisers.”<sup>310</sup>

*d. Mandatory Registration Would Effectively Raise the Standards for Direct Investments in Hedge Funds*

Our investigation of hedge funds was driven, in part, by the Commission’s concern that the growth in hedge funds was being fueled by the direct investments of less sophisticated investors in hedge funds. Although our investigation did not uncover significant direct investment in hedge funds by less sophisticated investors, we continue to believe that the rise in investor wealth and incomes could ultimately result in retail investors investing directly in hedge funds relying on Section 3(c)(1) of the Investment Company Act. A number of commenters expressed their views that this concern could be remedied by raising the wealth standards, primarily the accredited investor standard under Regulation D.<sup>311</sup> Registration of hedge fund advisers, however, would effectively address our concerns.

In general, the Advisers Act prohibits registered investment advisers from charging performance fees to hedge funds relying on Section 3(c)(1) of the Investment Company Act unless all of the fund’s clients are “qualified clients.”<sup>312</sup> The wealth standards for qualified

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<sup>309</sup> A registered adviser that is the general partner of a hedge fund must report that it advises a “pooled vehicle” in response to Item 5.D.4. of Part 1A of Form ADV, list each pooled vehicle on Schedule D (Section 7B) and disclose the amount of assets in the fund and the minimum amount of capital investment per investor.

<sup>310</sup> H.R. Rep. No. 1760, 86<sup>th</sup> Cong., 2d Sess. 2 (1960).

<sup>311</sup> See, e.g., Managed Funds Association Comment Letter, supra note 120 (proposing increases to the accredited investor thresholds to \$2 million in net worth, \$400,000 in annual income and \$500,000 in annual income jointly with one’s spouse); Comments submitted by the Ad Hoc Hedge Fund Committee of the Securities Industry Association (supporting suggestions to tighten the accredited investor standard built into Regulation D under the Securities Act of 1933); Comments submitted by David G. Tittsworth on behalf of the Investment Counsel Association of America (urging the Commission to consider revising the current definition of “accredited investor”).

<sup>312</sup> See Section 205(a)(1) of the Advisers Act and Rule 205-3(d)(1) thereunder. See supra note 212.



clients are appreciably higher than those for “accredited investors,” requiring that the investor have \$750,000 invested with that adviser, or generally have a net worth of \$1.5 million.<sup>313</sup> Our recommendation also has the salutary effect of permitting the Commission to reevaluate any future concerns about the nature of hedge fund investors and address any such concerns through regulation under the Advisers Act.

## 2. *Concerns about Mandatory Registration*

We recognize that adviser registration will impose additional costs on hedge fund advisers that are not already registered with the Commission. Nevertheless, we believe that the benefits of adviser registration outlined in this Report outweigh the additional costs that would be imposed on unregistered hedge fund advisers.<sup>314</sup> There are three types of costs associated with registering: (1) electronic filing, which costs \$1100 the first year and \$550 each year thereafter; (2) recordkeeping systems meeting the requirements of the Advisers Act, which are typically provided by the hedge fund’s prime broker and thus, in many cases, would involve no additional costs; and (3) ongoing costs related to regulatory compliance. Most of these latter costs are attributable to compliance with the Act’s antifraud provisions to which unregistered advisers already are subject and thus should be incurred regardless of whether the adviser is registered under the Act. In connection with any rulemaking, the staff would prepare a more complete analysis of the costs and benefits of requiring hedge fund advisers to register under the Advisers Act.

We are also mindful that the Commission’s resources available to examine advisers are limited. Thus, we recommend that any rule the Commission adopts requiring advisers to count clients by “looking through” the hedge fund limit the number of new registrants by distinguishing between hedge funds and other investment vehicles that do not register under the Investment Company Act in reliance on Sections 3(c)(1) or 3(c)(7). These other investment vehicles include venture capital funds, private equity funds and structured financing vehicles.<sup>315</sup>

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<sup>313</sup> Our recommendation also is attentive to the Commission’s interest in maintaining existing regulations that support its mission to assist small business development. See Chairman Donaldson Testimony, supra note 184. By leaving eligibility requirements for “accredited investors” under Regulation D unchanged, small businesses may continue to seek capital from historical sources.

<sup>314</sup> In addition, some advisers to hedge funds that are already registered with the Commission have indicated that the burdens of adviser registration do not impose significant additional costs on their operations. Further, many advisers of hedge funds that are not registered have indicated that they conform their operations to those of registered advisers.

<sup>315</sup> The President’s Working Group cited the difficulty of limiting registration to advisers to hedge funds as one reason for not requiring hedge fund managers to register under the Advisers Act. LTCM Report, supra note 126, at B-16. In developing anti-money laundering rules under the USA Patriot Act, the Treasury Department was, however, able to craft such a limitation by

In addition, we recommend that the Commission consider its available resources when establishing the amount of assets under management threshold for registration with the Commission.

The Commission should carefully evaluate its resources and capabilities to seek to ensure that any rulemaking would not affect the efficacy of the Commission's examination program before taking action on our recommendations. Moreover, the Commission would have to devote the resources necessary to modify its existing investment adviser examination program so that it recognizes the unique nature of hedge fund advisers and identifies deficiencies and possible violations.<sup>316</sup> We also believe that our recommendations would require that additional resources be dedicated to the Division of Investment Management so that it may consider and evaluate regulatory policy regarding hedge fund investment advisers.

**B. The Commission Should Consider Revising its Regulations Under the Advisers Act to Require Advisers to Provide a Brochure Specifically Designed for Hedge Funds**

We recommend that the Commission consider revising its rules to require that hedge fund advisers file with the Commission, and deliver to investors, a disclosure statement tailored to meet the needs of hedge fund investors.<sup>317</sup> Disclosure could be in the form of a brochure and

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proposing to apply its rule only to funds that offered certain redemption rights. See Treasury Anti-Money Laundering Proposal, supra note 265; see also supra Part III.E.4.c.

<sup>316</sup> Requiring hedge fund advisers to register with the Commission would not impose any additional burdens on state securities authorities. Hedge fund advisers registered under state law would, upon registering with the Commission, be eligible to withdraw their state registrations. See Section 203A(b)(1) of the Advisers Act. The rulemaking that we recommend that the Commission consider may thus be expected to relieve some state regulators of their regulatory obligations with respect to some hedge fund advisers that are registered with state securities authorities. See supra Part III.E.5.c. (discussing state regulation of hedge fund advisers).

