IV. Hedge Fund Adviser Regulation

A. Introduction

The Private Fund Investment Advisers Registration Act of 2010 ("PFIARA" or "Act") was signed into law, as contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, on July 21, 2010 by President Barack Obama.[1] The Act aims to protect consumers and financial markets from future meltdowns by requiring certain funds to register and disclose information to the Securities and Exchange Commission ("SEC") and other regulatory agencies.[2] Hedge funds and private equity funds have traditionally been exempt from laws that regulate investment companies' operations and management.[3] Hedge funds, primarily dealing in investing or trading securities, would ordinarily be required to register under section 3(a)(1)(A) of the Investment Companies Act of 1940 ("ICA"), except that many qualify for certain exemptions.[4] Most hedge funds avoid registration by making the fund available only to qualified investors.[5] Similarly, hedge fund advisers avoid registration with the SEC under the Investment Advisers Act of 1940 ("IAA") by limiting the number of clients to less than fifteen over the preceding twelve months and neither holding themselves out generally to the public, nor acting as investment advisers to any investment company registered under the ICA.[6]

Registration with the SEC subjects advisers to examinations of their activities, books and records, including review of the firm's internal compliance policies and procedures.[7] The SEC designates the types of books and records to be maintained, and the duration and

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[1] Press Release, Office of the Press Secretary, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010).
[2] S. Rep No. 111-176, at 53 (2010).
[3] Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 Am. J. Comp. L. 295 (2010).
[4] *Id.* at 300.
[5] *Id.*
[6] Client Alerts, *Regulation of Private Fund Managers Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, COOLEY LLP, Aug. 20, 2010.
[7] Nathan J. Greene & John M. Adams, *Private Fund Manager Regulation: US and European Initiatives Compared*, 3 J. Sec. L., Regulation and Compliance, no. 3, at 243 (July 2, 2010).

manner for which they must be maintained.[8] In addition, registered advisers with custody of their clients' assets must also maintain those assets with a qualified custodian, such as a bank or registered broker-dealer.[9] Furthermore, the ICA prohibits investment companies from selling short or utilizing substantial leverage, two activities characteristically taken by hedge funds.[10]

Previously, the SEC targeted hedge funds for increased regulation to protect consumers from fraud and systemic risk.[11] In 2004, the SEC adopted rule amendments under the ICA to require advisers to "look through" a pooled investment vehicle.[12] The rule closed a loophole allowing hedge fund advisers to avoid registration in situations where the assets of hedge fund investors are managed similarly to the manner in which a registered adviser manages the assets of clients who directly open accounts with the adviser.[13] While recognizing the SEC's desire to increase regulation of hedge funds as understandable,[14] the D.C. Circuit Court in *Goldstein v. SEC* found the SEC's rule to be "arbitrary"[15] and that interpreting "client" to include investors was "close to violating the plain language of the statute."[16] Following the court's decision, former SEC Chairman Christopher Cox argued that the "lack of public disclosure about the way hedge funds operate, the lack of standards . . . , the possibility for undisclosed conflicts of interest, the unusually high fees and indeed the higher risk that accompanies a hedge fund's expected higher returns, . . . [make hedge funds] risky ventures."[17] However,

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[8] *Id.* at 244.
[9] *Id.*
[10] Ordower, *supra* note 3, at 297.
[11] Goldstein v. Securities and Exchange Commission, 451 F.3d 873, 877 (D.C. Cir. 2005).
[12] Rachel McTague, *D.C. Cir. Strikes Down SEC Regulation Requiring Hedge Fund Advisers to Register*, 38 Sec. Reg. & L. Rep. (BNA) 1105, 1105 (June 26, 2006).
[13] Jeffrey M. Sneeringer, *Note: The Lesson of Goldstein v. SEC: If At First You Do Not Succeed, Regulate Again?*, 36 Cap. U.L. Rev. 1173, 1174 (2008).
[14] Goldstein, 451 F.3d at 882.
[15] *Id.* at 884.
[16] *Id.* at 881.
[17] *Testimony Concerning the Regulation of Hedge Funds Before the S. Comm. on Banking, Hous. and Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Chairman of SEC) *available at* http://www.sec.gov/news/testimony/2006/ts072506cc.htm.

hedge funds contribute substantially to capital formation, market efficiency, price discovery and liquidity, help counterparties hedge their own risks by participating in derivatives markets and provide a way for institutional investors to reduce their exposure to downside risk.[18]

