Pillsbury Winthrop Shaw Pittman LLP

Corporate & Securities

Jay B. Gould
+1.415.983.1226
jay.gould@pillsburylaw.com

Jay Gould practices in the Corporate & Securities area and is co-leader of Pillsbury Winthrop Shaw Pittman's Investment Funds and Investment Management Practice Team.

This article first appeared in
Institutional Investor Hedge Fund Asset Flows & Trends Report 2006-2007
March 2007

The Secret Life of Hedge Funds May Be Over

by Jay B. Gould

The secret life of hedge funds may have officially come to an end in 2006 due to an interesting convergence of market and regulatory forces. These forces catapulted the furtive existence of hedge fund managers onto the front pages of the popular press, laying bare investment strategies, fee structures and the market impact of hedge funds—during a year that produced less-than-stellar returns and some very high-profile scandals and implosions.

The trend is certain to continue as pension funds seek higher returns to meet their underfunded obligations, hedge funds themselves seek more efficient and reliable distribution through alliances, business combinations and public offers, and regulators around the world search for ways to address investor protection and systemic risk issues associated with hedge funds.

Registration Mandate…

In an attempt to gain greater regulatory control over hedge funds, the Securities and Exchange Commission passed new rules that became effective in February 2006. The rules required nearly all hedge fund managers to register with the SEC as investment advisers.

The SEC accomplished this by re-defining the term "client." Previously, a hedge fund manager had counted each fund it advised as a client and was not required to register until the manager had 15 such funds under management and $30 million under management. Because most hedge fund managers advised fewer than 15 funds, very few managers were registered with the SEC.

The new rule required fund managers to "look through" each fund and count individuals for purposes of registration but permitted managers that required a two year lock-up to avoid registration, as the SEC attempted to draw an artificial distinction between hedge funds and private equity funds.

The new rule also required all hedge fund managers without a place of business in the U.S., but which accepted subscriptions from more than 14 U.S. investors on a "look through" basis, to register with the SEC in what became known as "registration lite."

Most hedge funds managers dutifully complied with the registration mandate with some notable exceptions that opted for the two year lock-up.

The Secret Life of Hedge Funds May Be Over

Curiously, although the industry criticized the registration rule when it was adopted and applauded when it was struck down, most hedge fund managers have not de-registered.

…Overruled

The registration rule was adopted in late 2004, but the SEC gave the industry more than a year to prepare for life as a registered investment adviser. During that time, the SEC was sued by maverick hedge fund manager Phil Goldstein over its then-new rule, and in a landmark ruling handed down in June of 2006, the U.S. Court of Appeals for the District of Columbia vacated the rule and all of its related amendments.

The Court's sharp rebuke of the SEC's "arbitrary and capricious" action was not appealed and the decision became final in August. The SEC staff subsequently issued a "no-action" letter to the industry to reinstate certain aspects of the vacated rule and vowed to find another way to regulate hedge funds.

Few De-Registrations

Curiously, although the industry criticized the registration rule when it was adopted and applauded when it was struck down, most hedge fund managers have not de-registered. There has been a slight increase of managers deciding to escape the formalities required of SEC registration, but the great torrent of managers requesting de-registration has not materialized.

It could be that the SEC, in providing over a year for hedge fund managers to comply with the registration requirements, permanently altered the hedge fund landscape.

An Altered Landscape

Between the time that this now-defunct rule was adopted and the time the rule was finally thrown out by the Court, the industry went through little less than an internal revolution, or at least, a very fast evolution.

In their rush to comply with SEC mandates for registered advisers, hedge fund managers hired compliance officers, implemented compliance and risk management programs, and formalized processes and procedures that may have previously been only loosely followed.

Hedge fund managers who had not concerned themselves with SEC compliance matters were suddenly required to observe arcane and often indecipherable SEC rules and pay close attention to SEC "no-action" letters and staff speeches.

Among the SEC's pronouncements in 2006 was one in which the examinations staff would review "side letters" for overall fairness, and in particular, whether such side letters provided greater transparency and preferential liquidity to certain investors.

Plus Increased Assets

At the same time, and perhaps in some way as a result of the SEC registration requirement, pension funds and other large institutional investors started to allocate more assets to alternative investments, including hedge funds.

Many of these investors brought with them a higher level of due diligence and demanded greater transparency and fuller explanations of risk management capabilities in their exhaustive questionnaires of hedge fund managers.

This increased interest in hedge funds was accelerated when Congress passed and the President signed into law the Pension Protection Act of 2006, a comprehensive set of pension reforms, one of which was to allow hedge funds to accept more U.S. pension fund money and to unlimited amounts of foreign plan and government plan money.

