

Hedge Funds and Investor Protection Regulation

FRANKLIN R. EDWARDS

The author holds the Arthur F. Burns Chair in Free and Competitive Enterprise and is director of the Center for the Study of Futures Markets at the Graduate School of Business at Columbia University. This paper was presented at the Atlanta Fed's 2006 Financial Markets Conference, "Hedge Funds: Creators of Risk?" held May 15–18.

On September 29, 2003, the Securities and Exchange Commission (SEC, or the Commission) issued a report on the *Implications of the Growth of Hedge Funds* (SEC 2003). The report raised several concerns related to hedge funds and proposed a number of regulatory initiatives that the SEC might take. Its principal recommendation was that most hedge managers (advisers) be required to register with the SEC as investment advisers under the Investment Advisers Act (IAA) of 1940, as amended. On July 14, 2004, after a lengthy period of public comment on the report, the SEC adopted (by a three to two vote) Rule 203(b)(3)-2, requiring the registration of most hedge fund advisers by February 1, 2006.

The Commission's rationale for adopting Rule 203(b)(3)-2 was that SEC registration of advisers was necessary to protect "investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets" (SEC 2004b). Pursuant to its investor protection mandate, the SEC cited two concerns: the growing incidence of fraudulent activity by hedge fund advisers and the increasing "retailization" of hedge funds. Requiring hedge fund advisers to register, the Commission argued, would deter fraudulent conduct by providing the SEC with better information about the activities of hedge fund advisers, by giving the SEC the authority to conduct on-site examinations of hedge fund advisers, and by fostering a standard of conduct and an environment of compliance that would serve to better protect hedge fund investors.

The Rule 203(b)(3)-2 initiative is not the first time the SEC has expressed concern about the activities of hedge funds. More than thirty years ago, in 1969, the SEC instituted an investigation of the use of leverage and short selling by hedge funds (SEC 1969, 18). In 1972 it conducted a study of the use of hedge funds by institutional investors (SEC 1972, xv). In 1992 the Commission provided Congress with an analysis of the regulatory treatment of hedge funds under the federal securities laws. And in 1999, in the wake of the September 1998 near collapse of Long-Term Capital Management Inc. (LTCM) and the intervention of the Federal Reserve in arranging a

creditor bailout of LTCM, the Commission, along with other government agencies, participated in the President's Working Group on Financial Markets, which examined the potential impact of hedge funds on the stability of financial markets (President's Working Group on Financial Markets 1999).

The concerns about hedge funds manifested by these regulatory initiatives can be grouped under two general public policy issues: financial stability and investor protection. Specifically, are the activities of hedge funds a threat to financial stability (or do hedge funds pose a systemic risk)? And, second, are the legal or regulatory protections for hedge fund investors adequate? The focus of this paper is on the second issue: investor protection regulation. The discussion first considers the conceptual role of investor protection regulation: What are its goals and likely costs and benefits? The following sections describe alternative regulatory approaches to investor protection and the current regulatory structure under which hedge funds operate in the United States. A discussion follows of the new regulatory requirements associated with SEC registration of hedge fund advisers and the purpose of these requirements. The next sections examine the SEC's concern about the "retailization" of hedge funds and discuss the role of registered hedge funds and particularly funds of hedge funds (FoFs). The final sections examine the implications of increased investments in hedge funds by institutional investors such as pension funds and provide my key conclusions and suggestions for future regulatory initiatives.

Social Calculus of Investor Protection

In an ideal world all investors would have free access to all investment products and would have the right to decide for themselves which products to buy or which provided them with the best combinations of risk and return. Investors would make investment decisions taking into account their current and expected income, their current portfolio of assets and obligations, and their own tolerance for risk. In response, asset providers would provide an array of investment products that satisfied the needs of all investors. In this world investors would be solely responsible for their own miscalculations and for whatever bad luck they might encounter related to their investment decisions.

In the real world, of course, things are more complicated. Not all investors have the same information and are equally capable of knowing how to evaluate whatever information they do have, and not all vendors of investment products are honest and straightforward in their dealings with investors. Further, product providers typically know more about the products they offer than do consumers of that product, and providers often have an economic incentive not to communicate all of their information to consumers. And even if providers do wish to communicate all of their information fully, doing this credibly can sometimes be difficult.

These real-world complexities—information asymmetries, potential conflicts of interest, and disparate investor capabilities—are well understood by many investors, particularly more financially sophisticated ones, but are clearly not understood by all retail investors. A common solution for these market complexities is the intermediation of professional investment advisers, whom investors can retain to represent their interests and to advise them about the most appropriate investments for them. These advisers can be expected to know more about the investment products being offered than their investor-clients and should therefore be better able to protect their clients' interests. Alternatively, less knowledgeable investors can place their money with professional fund managers, who can make the appropriate investment decisions for them.

