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The SEC Stakes Out Hedge Fund Regulation

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Over the past five decades, the hedge fund industry has blossomed from a niche cottage industry for the wealthy to a major player in the financial markets. Given this rapid growth, and on the heels of some serious blow-ups in the sector—most notably Long-Term Capital Management[1] and most recently Canary Capital Partners and Millennium Partners[2]—the Securities and Exchange Commission has been considering possible regulations to increase monitoring of the managers, reduce exposure to systemic risk, and afford greater protection to investors. The Staff of the SEC issued a report (the "Staff Report") on September 29, 2003, offering its recommendations for changes in hedge fund regulation.[3] In this article, we will consider if regulation is required or desirable in the hedge fund industry, weigh the advantages and disadvantages inherent in various regulatory options facing the SEC, and discuss the recommendations of the Staff Report.

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What is a Hedge Fund?

Despite their relative ubiquity, the term "hedge fund" lacks a universally accepted legal definition. A hedge fund generally is "a pooled investment vehicle that is privately organized, administered by professional money managers, and not widely available to the public."[4]

The first hedge fund appeared on the financial scene in 1949 when Alfred Winslow Jones employed a combination of long and short equity positions to shield his portfolio from changes in market conditions. Typically, hedge funds attempt to achieve positive, absolute returns without regard to market conditions and to avoid drastic fluctuations in performance. Thus, the hedge fund is distinct from the traditional open-end mutual fund, which generally seeks returns relative to a particular index or benchmark.

Since 1949, hedge funds have grown significantly, with over 6000 funds and $600 billion in assets, branching out from Jones' market-neutral equity portfolio to a number of different styles, including equity long/short; index and statistical arbitrage; dedicated short; event-driven and merger arbitrage; market timing and directional; convertible arbitrage and long volatility; fixed-income arbitrage; diversified fund of funds and multi-strategy; non-diversified fund of funds; sector and emerging markets.[5] Funds of funds now control approximately $160 billion in assets, or 27% of the hedge fund market.[6]

Usually organized as limited partnerships or limited liability companies, hedge funds normally restrict offering of the limited partnership or LLC membership interests to high net worth individuals and institutions, relying on several exemptions and exclusions from federal securities laws to avoid registration of the fund or its interests. Interests are privately placed with sophisticated investors, usually in reliance on accredited investor status under Regulation D.[7]

By contrast, mutual funds are professionally managed pooled investments, generally keyed to relative returns against an index, the interests of which are publicly offered. Mutual funds are subject to regulation under the Investment Company Act of 1940, and interests sold to investors are registered securities.

Venture capital and private equity funds, like hedge funds, are unregistered entities; interests in these funds are privately placed. Unlike hedge funds, which rely primarily on trading strategies, venture capital and private equity funds provide financing at various stages in a company's growth, and have targeted exit strategies (often through an IPO or sale of the portfolio company). These funds are characterized by longer-term investments (usually illiquid), which are funded over time through mandatory capital contributions. Investor redemption rights are limited. Moreover, unlike hedge fund managers, venture capital and private equity fund managers usually take an active role in the management of their investee (portfolio) companies, even serving as board members.[8]

Currently, hedge funds are virtually free from regulation by the SEC.

Hedge funds can benefit the financial markets by providing efficacy and liquidity. By ferreting out mispricings and erroneous valuations that the market may place on certain securities or commodities, hedge funds can inject liquidity and push those instruments toward their true value, thereby improving efficiency. By the same token, hedge funds that make naked (or not fully hedged) bets on the directional movement of securities or commodities can produce destabilization.[9]

Present Hedge Fund Regulation

Currently, hedge funds are virtually free from regulation by the SEC and other federal regulators except for the general anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Hedge funds are generally organized, purposefully, to be excluded from the definition of "investment company" in the Investment Company Act.

Under Section 3(c)(1) of the Investment Company Act, a privately offered fund with fewer than one hundred beneficial owners is excluded from regulation. The staff of the SEC takes the position that offshore-incorporated funds that privately offer interests to U.S. investors do not have to count foreign investors when determining compliance with the 100-investor criterion.[10] Moreover, under Section 3(c)(7),

added in 1997, a private hedge fund that limits its investors to "qualified purchasers" is also removed from the definition of investment company.[11] There is no statutory limit on the number of investors in 3(c)(7) funds, although most funds restrict themselves to 499 investors to avoid registration and reporting under Section 12 of the Exchange Act.