B. Systemic Risk and the Financial Crisis

One significant task the Dodd-Frank Act seeks to undertake is to define and monitor systemic risk. Systemic risk is generally defined as the risk of a "broad-based breakdown in the financial system, often realized by a series of correlated defaults among financial institutions, typically banks."[19] Like banks, hedge funds and private funds expose the financial system to systemic risks.[20] Since the collapse of Long-Term Capital Management ("LTCM") in 1998, it has been apparent that hedge funds have the potential to impose significant systemic risk on the financial system, and have continually been the target for increased regulation and supervision.[21] The federal government was forced to step in and rescue the fund or risk collapse of major financial institutions and commercial banks due to their overexposure in LTCM.[22] The use of substantial borrowing and financial leverage by hedge funds creates economic risk to lenders and counterparties.[23] A default by a particularly large hedge fund or several funds might jeopardize the stability of the lending financial institutions.[24] A highly-leveraged fund's default may cause its lenders or derivative counterparties to default on their own obligations[25] and those defaults may lead to further defaults of other counterparties and lenders.[26] A default in a large credit

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[18] *Id.*

[19] *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Hearing on Hedge Funds Before the H. Comm. on Oversight and Government Reform,* 111th Cong. 3 (2010) [hereinafter *Hearings*] (written testimony of Andrew W. Lo, Massachusetts Institute of Technology).

[20] *Id.* at 4.

[21] Scott V. Wagner, *Comment, Hedge Funds: The Final Frontier of Securities Regulation and A Last Hope for Economic Revival*, 6 J.L., Econ. & Pol'y 1, at 17 (Fall 2009).

[22] *Id.*

[23] Ordower, *supra* note 3, at 315.

[24] *Id*.

[25] *Id.* at 316.

[26] *Id*.

institution has the potential to a cause a domino effect reaching minute corners of the economy.[27] Hedge funds have increasingly taken on the role traditionally filled by banks, taking a significant position in the shadow banking system.[28] However, unlike banks, hedge funds are outside the jurisdiction of the Federal Reserve, the Office of the Comptroller of the Currency, the SEC, the CFTC and the Treasury.[29] Without registration and oversight, it is impossible to determine conclusively how hedge funds contribute to systemic risk.[30] While hedge funds were not the cause of the financial crisis, they are rightfully subject to increased regulatory requirements to monitor systemic risk given their increased role in financial markets.[31]

C. Private Fund Investment Advisers Registration Act

The PFIARA heightens the registration and reporting requirements of hedge funds and private funds to the SEC under the IAA by narrowing the exemptions used by hedge funds to avoid registration.[32] The Act eliminates one of the most commonly used exemptions to the Investment Advisers Act.[33] The section exempted advisers with fewer than 15 clients who did not "hold themselves out to the public as investment advisers," and did not provide advice to investment companies registered under the ICA.[34] The PFIARA also revises the exemption for commodity trading advisers registered with the Commodity Futures Trading Commission ("CFTC").[35] Those registered with the CFTC may also be required to register with the SEC if their business becomes "predominantly" securities-related

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[27] *Id.*
[28] Preliminary Staff Report, *Shadow Banking and the Financial Crisis*, Fin. Crisis Inquiry Comm'n 4 (May 4, 2010).
[29] *Hearings, supra* note 19, at 8.
[30] *Id*.
[31] Stephen Taub, *AIMA's Todde Groome Advocates Practical Regulation*, AR (Absolute Return & Alpha) (February 1, 2010).
[32] *See generally* Clients & Friends Memo, *Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act,* CADWALADER, WICKERSHAM & TAFT, July 20, 2010.
[33] *Dodd-Frank: What It Means To You*, Futures Magazine (October 2010).
[34] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 203, § 403, 124 Stat. 1376 (2010).
[35] *Id.*

advice.[36] Those not registered with the CFTC and not "predominantly" engaged in securities-related advice are considered well-monitored for purposes of systemic risk and consumer protection.[37] The Act also provides exemptions for foreign private advisers, venture capital advisers, small- and mid-sized private fund advisers, small investment company advisers and family office advisers.[38] PFIARA raises the threshold for SEC registration from $25 million to $100 million assets under management ("AUM"); advisers with less than $100 million AUM may be forced to deregister from the SEC.[39] The Accredited Investor Standard, required for exemptions under Regulation D, was amended to exclude the value of the investor's primary residence in calculation of whether such person's net worth exceeds $1 million at the time of purchase into the fund.[40]

SEC registration may require strict maintenance of records and reporting.[41] The SEC may require registered investment advisers to maintain any records necessary and appropriate for the protection of investors or for the assessment of systemic risk.[42] Registered advisers will be required to maintain records and reports including the amount of AUM, the use of leverage (including off-balance sheet leverage), counterparty credit risk exposure, trading and investment positions, valuation policies and practices of the fund, types of assets held and trading practices.[43] Along with recordkeeping and reporting, the Act also directs the SEC to conduct periodic inspections of all records of private funds managed by registered advisers.[44] The Act exempted the SEC from disclosing records and information resulting from "surveillance, risk assessments, or other regulatory and

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[36] KATHLEEN ANN RUANE & MICHAEL V. SEITZINGER, CONG. RESEARCH SERV., R40783, HEDGE FUNDS: LEGAL HISTORY AND THE DODD-FRANK ACT, at 6 (2010).