But these market intermediaries are unlikely to eliminate completely information asymmetries and disparities of investor sophistication, and they may create additional information problems. Investment advisers, while knowing more than many investors, are still unlikely to know as much as product providers. They also are likely to be more motivated to sell their own products than to protect the long-run interests of their clients (even recognizing the potential loss of “reputational capital” of not doing so). The solution of imposing legal liability on advisers and fund managers for inappropriate recommendations or investment decisions (such as suitability requirements) does not fully solve the problem because of the difficulty of drafting and enforcing effective and practicable legal standards.

Thus, in the real world governments and regulators are left to decide how to deal with these market complexities, or how to balance the perceived costs of doing nothing to protect investors against the perceived benefits of proactive intervention to protect them. Government intervention itself is costly. Direct administrative and bureaucratic costs are associated with regulation, compliance, market rigidities due to regulatory barriers or prohibitions, distortions of economic incentives as market participants “game” the regulations, and, possibly, political costs as various private interest groups vie with one another to capture regulators and shape the regulatory agenda. Also, a potentially large cost of investor protection regulation is that it may preclude a certain class of investors from participating in certain investment products, relegating all members of this class to less desirable investment products.

Hedge funds are an example. Unencumbered by regulatory restrictions on short selling, leverage, and fee arrangements and by liquidity requirements and portfolio distributions constraints, hedge funds can use trading strategies not typically available to retail investors, relegating these investors largely to investment products provided by mutual funds. As a result, hedge funds may be able to provide investors with better downside protection against precipitous falls in asset (stock) prices, such as occurred in early 2000, than are mutual funds, which typically hold long equity or bond positions and cash. Thus, blocking retail investor access to hedge funds may impose significant costs on the excluded investors by forcing them into inferior investment products, which must be balanced against the potential benefits of protecting investors against losses they might incur if they were to invest in hedge funds.¹ The difficulty of quantifying these competing considerations has resulted in different countries reaching different conclusions about how best to balance these interests. But in almost all countries the issue has been resolved in favor of regulation to protect some, if not all, retail investors, although not always in the same way. Implicitly, most countries have judged that the social costs associated with real-world market complexities (or imperfections) are greater than the costs of regulatory intervention, or, put another way, that the potential benefits of regulation are greater than the potential costs. Not everyone can be expected to agree with this social calculus, and some will argue that all government decisions are driven only by the political power of special-interest groups rather than considerations of social or economic welfare. But for purposes of this paper I accept that some investor protection regulation will

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1. For a discussion of the investment performance of hedge funds, see Edwards and Gaon (2003); for a comprehensive survey of past research on hedge fund performance, see Naik and Aggarwal (2005).

always be an integral component of retail investment markets in most countries and that the more relevant question is how best to shape investor protection regulation.

Alternative Investor Protection Regimes

Investor protection regulatory regimes in most countries can be described as either “top down” or “bottom up.” A top-down regime is characterized by the requirement that investment products or schemes be authorized together with rules about what that scheme can and cannot do. For example, the regulation of investment companies (mutual funds) in the United States is primarily a top-down structure. Mutual funds must register under the Investment Company Act (ICA) of 1940 and must adhere to detailed SEC regulations with respect to custodial requirements, liquidity and diversification portfolio requirements, restrictions on leveraging and short selling, management fee arrangements, redemption requirements, disclosure and reporting requirements, and so forth. The primary purpose of these regulations is both to better inform investors and to protect them by limiting exposure to financial loss. The regulatory regimes for listing and authorization of investment funds in the United Kingdom are predominately top-down, as is much European legislation governing investment funds.²

In contrast, a bottom-up regulatory regime is basically a disclosure-based regime. Greater reliance is placed on rules that require investment product providers to accurately describe the nature of these investment products and their potential risks. Armed with this information, investors are given much more responsibility to assess the risks and to determine whether the investments are suitable for them. Fundamental to this scheme is an acceptance on the part of both regulators and investors that some investment products will fail and that some investors will experience significant financial losses, perhaps even their entire investments. Australia’s regulatory scheme for mutual funds is an example of this approach. As a result, in Australia a very wide range of retail funds exists, including hedge funds and other exotic funds, such as raptor funds that invest in ostrich farms.

U.S. Regulation of Hedge Funds

In the United States the regulation of hedge funds might be best characterized as a patchwork of exemptions from various investor protection laws rather than a thoughtfully crafted top-down or bottom-up regulatory scheme. The United States neither requires government authorization of hedge funds nor restricts what hedge funds are able to do, nor does it mandate that hedge funds and hedge fund advisers (prior to this year) make specific disclosures to investors. But to gain these exemptions hedge funds must restrict their clients to investors who meet certain threshold wealth or income requirements. Qualifying investors are given unlimited access to hedge funds with virtually no regulatory protections, while low-wealth or low-income investors are entirely excluded from participating in any kind of hedge fund investment.