Often managers of a hedge fund are themselves exempt from registration.

Because of their structure, hedge funds are generally exempt from periodic reporting otherwise mandated under the Exchange Act, although hedge fund managers, like other institutional investors, must disclose large long-equity positions and are bound by SRO disclosure requirements for short sales.

Often managers of a hedge fund are themselves exempt from registration. Under Section 203(b)(3) of the Investment Advisers Act of 1940, an investment adviser that does not hold itself out to the public as such and has fewer than 15 clients is not required to register. Regulations under the Advisers Act allow advisers to count a hedge fund as one client rather than "looking through" the fund to the investors, each of whom could be deemed a single client.[12] While some hedge fund managers voluntarily register with the SEC, they are in the minority.

Hedge funds are regulated more directly by other federal agencies. Under the Gramm-Leach-Bliley Act,[13] the Federal Trade Commission requires hedge funds to adopt an information security program to safeguard non-public, personally identifiable customer information.[14] Some hedge fund managers also may fall within the purview of the Commodity Futures Trading Commission. The CFTC regulates commodity pool operators (CPOs) and, therefore, the hedge fund managers who trade in futures, options on futures, or commodity options. The complete regulatory scheme includes anti-fraud protection through registration requirements for CPOs and commodity trading advisors (CTAs), and disclosure and recordkeeping obligations. The disclosure, which must be updated every nine months and provided to every prospective investor prior to investment, includes information on the investment program, its principal risk factors, the past performance of the fund, the fee structure and expenses, and conflicts of interests.

Despite the seemingly broad sweep of the CFTC regime, there is substantial regulatory relief for CPOs and CTAs who deal with sophisticated investors, reducing the burden essentially to registration.[15] Moreover, the CFTC recently adopted new rules that offer even greater relief for hedge fund managers, including a *de minimis* exemption for hedge funds conducting only nominal activities in the futures markets.[16]

Sales of interests in hedge funds are indirectly regulated by the NASD to the extent broker-dealers are used in the placement effort. Investor suitability requirements may prevent brokers from suggesting hedge funds if they are inappropriate in a business sense, given the investor's needs and objectives.

Areas of Concern

The SEC's reach into the universe of hedge funds has been minimal; the SEC concedes that it has insufficient or incomplete information on hedge funds. Without any periodic disclosure, availability to a mass market, or registration requirements for funds and their managers, the SEC has had limited opportunity to gauge the risks of the market and become familiar with its active players. While enforcement of the anti-fraud provisions of the Securities Act and the Exchange Act against hedge funds has provided some insight, enforcement actions arise only after significant damage has been done.[17] Indeed, many "hedge funds" facing down anti-fraud enforcement have often not been true hedge funds at all, but sham organizations set up to line the pockets of dishonest managers.[18]

The SEC's increased focus on the hedge fund industry begs the question of whether there really is a need for more oversight of these entities. As the general counsel of the CFTC warned, the SEC should "think long and hard before doing something to a segment of the financial services industry that's been so successful."[19] With this in mind, we now consider some of the areas of concern, the potential options for regulation, and their inherent benefits and drawbacks.

Retailization

With the steady growth of the hedge fund industry, the SEC has become concerned that managers will try to bring this asset class to the retail market. By registering their securities and submitting to additional disclosure and reporting obligations, several funds of funds have emerged to meet the perceived demand for alternative investments. Some funds of funds have reduced investment minimums to as low as $25,000, potentially allowing a broader range of investors to participate in hedge fund diversification, although funds of funds generally have continued to direct sales to accredited investors under Regulation D.[20] Still, most hedge funds and funds of funds have shunned registration.

