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Statement of the Shadow Financial Regulatory Committee

On

The SEC's Proposal for Regulating Hedge Funds

On September 29, 2003, the Securities and Exchange Commission (SEC) issued a report on the "Implications of the Growth of Hedge Funds" (the "Report"). The Report raised several issues related to hedge funds and proposed a number of regulatory initiatives that the SEC might take. Its principal recommendation was that the SEC should require most hedge managers to register as investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). On July 14, 2004, after a lengthy period of public comment on the Report, the SEC ("Commission") adopted (by a split vote) Rule 203(b)(3)-2, which implements this registration recommendation, and set a two-month period for public comment before formally adopting the Rule. The Shadow Financial Regulatory Committee (the "Committee") believes that the SEC has not met its burden of demonstrating that there is a significant problem in the hedge fund industry or that registration of hedge fund advisers would be an effective response to any of the problems identified in the Commission's Release.

In support of Rule 203(b)(3)-2, the SEC argues that requiring registration of advisers would address two problems: the growing incidence of fraudulent activity by hedge fund advisers and the increasing "retailization" of hedge fund investments.

The Commission argues that registration would deter fraudulent conduct by providing the Commission with more information about hedge funds, by giving the SEC the authority to conduct examinations of the adviser's hedge fund activities, by fostering an environment of compliance, by bringing about the more accurate valuation of hedge fund assets, by keeping unfit persons from using hedge funds to perpetrate frauds, and by requiring hedge fund advisers to provide additional information about themselves and their funds to investors and prospective investors (through Form ADV and otherwise). The Commission argues that Rule 203(b)(3)-2 would address the growing retailization of hedge fund investments by reducing the number of less sophisticated investors who would have access to hedge funds because of the higher minimum net worth requirement necessary for investors to have access to registered hedge fund advisers who receive performance-based fees [as almost all do] (see Rule 205-3).

Rule 203(b)(3)-2 would amend the existing "private adviser" exemption (section 302(b) (3)) under the Advisers Act by changing the definition of "client." Section 302(b)(3) now exempts hedge fund advisers from registration if they have had fourteen or fewer "clients" during the preceding twelve months and do not hold themselves out generally to the public as investment advisers, or if they have no more than $25 million under management. Under existing rules a limited partnership is treated as a single "client." Thus, a hedge fund is considered to be a single client, even though the hedge fund might have dozens of investors (typically limited partners). In contrast, the proposed Rule 203(b)(3)-2 would require that each owner of a "private fund" (and each individual investor) be counted as a client.

As a consequence, an adviser to a hedge fund with 15 or more limited partners (investors) would now be viewed as having more than 14 clients, and would be required to register under the Advisers Act, unless it had no more than $25 million under management. In addition, the minimum net worth requirement for clients of "3(c)(1) hedge funds" would effectively be raised to $1.5 million from the current $1 million (which is the "accredited" investor requirement for non-public offerings under Regulation D). All registered advisers who receive performance-based fees (as almost all hedge fund advisers do) are required to have only "qualified clients," which are defined as investors having either $750,000 invested with the Adviser or a net worth of more than $1.5 million (Rule 205-3).

Rule 203(b)(3)-2 also defines a "private fund" in a way that would capture most advisers to hedge funds (while continuing to exclude advisers to most other business organizations, such as insurance companies, broker-dealers, and banks, as well as advisers to private equity funds and venture capital funds).

It defines a "private fund" as companies or funds that, first, would be subject to regulation under the Investment Company Act (ICA) but for the exceptions provided by either section 3(c)(1) or section 3(c)(7) of the ICA; second, would permit investors to redeem their interests in the fund within two years of purchasing them (i.e., less than a two-year "lock-up"); and, third, have investment strategies that depend critically on the ongoing skills, ability or expertise of the investment adviser to achieve their intended investment goals. The SEC acknowledges that other private funds, such as private equity and venture capital funds, are similar to hedge funds, but defends its definition by arguing that it has not encountered significant enforcement problems with advisers to such funds, in contrast to its experience with hedge fund advisers.