Thus, in the United States we have, perhaps unwittingly, separated hedge fund investors into two distinct classes: retail (investors who do not meet the threshold wealth requirements for exemption) and wholesale (investors who do meet the threshold wealth requirements). Exactly where the legal threshold levels of wealth and income are set determines which investors are retail and which are wholesale. These legal thresholds, it should be noted, are not specific to hedge funds and were established years ago, when hedge funds were not part of the financial landscape. Rather, their purpose was to determine the disclosure obligations applicable to issuers in public versus private securities and the scope of mutual fund regulation.

To be more precise, hedge funds are investment pools and are potentially subject to a variety of legal restrictions and regulations unless they are organized in a way that exempts them from these regulations, specifically from the 1933 and 1934 Securities Acts, the ICA, and the IAA. Hedge funds are exempt from the Securities Act of 1933 if they obtain their investors through private placements rather than a public offering. This exemption hinges on meeting the requirements of section 4(2) or Regulation D of the 1933 act; it usually means restricting the fund's investors to "accredited" investors. If hedge funds fail to meet this test, they would have to file a registration statement under the 1933 act, which would require that extensive information be disclosed and would create liability for material misstatements or omissions.³

Accredited investors are individuals who have incomes of at least \$200,000 in each of the two most recent years, who have a joint income with a spouse in excess of \$300,000 in each of those years (and who have a reasonable expectation of reaching the same income level in the current year), or who have a net worth, or joint net worth with a spouse, that exceeds \$1 million at the time of purchase. Institutional investors with assets in excess of \$5 million, banks, savings and loan associations, broker/dealers, insurance companies, investment companies, and small business investment companies licensed by the U.S. Small Business Administration are also accredited investors. The rationale for limiting investor access to private placements to accredited investors is that such investors can be assumed to be both informed and sophisticated enough not to need the protections afforded to other investors under the federal securities laws.

Hedge funds typically exempt out of the 1934 Securities Act by limiting their investors to fewer than 500. If a fund has more than \$10 million and 500 investors, its securities would have to be registered with the SEC under the 1934 act, and it would become a "reporting" company. This classification would mean providing investors with extensive disclosure: annual reports (Form 10-K), quarterly reports (Form 10-Q), and so on.

Most hedge funds also exempt out of the ICA, which regulates mutual funds, by relying on the exceptions in either section 3(c)(1) or 3(c)(7) of the act. Under 3(c)(1), the act does not apply to an investment pool (or hedge fund) that does not obtain its investors through a public offering (and is therefore exempt from the 1933 Securities Act) and has fewer than 100 persons or legal entities (investors). Under section 3(c)(7), a hedge fund is exempt from the act if it has only investors who meet the criterion of qualified purchasers—individuals or companies who have at least \$5 million in investments. The qualified-purchaser threshold is considerably higher than the accredited-investor threshold.⁴

If a hedge fund were not to exempt out of the ICA, it would have to file as a "registered investment company" under the act and would become subject to numerous top-down regulations governing its portfolio holdings, leverage, short selling, marketing, governance, and conflict-of-interest and disclosure rules. Because of the nature of most hedge funds' investment strategies, such registration would most likely take the form of a closed-end fund, relieving the fund of the same reporting and redemption requirements imposed on open-end mutual funds.

2. For an overview, see the Financial Services and Markets Act 2000 and a council directive of the European Commission (1985), as amended.

3. While Rule 506 of the 1933 act does allow them to have as many as thirty-five "nonaccredited" investors, most hedge funds find it is not worthwhile to involve themselves with such investors.

4. See the ICA, sec. 2(1)(51), and SEC Rule 2a 51-1.

As exempt investment pools, hedge funds can trade any type of security or financial instrument, operate in any market anywhere in the world, make unlimited use of derivatives instruments, engage in unrestricted short selling, employ unlimited amounts of leverage, hold concentrated positions in any security without restriction, set their own redemption policies without restriction, and use whatever fee structure seems most productive to compensate their managers or advisers. Nor are exempt pools required to make extensive disclosures to investors or regulators. Thus, limits or restrictions on hedge funds' activities are determined not by regulation but primarily by the contractual relationships they have with their investors and by market discipline

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exerted by the creditors, counterparties, and investors with whom they transact.

In February 2006 the SEC adopted Rule 203(b)(3)-2, which introduced a top-down approach to regulating the activities of hedge funds by requiring SEC registration of most hedge fund advisers. The rule's

intent is to provide greater protection for hedge fund investors through enhanced disclosure and increased regulatory oversight of the activities of hedge fund advisers.⁵

Until this year advisers to hedge funds did not have to register under the IAA because they typically met the private-adviser exemption. Specifically, if they had fewer than fifteen clients in the past twelve months and did not hold themselves out to the public as an investment adviser or act as an investment adviser to a registered investment company or business development company, they were not required to register (Rule 203(b)(3)). Under previous SEC rules each separate company (hedge fund, investment partnership, managed account, etc.) that the adviser managed was considered a single client for purposes of registration if the adviser based its advice to the company on the company's investment objectives as opposed to the investment objectives of the company's individual owners.

