PROTECTING INVESTORS THROUGH HEDGE FUND ADVISOR REGISTRATION: LONG ON COSTS, SHORT ON RETURNS

SECURITIES AND EXCHANGE COMMISSIONER
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Thank you, Dean O'Rourke. It is a great honor to be with you here as the speaker for the inaugural lecture of the Edward Lane-Reticker Speaker Series. Although I did not have the pleasure of knowing Professor Lane-Reticker as most of you probably did, it is clear that he left an indelible mark here at Boston University, in the world of banking and financial law, and indeed beyond. Before I start, you should know that the views that I express here are my own and do not necessarily represent those of the Securities and Exchange Commission ("SEC" or "Commission") or my fellow commissioners.

I understand that Professor Lane-Reticker was the consummate mentor. He was deeply interested in helping students in the graduate program learn. He wanted to work with them to discover their career aspirations. And, he was there to assist them to realize their dreams through networking and counseling. Apparently, among his favorite times for interaction were the brown-bag lunches that you all may still have. He found that in these settings he could connect with students and get to know them. If this lecture series is an outgrowth of his efforts, then you have embarked on an auspicious program to increase outside participation to that end.

Today, I would like to talk with you about hedge fund advisor regulation from the perspective of a skeptical regulator. In October of 2004, in a rare three to two vote, the Commission adopted

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a requirement that hedge fund advisors register with the Commission.[1] As one of the dissenting commissioners, I was but one of many critics of the new requirement.[2] The rule's proponents, however, wanted badly to have the rule in place and so marshaled facts to make its case that the Commission needed to "legitimiz[e] a growing and maturing industry that is currently perceived as operating in the shadows."[3] Upon cursory review, the proponents'

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[1] The rule was adopted at an open meeting on October 26, 2004 and published in December 2004. Registration under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.htm.("Adopting Release"). Commissioner Cynthia A. Glassman and I dissented. Our written dissent is appended to the Adopting Release. *See* 69 Fed. Reg. at 72,089 ("Dissent"). A webcast of the open meeting is available at http://www.sec.gov/news/openmeetings.shtml. On June 23, 2006, after this article was first sent to the publisher, the United States Court of Appeals for the District of Columbia Circuit vacated and remanded the rule. *See* Goldstein v. Securities and Exchange Commission, No. 04-1434, 2006 WL 1715766 (D.C. Cir. June 23, 2006).

[2] One of the most unabashed critics was Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System from 1987 through 2006. In connection with the SEC's proposal to adopt a hedge fund advisor registration rule, he stated, "[m]y problem with the SEC's current initiative is that the initiative cannot accomplish what it seeks to accomplish. Fraud and market manipulation will be very difficult to detect from the information provided by registration under the [Investment Advisers Act of 1940]." Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004). Sharon Brown-Hruska, Acting Chairman of the Commodity Futures Trading Commission, also criticized the SEC's rule. *See* Sharon Brown-Hruska, Acting Chairman of the Commodity Futures Trading Commission, Keynote Address before the Securities Industry Association Hedge Funds Conference (Nov. 30, 2004), *available at* http://www.cftc.gov/opa/speeches04/opabrown-hruska-22.htm ("So do hedge fund managers require increased regulatory scrutiny? 3 out of 5 Commissioners at the SEC think so. I have a number of concerns. One, of course, is that the new regime will utilize taxpayer money to essentially duplicate the efforts of the CFTC and the [National Futures Association]. The second is that a registration regime by the SEC creates a moral hazard that would give would-be investors a false sense of security that they do not need to do the necessary due diligence to evaluate the advisor."). *See also* Judith Burns, *Split SEC Set to Vote on Tighter Hedge Fund Oversight*, DOW JONES NEWS SERVICE, Oct. 25, 2004 ("Federal Reserve Chairman Alan Greenspan and Treasury Secretary John Snow worry that more regulation won't prevent fraud and could reduce benefits that hedge funds bring to markets."); *Hands off Hedge Funds*, WASH. POST, July 18, 2004, at B6; *Reforming Hedge Funds*, N.Y. TIMES, June 27, 2004, at D12; *The SEC's Expanding Empire*, WALL ST. J., July 13, 2004, at A14.

[3] Registration under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172 (July 28, 2004), *available at* http://www.sec.gov/rules/proposed/ia-2266.htm ("Proposing Release").

justifications might sound compelling, but a closer look reveals them to be rooted more in rhetoric than in reality. I hope that you will join me now in taking a closer look at some of these justifications.

According to the rule's proponents, a key objective was to get more information about the hedge fund industry. The hedge fund industry is an important one. It is large and growing with an estimated 8,000 funds and over $1 trillion in assets worldwide. Understanding how the industry works is a worthy objective. But the reasonableness of a regulation's stated objective does not mean that the regulation itself is reasonable. Before undertaking any regulatory steps, the Commission ought to have assessed how much information we would be able to get from the investment advisor registration form, Form ADV,[4] explored other options for getting the information, and compared the costs of alternative methods of information collection. As an initial step, the Commission could have considered whether it could obtain information from entities already registered with it. Prime brokers, for example, are one potential source of information. Alternatively, a requirement that unregistered advisors file an annual census form or audited financials with the Commission would have been a straightforward method of obtaining information.