Rule 203(b)(3)-2 also contains a special provision for advisers to hedge funds in which registered investment companies (mutual funds) invest: hedge fund advisers would have to count all investors in those mutual funds as clients. Without this provision, an advisor could advise a hedge fund which had fourteen or fewer mutual funds as investors without registering, even though each of the mutual funds might have thousands of individual investors.

While the intent underlying Rule 203(b)(3)-2 -- to deter fraud – is laudatory, the Committee believes that the SEC has failed in its fundamental burden of showing (1) that there is a significant fraud problem in the hedge fund industry, and (2) that the proposed rule would be an effective deterrent to fraudulent activity, and (3) address that the likely benefits of the proposed regulation would outweigh its likely costs (a burden imposed on regulatory agencies by law).

With respect to the SEC's concern about fraudulent activity, it cites the enforcement actions it brought against 46 hedge fund advisers (registered and unregistered) during the past five years. This number, however, constitutes a very small percentage of the 2,600 enforcement actions initiated by the Commission during the same period. Indeed, the SEC staff, on the basis of these facts, concluded that there is "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity." Further, the SEC produces little evidence to suggest that fraud is a growing problem in the hedge fund industry.

Requiring hedge fund investors to register also is unlikely to be effective in deterring hedge fund fraud. In the 46 hedge fund fraud cases cited by the Commission, the implicated hedge fund advisers were either too small to be required to register under Rule 203(b)(3)-2 or were already registered with the Commission (or had ignored the requirement to register). The Commission also cites hedge fund

involvement in the recent mutual fund scandals in support of its proposal, but it is not clear how registration of hedge fund advisers would have made any difference. All of the implicated mutual funds and their advisers were already registered and SEC examiners were already inspecting these mutual funds, but the SEC did not turn up any evidence of the fraudulent activities until others brought it to the SEC's attention.

The Commission's second concern is the growing "retailization" of hedge funds, presumably because it believes that hedge fund investments may be inappropriately risky investments for retail investors. In particular, it points to the growth of registered funds of hedge funds. This is an important issue that deserves attention, but Rule 203(b)(3)-(2) is not a constructive response. The proposed rule addresses the issue only by further restricting investor access to hedge fund advisers through the indirect device of raising the minimum net worth threshold for 3(c)(1) hedge fund investors to $1.5 million (the qualified client standard) from $1 million (the accredited investor standard).

The net social benefit from this higher new worth requirement is unclear. While it may keep some investors from taking losses in hedge fund investments, it will also exclude some investors from the benefits of investing in hedge fund strategies. The Committee believes that the critical public policy issue is how to make hedge fund investment strategies accessible to more (rather the fewer) retail investors in a way that does not expose retail investors to undisclosed and inappropriate risks. The Commission's proposal to register hedge fund advisers does nothing to advance this agenda. Importantly, the Commission does not consider other ways to accomplish this goal that the Committee believes would be more effective and less costly, such as simply updating the "accredited investor" standard or requiring the disclosure of additional information.

There also will be costs associated with Rule 203(b)(3)-(2): additional administrative costs to hedge funds and hedge fund investors, additional regulatory and supervisory costs to the SEC, and "opportunity costs" to investors. Higher regulatory costs also have the potential to increase the regulatory barrier to entry into the hedge fund industry, which could reduce competition.

Finally, there is an opportunity cost associated with the
SEC's allocating more of its resources to hedge funds rather than to more effective oversight of mutual funds. As the recent mutual fund scandals make clear, SEC oversight of mutual funds has not been all that effective. Mutual funds have over 90 million investors and manage over $7 trillion, while hedge funds have perhaps 200,000 relatively well-off and sophisticated investors and manage perhaps $800 billion. It seems fairly

obvious that the potential social benefit of protecting mutual fund investors is likely to be much higher than is protecting a much smaller number of hedge fund investors, who are typically more knowledgeable and better able to tolerate risk and investment losses.

It is the Committee's policy that members abstain from voting on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Charles Calomiris abstained from voting on this statement.