<sup>317</sup> Investment advisers register with the Commission or state securities administrators on Form ADV. See <http://www.sec.gov/divisions/investment/iard.shtml>. Part I of Form ADV requires general disclosure about the adviser's business and certain disciplinary information. Part I of an adviser's Form ADV is available on the Commission's web site. Part II of Form ADV requires disclosure of certain information, including conflicts of interest, assets under management and whether the adviser manages any pooled assets. Part II of Form ADV (or a brochure incorporating the information required in Part II) must be delivered to clients and prospective clients under Rule 204-3 under the Advisers Act. Advisers to hedge funds must deliver their brochures to the hedge fund investors, rather than the hedge fund itself. *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Advisers Act Release No. 1862 n.117 (Apr. 5, 2000). The Commission has under consideration a proposal to make Part II of Form ADV available on the Commission's website.

would prescribe minimum requirements for basic disclosure information provided to investors and prospective investors. The Commission could require, for example, disclosure about various conflicts of interest, what risk management measures the adviser performs,<sup>318</sup> how the adviser values securities held by hedge funds (and the extent to which that valuation will be determined independently) and what lock-up periods may apply to an investor's investment in hedge funds managed by the adviser. Although hedge fund investors may already receive some of the information in the fund's PPM, we would propose that the Commission require that this information be disclosed in the "hedge fund brochure" – the brochure having the added benefit of requiring the adviser to update its disclosures periodically and make that information available to investors on an ongoing basis.<sup>319</sup> Moreover, these disclosures could be useful to other clients of the adviser in identifying conflicts of interests on the part of the adviser.

The information contained in Form ADV would not, we recognize, give investors in hedge funds all the information that they may need or want. Because that form is designed to provide information about investment advisers, there would be limitations on information about specific hedge funds. In addition, Form ADV cannot provide investors with sufficient information to evaluate the character of the hedge fund adviser or its employees.<sup>320</sup> But Form

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<sup>318</sup> The Commission also could consider exploring the possibility of developing appropriate risk measures that hedge fund advisers could use to provide investors with ongoing risk information. Hedge fund advisers, institutional investors and knowledgeable groups such as the Investor Risk Committee of the International Association of Financial Engineers could be contacted to assist the Commission in developing risk measures that would be meaningful to, and meet the needs of, hedge fund investors.

We note that our recommendation would implement one of the recommendations in the LTCM Report, supra note 126, at 32-33. The Working Group recommended the enactment of legislation granting any necessary authority to require disclosure by hedge funds that were not registered with the CFTC as commodity pools. Legislation was introduced into Congress but was never enacted. Legislation would be unnecessary to effect the Working Group's recommendation once hedge fund advisers registered with the Commission.

<sup>319</sup> See Roundtable Transcript of May 14 (statement of George Hall) (the private placement memorandum does not provide for ongoing information – ongoing information is provided more informally, "more outside of the documents").

<sup>320</sup> Roundtable Transcript of May 14 (statement of David Swensen) ("[W]hat we really care about when we're making investment decisions is, first and foremost, the quality of the people, and there's no way that you can look at somebody's disclosure document and figure out if the people that you're invested with have the character, the intelligence, the integrity, the creativity, and market savvy that you want to have in a partner in this arena or any other investment arena, for that matter."); Roundtable Transcript of May 15 (statement of Pamela Parizek) ("While there is a great deal of information that's available in the public domain, . . . things like reputation and integrity [are] not generally going to be available and frequently we are called upon to get that type of information for many of our investors.").

ADV disclosure would, we believe, make the due diligence process in which many hedge fund investors engage substantially more efficient and provide investors with more current information about the operations of hedge fund advisers and the strategies, policies, management and operations of the hedge funds that they operate.

**C. The Commission Should Consider Requiring Certain Registered Investment Companies to Follow Board Adopted Valuation Procedures**

We recommend that the Commission consider rulemaking to address our concerns about how registered investment companies, including registered FOHFs, that invest their assets in hedge funds value their portfolio holdings. As noted above, the Investment Company Act requires boards of directors to fair value in good faith any securities for which there are no readily available market quotations. Best practices would suggest that all registered investment companies adopt procedures under which they may satisfy this requirement. Because of our heightened concerns relating to registered FOHFs, however, we recommend that the Commission consider a rule that would prohibit registered investment companies from investing in the securities of hedge funds unless their boards of directors have adopted procedures designed to ensure that the funds value those assets consistently with the requirements of Section 2(a)(41) of the Investment Company Act. In making this recommendation, however, we note that the requirement under Section 2(a)(41) that a board of directors determine, in good faith, the fair value of securities for which there is no readily available market quotation reflects Congress's recognition that a board of directors must exercise its best business judgment in valuing these types of securities. We do not recommend, therefore, that the Commission consider mandating the specific procedures that a fund must follow in valuing its assets.<sup>321</sup>

**D. The Commission Should Consider Requiring Additional Disclosure to be Provided About Layered Fees of “Funds of Funds”**

We recommend that the Commission consider adopting its recently proposed rule that would expressly require all registered investment companies, including registered FOHFs, that invest all or substantially all of their assets in hedge funds (collectively “funds of funds”) to disclose in the fee table the estimated fees (both asset based and performance based) and expenses of the underlying funds.<sup>322</sup> The staff believes that disclosure of the expenses of both the fund in which an investor invests and the funds in which a fund of funds invests is important to provide meaningful information to investors.

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<sup>321</sup> We believe that this recommendation could ultimately address our concerns about a registered FOHFs diversification and risk exposure. See supra Part VI.C.2. (discussing concerns relating to registered FOHFs).

<sup>322</sup> See *Fund of Funds Investments*, Investment Company Act Release (to be released).

We believe our recommendation is particularly germane to registered FOHFs. Neither the Investment Company Act nor the Advisers Act limits the amount of fees that may be charged by hedge fund advisers. Moreover, to the extent that performance fees may be charged at the hedge fund level, a registered FOHF investor may indirectly pay performance fees to some hedge fund advisers regardless of how poorly the investor's registered FOHF performed overall. Because an investor in a registered FOHF has access only to the fee disclosure in that fund's prospectus, the investor cannot accurately evaluate his or her investment goals and expectations against the costs of the investment, without additional disclosure that would be required under the recommended rule.

**E. Regulators Should Continue to Monitor Whether Suitability Obligations Are Being Met**

We do not recommend specific measures to be taken with respect to suitability determinations at this time. We believe that the staffs of the NASD and the Commission are carefully focusing their examinations of broker-dealers to, among other things, ensure that they are meeting their obligation to evaluate and disclose to investors the general suitability of hedge funds and FOHFs (both registered and not registered with the Commission), as well as their suitability for specific investors. Although we believe that the examination of broker-dealers has been effective in deterring abusive sales practices relating to these securities, we also urge the examination staffs of the NASD and Commission to continue to be vigilant in identifying any violations of broker-dealer suitability obligations.