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Against this backdrop, the SEC has worried that investors, even those satisfying the accredited investor test, may be quite unfamiliar with complex hedge fund style investing. At a recent SEC-sponsored Roundtable on hedge funds,[21] it was noted that some investors may be unaware that they cannot track a hedge fund's daily performance on the Internet like regularly traded stocks; they cannot liquidate their investment at any moment as in an open-end fund; they cannot expect returns to follow market benchmarks like a relative return fund; and they may experience a hedging drag, or even a loss, on the long portions of the fund portfolio during a market boom.[22]

The SEC's concerns about retailization, however, may be exaggerated. One panelist at the Roundtable noted, "the lion's share of the hedge fund industry is actually not interested in the retail investor."[23] Other participants echoed this view. "From a business perspective, I know that I am not comfortable soliciting funds from individuals who simply meet the minimum criteria of Regulation D/accredited investor/3(c)(1) exemption," said one fund president.[24] He instead cited his focus on a "sufficiently knowledgeable" investor, "able to tolerate the risks" inherent in hedge fund investments. Many industry players have contended that the hedge funds are, in fact, seeing a shift toward institutional buyers, not toward smaller retail individuals. Indeed, the investor base seems to be moving away even from high net worth individuals.[25]

Disclosure and transparency

Hedge funds initially disclose information to the investor in a private placement memorandum ("PPM"). There is no mandated form of a PPM, and the type of information disclosed varies from fund to fund. Usually, PPMs lay out the general investment strategy, fund expenses, liquidity constraints and lock-up periods, and potential conflicts of interest.

The SEC's concerns about retailization … may be exaggerated.

There is increasing concern that managers are not adequately disclosing conflicts of interest, particularly when managing several funds at one time. With multiple funds to control, a manager may have reason to allocate favorable trades or deals to one fund over another depending on the nature of the performance fee arrangement. For example, if a manager of two funds is very close to reaching his benchmark for a 20% performance fee for one fund, his incentive would be to allocate good trades to that fund, perhaps at the expense of the other fund. This type of situation may drive away potential sophisticated investors, but its significance may be harder for an unwary, albeit accredited, investor to detect.

Hedge fund disclosure to investors post-PPM delivery also is not uniform. Indeed, the funds' ongoing transparency may be rather minimal. While hedge funds may readily disclose a measure of the fund's risk profile, they are loathe to provide information about their positions, and they are highly protective of their proprietary strategies.

With the rapid growth of the industry and the potential expansion into retail markets, there is concern that many investors will lack the requisite sophistication and clout to fend for themselves in investigating and negotiating hedge fund investments—both at the time of investment and on an ongoing basis. If investors are refusing to invest without adequate disclosure by managers, then managers, in response to ordinary

market forces, will have to either adapt or lose business to a competitor who is willing to offer the desired information. However, if this private bargaining paradigm is too one-sided, and enables hedge funds to produce inadequate information (leading, perhaps, to investors making uninformed decisions), then the case for more activist federal regulation is enhanced.

There is increasing concern that managers are not adequately disclosing conflicts of interest.

Funds of hedge funds present particular problems of disclosure and transparency. Since funds of funds invest in other funds, investors incur not only the fund of funds' fees for management and performance, but also those of the underlying funds. Disclosure of such information may well be material to informed investment decision-making, but the benefits of such disclosure need to be weighed against the compliance costs. Moreover, disclosure of specific positions in other hedge funds may compromise proprietary investment strategies.

Fraud

As discussed above, the hedge fund industry is subject to the anti-fraud provisions of the securities laws. The number of enforcement actions by the CFTC and the SEC has steadily increased over the past five years. The popularity of hedge fund investments and the wealth they attract make them targets for fraud.[26] Fraudulent acts have included, among other things, misappropriation of assets and misrepresentation of performance, management credentials, and track record.[27] The SEC attributes the increase to a combination of factors, such as the influx of less sophisticated investors and the lack of checks on management. Yet, as the SEC points out, there is no indication that the hedge fund industry is disproportionately engaging in fraud in comparison to other sectors.[28]

Despite increasing enforcement, actions against hedge funds by the CFTC and the SEC comprise only 2-3% of all cases brought by both agencies. To be sure, fraud is a growing problem, but it remains a small fraction of the overall enforcement picture. Nevertheless, the lack of ongoing SEC regulation and disclosure prevents any significant regulatory involvement until after the fraud has occurred, when investors have already lost money with little likelihood of recovery.

