Coalition of Private Investment Companies

Hedge Fund Regulation

Hedge funds are subject to the same statutory and regulatory restrictions on their investment and portfolio trading activities as are other institutional market participants engaged in the same trading and investing activities.

Laws and regulations covering hedge funds, or private investment companies, include:

- Anti-fraud and anti-manipulation requirements [15 U.S.C. §78i, §78j], as well as insider-trading prohibitions [CFR §§240.10b-5, 17 CFR §240.10b-5]
- Margin rules, which cover the use of loans to purchase and carry publicly traded securities and options [12 CFR §§220.1, §221.1, §224]
- Securities and Exchange Commission Regulation SHO governing short selling activities and reporting [17 C.F.R. §§242.200-203]
- Williams Act amendments regulating and requiring public reporting on the acquisition of blocks of securities in connection with takeovers and proxy contests [Exchange Act §§13(d), 13(e), 14(d), 14(e), and 14(f); 15 U.S.C. §§78 n(d), 78 n(e), and 78 n(f)]
- Laws covering hedge funds include SEC, CFTC and Treasury reporting requirements for large positions [Securities Exchange Act of 1934 Sections 13(d), (f), (g), and (h) (15 USC 78m(d), (f), (g), and (h)); Commodity Exchange Act Section 4i (7 USC 6i); Securities Exchange Act of 1934 Section 15C(f) (15 U.S.C. 78o–5(f))]
- Financial Industry Regulatory Authority "new issues" rule 2790 (governs initial public offering allocations) [FINRA (formerly NASD) Notice to Members 05-65]
- Rules and regulations of markets in which they seek to buy or sell financial products. [e.g., New York Stock Exchange and NASDAQ OMX]

The current regulatory structure is based on the rationale that, since it is "accredited investors" or "qualified purchasers" who are permitted to invest in hedge funds, these investors have sufficient experience and access to advice, unlike those investors with less wealth and experience.[1] Hence, they do not require the same level of regulatory oversight as "retail" investors.

Seventy percent of the $1.43 trillion in hedge fund assets is covered by voluntary registration as investment advisers with the SEC as of June 2009. SEC-registered firms manage nearly 71 per cent of all US-based hedge fund capital.[2]

Hedge funds are required to comply with rules, regulations, and laws that affect virtually all investors in the public and private financial markets.

"The hedge fund legal regime includes not only federal securities law but also the entity and contract law provisions governing the fund, its manager, and investors."

Houman B. Shadab
Senior Research Fellow
George Mason University
September 25, 2008

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1. An individual is considered to be an "accredited investor" if they have a net worth of at least $1 million or have made at least $200,000 each year for the last two years ($300,000 with his or her spouse if married) and have the expectation to make the same amount this year. Qualified purchasers include: (a) Individuals who own $5 million in investments; (b) Institutional investors who own $25 million in investments; (c) A family owned company that owns $5 million in investments; and, (d) A "qualified institutional buyer" under Rule 144A under the Securities Act of 1933.
2. On December 2, 2004, the SEC adopted a new rule and rule amendments under the Investment Advisers Act of 1940 that would require hedge fund managers to register as investment advisers by February 1, 2006. However, on June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated these rule changes. Many hedge fund managers choose voluntarily to continue their registration.

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Best Practices

The President's Working Group on Financial Markets set out best practices in 2009 for hedge funds. For fiduciary investors, the best practices recommend that investors:

- ☐ Should not feel forced to invest in hedge funds
- ☐ Consider the role of the hedge fund investment in their investment program
- ☐ Consider the appropriateness of the investment, which depends "upon the goals of the plan, [the] sophistication of the investor/plan," the ability to determine whether the fund has a "compelling role in the portfolio, and [the] ability to identify compelling hedge funds"

Recommendations for individual investors include that they should:

- ☐ Have a detailed investment policy,with performance and risk expectations and parameters
- ☐ Perform effective due diligence, needed to "effectively evaluate managers and the expected impact on portfolio risks/returns typically using customized due diligence questionnaires"
- ☐ Have adequate risk measurement procedures.

Both fiduciary and individual investors should also have the expertise to sufficiently evaluate, monitor, hire, and fire hedge fund managers.

SOURCE: President's Working Group on Financial Markets. Investors' Committee. *Principles and Best Practices for Hedge Fund Investors.* January 15, 2009. Available at: http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf. Asset Managers' Committee. Best Practices for the Hedge Fund Industry. January 15, 2009. Available at: http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf.

As registered investment advisers, hedge fund advisers are subject to SEC examinations and reporting, record keeping, and disclosure requirements. Registered funds must also file Form ADV. This filing contains information about potential conflicts of interest, both internal and external, any past regulatory or legal problems of both the hedge fund management company and any of its related advisors, and specific ownership data.

Once registered, hedge fund managers are considered legal fiduciaries, which requires fund managers to put the interests of their funds above their personal interests.

Hedge Funds Operate in Regulated Markets with Regulated Participants

The SEC primarily monitors hedge fund activities through its regulation of registered advisers at hedge funds and its supervision of regulated entities affiliated with hedge funds. The CFTC oversees hedge fund activities through its market surveillance, regulatory compliance surveillance, and delegated examination programs, as the General Accountability Office notes.

Regulators also manage the systemic risk of hedge funds through the regulation of their counterparties, mostly banks and securities firms. This indirect oversight approach preserves the incentive for hedge funds to promote financial innovations.

One such regulated entity, the prime broker, monitors the potential impact of their trading strategies on systemic risks in providing clearing and settlement, custodial, credit, and securities lending services. These brokers are supervised and regulated by the SEC and the Federal Reserve.

Transparency

As with any investor, hedge funds must disclose their positions if they own more than five percent of a public company's equity securities. As "institutional investment managers," hedge funds larger than $100 million must report all securities and options positions quarterly. If 25 percent or more of a fund's equity assets are owned by a qualified employee benefit plan, the fund must comply with the reporting obligations under the Employee Retirement Income Security Act (ERISA).

Hedge funds must make substantial disclosures to potential investors in order to discharge fiduciary duties and avoid running afoul of anti-fraud rules prohibiting "misleading statements" and "omissions."

Hedge funds are subject to the same prohibitions against fraud as are other market participants. An SEC rule prohibits advisers from making false, misleading or deceptive statements or otherwise defrauding investors or prospective investors.

Most hedge funds provide a relatively high degree of access to relevant data and analyses about the fund and its holdings for their investors. If they don't, the investor could decide not to invest or to withdraw.

Due Diligence

Through "due diligence," investors identify managers with whom to invest and monitor those managers to ensure that investing with them is appropriate for the investor. The level of quantitative and qualitative analysis is considerable to understand the operational and financial risks of a hedge fund.

Institutional investors, or their financial managers, generally require a private investment company to provide answers to detailed questions regarding the company's background, strategies, research, personnel, returns, compliance programs, risk profile, and accounting and valuation practices. Prospective investors also review liquidity restrictions, management and performance fees, and any applicable lock-up periods (predetermined amount of time an investor must wait before redeeming fund investments for cash).