Rule 203(b)(3)-2 changes this definition of "client" and by doing so effectively requires all hedge fund advisers to register with the SEC (except those with no more than \$25 million under management or whose funds require a "lockup" longer than two years.)⁶ This rule change was accomplished by introducing a "look-through" provision that requires each owner (investor) of a private fund to be counted as a client. Under the new rule, an adviser to a single hedge fund with fifteen or more clients (investors) must register under the IAA. Further, Rule 203(b)(3)-2(k) requires advisers to hedge funds in which registered investment companies (mutual funds) invest to count all investors in those mutual funds as clients and to look through the top fund in a fund-of-fund structure and count as clients all investors in the portfolio hedge funds.

To limit the reach of Rule 203(b)(3)-2 to advisers of hedge funds, however, the Commission defines a hedge fund for purposes of registration to be a company or fund that (1) would be subject to regulation under the ICA but for the exceptions provided by either section 3(c)(1) or section 3(c)(7) of the act; (2) permits its investors to redeem their interests in the fund within two years of purchasing them (that is, have less than a two-year lockup); and (3) is offered with investment strategies that are based on the skills, ability, or expertise of the investment adviser. This definition is intended to exclude advisers to many other business organizations, such as insurance companies, broker-dealers, and banks, as well as advisers to private equity funds and venture capital funds that typically require lockup periods longer than two years. While the SEC acknowledges that private funds such as private equity and venture

capital funds are very similar to hedge funds, it defends its definition on the grounds that it has not encountered significant enforcement problems with advisers to such funds, in contrast to its experience with hedge fund advisers.

The import of requiring hedge fund advisers to register under the IAA is that they become subject to much the same rules that apply to advisers to mutual funds (registered investment companies). Specifically, hedge fund advisers are subject to examination by the SEC, conflict-of-interest and antifraud rules, additional disclosure requirements, and limitations on the use of performance fees (Section 205[a][1]). However, if all of the advisers' clients are qualified clients (have a net worth of more than \$1.5 million or \$750,000 invested with the adviser), registered advisers can employ an asymmetric fee structure.⁷ Because almost all hedge fund advisers will want to use asymmetrical performance-based fee structures, an indirect effect of Rule 203(b)(3)-2 is to raise the minimum net worth requirement for 3(c)(1) hedge funds to that of the qualified client standard from the prior accredited investor standard (net worth of \$1 million or annual income of more than \$200,000).⁸

What Will Registration of Hedge Fund Advisers Accomplish?

While a comprehensive description of the many regulatory requirements that accompany adviser registration is beyond the scope of this paper, a description of a few key requirements may provide a flavor of the nature of these regulations. Registered hedge fund advisers must complete the Uniform Application for Investment Adviser Registration (or Form ADV) under Rule 204-3. Part I of the ADV requires information about the adviser's business location, ownership structure, basic operations, and past disciplinary events. Part II requires information about the adviser's fees, investment style, potential conflicts of interest, brokerage practices, affiliations with other securities professionals, education and business background, and other information relevant to a client's decision to hire the adviser. Part I is made available on the Internet. Part II must be provided to clients and is, in effect, a mandated disclosure document. Unless

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5. In the absence of SEC registration, hedge fund advisers are still subject to antifraud provisions of both federal securities laws and state antifraud rules, such as New York's Martin Act, as well as to insider trading laws. Eliot Spitzer used the Martin Act to successfully prosecute widespread mutual fund fraud during the last few years, long before the SEC acted against these abuses.
 6. This lockup exemption is intended to exempt advisers to private equity funds and venture capital funds from registration.
 7. In the absence of this exception, performance-based fee structures for mutual fund advisers must be fulcrum fees that move in both directions equally, as opposed to the asymmetric fees that are common in hedge funds (for example, 20 percent of net returns above some "hurdle rate").
 8. Many hedge funds also are regulated by the Commodities Future Trading Commission as "commodity pool operators" (CPOs) because they invest in or trade one or more futures or options contracts on a regulated commodity exchange. The Commodity Exchange Act (CEA) subjects CPOs and their advisers (CTAs) to regulation but not the commodity pools themselves. Once registered, CPOs and CTAs must comply with the rules of the National Futures Association (NFA), avoid conflicts of interest and protect customer funds, provide written disclosure to prospective investors of the risks of investing in commodity interests, adhere to restrictions on advertising, satisfy record-keeping and reporting requirements, and be subject to periodic inspections of their activities by the NFA. In addition, advisers to hedge funds are subject to common law remedies for fraud, as well as claims for fraudulent manipulation under section 10(b) and Rule 10b-5 of the Securities Act of 1934. Typically, prior to investing in a hedge fund in a private placement, investors are given for review and agreement an offering memorandum and partnership agreement. These documents provide investors with information about the potential risks associated with the fund and serve as a notice of caveat emptor. They also form the basis for possible contractual law and fraud remedies available to investors.

the adviser utilizes a qualified custodian, it must send quarterly account statements to clients, deliver an audited balance sheet with Form ADV Part II, and undergo an annual surprise audit by an independent certified public accountant (CPA).