Fees

Hedge funds usually pay their managers with a combination of a management fee and a performance fee. The management fee tends to be 1-2% of fund assets, while the performance fee hovers at around 20% of fund profits in excess of a benchmark, known as a high watermark. This fee structure gives managers the incentive to "go for the gold" in structuring the fund's portfolio because their personal returns rise and fall with those of the fund.

To amplify returns, managers may also take on leverage, borrowing against the portfolio to increase the size of fund investments without the need for additional investor capital. While raising profit potential, this strategy, employed by many funds, raises risk. Hedge funds can take as much leverage as lenders will give them. After the Long-Term Capital Management debacle (the fund had leverage of nearly 100 to 1), the lending market has generally prevented hedge funds from assuming excessive leverage.[29] By contrast, registered investment companies are statutorily required to have asset coverage of at least 300 percent of indebtedness,[30] which acts as a constraint upon debt incurred to chase potentially higher returns.

The incentives to take risks for profit have been tempered somewhat by hedge fund investors' demands that managers invest their own money along with outside investor capital. In so doing, a manager aligns his interest with fund investors and will, in theory, take more calculated risks.[31] Investors are likely to avoid investing in a fund unless a manager is a co-participant. Thus, even without regulation, the market has placed a type of check on the wayward incentives of profit-seeking managers.

Valuation

Due to the complexity of hedge fund holdings, the underlying assets are often very difficult to value. Because pricing is not readily available for certain derivatives and illiquid securities, the hedge fund itself provides a fair

value based on the price for which a particular asset could be currently sold. If prices are inflated, investors will overpay for their interests upon entering the fund and may receive too much in redemption upon leaving, at the expense of remaining investors. Moreover, the manager's fee will not properly correspond to performance.[32]

The popularity of hedge fund investments and the wealth they attract make them targets for fraud.

Unlike the registered investment company context, where the corporate board offers a check on the advisor's incentive to overvalue the portfolio, managers of hedge funds are responsible for pricing the assets. Since hedge funds tend to be structured as limited partnerships or limited liability companies for the pass-through taxation advantages, they do not have boards of directors. Hedge fund managers also are not required to use third-party pricing services to provide independent judgment on valuation, although some do. The lack of a hard-and-fast rule for portfolio valuation and the use of managerial discretion can result in price inflation and investor confusion.

Some have suggested an independent review of hedge fund asset valuations through an independent audit according to generally accepted accounting principles. While hedge funds usually conduct audits on an annual basis, they are under no obligation to do so as a matter of federal securities law. For registered investment companies, the SEC presently mandates semi-annual financial reporting of at least a balance sheet and an income statement.[33]

The Staff Report

On September 29, 2003, the Staff of the SEC issued its report entitled *Implications of the Growth of Hedge Funds*, outlining suggestions for regulating the hedge fund industry. The recommendations are relatively hedge fund friendly, and they represent a creative approach to some of the SEC's concerns.

Registration of advisers

The Staff recommended to the Commission that all hedge fund advisers be required to register as investment advisers under the Investment Advisers Act. While bringing advisers within the regulatory scope, the hedge funds themselves would be left unregulated. Advisers would be targeted by amending the definition of "client" under Investment Advisers Act rules such that a hedge fund would no longer be classified as one client.[34] Instead, a "look through" to the actual number of investors would occur, and those advisers to funds with 15 or more investors would become subject to registration. The *de minimis* exemption from registration for advisers with fewer than 15 clients would therefore be continued. In addition, the Staff suggested that there be no "look-through" for funds with less than $25 million under management—a threshold along the line of the amendments to the Investment Advisers Act in the National Securities Markets Improvement Act of 1996.[35] This would effect a division of regulatory responsibility, with those advisers below the threshold subject to state regulation and those above it subject to federal regulation.

Registration of advisers … addresses the SEC's concern as to the adequacy of fund disclosure.

By registering, hedge fund advisers would become subject to the SEC's regular inspection and examination program, which offers potential additional deterrence against fraud. Examination of the funds on a periodic basis could increase the chances of catching fraud before real damage is done. Of course, the frequency of examinations and inspections would determine the degree of deterrence and early warning. The efficacy of regulation is highly dependent on whether the SEC dedicates sufficient resources to do the job. Otherwise, the investing public may develop a false sense of security arising from the SEC's perceived oversight.

