

Reforming Hedge Fund Regulations: The Way Forward

A new statute tailored to private investment companies will benefit investors through stronger regulatory oversight, broader disclosures, and better monitoring of systemic risks.

Implement a Private Investment Company Statute

The Coalition of Private Investment Companies (CPIC) urges Congress to enact a stand-alone “Private Investment Company” statute specifically focused on regulation of private investment funds.

Hedge funds are already 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.¹

The new statute would build from that foundation, putting into place a comprehensive regulatory framework for private investment companies. This would enhance the Securities and Exchange Commission’s (SEC) ability to monitor and address systemic risks while providing clearer regulatory authority to prevent illegal activities.

Highest Standards of Prevention without Eliminating Benefits of Responsible Innovation

CPIC’s “Private Investment Company Statute” would:

Require Registration: Private funds must register with the SEC and file basic census data that the public can access online. This will enable the SEC to conduct examinations and bring both administrative proceedings and civil enforcement actions (including fines and penalties for violations) against registered advisers, funds, and their personnel.

Prevent Theft, Ponzi Schemes, Fraud: The legislation would reduce the risks of theft and fraud by requiring money managers to hold client assets with a qualified custodian. Investment funds must be audited and only by independent public accounting firms that the Public Company Accounting Oversight Board (PCAOB) oversees.

Broaden Investor Disclosures: Funds must provide specific disclosures to potential investors before accepting any investment and provide ongoing disclosures to existing investors. These mandatory disclosures (see adjacent box) are consistent with the Best Practices recommended in January 2009 by

1. These include: margin rules (limit the use of leverage to purchase and carry publicly traded securities and options); SEC Regulation SHO (regulates short selling; the Williams Act amendments to the Securities Exchange Act of 1934 and related SEC rules (require public reporting of the acquisition of blocks of securities and regulate other activities in connection with takeovers); and, FINRA’s “new issues” Rule 5130 (governs allocation of initial public offerings).

Hedge funds are designed by law to operate with optimum flexibility.

Statute’s Disclosure Obligations

- Methodologies for asset and liability valuations
- Portion of income and losses derived from the Financial Accounting Standard (FAS) 157 Level 1, 2, and 3 assets
- Any and all investor side-letters and side-arrangements
- Investment and trade allocation policies of the fund and its investment manager
- Conflicts of interest
- Financial arrangements with interested parties such as investment managers, custodians, portfolio brokers, and placement agents
- Fees and expense structures, including use of soft dollars
- Annual audited financial statements and quarterly unaudited ones

Hedge Funds and Their Role in Markets

Coined by a Fortune magazine writer in 1966, the term “hedge fund” has no legal meaning but it generally refers to private offered, professionally managed pooled investment vehicles. Assets managed by hedge funds totaled \$1.43 trillion as of June 30, 2009. Hedge fund investment strategies vary widely and include arbitrage, market timing, short selling, and market neutral approaches (long and short positions to hedge sector and company-specific risks) to portfolio management.

“In my current view, hedge funds deserve a narrowly tailored regulatory treatment.”

Rep. Paul Kanjorski
May 7, 2009

Hedge Fund Benefits

- Provide liquidity
- Improve price efficiency
- Distribute risks
- Promote global integration of markets

the Asset Managers’ Committee of the President’s Working Group on Financial Markets.²

Reduce Risks: Private funds would provide lenders and counterparties with such information as the fund company’s audited annual financial statements, current private placement memorandum, the fund’s valuation methodology, side-letters, side-arrangements, material conflicts of interest, and financial arrangements.

Protect Against Risks of Large, Private Investment Funds: Funds that control gross assets above a specified amount must implement disaster recovery, business continuity, and risk-management plans to identify and control material operational, counterparty, liquidity, leverage, and portfolio risks. Detailed plans to address liquidity and conduct an orderly wind-down are also required.

Why is this Statute Needed? Consistent Regulation of Market Participants Performing the Same Functions

Private investment companies are regulated through exemptions granted in two acts – the Investment Company Act and the Investment Advisers Act – that are intended for retail investors choosing public offerings and mutual funds. Interests in hedge funds are sold in private offerings primarily to “accredited” investors (for example, institutional investors and “high net worth” individuals).³

A statute specifically tailed to private investment companies would:

Clear Legislative Intent: Should the SEC or the Courts need to determine the legal authority the SEC has in matters involving private investment companies, they will have clear legislative intent to guide their deliberations. Existing statutes have sparked challenges in court about the SEC’s authority.

Better Disclosures for Investors: As sophisticated institutional investors have committed more of their portfolios to alternative investments, they need stronger disclosure practices to provide them with information essential in determining whether to invest in a fund, monitor that investment, and make a decision whether to redeem their investment.

More Tools to Monitor Systemic Risk: The SEC would have more information and authority to deal with the risks of unfair dealing with clients, lack of transparency, certain custody issues, potential fraud, and conflicts of interest.

Weak Custodial Protections: Existing rules exempt from custodian protections certain instruments commonly owned by private investment funds and access controls to assets are rudimentary.

2. See *Best Practices for the Hedge Fund Industry. Report of the Asset Managers’ Committee to the President’s Working Group on Financial Markets*. January 15, 2009. Available at: <http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf>.
3. 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 of the ‘33 Act.

Members and associations of CPIC either manage directly or provide advice to funds with an aggregate of more than \$70 billion in assets. Their clients include pension funds, asset managers, foundations, other institutional investors, and qualified wealthy individuals.