Additional disclosure is required for registered advisers if they experience an impaired financial situation (if advisers' financial condition is "reasonably likely to impair the ability of the adviser to meet contractual commitments to clients" or if any legal or disciplinary events occur that are material to an evaluation of the advisers' integrity or ability to meet contractual commitments to clients (Rule 206[4]-4). Further, Section 207 of the IAA makes it unlawful for a registered investment adviser to willfully make an untrue statement of a material fact, or to willfully omit to state such a material fact, in any registration application or report filed with the SEC.

Registration carries significant record-keeping requirements for advisers. For example, advisers must keep copies of all disclosure documents given to clients or prospective clients and the dates that each disclosure was given or offered; retain performance data and supporting calculations and work papers related to the performance data used; retain client transaction records (securities purchased, sold, the date, amount, price) and client securities position listings; retain client suitability documentation, such as basic information on the client; and maintain performance records for the five-year period from the date last used. Additional record-keeping requirements apply to insider trading policies and reportable securities transactions by so-called access persons.

Finally, if hedge fund advisers meet the test of "having custody of client assets," as many will do, they will have to maintain client funds and securities with a qualified custodian, such as a bank or registered broker-dealer. The qualified custodian is required to deliver account statements (on at least a quarterly basis) directly to the client to ensure the integrity of the statement and enable the client to identify any erroneous or unauthorized transactions or withdrawals by the adviser. If an adviser does retain a qualified custodian, it does not have to send quarterly statements to clients or undergo an annual surprise examination by an independent CPA to verify the funds and securities of the clients.⁹

The obvious thrust of Rule 203(3)-2 is to provide greater protection for hedge fund investors against fraudulent activities by hedge fund advisers. Little in the new disclosure requirements will assist hedge fund investors in evaluating the nature of the hedge fund investments or the risks associated with those investment strategies. Thus, Rule 203(3)-2 will not assist investors in evaluating the likely performance of a particular hedge fund investment strategy or in comparing that investment with alternative investment products.

Critics of Rule 203(3)-2 argue that registration of hedge fund advisers is unlikely to provide effective protection against fraud. But even assuming that there will be some reduction in fraud losses to hedge fund clients, critics contend that the costs (direct and indirect) associated with registration are likely to be considerably greater than the benefits of greater protection for hedge fund investors, who are considerably wealthier and more financially literate than the average mutual fund investor. The costs associated with increased regulation include added SEC costs and compliance costs to hedge funds that will be passed on to investors, reducing their returns. Critics also find little reason to believe that there are significant negative externalities (or social costs) associated with private investment losses incurred by wholesale hedge fund investors.¹⁰ Such losses are unlikely to undermine confidence in financial markets generally or result in contagion effects that undermine other financial institutions. Finally, Rule 203(3)-2 will shut out more investors from hedge fund invest-

ments by effectively raising the minimum wealth threshold for hedge fund investors to that of the qualified-client standard, arguably relegating them to inferior investment vehicles.

The Retailization of Hedge Funds

In supporting Rule 203(3)-2 the SEC expressed concern about the growth of what it termed the retailization of hedge funds—the increasing ability of less qualified (or retail) investors to access hedge fund investments. It pointed to three ways that this increased access was happening (SEC 2004a).

First, the wealth thresholds that restrict investor access to hedge funds, such as the accredited investor standard applicable to 3(c)(1) hedge funds, have been eroded over time by a general rise in income and wealth levels. For example, a recent report indicated that the number of American households with a net worth of \$1 million or more, excluding their principal residence, grew from 5.2 million in 2002 to 8.9 million in 2005 (Johnston 2006). If principal residence were not excluded this number would be two or three times greater. Thus, a far larger segment of the investing public is probably now able to meet the \$1 million accredited-investor standard necessary to access hedge funds than when this standard was established. The issue, however, is whether someone with \$1 million today is less financially sophisticated than in the past, which is not obvious. But it is possible that more unsophisticated investors are able to participate in hedge fund investments than in prior years and that this participation may have contributed to the growing fraud problem that the SEC has observed. (The underlying assumption, of course, is that a reasonably close positive correlation exists between an individual's financial wealth and his or her financial sophistication.)¹¹

Whatever the truth about this relationship, the adoption of Rule 203(3)-(2) indirectly redresses this concern by in effect raising the minimum wealth threshold for 3(c)(1) hedge fund investors to that of the qualified-client standard. Specifically, because most hedge fund managers will want to use an asymmetric performance-based fee structure, the minimum wealth standard for individual investors for 3(c)(1) funds will now be a net worth of at least \$1.5 million rather than the \$200,000 annual income or \$1 million net worth thresholds under the accredited-investor standard.¹²