Registration of advisers further addresses the SEC's concern as to the adequacy of fund disclosure. Through a suggested uniform disclosure brochure based on Form ADV, the registered advisers to hedge funds would be compelled to provide information on conflicts of interest, risk management procedures, valuation restraints, and lock-up periods. To meet perceived transpar-

ency needs, the proposal would require periodic updating of the form for existing investors. The proposal would not, however, entail the disclosure of hedge fund trading strategies and portfolio positions, or investor identities, thereby assuaging the concerns of hedge fund managers about the security of proprietary information.

Although the Staff Report does not suggest annual GAAP audits, adviser registration may lead to that result because of recent amendments to Investment Advisers Act Rule 206(4)-2,[1] known as the custody rule. Rule 206(4)-2 makes it a violation of the antifraud provisions of the statute for a registered adviser to have custody or possession of any client funds or securities unless all the conditions prescribed by the rule are met. Under amendments that become effective November 5, 2003 (and must be complied with by April 1, 2004), the term "custody" is now defined so that a registered adviser that acts as general partner or managing member and investment adviser for a pooled investment vehicle will be deemed to have custody of client assets— *i.e*., the assets of the pooled investment vehicle. An adviser having such custody must maintain such assets with a qualified custodian—generally a bank, savings association, registered broker-dealer, or registered FCM—and reasonably believe the custodian is providing account statements directly to clients or to each client's designated "independent representative" (which cannot be the registered investment adviser or its affiliates) no less often than quarterly. If quarterly account statements are instead provided to the registered adviser or an affiliate, the adviser must send those statements to clients and must undergo an annual surprise audit by an independent public accountant to verify client funds and securities. Registered advisers are exempt from these reporting and surprise audit requirements if the pooled investment vehicle (i) is audited at least annually, and (ii) distributes its audited financial statement prepared in accordance with GAAP to all beneficial owners of interests in the vehicle within 120 days after the end of each fiscal year. One would not expect hedge fund managers to embrace surprise audits when the alternative of yearly GAAP audits is available.

Finally, registration under the Advisers Act would innovatively deal with the SEC's concern over retailization. Mandating registration would effectively increase the accredited investor threshold for individuals investing in hedge funds. This occurs because registered advisers are prohibited from charging performance fees unless all investors are qualified clients with $750,000 invested with the adviser or a net worth of $1.5 million.[37] Since hedge fund managers are more likely to retain performance fees than drop below the qualified client level, investors not meeting those standards (even if otherwise deemed "accredited investors") may be pushed out of hedge fund investing.

Expanded use of hedge fund strategies

The Staff did not commit to a position on broadening the availability of alternative investments through other investment vehicles. Instead, the Staff proposed that the Commission issue a concept release to examine whether hedge fund investment strategies could be put to wider use in registered investment companies and whether the public would have the sophistication to understand them. The Staff requested input as to whether hedge fund strategies could be housed in an open-end fund given the liquidity issues posed by hedge fund investment. They also requested comment on whether the restrictions on leverage and short selling in the Investment Company Act have prevented mutual fund expansion into absolute return strategies.

Prime brokers

The Staff urged the SEC and the NASD to remain vigilant in monitoring the capital introduction services provided by prime brokers, and suitability obligations with respect to the sale of funds of hedge funds. Hedge funds rely on prime brokers for trade execution, margin finance, securities lending, and sometimes for office space and referrals. Absent from the Staff's suggestions is any new recommendation that prime brokers report suspected fraudulent hedge fund activity.

Best practices

The Staff also recommended that the Commission encourage the hedge fund industry to further develop best practices. The Managed

Funds Association, a trade association for the hedge fund industry, put out its own suggestions for operating hedge funds, entitled *2003 Sound Practices for Hedge Fund Managers*.[38] Other groups have published similar manuals for self-discipline in the industry. The adoption of best practices may well serve to standardize hedge fund portfolio valuation, accounting, performance presentation, and incentive fee computation by bringing hedge fund practices more in line with those of the regulated mutual fund industry.