Before adopting the hedge fund advisor registration rule, the Commission also could have made serious efforts to reach out to other regulators or respond to their overtures of cooperation to assess the collective data about hedge fund advisors. We could have worked, for example, with the Department of Treasury's Financial Crimes Enforcement Network, which, in 2003, proposed a rule that would require unregistered advisors to identify themselves by filing a form with the Department of Treasury.[5] We could have listened to the concerns expressed by the U.S. Commodity Futures Trading Commission ("CFTC")[6] and foreign commenters that the Commission's mandatory registration regime could result in duplicative regulation.[7] The Commission should have raised its

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[4] Pursuant to 17 C.F.R. § 275.203-1 (2006), advisors use Form ADV [17 C.F.R. § 279.1] to register as an investment advisor with the SEC.

[5] Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg. 23,646 (May 5, 2003).

[6] *See, e.g.*, Comment Letter of the CFTC (Oct. 22, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/sbhruska102204.pdf.

[7] Comment Letter of the European Commission (Sept. 15, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/dwright091504.pdf ; Comment Letter of the Fédération Européenne des Fonds et Sociétés d'Investissement (Sept. 15, 2004),

concerns for serious discussion within and input for a coordinated effort from the President's Working Group ("PWG"), which is made up of the heads of the Treasury, the Federal Reserve, the CFTC, and the SEC. Such discussions were particularly important in light of the report issued by the PWG in 1999[8] in the aftermath of a real crisis when Long Term Capital Management nearly collapsed. The PWG's report concluded that "requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity."[9] The PWG certainly would have been the appropriate place to discuss concerns about any systemic risk posed by hedge funds' active participation in the markets.

Early on, hedge fund registration proponents made the argument that registration is necessary because hedge funds pose a high risk to the financial system – "systemic risk" – because of their use of leverage, frequent trading, and speculation.[10] This argument rather quickly subsided, because the Investment Advisers Act does not provide an effective framework for the SEC to address systemic risk.[11] Regardless of the merits of this argument, it is certainly clear

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available at http://www.sec.gov/rules/proposed/s73004/smatthias091504.pdf; Comment Letter of the International Bar Association (Sept. 14, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/rwhelm091404.pdf.

[8] HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT – REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (Apr. 1999), *available at* http://www.treas.gov/press/releases/reports/hedgfund.pdf ("PWG Report") (the Council of Economic Advisers, the Federal Deposit Insurance Corporation, the National Economic Council, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision also participated in the study and supported its conclusions and recommendations).

[9] *Id*. at B-16.

[10] *See, e.g*., William H. Donaldson, Former Chairman, Securities and Exchange Commission, Testimony before the House Committee On Financial Services: Subcommittee On Capital Markets, Insurance, And Government-Sponsored Enterprises Holds A Hearing On Capital Market Structure (Oct. 30, 2003) ("[T]here are upwards of 6,000 to 7,000 of these funds out there right now. They're somewhere around $600 billion to $700 billion; they're growing like a weed . . . [W]e need to understand what impact these funds are having on the marketplace itself. It's been said that hedge fund investors are wealthy investors and they can take care of themselves, that may or may not be so, but what we can't afford to have is a hidden impact, if you will, in terms of some of these techniques that acts against the best interests of our functioning markets.")

[11] Unlike the regulatory scheme for broker-dealers, which provides minimum net capital levels, risk assessments, and firewalls between broker-dealers and related entities, the Advisers Act is primarily a framework for disclosure and responsibility standards.

that the non-prudential registration and periodic examination scheme under the Investment Advisers Act cannot effectively address any systemic risk posed by hedge funds, as the PWG's report pointed out.[12] In addition, any look at systemic risk of hedge funds would have to include an appreciation for hedge funds' function as liquidity providers, a role that could be compromised by regulatory restrictions.[13]

Now that the rule has been adopted, its proponents can no longer overlook its flaws, which many of us foresaw. The application of the registration requirement to hedge fund advisors, for example, has highlighted information gaps in the existing Form ADV. Form ADV is unlikely to provide any new information to investors who have performed even the most minimal level of due diligence about an advisor. Nor does Form ADV provide information that is particularly helpful for the Commission's purposes in keeping abreast of hedge fund activities. Some within the SEC have suggested that we look for new ways to get more data from advisors, such as requiring quarterly SEC filings. Others have suggested requiring advisors to disclose a few more pieces of information. Advisors might be asked, for example, to identify their auditors and indicate whether they prepare their own account statements.

As the Commission confronts the fact that registration alone does not give us a good vantage point from which to oversee the industry, we are likely to see calls for additional substantive regulation. Former Federal Reserve Chairman Alan Greenspan's predictions that registration would open the door to further

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[12] PWG Report, *supra* note 8, at B-16.