**F. The Commission Should Consider Permitting General Solicitation in Section 3(c)(7) Hedge Fund Offerings**

We question whether the restrictions on general solicitation for private placement offerings of interests in funds relying on Section 3(c)(7) of the Investment Company Act should be retained. Unlike a Section 3(c)(1) fund, a Section 3(c)(7) fund can be sold to an unlimited number of investors, so long as they are "qualified purchasers." There seems to be little compelling policy justification for prohibiting general solicitation or general advertising in private placement offerings of Section 3(c)(7) funds that are sold only to qualified purchasers.<sup>323</sup>

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<sup>323</sup> The Commission has requested comment in various rulemakings as to whether the restrictions on general solicitation should be relaxed as to certain types of offerings or certain types of investors. See, e.g., *The Regulation of Securities Offerings*, Securities Act Release No. 7606A (Nov. 13, 1998); *Securities Act Concepts and their Effects on Capital Formation*, Securities Act Release No. 7314 (July 25, 1996); *Exception for Certain California Limited Issues*, Securities Act Release No. 7285 (May 1, 1996); *Exemption for Certain California Limited Issues*, Securities Act Release No. 7185 (June 27, 1995). To date, the Commission has not adopted proposals to relax general solicitation or general advertising restrictions. The Commission and the staff have, however,

The staff would be reluctant to ease or eliminate the prohibition on general solicitation for hedge funds or other funds that use the accredited investor standard as their minimum investor criteria. We believe that such an arrangement could increase the level of risk of investment interest by less wealthy investors. On the other hand, permitting funds, including hedge funds, that limit their investors to a higher standard (e.g., “qualified purchasers”) to engage in a general solicitation could facilitate capital formation without raising significant investor protection concerns.

#### **G. Monitor Capital Introduction Services Provided by Prime Brokers**

Prime brokers frequently provide certain investors with information about hedge funds. In particular, prime brokers who provide capital introduction services to hedge fund advisers often invite these investors to attend capital introduction conferences and seminars. Prime brokers have asserted that these “dating service” activities do not rise to the level of acting as a broker or investment adviser. We question whether this conclusion is accurate in all circumstances. Accordingly, we encourage examiners to be vigilant in examining capital introduction services to determine whether prime brokers are complying with all applicable regulatory requirements.

#### **H. Encourage the Hedge Fund Industry to Embrace and Further Develop Best Practices**

The Commission should encourage the hedge fund industry and others involved with the industry to embrace existing “best practices” and expand and develop additional best practice guidelines in areas that further investor protections and enhance the ability of hedge funds to manage their operations. Generally, best practice guidelines allow firms to benchmark their activities relative to their peers and can produce a self-regulatory solution to issues arising within an industry. At least three industry groups and associations have issued best practice recommendations for hedge fund advisers.<sup>324</sup>

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recognized that a shorter time frame, 30 days, between the end of activities that may be considered general solicitation or general advertising and the commencement of an offering may be sufficient to eliminate a concern that investors in the subsequently commenced private offering were found by means of general solicitation or general advertising. See e.g., *Integration of Abandoned Offerings*, Securities Act Release No. 7943 (Jan. 26, 2001).

<sup>324</sup> See The Managed Funds Association, *2003 Sound Practices for Hedge Fund Managers* (Aug. 2003) (“MFA 2003 Sound Practices”); The Alternative Investment Management Association Ltd., *Guide to Sound Practices for European Hedge Fund Managers* (Aug. 30, 2002) (“AIMA Guide to Sound Practices”); and The International Association of Financial Engineers, Investor Risk Committee, *Hedge Fund Disclosure for Institutional Investors* (July 27, 2001).

Some best practice recommendations were developed in response to issues arising out of LTCM, and therefore focus largely on risk management techniques, addressing investor protection issues in the context of market, leverage, and operational risks. The Managed Funds Association recently revised its sound practices.<sup>325</sup> These sound practices include recommendations concerning the type of information that should be disclosed to a hedge fund's investors, such as the fund's investment objectives and strategies, performance information, and range of permissible investments as well as valuation policies and business continuity and disaster recovery. These recommendations also acknowledge that hedge fund operations may generally present conflicts of interest and that these conflicts, if material, should be appropriately disclosed. The Alternative Investment Management Association sound practices guide covers topics such as: creating and managing a hedge fund business; hedge fund structures and organizations; the investment process and portfolio risk management; portfolio administration and operation controls; as well as capital raising and investor relations. AIMA guidelines, for example, address among the most critical conflicts of interest confronted by investment advisers: side-by-side management of hedge funds and other clients. The AIMA guidelines emphasize that addressing side-by-side management issues in managing various portfolios should be an "overriding principle of business."<sup>326</sup>

The use of best practices can be an effective means of addressing issues that arise in the hedge fund industry. For example, based on its examination of major brokerage houses, the Commission staff discovered that many firms responded favorably to recommendations made in the President's Working Group on Financial Markets' report to address the risk management and transparency issues raised in LTCM. The Managed Funds Association has also indicated that the best practices it issued was "widely recognized by members of the hedge fund industry as a highly useful resource for hedge fund managers."<sup>327</sup> Best practices may thus be a useful tool to improve how firms address issues, such as conflicts of interest, beyond regulatory and legal mandates.

While we are encouraged by the best practice guidelines that currently exist, we believe that the industry should be encouraged to continue to refine and expand their scope, especially in light of evolving industry developments. For example, we believe that certain of these recommendations are general in nature and may be more meaningful if they provide specific policies and procedures that hedge fund advisers may follow or consider to improve their operations and to prevent conflicts from harming their clients.

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<sup>325</sup> See MFA 2003 Sound Practices, supra note 324.

<sup>326</sup> See AIMA Guide to Sound Practices, supra note 324.

<sup>327</sup> See MFA 2003 Sound Practices, supra note 324 (referring to sound practices recommendations that the MFA previously issued in 2000).

## I. Investor Education

As this Report notes, improvements in disclosure practices of hedge fund advisers is desirable to help investors make more informed investment decisions regarding hedge fund securities. Even if the Commission follows our recommendations, there may be practical limits on the extent to which investor education can assist retail investors to make informed decisions about hedge funds and FOHFs. It also may be that some investors overlook the correlation between risk and reward.

