



## Looming Changes in Hedge Fund Regulation

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The ongoing financial meltdown has resulted in intense scrutiny of the existing financial industry regulatory scheme, with calls for greater regulation coming from all quarters. Hedge funds have found themselves in the crosshairs in both the US and Europe; and increased regulation of hedge fund managers and the funds they advise is inevitable.

President Obama has promised changes in the way the federal government regulates Wall Street, calling for a "21st century regulatory framework to restore accountability, transparency and trust in our financial markets." The president specifically identified hedge funds as entities that should be subjected to "proper oversight." Under the Emergency Economic Stabilization Act of 2008 (commonly known as the bailout plan), the administration is charged with reviewing the current state of the financial markets and the regulatory system. By 30 April, it must submit a report to Congress providing recommendations for improvement, including "whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system." While hedge funds were not referenced directly, it is safe to assume that they were intended to be included. And on 26 March, the administration outlined its proposed "framework for regulatory reform" which includes new rules for hedge funds.

Although the administration has provided few specific details of the revised rules it will seek to impose on hedge funds, the general contours of the expected rules have become clear. On 6 February, President Obama created the President's Economic Recovery Advisory Board (PERAB), chaired by former Federal Reserve Chairman Paul A Volcker. PERAB is an advisory body charged with providing, among other things, "analysis and information with respect to the operation, regulation, and healthy functioning of the economy and of the financial and banking system." Volcker served as chairman of the Steering Committee of the Group of 30 which, on 15 January, issued a report focusing on recommended changes to the global framework of financial regulation. The report provides a series of core recommendations for the regulation of hedge funds that serves as a good indication of the changes which may be sought by the administration. The report also raises some interesting issues that the administration will likely address in any proposal for changes in regulation.

The first recommendation of the report is that "(g)aps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions, regardless of type, must be subjected to an appropriate degree of prudential oversight." The report sets forth a series of sub-recommendations relating to this core recommendation – applicable to banking organisations, non-bank financial institutions, money-market mutual funds, private pools of capital and government-sponsored enterprises.

The four sub-recommendations relating to private pools of capital are elegant in their simplicity, but leave unanswered some difficult questions of implementation. They are geared toward addressing systemic risk but also include proposals that may benefit investors. The recommendations are as follows:

- a) Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national prudential regulator. There should be some minimum size and venture capital exemptions from such registration requirement.
- b) The prudential regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing and performance of the funds under management. Since introduction of even a modest system of registration and regulation can create a false impression of lower investment risk, disclosure and suitability standards will have to be re-evaluated.
- c) For funds above a size judged to be potentially systemically significant, the prudential regulator should have authority to establish appropriate standards for capital, liquidity and risk management.
- d) For these purposes, the jurisdiction of the appropriate prudential regulator should be based on the primary business location of the manager of such funds, regardless of the legal domicile of the



funds themselves. Given the global nature of the markets in which such managers and funds operate, it is imperative that a regulatory framework be applied on an internationally consistent basis.

Under the report's recommendations, only those hedge funds "that employ substantial borrowed funds" and are of a "minimum size" would be required to register. Although the stated goal is to prevent systemic risk resulting from the over-leveraging of large funds, left unanswered is the ratio of leverage deemed "substantial" or the assets under management (AuM) threshold deemed significant. These limitations may operate to exempt many hedge funds from registration. Substantively, the recommendations seek to reduce systemic risk by requiring public disclosure of certain key information by hedge funds and imposing unspecified mandates regarding "capital, liquidity and risk management." Public disclosure may be a difficult pill for some funds to swallow, but it is certainly less burdensome than submitting to mandates concerning capital, liquidity and risk management. Again, the devil is in the details, and the recommendations do not even attempt to provide any degree of granularity. The recommendations recognise that the hedge fund business is global, and reasonably suggest an international regulatory structure that is consistent and harmonised, in an effort to avoid regulatory arbitrage.

The "framework for regulatory reform" released by the administration on 26 March, also focuses on systemic risk to the financial system and proposes regulating entities and conduct that may cause systemic risk. The administration has proposed the establishment of a single "systemic risk" regulator responsible for regulating firms based on "what they do" and not the "form they take." The administration has defined "systematically important firms," which may include hedge funds, based on three characteristics: "(1) the financial system's interdependence with the firm, (2) the firm's size, leverage (including off-balance sheet exposure), and degree of reliance in short-term funding, and (3) the firm's importance as a source of credit for households, businesses, and governments and as a source of liquidity for the financial system."