New SEC Proposals

True to its promise, the SEC recently proposed two new rules designed to indirectly regulate hedge funds.

As a result of the Court's decision in the Goldstein case, the SEC felt compelled to propose a new rule to "clarify" that all investment advisers, whether or not registered, owe a fiduciary duty to the investors in the funds that they manage, not just to the fund itself.

How can anyone argue that an investment adviser should not be required to observe its fiduciary duty to hedge fund investors? But the rule is problematic for hedge fund managers and, if adopted in its proposed form, will provide SEC examinations and enforcement staff with the ability to directly interfere in what has been considered to be the right of sophisticated investors and fund managers to set their own terms.

Specifically, Delaware partnership law provides that a limited partner may contract away any duty otherwise owed to it by a general partner, other than the duty of good faith and fair dealing.

Many hedge funds disclose in their limited partnership agreements that the general manager will engage in soft dollar arrangements that are outside the "safe harbor" of Section 28(e) of the Securities Exchange Act.

The SEC recently provided updated guidance that significantly narrowed the goods and services that fall within the Section 28(e) "safe harbor."

In that release, the SEC stated in fairly blunt terms that investment advisers that do not observe the "safe harbor" will be subject to enforcement. And what better way to attack hedge funds than on a "breach of fiduciary duty" theory where no scienter or intent is required to violate the rule.

There are other areas, such as potential conflicts of interest and allocation of investment opportunity where hedge fund managers may have previously thought that generalized disclosure in partnership agreements and private placement memoranda protected them, but which may now be the subject of aggressive SEC enforcement action.

Goldstein II?

The second set of rule proposals, which may one day be referred to as Goldstein II, would create a new category of investor that applies only to potential investors in hedge funds that rely on Section 3(c)(1) of the Investment Company Act for their exemption from registration.

A "natural accredited person" is defined in the proposed rules as an investor that meets the Regulation D standard for an "accredited person" but who also has $2.5 million in investments, excluding the person's primary residence.

Because a Section 3(c)(7) fund must be comprised of only "qualified purchasers"—the $5 million and above standard—the new rules would not affect hedge funds that attract institutional investors or ultra-high net worth individuals.

As a result of the Court's decision in the Goldstein case, the SEC felt compelled to propose a new rule to "clarify" that all investment advisers, whether or not registered, owe a fiduciary duty to the investors in the funds that they manage, not just to the fund itself.

The year 2007 will continue the trend towards greater institutionalization, the flow of capital across borders, more business combinations and public offerings of hedge funds, and regulators across the globe scrambling to keep up.

The SEC has proposed this new standard to protect small investors from unscrupulous hedge fund managers under the rationale that the Regulation D standard has not been revised since it was adopted in 1982 and must therefore be updated for inflation.

In addition to institutional only funds, the new definition would also not apply to small operating companies that are not publicly registered and offer securities pursuant to Regulations D or another private placement exemption.

The SEC has, therefore, made the determination that a corner T-shirt shop is inherently less risky for a small investor than a hedge fund and that it is appropriate to raise the 1982 accredited investor standard for hedge funds, but not for other small businesses.

This disparate treatment is based not in rationale or evidence, but in the political reality of what the SEC believes they can get done and the special treatment venture and small business companies have historically enjoyed at the SEC.

Nowhere in the public release for the new rules does the SEC provide evidence that hedge fund investors need more protection than investors in small operating businesses—that hedge funds engage in more fraud, or that some other public purpose is served by making this distinction. Indeed, many of the large hedge fund implosions, such as Amaranth Advisors, permitted only institutional investors.

The SEC should expect to find itself back in court defending this arbitrary and irrational rule with a result similar to that in Goldstein.

Trends To Watch

The year 2007 will continue the trend towards greater institutionalization, the flow of capital across borders, more business combinations and public offerings of hedge funds, and regulators across the globe scrambling to keep up.

The recent public offering by Fortress Investment Group LLC and the public debt offering by Citadel Investment Group has captured the imagination of hedge fund managers above a certain asset threshold.

The considerations are many for these managers who must decide if funds that access public markets will create a new stratum of hedge fund that might enjoy better access to deal flow or other preferential treatment from prime brokers and investment bankers. Managers must decide whether they want to make the commitment to create an investor relations department, subject themselves to Sarbanes-Oxley liability, and make periodic public disclosures, including disclosures concerning their own compensation.

Fund managers who decide to either access public markets or partner with a large institution may find it difficult to maintain their investment focus and discipline, and not allow performance to suffer.

Furthering the trend institutionalizing hedge funds are operational risk ratings first offered by Moody's Investors Services and followed quickly by Standard & Poor's. Such risk ratings, just like the mutual fund ratings before them, will become a requirement for hedge fund managers seeking large pension plan money. Pension funds, which have a fiduciary duty to their beneficiaries, will view risk ratings as a due diligence defense in the event markets turn against them.