The Commission's website provides a partial list of questions that investors should ask, and most importantly, understand the answers to before making any investments in hedge funds or registered FOHFs. These issues run the gamut from understanding the costs associated with investing in hedge fund or registered FOHF securities, to understanding any limitations on an investor's ability to liquidate the investment to understanding how the lack of transparency affects the investor's personal investment needs (e.g., diversification). We recommend that the Commission continue to provide and enhance investor education relating to hedge funds and registered FOHFs.

In February 2003, in response to increasing publicity about hedge funds and registered FOHFs, the Commission developed a website advertising a simulated hedge fund, Guaranteed Returns Diversified, Inc. ("GRDI" for short, pronounced "greedy").<sup>328</sup> This website demonstrates how easy it is to be taken in by false statements and seeks to sensitize investors to their vulnerability. Although the Commission's website provides a link to the fake scam, many investors appear to be finding it by surfing the Internet looking for quick and easy hedge fund returns. Several hedge fund websites, and bulletin boards frequented by hedge fund investors, also steer investors to the site. Since the Commission launched the website on February 13, 2003, there have been over 80,000 hits on it.<sup>329</sup>

## VIII. The Commission Should Consider Issuing a Concept Release for Examining Wider Use of Hedge Fund Investment Strategies in Registered Investment Companies

We recommend that the Commission consider issuing a Concept Release exploring the wider use of hedge fund-type/absolute return strategies. Many hedge funds use absolute return strategies that are designed to produce positive returns irrespective of the performance of other securities markets. These investments typically have lower correlations to the broader debt and equity markets and thus, may provide benefits to investors under a wider variety of market

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<sup>328</sup> See <http://www.growthventure.com/grdi>.

<sup>329</sup> The agency has received telephone calls and a handful of e-mailed comments from investors who have visited the GRDI site. Nearly half of these calls and comments came from investors who, upon reading the website's description of unbelievably high returns, wished to invest.



conditions. The staff believes that these investments may have benefits that could assist other investors, including retail investors, in diversifying their overall portfolios. The staff is not recommending that hedge funds be made more readily available and does not believe that direct investment into hedge funds by retail investors is appropriate.<sup>330</sup> Instead, we believe it may be the case that retail investors interested in absolute return strategies should be able to pursue those investments through the registered investment company structure.

We recommend that the Commission consider issuing a Concept Release assessing the steps that should be taken to encourage the wider use of absolute return strategies in registered investment companies. This release would seek information including, but not limited to, the following: what, if any, statutory or regulatory changes would enable more effective deployment of absolute return strategies in registered investment companies; and what is the ability of retail investors to understand absolute return strategies.

**A. Different Registered Investment Company Structures Provide Various Benefits and Challenges in the Deployment of Absolute Return Strategies**

Several registered investment companies currently offered to the public utilize absolute return strategies. Although still quite small, this group appears to have grown markedly since 1997 when Congress repealed the “short-short” rule, a tax regulation that limited the amount of profits that an open-end investment company could derive from short-term trading or short selling. Many of the strategies currently being used in registered investment companies attempt to use offsetting long and short positions in an attempt to mitigate market risk and generate positive returns. Among the types of funds currently being offered are market neutral, long/short equity and even merger arbitrage investment strategies.<sup>331</sup> The growth of these funds suggests that the Investment Company Act presents manageable impediments to the retail offering of hedge fund (or hedge fund-like) investment funds.

Some of the registered investment companies using hedge fund strategies are organized as open-end management companies, and thus must make payment on redemption requests no

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<sup>330</sup> A few jurisdictions, such as Hong Kong, Singapore and Switzerland, permit individual hedge funds to be marketed and sold directly to retail investors. *See Hedge Funds and the FSA*, Financial Services Authority Discussion Paper No. 16, at 21-22 (Aug. 2002) at <http://www.fsa.gov.uk/pubs/discussion/16>.

<sup>331</sup> Registered investment companies with market neutral, merger arbitrage and other absolute return strategies represent a very small niche of the approximately \$6.8 trillion investment company industry. One estimate is that there are approximately 50 such registered investment companies with about \$8 billion under management. *See Hedging Trims Some Fund Gains*, Wall Street Journal (Aug. 4, 2003).

more than seven days after receipt of those requests.<sup>332</sup> As a result, these funds are unable to impose “lock-ups” or notice requirements, both of which are common among hedge funds. Moreover, the need to manage cash flows as a result of purchases and redemptions (aggravated by market timers) may make the open-end management company structure less attractive or may negatively affect returns of the fund.<sup>333</sup> However, for those many hedge fund strategies involving investments in highly liquid securities, redemption requirements of the Investment Company Act do not present a significant obstacle.

Those advisers using strategies involving illiquid securities or who wish to avoid cash flow management obligations, may register their funds as closed-end investment companies. The closed-end investment company offers several significant advantages over the mutual fund structure in the utilization of absolute return strategies. Closed-end funds do not issue redeemable securities and are therefore not required to liquidate securities in order to meet redemption requests. This more stable asset base permits advisers to remain fully invested. Closed-end funds are also not required to hold any specified percentage of their assets in liquid securities and may engage in strategies that require large portions of illiquid securities as a percentage of their total assets.<sup>334</sup> Closed-end funds, of course, may offer less liquidity to their shareholders.<sup>335</sup> As discussed below, closed-end funds can engage in leveraging transactions

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<sup>332</sup> See Section 22(e) of the Investment Company Act (prohibiting registered investment companies issuing redeemable securities from suspending the right of redemption for more than seven days following tender of security).

<sup>333</sup> Open-end funds may hold no more than 15 percent of their assets in illiquid securities. A security is considered “illiquid” if a fund is unable to promptly sell or dispose of the security in the ordinary course of business at its current value within seven days. See *Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies*, Investment Company Act Release No. 14983 (Mar. 21, 1986) (adopting amendments to Rule 2a-7). The Commission has historically recommended the 15 percent ceiling in order to maintain and enhance a registered investment company’s liquidity. See *Revisions of Guidelines to Form N-1A*, Investment Company Act Release No. 18612 (Mar. 12, 1992). While the Guidelines were not republished when Form N-1A was amended in 1998, they continue to set forth the staff’s views on issues not addressed in the 1998 amendments to Form N-1A. See *Registration Form Used by Open-End Management Investment Companies*, Investment Company Act Release No. 23064 (Mar. 13, 1998).