[13] As Federal Reserve Chairman Alan Greenspan has stated, hedge funds have "been very helpful to the liquidity and hence the international flexibility of our financial system." Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (Feb. 12, 2004), *available at* http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=91. Similarly, Treasury Secretary John Snow stated that "one of the things we do right in the United States . . . is to put a high burden of proof on someone who wants to regulate a market activity" and cited "hedge funds, which perform an incredibly important role in disintermediating capital and making capital available on a huge scale to people who have need for capital for risk ventures" as a salutary example of an industry that the government has not regulated. Honorable John Snow, Secretary of the Treasury, Remarks before the Competitive Enterprise Institute (July 31, 2004), *available at* http://www.cei.org/gencon/028,04062.cfm.

regulation[14] may prove to be more accurate than the Adopting Release's impatient dismissal of "inchoate" concerns "about what the Commission *might* in the future do that could adversely affect the operation of hedge funds."[15]

The Adopting Release pointed with great alarm to the "substantial and troubling growth in the number of our hedge fund fraud enforcement cases."[16] The 51 cases over a five-year period that proponents cited as evidence of this "troubling" trend do not support a call for mandatory registration.[17] Most of the implicated advisors would have been too small to have been registered with the Commission, were already registered in some capacity, or should have been registered and had not done so. Many were garden-variety fraudsters who could just as easily have used a label other than "hedge fund" for their schemes.[18] In 2003, the Commission staff found that despite the growth in the number of cases identified as hedge fund fraud cases, there was "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."[19]

Of course, fraud does occur in the hedge fund industry. Sometimes this fraud is dramatic as you will see if you read the complaint we filed last fall against the managers of the Bayou Funds, who allegedly stole many millions of dollars and deceived investors with such tactics as the creation of a sham accounting firm.[20]

It is important to remember that we do not need registration as a hook to pursue fraud. Advisors, whether registered or not, have been subject to the antifraud provisions of the Act since 1960, when section 206 was amended to extend to all investment advisors,

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[14] Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (Feb. 12, 2004) (Greenspan asked "What is the purpose of [registration] unless you're going to go further?").

[15] Adopting Release, *supra* note 1, at text accompanying n. 72.

[16] Adopting Release, *supra* note 1, at text accompanying n. 27.

[17] Adopting Release, *supra* note 1, at n. 28 and accompanying text.

[18] For a discussion of these cases, *see* Dissent, *supra* note 1, at text accompanying nn. 30-34.

[19] STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 73 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf ("2003 Staff Hedge Fund Report").

[20] Complaint of the Securities and Exchange Commission, SEC v. Samuel Israel III (S.D.N.Y. filed Sept. 29, 2005), *available at* http://www.sec.gov/litigation/complaints/comp19406.pdf.

regardless of their registration status.[21] In addition, the Commission has subpoena power, which the staff already used to gather information for the report on the hedge fund industry that it prepared in 2003.[22]

Proponents of hedge fund registration argue, however, that the applicability of the antifraud provisions to investment advisors is not enough. Registration is, in their view, vital because it enables the Commission to conduct routine examinations, which, in turn, enable the Commission to discover fraud. But are routine examinations a particularly effective method for rooting out fraud?

Overseeing an ever-growing body of registrants with a small pool of examiners at a time when Commission budget constraints make hiring additional examiners unlikely is a Herculean task. Recently, the Government Accountability Office issued a report on SEC mutual fund oversight.[23] The report cited the hedge fund rule as an "oversight challenge facing SEC's mutual fund examination program"[24] and questioned the "SEC's capacity to effectively monitor the hedge fund industry … given the tradeoffs that the agency has had to make in overseeing the mutual fund industry."[25]

Adding to our registrant pool in this manner[26] reverses some of the progress made in 1996, when Congress, in the National Securities Markets Improvement Act,[27] addressed the SEC's overtaxed examination program by dividing the responsibility of examining investment advisors between the states and the SEC.[28] Raising the assets-under-management threshold for federal registration has been mentioned privately and publicly in conjunction

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[21] Amendments to the Investment Advisers Act of 1940, Pub. L. No. 86-750 (June 28, 1960) (amending 15 U.S.C. § 80b-6).
[22] 2003 Staff Hedge Fund Report, *supra* note 19.
[23] U.S. GOV'T ACCOUNTABILITY OFFICE, MUTUAL FUND INDUSTRY: SEC'S REVISED EXAMINATION APPROACH OFFERS POTENTIAL BENEFITS, BUT SIGNIFICANT OVERSIGHT CHALLENGES REMAIN, REPORT NO. 05-415, (Aug. 2005), *available at* http://www.gao.gov/new.items/d05415.pdf ("GAO Report").
[24] GAO Report, *supra* note 23, at 18.
[25] GAO Report, *supra* note 23, at 35.
[26] *See infra* note 53 and accompanying text.
[27] Pub. L. No. 104-290, 110 Stat. 3416 (1996).
[28] By 1996, the routine inspection cycle for investment advisors had grown to as long as 12 to 24 years for investment advisors. *See* Memorandum from Lori A. Richards, Director of SEC's Office of Compliance Inspections and Examinations, to former Chairman William H. Donaldson, Office of Compliance Inspections and Examinations at n.7 (Mar. 10, 2004), *available at* http://www.sec.gov/news/extra/apx-ts031004lar.pdf.

with adoption of the hedge fund advisor registration rule[29] as one possible way to counteract the influx of hedge fund advisor registrants. Ironically, this approach would shift registrants that serve retail investors out of the SEC's purview in order to make room for hedge fund advisors, who serve many fewer, mostly institutional and sophisticated investors.[30]

Aside from the challenges related to the increase in sheer numbers of registered advisors, the newly registered hedge fund advisors may pose unique challenges for our examiners. Examination models designed for traditional advisors may not easily translate to the hedge fund context in areas such as valuation techniques and risk management. Of course, many hedge fund advisors already were registered with us voluntarily before the rule took effect, and many of the things that examiners look for, such as recordkeeping requirements, custody, sufficiency and accuracy of disclosure, are common to any registered money manager. Nevertheless, the newly registered advisors might employ complex structures that our examiners have not seen before. It might be tempting for the Commission's Office of Compliance Inspections and Examinations ("OCIE"), to apply a uniform set of standards rather than to assess the effectiveness of a particular hedge fund advisor's internal controls in the context of its size, the nature of its investments, and the investment strategy that it employs. I am encouraged, however, by the fact that OCIE is training its examiners in a broad range of hedge fund issues with the help of outside experts with practical and academic hedge fund experience. I hope that this training will improve examiners' ability to distinguish the true problems from harmless departures from the "standard" approach.