Risk ratings then ultimately mean greater third party oversight of hedge funds and more information about these funds making its way into the public domain.

No Action From New Congress

The hedge funds community can expect to see very little legislative action from the new Democratic Congress.

The Hedge Fund Study Act requires that a report be delivered to Congress early this year that is expected to discuss the type of information that should be obtained from hedge funds and the practices that hedge funds should observe in order to mitigate systemic risk in the capital markets.

Congress may hold additional hearings and conduct further inquiry but, absent a major fund meltdown that produces substantial collateral damage, it is unlikely that Congress will take action during 2007.

Global Scrutiny

Across the globe, regulators in other countries are attempting to determine the appropriate level of hedge fund regulation.

Across the globe, regulators in other countries are attempting to determine the appropriate level of hedge fund regulation.

Regulators in the U.K. have reiterated their position that U.K.-based funds are required to disclose material terms of “side letters to investors and prospective investors in their funds.

Material terms would normally be those which provide greater transparency and preferential liquidity for certain investors. It is unclear at this point how and to what extent U.K.-based managers are complying with this mandate.

Hong Kong and Singapore have gone different directions with respect to hedge fund regulation. Hong Kong requires merit registration of fund managers, a process that can be frustrating and time consuming. Singapore has opted for the Cayman Islands model of more relaxed oversight, and also probably has the best tax regimen for hedge fund managers in the region.

Neither jurisdiction appears to be losing business as a result of the other’s decision, as fund activity in both jurisdictions remains strong.

Japan recently passed a new comprehensive financial services law that includes wholesale revisions to the investment advisory system. A Japanese fund manager that engages in the investment advisory business or discretionary investment management business in Japan will soon be part of the “financial instruments business” for which regulations are scheduled to be proposed for public comment later this spring and adopted by the end of 2007.

Many non-Japanese managers that maintain a presence in Japan will be interested to learn how the proposed regulations will deal with “research offices” in Japan. For the longer term in Asia, all eyes will be on Shanghai.

India continues to attract significant new interest from hedge funds and private equity funds. Indian regulators have indicated that they intend to permit true short selling, establish a stock market for smaller issuers, and eliminate the P-Note structure, all of which could facilitate investment by hedge funds.

Indian regulators continue to be concerned with foreign direct investment by Non-Resident Indians and Persons of Indian Origin and ownership restrictions of fund management companies by these individuals remains subject to limitations.

Conclusion

While regulatory or legislative actions aren't expected to expose hedge funds' books any further this year, markets forces—especially the demand from pension funds for alternative investments—are. Money managers' demands for more transparency are working to provide transparency where regulation has failed.

As a practical matter, regulating every hedge fund manager as an investment adviser did very little for transparency anyway. True transparency, to the extent it exists, is best driven by the markets and, in particular, the big pension funds and other institutional investors.

Pillsbury's Investment Funds & Investment Management Team

San Francisco

Jay B. Gould
+1.415.983.1226
jay.gould@pillsburylaw.com

Timothy P. Burns
+1.415.983.1541
timothy.burns@pillsburylaw.com

Michael G. Wu
+1.415.983.1655
michael.wu@pillsburylaw.com

John M. Dick
+1.415.983.6434
john.dick@pillsburylaw.com

Los Angeles

Dulcie D. Brand
+1.213.488.7244
dulcie.brand@pillsburylaw.com

Clifford C. Hyatt
+1.213.488.7582
clifford.hyatt@pillsburylaw.com

Yukinori Machida
+1.213.488.7314
yukinori.machida@pillsburylaw.com

New York

David G. Odrich
+1.212.858.1643
david.odrich@pillsburylaw.com

Brant K. Maller
+1.212.858.1437
brant.maller@pillsburylaw.com

Jeffrey R. Zuckerman
+1.212.858.1025
jeffrey.zuckerman@pillsburylaw.com

Washington, DC

Richard M. Rosenfeld
+1.202.663.8216
richard.rosenfeld@pillsburylaw.com

Kimberly V. Mann
+1.202.663.8281
kimberly.mann@pillsburylaw.com

Robert B. Robbins
+1.202.663.8136
robert.robbins@pillsburylaw.com

Kurt L.P. Lawson
+1.202.663.8152
kurt.lawson@pillsburylaw.com

London

Simon Fielder
+44.20.7847.9614
simon.fielder@pillsburylaw.com

Caroline Grange
+44.20.7847.9615
caroline.grange@pillsburylaw.com

Tokyo

William R. Huss
+81.3.5226.7253
william.huss@pillsburylaw.com