<sup>334</sup> Because of the ability to hold illiquid securities, closed-end investment companies tend to specialize in less liquid bonds, foreign securities, small/microcap securities and securities issued by companies that are not publicly traded.

<sup>335</sup> Most closed-end funds provide liquidity to their shareholders by listing their securities for trading on an exchange or on the over-the-counter markets. However, there is no requirement that closed-end fund shares be publicly traded and many funds provide their shareholders with liquidity solely through periodic purchases of their own shares or through tender offers.

beyond those of open-end investment companies. Unlike open-end investment companies, however, closed-end investment companies cannot engage in continuous offerings and often have difficulty raising additional assets.<sup>336</sup>

Closed-end investment companies that elect to operate as “interval” funds under Rule 23c-3 under the Investment Company Act may be well suited for use of absolute return strategies.<sup>337</sup> Interval funds are registered closed-end investment companies that adopt as a fundamental investment policy that they will engage in periodic repurchases of their own shares at net asset value.<sup>338</sup> There are few interval funds currently in operation.<sup>339</sup> One reason for the reluctance to use the interval fund structure may be the requirement that the fund maintain liquid assets equal to at least 100 percent of the amount of the mandatory repurchase offer. Complying with this provision may require selling securities in anticipation of the periodic repurchases. Interval funds also lack the same flexibility of other closed-end funds with respect to the use of leverage.<sup>340</sup>

We recommend that the Commission consider seeking comment through a Concept Release to learn the extent to which hedge fund investment strategies might be effectively deployed in the open-end investment company structure. The release should request comment on what measures could assist these companies in offering absolute return strategies consistent with the issuance of redeemable securities, including whether there should be flexibility with respect to the limitation on illiquid securities. The release should also seek comment on how closed-end investment companies could be made to be more conducive for the use of absolute return strategies. Similarly, the Concept Release should seek comment on what steps could be taken to increase the utility of Rule 23c-3 under the Investment Company Act, including whether raising the maximum permitted redemption amount above 25 percent would be helpful.

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<sup>336</sup> Section 23 of the Investment Company Act generally prohibits closed-end funds from issuing shares below NAV, and since closed-end fund shares often trade at discounts to NAV, the presence of a trading discount limits the issuance of additional shares to rights offerings, for practical purposes.

<sup>337</sup> *See Repurchase Offers by Closed-End Management Investment Companies*, Investment Company Act Release No. 19399 (Apr. 7, 1993).

<sup>338</sup> The periodic repurchase provisions are intended to allow closed-end investment companies to offer their investors a limited ability to resell shares—a benefit traditionally available only to shareholders of registered open-end investment companies. *Id.*

<sup>339</sup> Commission records indicate that 43 investment companies or portfolios operate pursuant to Rule 23c-3 under the Investment Company Act.

<sup>340</sup> Rule 23c-3 under the Investment Company Act requires that leveraged positions either mature or be callable in advance of the periodic repurchases.

## B. Registered Investment Companies are Subject to Restrictions on Leverage and Short Selling that Hedge Funds Avoid

While hedge funds may no longer engage solely in strategies that involve hedging and leverage, the majority of hedge funds still use these techniques to varying degrees. The ability to borrow money to engage in securities transactions and to sell securities short are of critical importance to most hedge fund advisers.

Congress chose to *limit*, but not to *prohibit*, the ability of investment companies to engage in leverage.<sup>341</sup> Section 18 of the Investment Company Act addresses leverage concerns by limiting the ability of investment companies to borrow and incur indebtedness.<sup>342</sup> Under the Investment Company Act, securities and related transactions in which the registered investment company is a borrower, or that involve indebtedness on the part of the registered investment company, are generally known as “senior securities.” Congress limited the ability of investment companies to engage in leverage by limiting their ability to issue “senior securities.”<sup>343</sup> In

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<sup>341</sup> See, e.g., Mutual Fund Use of Derivatives, Letter from Arthur Levitt, Chairman of the SEC, to Hon. Edward J. Markey and Hon. Jack Fields, U.S. House of Representatives, attaching Division of Investment Management Memorandum, at n. 83 (Sept. 26, 1994) (“The legislative history of the Investment Company Act indicates that the Act was not intended to eliminate all leverage from fund investments.”) See also id. at n. 82 (“The framers of the Investment Company Act specifically disavowed any attempt to prohibit speculative mutual fund investments.”). The Commission has stated that “[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return.” See Release 10666, supra note 133.

<sup>342</sup> See, e.g., Sections 18(a) - (e) of the Investment Company Act (restrictions on closed-end investment companies); Section 18(f) of the Investment Company Act (restrictions on open-end investment companies); Section 18(g) of the Investment Company Act (definition of “senior security”); and Section 18(h) of the Investment Company Act (asset coverage formula).

<sup>343</sup> Because securities issued by open-end investment company securities are redeemable, and securities issued by closed-end investment companies are not, Sections 18(a) and (f) of the Act limit the use of leverage by these different types of investment companies in different ways. A closed-end company may issue a senior security representing indebtedness if it maintains asset coverage of at least 300 percent. See Sections 18(a)(1)(A) and (h) of the Investment Company Act. A closed-end company may issue a senior security that is a stock, e.g., preferred stock, if it maintains asset coverage of at least 200 percent. See Section 18(a)(2)(A) of the Investment Company Act. The Investment Company Act generally limits a closed-end company to issuing one class of senior securities representing indebtedness and one class of senior stock, but the class of indebtedness or stock may be issued in one or more series. See Section 18(c) of the Investment Company Act. Under the Investment Company Act, open-end companies generally may not issue senior securities, except that they may borrow from banks provided that the borrowing is subject to 300 percent asset coverage. See Section 18(f) of the Investment Company Act. The Investment Company Act also permits open-end investment companies to engage in

practice, these restrictions limit the amount of leverage in which registered investment companies may engage. Hedge funds are not subject to these limitations.

The Investment Company Act does not prohibit a registered investment company from engaging in short selling.<sup>344</sup> Registered investment companies are permitted to short sell provided that they cover any open short positions by setting aside or “segregating” cash or other liquid securities.<sup>345</sup> Assets set aside to cover a short position are generally frozen and unavailable to the fund for any other purpose, including other short selling or leveraged transactions.<sup>346</sup> By taking these assets “out of circulation,” the asset set-aside (segregation) requirement serves as a de facto limit on the amount of short selling in which an investment company may engage.<sup>347</sup> Nonetheless, even with these limits, registered investment companies still have the ability to engage in high levels of short selling.