Second, there has been a proliferation of funds of hedge funds (FoFs), which has arguably made hedge fund investments more available to more retail investors because FoFs typically have lower investment minimums for individuals. FoFs are hedge funds that invest only in other hedge funds—the portfolio funds—or hold participations (or are limited partners) in the portfolio hedge funds. The appeal of FoFs to investors is diversification and professional management. FoFs provide diversification benefits by investing in many different hedge funds, thereby diversifying across

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9. Registered hedge fund advisers, unlike mutual fund advisers, do not have to file quarterly reports with the SEC listing all the securities they own, file semiannual reports to shareholders about their operations, disclose how they vote their proxies, have a capital structure that allows only one class of stock to be issued, or have a board with an independent chairman and a majority of independent directors.
 10. SEC registration may result in a higher incidence of fraud if hedge fund investors become more reckless in their choice of advisers because they believe SEC oversight now protects them against such fraud.
 11. Recent episodes of fraud suggest that this premise may not be sound. See “NFL players sue a hedge fund for fraud, theft” (2006).
 12. 3(c)(7) hedge funds are not affected because the applicable net worth threshold is already above the qualified-client threshold.

risks associated with different hedge fund investment strategies as well as protecting against the possible fraudulent behavior of hedge fund advisers. In addition, FoF managers arguably have greater expertise in identifying superior fund managers and in monitoring their performance than do individual investors, and they may be better positioned to detect and/or prevent fraudulent behavior on the part of advisers. As a result, one would expect FoFs to outperform (at least before fees) a passively managed index of diversified hedge fund strategies randomly selected.

These potential benefits do not come free. Investors in FoFs pay another layer of fees to advisers of FoFs similar to what is typically paid to the advisers of the portfolio funds. Specifically, FoF investors usually pay FoF managers an annual flat fee of 1 to 2 percent of assets and an incentive fee of, say, 20 percent of net returns above a threshold level. These fees are in addition to the fees (which are similarly structured) that the FoF pays to the advisers of each of its portfolio funds. The resulting total fees are substantial and typically require FoFs to earn before-fee net annual returns in excess of 40 percent before FoF investors can realize positive net returns. Despite these fees, FoFs have grown rapidly in recent years.

Third, institutional investors have increased their participation in hedge funds. While endowments and universities have long been active participants in hedge funds, more recently pension funds have been increasing their investments in hedge funds. This trend can be viewed as the indirect retailization of hedge funds because more pension fund beneficiaries (or retail investors) are indirectly exposed to the risks associated with hedge fund investments, possibly without any knowledge or understanding of these risks. Underlying this concern is the implication that the interests of pension fund managers and advisers may not always be aligned with the interests of their beneficiaries, which may result in fund managers undertaking investments that are inappropriate for fund beneficiaries (the principal-agent problem). Further, there is a veiled presumption that the governance structure of pension funds and other institutional investors cannot be relied on to represent the interests of fund beneficiaries.

Funds of Funds and Registered Hedge Funds

There are two types of FoFs: unregistered and registered. Unregistered FoFs are similar to other hedge funds. They are subject to the exemptions from regulation discussed earlier and to the wealth thresholds that apply to investors in hedge funds generally—the 3(c)(7) qualified-purchaser standard and the qualified-client standard in effect since the adoption of Rule 203(b)(3)-2. Thus, unregistered FoFs generally do not have retail investors and as such have not contributed to concern about the retailization of hedge funds.

Registered FoFs may have retail investors.¹³ These funds are registered under the ICA, mostly as closed-end (mutual) funds but sometimes as open-end mutual funds, and typically pursue an absolute-return investment strategy (such as long/short equity or market neutral) similar to what unregistered FoFs might utilize. Open-end mutual funds must honor all redemption requests immediately (or at least within seven days). Closed-end funds, in contrast, do not issue redeemable securities and may or may not have publicly traded shares; they may provide their shareholders with liquidity by agreeing to purchase periodically their own shares at net asset value (so-called interval funds). At year-end 2002 there were forty-two registered hedge funds, only thirteen of which had registered their securities under the 1933 Securities Act.

An example is Oppenheimer Tremont's Market Neutral Fund, which is a registered FoF. The fund pursues a typical FoF investment strategy, offers its securities

publicly, and requires a minimum investment of only \$25,000. Further, though the provision is not necessary under the ICA, Oppenheimer Tremont requires its investors to have a net worth of at least \$1.5 million so that its advisers can utilize the standard hedge fund (asymmetric) incentive fee structure (Rule 205-3).

Registered hedge funds are not a significant threat to the current regulatory scheme for protecting retail investors. Neither closed-end nor open-end registered mutual funds are an attractive vehicle through which to pursue most hedge fund investment strategies. First, current regulations require mutual funds to hold substantial amounts of liquid assets against possible redemption requests, even in the case of closed-end interval funds. Because many hedge fund strategies entail holding substantial amounts of illiquid assets, such a liquidity requirement makes it impossible to profitably pursue these illiquid strategies.