Fee disclosure

The Staff took aim at registered investment companies, including registered funds of hedge funds, focusing on fee disclosure and valuation issues. The Staff recommended prospectus disclosure in the fee tables of the estimated fees (both asset-based and performance-based) and expenses, not only of the fund itself but also of each hedge fund in which such fund invests. This proposal is intended to increase investor awareness as to the fees that are compounded by layers of fund investment.

Valuations

"[H]eightened concerns relating to registered [funds of hedge funds]" prompted the Staff to make additional recommendations with respect to valuation. The Staff proposed that the Commission adopt rules to *prohibit* registered investment companies from investing in hedge funds unless their boards of directors have adopted procedures (not specified by the Staff) to "ensure that the funds value those assets consistently with the requirements of Section 2(a)(41) of the '40 Act."[39] Section 2(a)(41) requires the board of directors of a registered investment company to make good faith, fair value determinations of fund assets for which market prices are not readily available. Such a rule could offer investors protection from inflation of portfolio valuations.

On the other hand, to ensure such statutory compliance, valuation of an investment in a hedge fund (for which no secondary trading market exists) would seemingly require valuation of each asset in the fund's portfolio, which may not be possible if the fund does not report its portfolio assets (and the Staff does not go so far as to call for such disclosure). Thus, one may be left with little more than blind acceptance of hedge fund reported NAV, which does not promote investor protection. Perhaps the Staff believes that compliance with Section 2(a)(41) will inexorably lead funds, as investors, to insist on per-asset portfolio valuation by investee hedge funds, and so fuller disclosure will be obtained through market forces rather than direct SEC mandate. Cynics, however, might see such proposals as an indirect, albeit intentional, way to brake the growth of funds of hedge funds.

Solicitation

Perhaps the most notable proposal was to permit general solicitation in fund offerings under Section 3(c)(7) of the Investment Company Act, a key departure from SEC precedent. The Staff pointed out (correctly) that there is little justification for limiting the solicitation process to hedge funds that can be sold only to qualified purchasers with $5 million in investments, and there seems to be no principled way for the Commission not to extend relief to all private investment pools that have only qualified purchasers as investors. Easing restrictions on public solicitation would reduce the cost of capital formation for such vehicles, benefiting not only hedge funds but also venture capital and private equity funds.

Awaiting the Commission's Reaction

The extent to which the full Commission will adopt these recommendations remains to be seen, but the hedge fund industry will likely face some new regulation, at least indirectly. For hedge funds and their managers, the impact may not be dramatic. Short selling, leverage, derivatives, lock-up periods, and illiquidity will remain fixtures in the hedge fund industry. The Staff proposals, if adopted by the Commission as rules (which is likely, at least in some form[40]), would generally preserve the nature and character of hedge funds, while allowing greater oversight of the industry. Whether such oversight will produce more than theoretical benefits is yet to be determined.

Notes

1 Long-Term Capital Management's highly-leveraged hedging strategy (predominantly based on arbitrage of U.S. Treasuries and international fixed-income instruments) turned out to be a massive failure, with losses of nearly 90% of its capital. *See generally* Jonathan H. Gatsik, "Hedge Funds: The Ultimate Game of Liar's Poker," 35 Suffolk U. L. Rev. 591 (2001).

2 N.Y. Attorney General Eliot Spitzer sued Canary Capital Management, a hedge fund with nearly $1 billion under management at its peak, alleging "late trading" and "timing" of trades in mutual funds. These schemes allowed Canary to profit from market-moving information that came after the closing of the trading day. *See* NYAG Press Release, State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), *available at* <www.oag.state.ny.us/press/2003/sep/sep03a_03.html>. A trader at Millennium Partners pleaded guilty to violating New York's Martin Act based on Attorney General Spitzer's on-going investigation into after-hours trading of mutual funds by certain hedge funds. *See* NYAG Press Release, New York Attorney General and Securities and Exchange Commission Bring Criminal and Civil Actions Against Hedge Fund Executive (Oct. 2, 2003), *available at* <www.oag.state.ny.us/press/2003/oct/oct02a_03.html>. Similar clouds are hovering over Alliance Capital Management, Prudential Securities, Citigroup, and Bank of America.

3 *See* "Implications of the Growth of Hedge Funds," at <www.sec.gov/news/studies/hedgefunds0903.pdf>.