The Concept Release should seek comment on whether the Investment Company Act’s restrictions on the use of leverage and short selling are discouraging the use of absolute return strategies in registered investment companies, as well as impairing the ability of registered investment companies to effectively employ such strategies. The release should also consider whether certain types of derivatives may be useful to registered investment companies seeking to use absolute return strategies. The release should also invite comment on what additional steps,

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certain private and temporary borrowings, from banks and non-banks, without 300 percent asset coverage, because such borrowings are not “senior securities.” See Section 18(g) of the Investment Company Act.

<sup>344</sup> According to Commission records, for the six-month period ended April 30, 2003, approximately 3,900 mutual funds, out of a universe of approximately 9,000 mutual funds, disclosed that they were authorized to short sell. During this period, 236 mutual funds engaged in short selling.

<sup>345</sup> Registered investment companies must set aside or segregate an amount equal to the daily price of the shorted securities less any non-proceeds margin posted under applicable margin rules. See, e.g., Release 10666, supra note 133; *MLAM*, supra note 133; *Robertson Stephens Investment Trust* (pub. avail. Aug. 24, 1995); *Dreyfus*, supra note 133. Instead of setting aside assets, the staff has permitted a fund to cover its short positions by owning the security or holding a call option on the security with a strike price no higher than the price at which the security was sold. See id.

<sup>346</sup> See, e.g., Release 10666, supra note 133.

<sup>347</sup> All mutual funds, irrespective of whether they are engaging in short selling, must ensure their ability to satisfy their redemption requirements under Section 22(e) of the Investment Company Act. A fund’s board of directors must ensure that short selling will not interfere with the fund’s ability to: meet current obligations; honor requests for redemptions (in the case of a mutual fund); and manage properly its investment portfolio in a manner consistent with the fund’s stated investment objectives, especially as short selling approaches high levels. Id.

including clarifying existing guidance, may be taken to enhance the ability of all registered investment companies to utilize these tools.

### C. Alignment of the Investment Adviser's Interests with Investors

Hedge funds advisers argue that two factors are critical to aligning their interests with those of their investors. First, they assert that a properly configured performance fee arrangement providing compensation based on capital gains and capital appreciation provides a greater incentive for the adviser to produce absolute returns. The requirement that an absolute return be achieved before the performance fee is paid, in their view, insures diligence in managing the fund.<sup>348</sup>

Second, investment of the adviser's own assets alongside the investors' helps assure that the adviser acts responsibly.<sup>349</sup> Hedge fund investors rely on having the adviser's assets in the fund to serve as a curb on any adviser who may seek to engage in high-risk investment strategies. If the adviser stands to lose as much as the fund's investors by engaging in unduly risky investment activities, that adviser may be deterred from such activities.<sup>350</sup> Not surprisingly, a number of private placement memoranda include provisions requiring that the general partner disclose significant withdrawals from their capital account.

Performance fees based on capital gains and capital appreciation have an interesting history under the federal securities laws.<sup>351</sup> Congress originally limited the receipt of these types

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<sup>348</sup> “Hedge fund managers seek out and exploit mispricings of securities using a variety of financial instruments. They produce superior performance, and they are not judged by their ability to track a passive benchmark. As a result, the compensation structure within the industry is based largely on performance.” See Steven J. Brown *et al.*, *Offshore Hedge Funds: Survival and Performance, 1989-95*, 72 *Journal of Finance* 91 (1999).

<sup>349</sup> Hedge fund investors also look to the adviser's own investment in the fund as a measure of prudence to ensure that the manger acts responsibly in others areas, *e.g.*, brokerage fees, soft dollars, etc.

<sup>350</sup> The Commission has recognized that where advisers have their own substantial investment in certain accounts, it reduces their incentive to take undue risks. See, *e.g.*, *Foster Management Company*, Advisers Act Release Nos. 646 (Nov. 1, 1978) and 651 (Nov. 28, 1978); *Weiss, Peck & Greer*, Advisers Act Release Nos. 623 (Mar. 28, 1978) and 625 (Apr. 25, 1978).

<sup>351</sup> Section 205(a) of the Advisers Act, in general, prohibits registered investment advisers from entering into a contract to provide investment advisory services that, among other things, “provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client.” See Section 205(a)(1) of the Investment Advisers Act. For a discussion of the history of performance fees in

of fees out of a concern that they encouraged managers to take inappropriate risks.<sup>352</sup> Notwithstanding this history, the Investment Advisers Act did not originally prohibit registered investment advisers from charging a performance fee to registered investment companies.<sup>353</sup> In 1970, however, Congress extended the performance fee prohibition to cover advisory contracts with registered investment companies in response to information demonstrating that performance fee arrangements that were included in such contracts were unfair to the registered investment companies' shareholders.<sup>354</sup>

The staff believes that it is appropriate to re-examine whether fee arrangements that are based on a share of the capital gains and capital appreciation may be appropriate for agreements between investment advisers and registered investment companies. The staff also believes that it is worth exploring whether encouraging investment advisers to invest in the funds that they manage may help to ensure responsible management of registered investment companies using absolute return strategies.<sup>355</sup>

#### **D. Absolute Return Strategies May Challenge Traditional Investor Expectations**

Perhaps the most formidable obstacle to further use of absolute return strategies may lie in whether investors can understand and feel comfortable with these products. Absolute return investment vehicles operate differently from traditional, long-only/relative return products. Thus, it would be useful for the Concept Release to explore some of these differences, as highlighted below.

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investment advisory contracts, *see* *Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management 237-249 (May 1992) (“*Protecting Investors*”).

<sup>352</sup> H.R. Rep. No. 2639, 76<sup>th</sup> Cong., 2d Sess. 29 (1940).

<sup>353</sup> The investment company industry persuaded Congress that performance fees closely linked the interests of investors and management and that the basis for management's compensation should not be specified by statute as long as the basis for such compensation was adequately disclosed to shareholders. *See* *Protecting Investors*, *supra* note 351, at 242.

<sup>354</sup> More than two-thirds of the performance fees in existence at that time either permitted the registered investment company's adviser to earn a bonus for good performance without suffering a penalty for poor performance, or had fee arrangements in which the potential rewards were substantially greater than the potential penalties. *See id.*, at 242.

<sup>355</sup> The Investment Company Act requires that the sponsors of registered investment companies make initial investments in those companies. *See* *Automation Shares*, 37 S.E.C. 771 (1957) (Section 14(a) of the Investment Company Act requires that seed capital be provided by “shareholders with a *bona fide* investment purpose without any present intention to dispose of the security.”).