Second, most hedge fund strategies rely heavily on the use of leverage, which is subject to cumbersome restrictions when operating as a mutual fund. While the use of leverage by closed-end funds is less restricted than for open-end funds, both types of funds are limited in the amount of leverage they may use. Hedge funds are unrestricted in their use of leverage.

Third, most hedge fund strategies employ short selling, which is effectively limited by mutual fund regulation. Although short selling is not prohibited per se under mutual fund regulation, the requirement that mutual funds segregate cash and other liquid securities to cover short positions effectively makes these assets nonproductive and discourages short selling. Hedge funds have no deterrents to short selling.

Fourth, mutual fund regulation restricts the use of the standard performance-fee structure used by hedge funds to align the interests of fund advisers and investors. In particular, hedge funds typically compensate advisers based on the performance of the fund's portfolio (typically 20 percent of returns above a designated hurdle rate or absolute return such as the Treasury bill rate) in order to provide an incentive for them to produce positive returns in all kinds of market environments (even declining stock markets). In addition, hedge funds usually require advisers to invest their own assets alongside their investors' to ensure that they do not engage in excessively high-risk strategies.

Thus, registration under the ICA is unlikely to attract a great number of hedge funds because of regulatory restrictions that make it difficult for them to pursue most hedge fund investment strategies. More generally, Congress and the SEC need to reexamine these regulatory restrictions to determine whether they are still necessary. Relaxing these restrictions would have two potential benefits: Hedge funds would have a greater incentive to register under the ICA, and traditional mutual funds would be able to provide absolute-return investment strategies in competition with hedge funds. This change could provide retail investors with access to hedge fund strategies under an acceptable regulatory structure.

The current regulatory structure is, in any case, probably unworkable. While registered FoFs and other hedge funds are subject to the ICA and IAA and to corresponding SEC regulations, like mutual funds, it is not clear how current mutual regulations can be effectively applied to registered hedge funds. A few examples may

An analysis of the likely costs and benefits of increased regulatory protection for hedge fund investors suggests that the costs are likely to be greater than the benefits.

13. Investors in registered funds are not subject to the net-worth or income thresholds applicable to investors in unregistered hedge funds.

illustrate this point. First, although mutual funds are subject to substantial disclosure requirements intended to make their investments and risk exposures transparent to investors, the same disclosure requirements applied to hedge funds may not provide much transparency about investment risks and returns. Registered FoFs will typically not be able to disclose much about the investment strategies pursued by their portfolio hedge funds other than what these funds do generally and the magnitude of the FoFs' own investments in each of the portfolio funds. Very little about the nature of the risks associated with the underlying investment strategies of these funds is likely to be revealed for proprietary reasons.

Second, the valuations of the FoFs' portfolio assets and liabilities (or investments) also are likely to be more challenging than for most mutual funds' assets, which are usually traded in liquid public markets. Hedge fund portfolios typically include illiquid assets and complex derivatives trades that make asset valuation considerably more difficult and inexact. The valuation process may also contain an inherent conflict of interest because it is often done by hedge fund advisers themselves.

Third, while current mutual fund regulation effectively limits the use of leverage and short selling by mutual funds, it is not clear how these restrictions would be effective in limiting the use of leverage and short selling by the portfolio funds of registered FoFs. Unregistered portfolio hedge funds held by registered FoFs would presumably not be subject to these restrictions.

Fourth, the standard reporting requirements directed at mutual fund performance may be inappropriate for registered FoFs as well as for other hedge funds and may even mislead investors about the true nature of the returns and risks associated with investments in these funds. For example, conventional performance measures such as Sharpe ratios can be highly misleading when applied to hedge fund strategies because of their use of conventional measures of return volatility (such as variance) as a measure of risk. Such measures do not adequately capture the so-called fat-tail risks implicit in many hedge fund strategies. Moreover, at present no consensus exists about how to measure and report hedge fund performance so that investors will be provided with a clear idea of the likely risks and returns associated with different hedge fund investment strategies (Financial Economists Roundtable 2005).

Thus, there needs to be an open discussion among regulators, industry representatives, academics, and other policymakers about whether all current mutual fund regulations are necessary and whether the same regulations can be effectively applied both to mutual funds and to registered hedge funds. Potential benefits exist in allowing retail investors greater access to hedge funds through registered FoFs. Hedge fund investment strategies provide greater diversification opportunities and may result in higher risk-adjusted returns for investors.¹⁴ For example, during the 2000–02 period, when stock markets were in decline, hedge funds in general performed significantly better than did stock and bond mutual funds.¹⁵ Had retail investors been able to include in their portfolios some hedge fund investments, they may have been able to avoid or mitigate the substantial losses that most mutual funds investors incurred during this period.¹⁶

The Financial Services Authority (FSA) in the United Kingdom has already begun this process. It announced recently that it is considering allowing FoFs to be marketed to retail investors under the same rules that govern mutual funds. Clive Briault, FSA managing director for retail markets, said, "Given the reality of the contemporary retail market, it seems sensible to permit the marketing of funds of hedge funds through authorized, onshore vehicles. These onshore funds of funds would benefit from the protections already in place for authorized funds" ("Hedge funds for the masses" 2006).