The list of potential misdeeds by hedge fund advisors (or, for that matter, any advisor) is long and features, among other things, market manipulation, insider trading, misappropriation of client funds, cherry picking, faulty valuation, and favoritism. We should

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[29] Sara Hansard, *More Advisers May Go To States; Increase in Hedge Fund Registration Could Trigger Regulatory Changes*, INVESTMENT NEWS, Nov. 15, 2004 (quoting Paul Roye, Director of the SEC's Division of Investment Management: "'That is a contingency,' Mr. Roye said of the idea [of raising the asset threshold to $40 million]. 'If we get into a situation where we think we can't manage the registrants, Congress set up a system to give us the larger advisers, and the states take the smaller advisers. We could adjust our registrant base by raising the threshold. Congress contemplated we would adjust that periodically to manage the workload, in consultation with the states.'").

[30] *See infra* note 52 and accompanying text.

not tolerate these or other violations from registered or unregistered advisors, but we have seen time and again over the years just how difficult it is for any examiner or auditor to ferret out fraud at large and small retail-oriented investment advisors who use straightforward long strategies. Even if we examine a particular firm that is violating the law, there is no guarantee that we will find the bad practice. Egregious market timing and late trading practices at mutual funds did not attract Commission attention during routine inspections of the funds, the advisors, and the broker-dealers that were registered with us. Proponents of hedge fund advisor registration nevertheless argue that, had the registration requirement been in place, the Commission would have identified the illegal practices sooner.[31]

In order to target its examinations, the Commission is working on a risk-based approach to identifying advisors in need of a closer look. But some, like former Federal Reserve Chairman Greenspan, take a rather pessimistic view of the possibilities for a risk-based approach in the hedge fund arena: "Even should SEC's proposed risk evaluation surveillance of hedge funds detect possible trading irregularities, which I doubt frankly, those irregularities will likely be idiosyncratic and of mainly historic interest, because by the time of detection, hedge funds would have long since moved on to different strategies."[32]

Registration advocates would do well to moderate their expectations about how effective examinations will be at rooting out fraud. By their nature, fraudsters tend to be crafty and go to great lengths to hide their fraud. We are far more likely to learn of fraudulent activities from an injured investor, whistle-blowing employee, or suspicious business partner, such as prime broker, than from going in and investigating circumstances on our own. Proponents of registration argue that the mere possibility of an

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[31] *See, e.g.*, Harvey Goldschmid, Commissioner, Securities and Exchange Commission, Remarks at Columbia Business School (Nov. 17, 2004), *available at* http://www.sec.gov/news/speech/spch111704hjg.htm ("[I]f we had been going into the hedge funds [that were involved in market timing] it would have been easy for our inspectors to have seen what was wrong. Using any kind of risk analysis, and looking at how money was being made, it is perfectly clear to me that had we been inspecting hedge funds, we would have picked up the scandals earlier.").

[32] Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004) (response to Senator Charles Schumer).

examination will deter wrongdoing. The Adopting Release articulated this view as follows:

> The prospect of a Commission examination . . . increases the risk of getting caught, and thus will deter wrongdoers. This risk should alter hedge fund advisers' behavior by forcing them to account for the consequences of a compliance examination that, like a tax audit, may not occur with great frequency. Hedge fund advisers each day make decisions based on risk analysis of alternative investments, and should be particularly sensitive to the consequences of getting caught if their conduct is unlawful . . . This sensitivity, which may be reflected in the strength of the opposition among some hedge fund advisers to this rulemaking, suggests that the benefits of our oversight may be substantial.[33]

This line of reasoning assumes that the fear of getting caught is what drives advisors to avoid unlawful acts. I cannot subscribe to a view that is premised on the assumption that a stark risk analysis is all that separates the average advisor from common crooks. To the extent that it is, the possibility of an examination by a resource-challenged Commission might not factor strongly in the risk analysis. Moreover, it would be naïve to believe that advisors whose intentions truly are bad will register in compliance with our rulemaking and then, because of the specter of an examination, will become upstanding citizens. It is more likely that they will not register with us, but will instead adopt a new moniker for their next fraud.

Others might find that the simple fact that they are registered with the Commission is a nice selling point for investors. A duly skeptical investor will not give any weight to registration,[34] and Section 208(a) of the Advisers Act prohibits advisors from representing or implying that they are "sponsored, recommended, or approved, or that their abilities or qualifications have in any respect

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[33] Adopting Release, *supra* note 1, at text accompanying nn. 87-88.