Registered investment companies generally engage in long-only/relative return strategies whose performance is highly correlated to specific benchmarks or indexes.<sup>356</sup> One benefit of relative-return strategies is the ease with which investors may compare their investment's performance with that of the relevant benchmark, as well as against similar funds using the same benchmark. These characteristics help shape many of the expectations that retail investors have today. For example, an investor in a long-only/relative return product will generally be able to assume that if the major equity markets are rising, the performance of the investment will rise as well. Index funds and exchange-traded funds, which are designed to replicate entire markets or segments of markets, further attune investors to performance results that track the broader markets.

In contrast, absolute return strategies generally seek to achieve a high level of return for their funds in a variety of market environments, rather than attempting to duplicate or exceed the performance of a particular benchmark or index. Absolute return strategies are designed to move independently of the underlying markets and thus, have lower correlations to the broader markets. During falling markets the performance of the fund should stay independent from that of broader market movements, thus providing some protection from those downward movements. In rising markets, however, it is not uncommon for funds employing absolute return strategies to lag behind more traditional, long-only investments.<sup>357</sup> Indeed, some proponents of hedge funds admit that during periods of strong equity performance, hedge fund performance may suffer.<sup>358</sup>

Broader use of absolute return strategies might also require investors to modify their expectations with respect to the investment flexibility accorded to investment advisers. Perhaps the most critical aspect of an adviser's ability to seek absolute returns is the often unfettered discretion to manage the fund in light of changing market conditions. Many hedge funds have broad investment objectives and are authorized to use multiple strategies in order to take advantage of changing market conditions.<sup>359</sup> In adverse markets, a hedge fund adviser will

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<sup>356</sup> See supra Part IV.A. (discussion of hedge fund investment strategies).

<sup>357</sup> This is because the hedging portions of the portfolio will act as a drag on the long portions. One Roundtable participant explains that “[b]y definition, hedge funds are not going to outperform a broad index in a strongly rising market, like the one we saw in the second quarter [April-June 2003].” See Neil Martin, *Bull in the Hedges*, Barron's (July 28, 2003) (quoting Greg Newton).

<sup>358</sup> “Hedge funds under perform the stock market only when the latter is strong, that is, when the stock market yields a positive annual return.” See *Absolute Returns*, supra note 118, at 105.

<sup>359</sup> See Roundtable Transcript, May 14 (statement of Robert Schulman) (“The hedge fund industry has avoided, in large measure, the catastrophic impacts of the market by having enough flexibility in the [private placement ] document and using it to react to what you would call changing market conditions.”).



generally have the flexibility to hedge against market declines, engage in short-selling or take positions that are less dependent on the price movements of broad market averages to make profits or limit losses.<sup>360</sup> Most traditional relative-return products, including registered investment companies, are either limited in their flexibility or forego engaging in these strategies.

More flexible investment mandates permit the adviser to manage the fund according to his or her best judgment. Poor choices, of course, are a continual possibility for absolute return advisers, as they are for all investment advisers. For example, if an absolute return adviser redeploys assets incorrectly, the performance of the fund may suffer. This may contrast with instances where an adviser with less flexibility must adhere to a particular investment mandate, which, in the end, prevents the adviser from exercising more discretion, and possibly, making a mistake.

The flexibility that absolute return advisers require often makes it more difficult for investors to categorize the precise nature of their investments. For example, investors in long-only/relative return strategies often associate their investment with the type of portfolio securities that their mutual fund or closed-end fund typically holds. Retail investors often rely on the structure and nature of the particular fund's investments to provide continuity to their portfolio. In contrast, absolute return investments may lack that continuity or assurance. In one sense, investors in funds utilizing absolute return strategies must rely more heavily, and may associate their investment more closely, with an adviser, rather than with a fund itself.<sup>361</sup>

The Concept Release should explore whether investor education would be helpful in connection with absolute return investments. The Concept Release should also examine whether any particular absolute return strategies raise especially difficult issues with respect to investor expectations. The Concept Release should explore whether more education is necessary to familiarize retail investors with the risks of engaging in short selling and leveraging transactions.<sup>362</sup> Moreover, the Concept Release should seek comment on what, if any, additional

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<sup>360</sup> Because these strategies often necessitate a steady turnover in the nature and character of the underlying investments, investors should recognize that they may have little ongoing insight into how a hedge fund is invested. This may differ from traditional long-only relative return products that permit investors to remain focused on sectors or sub-sectors of the broader markets.

<sup>361</sup> “[T]he most interesting feature of hedge funds is that they are thought of as nearly pure ‘bets’ on manager skill.” See Brown, *supra* note 348.

<sup>362</sup> The primary market risk from short selling is the fact that losses “can be infinite, depending on how high the stock price moves after the [short] sale.” Comment submitted by Roundtable Panelist James Chanos.

disclosure is necessary to ensure that absolute return investments are fully understood by investors.<sup>363</sup>

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<sup>363</sup> In the Concept Release, the Commission may also wish to explore whether there are other alternatives that will expand the accessibility of absolute return strategies to a broader group of suitable investors. It could explore, for example, whether certain hedge funds relying on Section 3(c)(7) of the Investment Company Act may be permitted to accept investors below the qualified purchaser standard, so long as that hedge fund provides fundamental Investment Company Act protections commensurate with the level of investors permitted to invest.

## Summary of the Commission's Previous Studies or Investigations of Hedge Funds

In January 1969, the Commission commenced an investigative study of hedge funds in response to the rapid increase in the number of hedge funds and their assets under management. At that time, the Commission estimated that there were almost 200 hedge funds in existence with estimated total assets of \$1.5 billion. The Commission's study, however, was not limited to unregistered funds. It also examined the activities of registered investment companies that engaged in hedge fund trading techniques such as leveraging and short selling. The Commission sent questionnaires to registered and unregistered funds in an effort to obtain basic background information, information about trading and brokerage practices, affiliations of hedge fund principals, borrowing practices and sources of credit.

Twenty three years later, the Commission, in collaboration with representatives of the Treasury Department and the Board of Governors of the Federal Reserve System ("Federal Reserve") issued a report focusing on abuses in the market for United States government securities (*i.e.*, Treasury bills, notes and bonds) following admissions by Salomon Brothers Inc. of violations of Treasury auction rules.<sup>1</sup> The report did not make any legislative proposals with respect to hedge funds, but did recommend reforms for administrative and regulatory changes regarding Treasury auction participation, policies and enforcement as well as the means for detecting and combating short squeezes in the U.S. government securities market.<sup>2</sup>

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<sup>1</sup> See *Joint Report on the Government Securities Market* (Jan. 1992) ("Joint Report").