Institutional Investors

Another concern has been the growth of investments in hedge funds by institutional investors, particularly by both private and public pension funds. This concern centers on whether pension fund beneficiaries understand the potential risks associated with hedge fund investments, and it indirectly raises the principal-agent problems that may occur when retail investors delegate decision-making authority to professional fund advisers or managers. In particular, pension fund managers may have conflicts of interest that are not well understood by the fund's beneficiaries and that result in the misalignment of their interests with those of the fund's beneficiaries. For example, fund managers may be willing to take more risk than fund beneficiaries would wish in the hope of increasing the fund's returns in order to increase their own compensation.

This conflict is not new and is well understood by many investors. Standard solutions have been to try to structure fund-management fees in a way that aligns the interests of fund managers and beneficiaries or to establish effective institutional oversight and governance mechanisms to monitor fund managers. In practice, however, these solutions seldom completely eliminate all conflicts or align the interests of fund managers and beneficiaries.

Hedge funds are not the source of this conflict, only its latest manifestation. Hedge funds are attractive to professional fund managers because they hold the promise of higher risk-adjusted returns, which is especially enticing currently because traditional asset classes like stocks and bonds are not yielding high returns. As a consequence, some observers have suggested placing restrictions on the ability of pension funds to invest in hedge funds, such as limiting the hedge fund investments of pension funds to no more than 5 percent of the fund's assets. Blanket restrictions on hedge investments by institutional investors, however, would be counterproductive. Any specific limits would obviously be arbitrary and would suffer from the one-size-fits-all shortcoming. The problem is not hedge funds but the principal-agent conflicts implicit in delegating fund management responsibilities to professional fund managers. The preferable way to address this problem, therefore, is to focus on solutions to that problem, in particular how to enhance the governance of institutional investors so that there is more effective oversight of fund managers by fund beneficiaries.

Conclusions and New Regulatory Directions

While a number of concerns have been voiced about the growth of investor interest in hedge funds, this paper concludes that there is not a strong case for increased regulatory protection for hedge fund investors. An analysis of the likely costs and benefits of such regulation suggests that the costs are likely to be greater than the benefits. Indeed, I believe that, on a cost-benefit basis, it is difficult to make a case even for the recently adopted Rule 203(b)(3)-2. Nonetheless, the most important conclusion of this paper is

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14. See Edwards and Gaon (2003, 8–21, table 4), who show that the correlations between stock returns and the returns on some hedge fund strategies are often low, and Edwards and Caglayan (2001, 97–108).
 15. See Edwards and Gaon (2003, 13, table 3). If the performance of hedge funds pursuing a particular investment strategy is measured by the average risk-adjusted returns earned by these funds (that is, their Sharpe ratios), most hedge funds would have outperformed an investment in either the Standard & Poors 500 stock index or the JP Morgan U.S. Bond Index during the 1990–2002 period.
 16. Such restrictions also may distort the flow of investor capital, resulting in market inefficiencies and reduced liquidity in some markets. Indeed, one explanation for the success of hedge funds is that they have been able to exploit market inefficiencies in markets that are not mainstream markets. Restricting the flow of capital into hedge funds therefore may perpetuate these inefficiencies.

that hedge fund investment strategies should be made more, not less, accessible to a broader spectrum of investors than at present. In particular, the SEC should consider authorizing funds of hedge funds under a regulatory structure that better enables hedge funds to pursue absolute-return strategies so that retail investors can benefit from them. Part of this process would be to reexamine current mutual fund regulations. The goal of this process should be to establish a regulatory approach that enables both mutual funds and hedge funds to provide absolute-return investment strategies to a broader segment of investors under a regulatory structure that adequately protects investors.

A related proposal was made in a 2003 SEC staff report, which the Commission refers to in support of its adoption of Rule 203(b)(3)-2. In that report the SEC staff says, “We recommend that the Commission consider issuing a Concept Release exploring the wider use of hedge fund-type/absolute return strategies. . . . These investments typically have lower correlations to the broader debt and equity markets and thus may provide benefits to investors under a wider variety of market conditions. The staff believes that these investments may have benefits that could assist other investors, including retail investors, in diversifying their overall portfolios. The staff is not recommending that hedge funds be made more readily available and does not believe that direct investment into hedge funds by retail investors is appropriate. Instead we believe it may be the case that retail investors interested in absolute return strategies should be able to pursue those investments through the registered investment company structure” (SEC 2003, 103–04).

To my knowledge, the Commission has not followed up on that recommendation. In my view, the SEC should begin the process of evaluating the need for many of the regulations now imposed on mutual funds by the ICA (such as those pertaining to leverage, short selling, and liquidity) and should consider developing disclosure requirements more responsive to the absolute-return strategies now used by many investment funds.

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