4 The President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," 1 (Apr. 1999), *available at* <http://hongkong.usconsulate.gov/gf/1999/hedgfund.pdf>.

5 *See generally* David Varadi, "Alpha, Beta, Gamma: Hedge Funds for the Retail Investor," IFID Centre, Research Report #01-02 (2001).

6 Comment letter of Charles J. Gradante, Managing Principal, Hennessee Group LLC, for SEC Roundtable on Hedge Funds, *available at* <www.sec.gov/spotlight/hedgefunds/hedge-gradante.pdf>.

7 Individuals are considered "accredited" if their net worth exceeds $1 million or annual income exceeds $200,000, or $300,000 with a spouse. Relying on Rule 506 of Regulation D, a hedge fund also could sell to up to 35 non-accredited investors, provided the issuer reasonably believes that they or their representatives have the requisite sophistication to understand the nature of the investment and its risk.

8 Staff Report, *supra* note 3, at 7-8.

9 Long-Term Capital Management crumbled upon the announcement of a moratorium on Russian debt, one of the fund's heavy directional positions. The Federal Reserve gathered a consortium of private sector entities to bail out LTCM, fearing that the rush to liquidate the fund's positions could cause a global market collapse. *See* United States General Accounting Office, Report to Congressional Requesters, "Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk," at 2-4 (Oct. 1999), *available at* <www.house.gov/markey/iss_finance_hr3483gao.pdf>. The speculative directional bets on currencies of George Soros's Quantum Funds have also been blamed for destabilizing economies in Asia and other regions of the world. *See* Phillip L. Zweig, "The Hedge Funds: The Rich Get a Little Richer," Businessweek (Aug. 7, 1997), *available at* <www.businessweek.com/1997/34/b3541191.htm>.

10 *See* Investment Funds Institute of Canada, SEC No-Action Letter, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,133 (Mar. 4, 1996).

11 "Qualified purchasers" are individuals or companies with $5 million in investments or persons with $25 million to invest acting on behalf of themselves and/or other qualified purchasers.

12 *See* 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i).

13 Pub. L. No. 106-102, § 1(a), 113 Stat. 1338 (1999).

14 *See* 16 C.F.R. Pt. 313.

15 *See* Comment letter of Jane Kang Thorpe, Director of the Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, for the SEC Roundtable on Hedge Funds, *available at* <www.sec.gov/spotlight/hedgefunds/hedge-thorpe.htm>.

16 Under Rule 4.13(a)(3), CPOs are entitled to regulatory relief if: 1) the pool is exempt from Securities Act registration and is not marketed to the public; 2) the pool does not commit more than 5 percent of assets to establish commodity interest positions and the notional value of its commodity interest positions does not exceed 100 percent of the pool's liquidation value; and 3) the pool includes only accredited investors and other qualified buyers. *See* 17 C.F.R. § 4.13(a)(3).

17 Lancer Management Group, for example, may have lost $613 million or more of investor capital. The SEC has filed charges against the fund principal alleging manipulation of the fund's valuations. *See* SEC Litigation Release No. 18247 (July 23, 2003), *available at* <www.sec.gov/litigation/litreleases/lr18247.htm>.

18 The SEC filed suit against Ryan Fontaine, a 22-year-old college student, who set up Simpleton Holdings Corp. and made outrageous misrepresentations about his "hedge fund." He claimed that he had averaged a 39.5% return over the 13-year history of the fund and that he had $250 million under management. He also misrepresented that Salomon Smith Barney was his subadvisor, KPMG LLP was his auditor, and Delaware Charter Guarantee & Trust Co. was holding investors' funds in trust. *See* SEC Litigation Release No. 17864 (Nov. 26, 2002), *available at* <www.sec.gov/litigation/litreleases/lr17864.htm>. Donald C. O'Neill, the manager of several funds, raised $13.7 million purportedly to invest in foreign currencies, but allegedly misappropriated more than $10 million for personal expenses. The Department of Justice filed charges against O'Neill in September 2003. *See* Press Release, U.S. Department of Justice, "Director of $13.7 Million Foreign Currency Hedge Fund Charged in 40-Count Indictment" (Sept. 9, 2003), *available at* <www.usdoj.gov/usao/fls/Neill.html)>.