[37] *House-Senate Conference Committee Holds A Meeting On The Wall Street Reform And Consumer Protection Act,* 111th Cong. (June 15, 2010)[hereinafter *House-Senate Conference*] (describing funds that trade predominantly in commodities as "well-regulated" by the CFTC).

[38] CADWALADER, *supra* note 32, at 4.

[39] *Id.* at 3.

[40] *Id*. at 17.

[41] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 203, § 408, 124 Stat. 1376 (2010).

[42] *Id*.

[43] *Id*.

[44] *Dodd-Frank: What It Means To You, supra* note 33.

oversight activities."[45] To further protect consumers from fraud and safeguard consumer assets, the Act requires registered investment advisers with custody over clients' assets to have such assets verified by an independent public accountant.[46]

Within a year of the passage of the Act, the SEC will propose and adopt rules implementing the reporting obligations on investment advisers, the transition of mid-sized advisers from SEC to state regulation and the exemptions from registration for advisers to venture capital firms and certain private funds.[47] Additionally, the Commission will define "family office," adjust the threshold for "qualified client," and revise the "accredited investor" standard.[48]

D. Analysis of Legislation

The PFIARA focuses regulation and oversight to those funds that are systemically significant. This is made apparent by the exemptions for venture capital advisers, family offices, small and mid-sized funds and small business advisers, while imposing greater registration and reporting requirements for larger funds with more systemically significant trading activities.[49] Congress identified these types of funds as producing less systemic risk than hedge funds, thus requiring less oversight.[50] The registration and reporting requirements for larger funds will bring further transparency into the activities of these funds, allowing the SEC and Financial Stability Oversight Council ("FSOC") access to the information that may be needed to avoid another crisis by identifying systemic risk.[51] Although hedge funds and venture capital funds are similar, in that they are unregulated investment pools and highly leveraged, venture capital funds may require mandatory capital contributions, their investments are typically maintained for the fund's lifetime and the

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[45] *Rep. Towns' Testimony on Legislation to Eliminate SEC FOIA Exemptions in Wall Street Reform Act*, US Fed News, HT Media Ltd. (Sept. 18, 2010).
[46] CADWALADER, *supra* note 32, at 11.
[47] Securities and Exchange Commission Home Page, www.sec.gov (follow "Implementation of Dodd-Frank Act"; then follow "Advisers to Hedge Funds and Other Private Funds").
[48] *Id.*
[49] *House-Senate Conference, supra* note 37.
[50] S. Rep No. 111-176, at 53 (2010).
[51] RUANE & MICHAEL V. SEITZINGER, *supra* note 36, at 4.

fund's managers are usually interested in the management of the companies in which they invest.[52] While increased regulation and transparency into systemically risky funds is generally regarded as needed and beneficial, a number of issues must be considered when implementing the Act.

The first major concern of increasing oversight of hedge funds is decreasing the liquidity in financial markets. Particularly, hedge funds, motivated by profit-sharing incentive fees, take on a broad array of risks that many other market participants are less willing to take.[53] In short, the increased risk-sharing capacity and liquidity provided by hedge funds has contributed significantly to the growth and prosperity enjoyed in the economy.[54] Hedge funds contribute significantly to efficient pricing across markets with their ability to pursue arbitrage trading activities in all markets.[55] Furthermore, by actively trading in credit derivatives, hedge funds contribute to accurate and efficient management of counterparties' risk.[56]

Additionally, hedge funds develop unique, highly-complex investment strategies that allow investors to diversify their investment portfolios.[57] Institutional investors worry that registration and transparency will hold back innovation by managers because their proprietary strategies will be open to review by the SEC and competitors.[58] While increased transparency is essential to monitor systemic risk, it must be balanced with the importance of preserving the intellectual property of hedge funds.[59] Because financial innovations are primarily protected through trade secrecy and not patents, hedge funds are some of the most secretive of financial institutions.[60] Hedge funds receive their value almost entirely through the performance of their investment strategies, and thus have an obligation to their investors to protect the confidentiality of such

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52 Wagner, *supra* note 21, at 5.
53 *Hearings, supra* note 19, at 8.
54 *Id.*
55 Charles Gottlieb, *Hedge Funds: Heading For a Regulatory Hard Landing?*, ECMI Policy Brief, No. 5 at 4 (April 2007).
56 *Id.* at 4-5.
57 *Hearings, supra* note 19, at 10.
58 Arleen Jacobius, *Changes In Store For Alternative-Investment Firms, Investors Worry Financial-Reform Bill Will Hurt Innovation*, Investment News, Crane Communications Inc. v.4; iss. 34 (September 6, 2010).
59 *Hearings, supra* note 19, at 7.
60 *Id.* at 8.