[34] One fund-of-funds advisor was quoted as saying, "Any investor who feels better about me because I'm registered would just show me how ignorant they are . . . I can think of 100 things more important than that." Jeff Benjamin, *Hedge Fund Industry Braces for Showdown*, INVESTMENT NEWS (Jan. 30, 2006) (quoting Richard Van Horne).

been passed upon" by the government.[35] Although we remind people that registration is not a Commission seal of approval, our message is sometimes mixed. For example, former Chairman Donaldson implicitly endorsed the notion that registration is a dividing line between good and bad advisors when he stated, with respect to registration: "I don't get much push back from people who are operating good funds," he said. "I don't get much push back from people who have nothing to hide."[36]

Proponents of registration pointed to the alleged growing retailization of hedge funds. No longer, they argued, are the elite and wealthy investors the only ones with exposure to hedge fund risk.[37] Advocates of mandatory registration took no comfort in the fact that the Commission staff, in its report, noted that it had "not uncovered evidence of significant numbers of retail investors in hedge funds."[38] Instead, they focused on what could be termed indirect retailization in the form of hedge fund investments by pension funds and other institutional investors.

As with the other justifications for the registration mandate, this "pension fund canard" sounds compelling, but on further investigation, falls short. Pension funds have both the fiduciary obligation and the means to allocate pension money wisely by hiring experts to advise them. Accordingly, they are not subject to the limitations that would preclude most retail investors from accessing hedge funds. Moreover, on average, pension funds invest only an estimated one percent of their assets in hedge funds.[39] Their

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[35] 15 U.S.C. § 80b-8(a) (2006).

[36] William H. Donaldson, Former Chairman, Securities and Exchange Commission,Testimony on Regulation of the Hedge Fund Industry before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (July 15, 2004), *available at* http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=122.

[37] *See, e.g*., William H. Donaldson, Former Chairman, Securities and Exchange Commission, Remarks before Financial Services Leadership Forum (Sept. 27, 2004), *available at* http://www.sec.gov/news/speech/spch092704whd.htm) ("The industry has witnessed an explosive increase in the use of hedge funds targeted increasingly to smaller investors, and by trustees and managers of pension and other similar funds on behalf of smaller investors who may not know their savings are invested in hedge funds.").

[38] 2003 Staff Hedge Fund Report, *supra* note 19, at 80.

[39] *See, e.g.,* Svea Herbst-Bayliss, *Pension Funds Not Big Hedge Fund Investors*, REUTERS (May 17, 2006) (reporting finding by Greenwich Associates that "U.S. corporate pension funds allocated just 0.9 percent of their assets to hedge funds while public pension funds put in even less, sending only 0.7 percent into the asset class.").

portfolios also include other investment vehicles with unregistered advisors such as off-shore investment vehicles, real estate investment trusts, and venture capital funds. The data show that institutions are replacing wealthy individuals as the primary source of hedge fund assets, but trends also show that, in response, hedge fund advisors are having to meet institutional demands for "very high standards for professional conduct."[40] Regardless of their registration status, advisors will have to satisfy market demands for stronger compliance.

Mandatory registration could have the unintended effect of stimulating the very trends that worry the proponents of registration. It will facilitate investment by pension funds and other institutional investors in hedge funds because registration is often a prerequisite to their investing. In addition, if all hedge fund advisors are registered, there is likely to be grassroots demand for access to hedge funds by retail investors. We see this trend developing in Europe.

If retailization were a well-founded concern, a conclusion that is not supported by the facts, mandatory registration would be a poor solution. The most direct way to reverse a retailization trend would be to tighten accredited investor standards.[41] These definitions were set in the 1980s, and inflation has since taken its toll on them.[42] Hedge fund advisors would likely support a tightening of accredited investor standards.[43]

Disappointment with the registration mandate is likely to be felt most strongly when an inevitable hedge fund failure comes. The likely response to such an event is an increase in regulatory burdens on hedge funds. The bottom line is that SEC mandates are no substitute for the implementation of careful, consistent controls by

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[40] The Bank of New York and Casey, Quirk & Acito, Institutional Demand for Hedge Funds: New Opportunities and New Standards 15 (Sept. 2004).

[41] Pursuant to Regulation D under the Securities Act, which was first adopted in 1982, accredited investors include natural persons with individual incomes in excess of $200,000 (or joint spousal incomes of $300,000) for the two most recent years, if they reasonably expect to earn at least the same amount in the current year. Natural persons with individual (or joint spousal) net worths of over $1 million also are accredited investors. 17 C.F.R. § 230.501(a)(5) and (6) (2006).

[42] For example, the $200,000 threshold set in 1982 would be more than $400,000 in 2006 dollars.

[43] *See, e.g.*, Comment Letter of Managed Funds Association 20 (Sept. 15, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/jggaine091504.pdf, ("the SEC staff's concern regarding the increase in the number of persons qualifying as accredited investors is valid . . . the SEC should address this increase directly by raising the accredited investor standard . . .").

hedge fund advisors and thorough due diligence by investors, who might demand, for example, third-party affirmation of compliance with these practices, as registered funds and others do with Statement on Auditing Standards ("SAS") 70 reports.