<sup>2</sup> *Id.*, at xiii-xv. The report also made related legislative recommendations. However, in an appendix discussing hedge funds, the report recognized the potential dangers of the use of leverage by hedge funds, stating:

Events in the government securities market have shown that their capacity for leverage allows hedge funds to take large trading positions disproportionate to their capital base. Thus far, [hedge] fund managers have proved very adept at controlling their market risk, and their lending counterparties appear to consider them creditworthy. However, the sheer size of the positions taken by hedge funds raises concerns about systemic risk that these funds may introduce into the financial markets.

In 1992, the Commission's Division of Investment Management looked at hedge funds in connection with its study of the Investment Company Act and recommended that the Commission propose a new private investment company exception for qualified purchasers.<sup>3</sup>

Later that year, in response to a Congressional inquiry, the Commission provided detailed information about both the nature and regulatory treatment of hedge funds to Congress.<sup>4</sup> That staff report focused on the systemic risk posed by hedge funds and analyzed how various provisions of the federal securities laws affect hedge funds. The staff made clear at that time that it had no direct source of information regarding hedge fund activities, and that a limited amount of information about hedge funds was publicly available.<sup>5</sup> The report concluded that the relevant regulatory issues did not involve the protection of hedge fund investors, but instead, the potential of hedge funds to affect the equity markets due to their size and active market presence. At that time, the Commission believed that its proposed large trader reporting system would enhance its ability to examine the activities of hedge funds in the event of large movements in the equity markets.<sup>6</sup>

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<sup>3</sup> See *Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management, May 1992, p. 103-105. The Division's recommendation was subsequently adopted as Section 3(c)(7) as part of the National Securities Markets Improvement Act of 1996. See *Privately Offered Investment Companies*, Investment Company Act Release No. 22597 (Apr. 3, 1997).

<sup>4</sup> See Letter from Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (June 12, 1992).

<sup>5</sup> Press reports estimate that approximately 400 hedge funds existed at that time. With respect to the asset base of the hedge fund industry, the staff was able to identify publicly available information for only 17 hedge funds with approximately \$13 billion in assets under management as of December 31, 1991.

<sup>6</sup> The Commission's authority to implement the large trader reporting system is provided in Section 13(h) of the Exchange Act, which was added to the statute by the Market Reform Act of 1990 to remedy difficulties that the Commission encountered during its attempts to reconstruct and analyze trading activity following the stock market breaks of October 1987 and October 1989. The Commission, however, never adopted implementing regulations due, in part, to the availability of other mechanisms for monitoring stock market activity (e.g., the electronic blue sheet system). See also *Electronic Submission of Securities Trading Data by Exchange Members, Brokers and Dealers*, Exchange Act Release No. 42741 (May 2, 2000) (proposing rule 17a-25 under the Exchange Act and stating that public comments raised concerns that, among other things, the comprehensive system envisioned by Section 13(h) could prove difficult to implement and maintain, and most likely would not expedite trading reconstructions to the extent contemplated in 1990).

The President's Working Group on Financial Markets ("Working Group")<sup>7</sup> issued a report in April 1999 in the wake of the near-collapse of Long Term Capital Management ("LTCM").<sup>8</sup> The report examined hedge funds in general as well as LTCM, analyzed the public policy issues presented to the markets by leverage, risk and bankruptcy, and recommended a number of measures designed to constrain excessive leverage in the financial system.

The report focused on the risk management and transparency issues raised by LTCM as well as "highly leveraged institutions" in general. It also focused on the exposure of banks and others to the counterparty risks of highly leveraged entities such as hedge funds. The Working Group looked at such issues as these entities' use of leverage and whether that use was excessive, counterparty adherence to stated policies, margin and collateral requirements and how well risk models functioned. The Working Group also recommended in its report that no changes be made to the exemptions for hedge funds and hedge fund advisers under the Investment Company Act and the Advisers Act.<sup>9</sup> The report took the position that registration of hedge funds and their advisers at that time did not appear to be a useful method of monitoring hedge fund activity.

In addition to the examination of risk management and transparency issues by the Working Group, the Commission staff actively supported the work of the Multidisciplinary Working Group on Enhanced Disclosure ("MWGED"), which was established by the international regulatory and central banking community to assess the feasibility and utility of enhanced public disclosure by financial intermediaries (*i.e.*, banks, securities firms, insurance companies and hedge funds). The MWGED issued a report in April 2001 that recommended that all regulated financial intermediaries move promptly to make routine, periodic disclosures of certain quantitative risk measurements to their shareholders, creditors and counterparties. It also recommended that hedge funds be encouraged to make such disclosures, when material, to their

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<sup>7</sup> The President's Working Group, which continues to examine market leverage and counterparty risks, includes representatives from the Commission, the Treasury Department, the Federal Reserve and the Commodity Futures Trading Commission.

<sup>8</sup> *See Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management - Report of The President's Working Group on Financial Markets* (Apr. 1999) ("LTCM Report"). LTCM was a prominent and successful hedge fund in the 1990s that was distinguished by its size, leverage and trading strategies (*e.g.*, convergence trading and dynamic hedging). These characteristics made LTCM vulnerable to the market conditions that followed Russia's devaluation of the ruble, and caused it to suffer approximately \$1.8 billion in losses in August 1998. At that time, LTCM's simple balance sheet leverage ratio had reportedly climbed to in excess of 25 to 1, and the hedge fund had difficulty meeting its margin call requirements. Because, among other things, many Wall Street firms were creditors and counterparties to LTCM, there was a general concern that the fund's collapse would have an impact on the financial markets, and the Federal Reserve intervened by facilitating a private-sector recapitalization of the fund.

<sup>9</sup> See Appendix B to LTCM Report.

investors, creditors and counterparties. The MWGED's successor, the Joint Forum Working Group on Enhanced Disclosure ("JFWGED"), which the Commission chairs, also addresses issues of enhanced disclosure for financial intermediaries. The work of the JFWGED is ongoing, and the Commission believes that many in the hedge fund industry are considering the recommendations of these two groups and continuing to explore ways to improve some of their practices.<sup>10</sup>

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<sup>10</sup> The Commission has also been involved in other reviews of market stability and counterparty risk issues posed by hedge funds in the wake of LTCM's near collapse conducted by foreign financial regulators. See, e.g., *Review of issues relating to Highly Leveraged Institutions (HLIs)*, Basel Committee on Banking Supervision and International Organization of Securities Commissions (Mar. 2001).