Among other rules, the administration has proposed new rules for regulating hedge fund managers and the funds they advise. According to the proposal, because hedge funds are generally not required to register with the SEC, "there are no reliable, comprehensive data available to assess whether such funds, individually or collectively, pose a threat to financial stability." The administration has proposed the following for hedge funds and other private pools of capital:

1. **Requiring registration of all hedge funds:** All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose AuM exceed a certain threshold should be required to register with the SEC.
2. **Mandating investor and counterparty disclosure:** All such funds advised by a SEC-registered investment adviser should be subjected to investor and counterparty disclosure requirements and regulatory reporting requirements.
3. **Providing information necessary to assess threats to financial stability:** The regulatory reporting requirements for such funds should require reporting, on a confidential basis, information necessary to assess whether the fund or fund family is so large or highly leveraged that it poses a threat to financial stability.
4. **Sharing reports with systemic risk regulator:** The SEC should share the reports that it receives from the funds with the systemic risk regulator, which would then determine whether any hedge funds could pose a systemic threat and should be subjected to the prudential standards outlined above.

In his testimony before Congress, Treasury Secretary Geithner promised that further details of the administration's proposal, along with other regulatory reforms in the areas of consumer and investor protection, will be presented in the coming weeks.

A renewed proposal for hedge fund regulation has also been introduced in Congress. On 29 January, Senators Charles Grassley (R-Iowa) and Carl Levin (D-Mich) introduced Senate Bill S 344, "The Hedge Fund Transparency Act," which was immediately referred to the Committee on Banking, Housing, and Urban Affairs. It was described as "a bill to require hedge funds to register with the SEC and for other purposes." Notwithstanding its title and the intent of its sponsors, the bill impacts not only hedge funds but all private



investment companies, including private equity funds and venture capital funds, with assets of US\$50 million or more.

This proposed legislation was conceived three years earlier, after Senator Grassley conducted SEC oversight hearings in response to a whistleblower who complained that SEC supervisors were impeding an investigation into a major hedge fund. The next year, Grassley introduced bill S 1402, which sought to amend the Investment Advisers Act of 1940, unlike this bill which seeks to revise the Investment Company Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934 and the Internal Revenue Code. S 1402 was never taken up by the Senate Banking Committee.

Together with Senator Levin, Grassley has substantially revised S 1402 to create The Hedge Fund Transparency Act. In Grassley's words, this proposed legislation "clarifies current law to remove any doubt that the SEC has the authority to require hedge funds to register – simply to register – so the Government knows who they are and what they are doing. It removes the loophole previously used by hedge funds to escape the definition of an "investment company" under the [ICA]."

Hedge funds that want to avoid registering under the ICA will only be exempt if they file basic disclosure forms and cooperate with requests for information from the SEC. The proposed legislation seeks to amend the definition of an investment company. Hedge funds and other private investment vehicles, like private equity and venture capital funds, typically avoid regulation by claiming the exceptions to the definition of an investment company contained in ICA Section 3(c), paragraphs (1) - less than 100 beneficial owners - or (7) - investments exclusively by qualified purchasers. The bill would convert these provisions from exceptions to the investment company definition to registration exemptions. It would accomplish this by moving the exceptions, without substantive change, to new Sections 6(a)(6) and 6(a)(7) of the ICA. Accordingly, if an investment company satisfies either Section 6(a)(6) or (a)(7) it will be exempted from the normal registration and filing requirements of the ICA.

However, an investment company that meets the criteria in paragraphs (6) or (7) of Section 6(a) but has assets or AuM of US\$50,000,000 or more, must meet several requirements in order to maintain its exemption. These requirements include:

- Registering with the SEC;
- Maintaining books and records that the SEC may require;
- Cooperating with any request by the SEC for information or examination; and
- Filing an information form with the SEC electronically, at least once a year.

Changes to hedge fund regulation will not be limited to the US regulatory system. Both the Obama administration and European leaders have identified reform of the global regulation of financial markets as a key agenda item for the Group of 20 Summit on 2 April in London. In a recent meeting to coordinate their position for the Group of 20 Summit, European leaders jointly called for enhanced hedge fund regulation.

We have therefore today underscored once again our conviction that all financial markets, products and participants must be subjected to appropriate oversight or regulation, without exception and regardless of their country of domicile. This is especially true for those private pools of capital, including hedge funds, that may present a systemic risk. Therefore we call for appropriate oversight or regulation of these sectors in order to prevent excessive risk-taking.

Further, on 18 March, it was reported that the European Commission will release a directive (essentially a draft law) on 21 April 2009 providing for increased regulation of hedge funds and private equity firms. Given the obvious political will to transform the domestic and global financial regulatory scheme, and the specific targeting of hedge funds; substantial changes to the regulation of hedge funds are inevitable.

As the upcoming proposals are released, we will report further on the details of these proposals and the implications for hedge fund managers and investors.



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<sup>1</sup> [http://www.gibbonslaw.com/biographies/attorney\\_biography.php?attorney\\_id=272](http://www.gibbonslaw.com/biographies/attorney_biography.php?attorney_id=272)  
<sup>2</sup> [http://www.gibbonslaw.com/biographies/attorney\\_biography.php?attorney\\_id=498](http://www.gibbonslaw.com/biographies/attorney_biography.php?attorney_id=498)