The registration mandate is not only likely to disappoint its advocates by failing to achieve the positive objectives that they cited in its favor, but it is likely to impose real costs on investors. Proponents of mandatory registration have insisted that registration imposes relatively few costs on advisors. After all, registration supposedly is nothing more than filling out a form. But even filling out a form can be expensive if it will be submitted to a regulator[44] and scrutinized by the trial bar. Once registered, advisors face numerous substantive requirements, including recordkeeping, custody, and compliance requirements, all of which impose costs. The Adopting Release sought to alleviate any concern about compliance costs by making a number of irrelevant observations about the hedge fund industry's relative scale, high fees, "substantial cash flow," and low barriers to entry.[45]

Proponents take the view that the fact that many advisors registered voluntarily before the rule was in place clearly shows that the costs of registration are reasonable. Former Chairman Donaldson, for example, said that he could not "imagine that these advisers would voluntarily assume burdensome, inflexible or costly regulatory obligations."[46] This reasoning misses the point that advisors would voluntarily assume regulatory obligations, if doing so would bring benefits that outweighed the costs of those obligations. Benefits could include access to Employee Retirement Income Security Act ("ERISA") money.[47] The determination by certain

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[44] *See* Comment Letter of the Investment Counsel Association of America (since renamed "Investment Adviser Association") 5 (Sept. 14, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/dgtittsworth091404.pdf ("[W]e must take issue with the statements in the [hedge fund] proposal that the burdens of registration under the Advisers Act are 'minimal' and the costs associated with registration 'would not be high'") (citing Adopting Release, *supra* note 1).

[45] Adopting Release, *supra* note 1, at text accompanying nn. 188-121.

[46] William H. Donaldson, Former Chairman, Securities and Exchange Commission, Testimony Concerning Investor Protection and the Regulation of Hedge Funds Advisers, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (July 15, 2004), *available at* http://www.sec.gov/news/testimony/ts071504whd.htm.

[47] Boards of trustees of ERISA-qualified pension funds (including 401(k) plans and defined benefit plans) may delegate certain aspect of their fiduciary duties of managing beneficiaries' funds if this money is entrusted to a SEC or state registered

advisors that registering would give rise to more benefits than costs is not definitive across the board for all advisors. For this reason, it is understandable that three-quarters of the new registrants waited until the last minute to file. Presumably they had determined that registration would not bring sufficient benefits to justify its costs, so they were deferring those costs as long as possible.

The Investment Adviser Association ("IAA"), which represents registered advisors (and thus not surprisingly, supported the mandate), nevertheless disputed "the claim that the costs of adviser registration and compliance are relatively inconsequential and thus will not pose any burden for hedge fund advisers" because "investment adviser registration and compliance have become increasingly complex and costly."[48] The IAA's cognizance of cost has been heightened by the recent experiences of registered advisors who are undergoing multiple simultaneous document requests or examinations conducted by different regional offices of the SEC and facing broad email requests from Commission examiners.[49] The new requirements that advisors must designate a chief compliance officer

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investment advisor, a bank, or a qualified insurance company to manage. *See* 29 U.S.C.§ 1102(c)(3) (2006) (permitting ERISA fiduciaries to appoint investment managers); 29 U.S.C. § 1105(d) (2006) (relieving trustees of liability for the acts or omissions of investment managers and permitting delegation of asset management to investment managers); and 29 U.S.C. § 1002(38) (2006) (defining "investment manager"). Thus, in issuing requests for proposals or soliciting investment advisors, many pension funds have focused on seeking registered investment advisors. This has led many hedge fund managers to register with the SEC to qualify to manage that money.

[48] Comment Letter of the Investment Counsel Association of America (since renamed "Investment Adviser Association") 6 (Sept. 14, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/dgtittsworth091404. pdf.

[49] *See, e.g.,* Letter from David G. Tittsworth, Executive Director of the Investment Counsel Association of America, to Paul F. Roye, Director of SEC Division of Investment Management, and Lori A. Richards, Director of SEC Office of Compliance Inspections and Examinations (Nov. 19, 2004), *available at* http://www.icaa.org/public/letters/comment111904.pdf (discussing SEC's new, burdensome practices with respect to email retention and production); Carol E. Curtis, *Congressman Takes Aim at SEC*, SECURITIES INDUSTRY NEWS (Jan. 16, 2006) (quoting Lisa McGreevy, Executive Vice President of the Financial Services Roundtable: "When recipients of sweeps get requests for every e-mail without it being targeted, they want to comply, but ... in practice you have examiners coming in without coordinating with the operating divisions that set policy."); Marietta Cauchi, *Hedge Funds Focus on Email Retention Before New SEC Rule*, DOW JONES NEWSWIRES (Jan. 9, 2006) ("[T]he SEC has taken the view that it is entitled to see everything under an adviser's roof and this extends to the chatty type of correspondence that develops in working relationships with third parties, as well as internal correspondence.").

and develop and maintain written compliance policies and procedures are substantive and costly requirements.[50] As with all costs, the costs associated with registration will be passed on to investors in one way or another through diminished choices, less competition and increased costs.

The indirect costs on U.S. investors might be even more significant than the direct costs. Across-the-board regulatory mandates, although generally well-intentioned, deprive investors of decision-making power that is rightfully theirs and may impose costs on investors that do not produce a proportionate return. Because many hedge fund advisors registered voluntarily before the rule went into effect, investors who valued registration could have selected registered advisors. If SEC-registration were perceived to be uniformly desirable, the market – meaning investors – would eventually lead all hedge fund advisors to register.

The registration mandate might have a number of chilling effects. Would-be advisors might shelve plans to join the industry because of compliance and registration costs. Existing hedge fund advisors might avoid using complex investment strategies that they cannot explain to Commission examiners. Others might have to move to less efficient ways of doing business, by, for example, foregoing instant messaging because of recordkeeping concerns. The hedge fund registration requirement may further constrain investor choice by discouraging foreign investment advisors from serving American clients. The Adopting Release acknowledged that "as a practical matter, U.S. investors may be precluded from an investment opportunity in offshore funds if their participation resulted in the full application of the Advisers Act and our rules."[51] But even the "registration light" that was adopted for non-U.S. advisors, under which books and records requirements apply and the prospect of an SEC examination looms, could, and I believe will, dissuade foreign advisors from offering investment opportunities to U.S. investors.