19 Patrick McCarty, General Counsel, Commodity Futures Trading Commission, Comment at the SEC Roundtable on Hedge Funds (May 15, 2003) (transcript available at <www.sec.gov/spotlight/hedgefunds/ hedge1trans.txt>).

20 Continued reliance on accredited investor status may be misplaced. Since the term "accredited investor" was defined in 1982, inflation has eroded its significance as a measure of financial wherewithal. Over the past two decades, the number of people with $1 million net worth or an annual income of $200,000 has grown dramatically. It is doubtful that accreditation is the proxy for investor sophistication it once was.

21 The SEC's Roundtable, featuring panelists representing different interests in the hedge fund field, convened on May 14-15, 2003. *See generally* <www.sec.gov/spotlight/hedgefunds.htm>. The Staff Report was written partly in response to the comments at the Roundtable and to the prepared statements of a number of panelists.

22 *See* Staff Report, *supra* note 3, at 111, n.357.

23 James R. Hedges, Founder, President and Chief Investment Officer, LJH Global Investments, LLC, Comment at the SEC Roundtable on Hedge Funds (May 14, 2003).

24 Comment letter of James Chanos, President, Kynikos Associates, for SEC Roundtable on Hedge Funds, *available at* <www.sec.gov/spotlight/hedgefunds/hedge-chanos.htm>.

25 Michael Neus, Principal and Chief General Counsel, Andor Capital Management, Comment at the SEC Roundtable on Hedge Funds (May 14, 2003).

26 Staff Report, *supra* note 3, at 73.

27 *See, e.g.,* United States v. Jung, SEC Litigation Release No. 17995 (Feb. 25, 2003) (fund manager misappropriated investors' assets to collateralize his own securities trading), *available at* <www.sec.gov/litigation/litreleases/lr17995.htm>; SEC. v. Jean Baptiste Jean Pierre, SEC Litigation Release No. 18216 (July 7, 2003) (fund employee made false misrepresentations about the manager's past performance, claiming 50% annual returns in

other funds), *available at* <www.sec.gov/litigation/litreleases/lr18216.htm>; SEC v. Smirlock, SEC Litigation Release No. 17630 (July 24, 2002) (fund manager inflated the value of the fund's investment portfolio), *available at* <www.sec.gov/litigation/litreleases/lr17630.htm>; SEC v. Fontaine, SEC Litigation Release No. 17864, *supra* note 18; SEC v. Berger, 322 F.3d 187 (2d Cir. 2003) (fund manager vastly overstated value of fund's holdings and failed to report losses in excess of $300 million).

28 Staff Report, *supra* note 3, at 73.

29 Willa E. Gibson, "Is Hedge Fund Regulation Necessary?," 73 Temple L. Rev. 681, 708 (2000).

30 15 U.S.C. § 80a-18(f).

31 Lawrence E. Harris, Chief Economist and Director, Office of Economic Analysis, U.S. Securities and Exchange Commission, Comment at the SEC Roundtable on Hedge Funds (May 15, 2003).

32 Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, Comment at the SEC Roundtable on Hedge Funds (May 14, 2003).

33 15 U.S.C. § 80a-30(e).

34 It appears from the Staff Report and surrounding history that adviser registration is to be limited to hedge funds (as opposed to venture capital or private equity or other forms of collective investment funds). This may prove to be a daunting task, particularly as it applies to the manager of an investment vehicle that combines features commonly associated with hedge funds and those commonly associated with one or more other private investment vehicles.

35 *See* 15 U.S.C. § 80b-3a.

36 17 C.F.R. §275.206(4)-2.

37 17 C.F.R. § 275.205-3.

38 This paper is available at <www.mfainfo.org/images/pdf/2003SoundPractices_forHedgeFundManagers.pdf>.

39 Staff Report, *supra* note 3, at 99.

40 Testifying recently before Congress, Chairman Donaldson stated: "I believe that the Commission needs to have a means of examining hedge funds and how they operate. Speaking only for myself, I believe that registration of hedge fund advisers would accomplish this." Testimony Concerning Recent Commission Activity To Enhance Investor Protections Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Sept. 30, 2003), *available at* <www.sec.gov/news/testimony/ts093003whd.htm>.

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