strategies.[61] If required to disclose their investment strategies, many funds will "cease to exist or move to less intrusive regulatory jurisdictions"—a major loss to the financial system.[62]

Concerned that the Freedom of Information Act ("FOIA") exemption given to the SEC in the Act was too broad and would undermine the goal of restoring transparency and accountability in the financial system, Congress promptly repealed the FOIA exemption unanimously on September 23, 2010.[63] In testimony against repealing the exemption, SEC Chairman Mary Shapiro warned that the SEC needs the broad authority to effectively examine registered advisers and that if Congress limits such authority, registrants will be "reluctant to cooperate with the agency for fear that any information provided in the course of examinations could eventually be leaked to the public as a result of a FOIA request."[64] The repeal further clarified that the SEC can protect sensitive records derived from its regulatory activities by using an existing FOIA exemption covering records of financial institutions.[65] Because of concerns that advisers and funds newly falling under SEC regulation would not be covered under the repeal as "financial institutions," the new legislation broadly defines the term "as any entity the SEC examines, regulates or supervises."[66]

Accordingly, the challenge of addressing systemic risk and consumer protection is to set transparency standards that balance the need for information with hedge funds' needs to protect their proprietary strategies.[67] A key distinction that must stay intact under the PFIARA is that between registration and regulation. Registration requires advisers to provide information regarding their experience, staff, systems, infrastructure, accountants, lawyers, prime-brokers and other broad-based information at the manager level, not at the

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[61] *Id*.

[62] *Id.*

[63] Dunstan Prial, *Obama Repeals SEC FOIA Exemption*, Fox Business (October 5, 2010) *available at* http://www.foxbusiness.com/markets/2010/10/05/obama-repeals-sec-foia-exemption.

[64] *Regulatory Reform: Congress Moves Quickly to Repeal Dodd-Frank's SEC Confidentiality Provision*, Securities Law Daily (Sept. 24, 2010).

[65] *Rep. Towns' Testimony, supra* note 45.

[66] James Hamilton, *Congress Clears Legislation on SEC Dodd-Frank FOIA Exemptions for President's Signature*, Jim Hamilton's World of Securities Regulation, Newstex Web Blogs (September 23, 2010).

[67] Gottlieb, *supra* note 55, at 5.

fund level.[68] Periodic reporting of systemically relevant information to the SEC, CFTC, or FSOC would also be consistent with registration requirements.[69] Given the complexity of the financial market and its ability to adapt, any requirements of disclosure should identify leverage, liquidity, correlation, concentration, sensitivities and connectedness.[70] The SEC must cautiously determine reporting requirements concerning the fund's trading and investment positions, valuation policies and practices and trading positions.[71] Requiring too much disclosure under these categories, while highly relevant to monitor systemic risk, will highlight concerns over the protection of funds' proprietary information.

In addition to concerns regarding the substance of information to be reported, the SEC will need to carefully consider the costs of implementing and maintaining compliance with reporting and registration requirements. Compliance costs will disproportionately impact smaller hedge funds and, if the costs are too great, funds will either be forced out of the market by shifting investment strategies or will be forced to increase in size to gain economies of scale.[72] Because many funds' strategies seek to exploit market inefficiencies, which becomes more difficult as fund size increases, consolidation of the industry could hurt the performance of hedge funds.[73]

E. Conclusion

The Dodd-Frank Act provides for significant rulemaking and studies to be conducted by the SEC, Government Accountability Office and the Comptroller General. While the scope of the Act's coverage is still uncertain, the rulemaking will focus on increasing transparency to hedge fund trading activities that may contribute to systemic risk in an effort to ensure against another financial crisis. The reporting and registration requirements defined by the SEC will need to be reasonable to implement, or the SEC risks consolidation

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[68] Taub, *supra* note 28.
[69] *Id.*
[70] *Hearings, supra* note 19, at 4.
[71] *Id.* at 8.
[72] *See generally* Allison Bisbey Colter, *Does M&A Wave Loom for Smaller Hedgies? Investor Preference for the Biggest Hedge Funds Leaves Others Struggling to Stay Afloat as Compliance Costs Climb*, Investment Dealers' Digest (Aug. 20, 2010).
[73] *Id.*

in the hedge fund industry. In sum, agencies designated to regulate and monitor systemic risk must carefully balance the hedge fund industry's ability to provide liquidity and innovation to financial markets with the need for increased transparency to carry out their regulatory and oversight functions.

John Chambers[74]

[74] Student, Boston University School of Law (J.D. 2012).