Hedge fund investors are not the only ones who will bear the brunt of indirect costs. The introduction of more than 1,000 new registrants makes a significant claim on the precious time and attention of our examination staff. Tradeoffs are necessary when a staff of approximately 500 examiners oversees 8,000 funds and

[50] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,714 (Dec. 24, 2003), *available at* http://www.sec.gov/rules/final/ia-2204.htm..

[51] Adopting Release, *supra* note 1, at n. 213.

nearly 10,000 investment advisors. Is it wise to shift resources to the oversight of advisors that manage the money of perhaps only 200,000 sophisticated investors[52] and away from the oversight of the investments of more than 90 million mutual fund investors?

The SEC has a responsibility to investors to allocate its resources wisely. A police department might be questioned if it dispatched routine patrols to the neighborhoods with gated estates guarded by private security guards. Why not instead concentrate patrols in densely populated neighborhoods that are unguarded by private security details and rely on residents of the estates to call for help if any problems arise? Our regulatory scheme supports a mix of lightly and heavily regulated products and sectors. The SEC has broad jurisdiction to crack down on fraudulent activities in the financial markets and regularly acts on tips with respect to parts of the markets that are unregistered. The registration mandate inserted the Commission in an unnecessarily activist capacity in a sector of the market that has thrived without the Commission's having to play such a role.

By February 1st of this year, 979 hedge fund advisors registered with us. Since then, more firms have registered.[53] Much to the exasperation of the rule's proponents, some advisors took deliberate, but legal, steps to avoid registration. As I mentioned before, some foreign advisors have decided that U.S. investors are not worth the bother and are forcing them out. The percentage of hedge fund advisors that are not registering is estimated to be approximately twenty-five percent.[54] This group includes some large advisors with significant assets under management.

The Commission's rule left a way out for advisors that could convince their investors to agree to a two year lock-up. As the registration mandate is written, it does not reach advisors to funds

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[52] *See The SEC's Expanding Empire*, WALL ST. J. (July 13, 2004), at A14 ("It hardly makes sense for the SEC to divert money and resources from policing mutual funds, with $7.6 trillion and 95 million investors, to oversee hedge funds with about $800 billion and under 200,000 wily investors.").

[53] As of the end of April 1, 179 hedge fund advisors had registered since the new rule took effect. *See* Susan Ferris Wyderko, Director, SEC Office of Investor Education and Assistance, Testimony Before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, at text accompanying note 14 (May 16, 2006) *available at* http://www.sec.gov/news/testimony/ts051606sfw.htm.

[54] *See, e.g.*, Jonathan Tonge, *Offshore: A New Regime*, LEGAL WEEK (Mar. 16, 2006) ("We have seen lock-ups being used by 20-30% of the new funds with which we are working.").

with redemption periods of longer than two years. That some advisors would choose to place themselves beyond the rule's reach by lengthening lock-up periods should not have taken anyone by surprise. Nevertheless, anything that strengthens advisors' leverage in seeking to lock up investors' money for a longer period is not helpful for investors. Longer lock-up periods lessen the pressure on advisors to do their job well in order to discourage investors from leaving. Since hedge fund managers are opportunistic investors and the documentation for their funds usually gives them flexibility to react to changing markets, a fund's style can shift over time. Investors whose money is locked up for longer terms will not be able to vote effectively with their feet if the fund's style shifts in a way that is not to their liking.

The purpose of using a fund's two-year redemption period as one criterion in identifying advisors subject to the rule was to exclude advisors to venture capital and private equity funds. The Adopting Release explained: "Because hedge funds are where we have seen a recent growth in fraud enforcement actions, we will focus our examination resources on their advisers, rather than on advisers to private equity or venture capital funds, at this time."[55] I have cautioned and continue to caution advisors to these other types of funds that when their time comes, it will be quite easy to tweak the rule to pull them in also.[56] This is particularly so since distinctions between advisors to hedge funds and private equity funds are blurring.[57] Hedge fund managers are looking for new ways to produce the returns that their investors demand. Until registration disparities are eliminated, investors who do not want to absorb the costs of registration may opt for private equity and venture capital funds.

Other advisors have avoided registration by not accepting new money as they await a decision by the United States Court of

[55] Adopting Release, *supra* note 1, at text accompanying n. 237.

[56] During the latter stages of debate on the hedge fund rule, some advisors to other types of unregistered funds recognized the potential for a much-expanded ambit of the rule. *See, e.g.*, Comment Letter of the National Venture Capital Association (Sept. 15, 2004) ("NVCA believes that the [proposing] Release and the proposed rule create a risk of future burdensome regulation on venture capital that outweighs any investor protection benefit that would come from the proposed rule.") (on file with author).

[57] *See, e.g.*, Michael G. Tannebaum, *Convergence of Hedge Funds and Private Equity Funds,* INTERNATIONAL INVESTMENT & SECURITIES REVIEW 2006, Mar. 21,2006, *available at* http://www.thehfa.org/Articles.cfm.

Appeals for the District of Columbia Circuit in a challenge to the new rule by Phillip Goldstein, a hedge fund advisor.[58] The oral argument took place in December of last year. The Court's decision in the matter should be forthcoming shortly.[59]

In order to understand why some believe that Mr. Goldstein's challenge has legal legs, it is useful to take a quick look at our registration requirements for investment advisors. The Investment Advisers Act of 1940 and our rules generally require investment advisors who manage $30 million or more and advisors to registered investment companies to register with the SEC.[60] An advisor with less than $25 million under management generally may not register with the Commission.[61]

The Advisers Act offers an exemption from registration for any investment advisor that has had fewer than fifteen clients during the preceding twelve months, does not hold itself out generally to the public as an investment advisor, and does not serve as an investment advisor to any registered investment company.[62] The availability of this exemption for advisors to hedge funds turns in large part on whether the hedge fund or the investor is counted as the client. If each hedge fund investor counts as a client, most advisors would be above the fifteen client threshold, but if hedge funds are counted as clients, an advisor might fall under the fifteen client threshold.

The latter approach to counting clients reflects the reality that when an advisor advises an entity, the advisor tailors the advice not to the financial circumstances, investment needs, preferences, and risk tolerances of each individual owner of that entity, but rather to the objectives of the entity as a whole. A prospective hedge fund

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[58] Goldstein v. Securities and Exchange Commission, No. 04-1434 (D.C. Cir. *petition filed* May 18, 2005).

[59] As noted above, the Court ruled in this case in Mr. Goldstein's favor on June 23, 2006, after this article was first sent to the publisher. *See* supra note 1. The Court, in a direct and well-reasoned opinion, vacated the rule because it was arbitrary. The Court focused on the Commission's unwieldy redefinition of the term "client" for purposes of the rulemaking and noted that "the Commission's interpretation of the word 'client' comes close to violating the plain language of the statute." Goldstein, 2006 WL 1715766, at *7.

[60] *See* Investment Advisers Act § 203A(a)(1), 15 U.S.C. § 80b-3a(a)(1) (2006); Rule 203A-1(a), 17 C.F.R. § 275.203A-1(a) thereunder.

[61] *See* Investment Advisers Act § 203A(a)(1), 15 U.S.C. § 80b-3a(a)(1) (2006); Rule 203A-2, 17 C.F.R. § 275.203A-2 thereunder. Advisors who manage between $25 million and $30 million may choose state or SEC registration. *See* Investment Advisers Act Rule 203A-1(a)(2), 17 C.F.R. § 275.203A-1(a)(2).

[62] See Investment Advisers Act § 203(b)(3), 15 U.S.C. § 80b-3(b)(3) (2006).

investor searches for a fund that fits his objectives and does not expect the fund to shift in response to individual investors' needs. To focus on the unique needs of individual investors would undermine the very purpose of aggregating investors into a common investment pool.

By the same logic, an advisor should not treat individual investors as clients unless they are receiving personalized advice. Thus, in 1997, the Commission created a safe harbor to enable investment advisors to group clients together without having these groups be treated as investment companies, but included safeguards to ensure that an advisor would provide individualized consideration to investors.[63]

As a result of counting clients based on the person for whom the advice is tailored, some unregistered advisors manage the money of many more than fifteen investors. This fact has not escaped Congressional notice. In fact, in 1996, Congress added section 3(c)(7) to the Investment Company Act to permit the formation of unregistered pools of an unlimited number of highly sophisticated investors.[64]

The Commission, in adopting the registration mandate, abandoned the notion that the client is the person for whom the advice is tailored. The final rule redefined "client" solely for advisors to hedge funds[65] and then only to determine their eligibility to rely on the fifteen client exemption from registration.[66] Specifically, hedge fund advisors were precluded from using a previously available safe harbor for counting hedge funds as clients

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[63] *See* Status of Investment Advisory Programs Under the Investment Company Act of 1940, Investment Advisers Act Release No. 1623, 62 Fed. Reg. 15,098 (Mar. 31, 1997), *available at* http://www.sec.gov/rules/final/ic-22579.txt.

[64] 15 U.S.C. § 80a-3(c)(7) (2006). In fact, it was this congressional action that made it necessary for the SEC's rule to apply to hedge fund advisors as opposed to hedge funds themselves.

[65] The rule uses the term "private funds" instead of "hedge funds." A private fund is defined as a fund that would be subject to regulation under the Investment Company Act but for the exception, from the definition of "investment company," provided in either section 3(c)(1) or section 3(c)(7) of the Investment Company Act, 15 U.S.C. § 80a-3(c)(1) or (7) (2006), has a redemption period of less than two years, and interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser. *See* Rule 203(b)(3)-1(d), 17 C.F.R. § 275.203(b)(3)-1(d).

[66] *See* Adopting Release, *supra* note 1, at notes 184-187 and accompanying text.

and added an affirmative requirement to force advisors to count each owner of a hedge fund as a client.[67]

Regardless of how the Court rules, the challenge has already reminded us of the danger of undergoing regulatory contortions to achieve a questionable objective. At the Commission, we typically speak of litigation risk in terms of enforcement actions: what is the likelihood of prevailing in court against a particular person on a particular charge? Of late, increasingly we have found ourselves considering the litigation risk of our own rules. Would it not make more sense to adopt rules that are clearly within our authority and consequently would make poor subjects for legal challenges?

As long as the rule is in place, however, I am hopeful that we at the Commission will use it as best we can to assist us in our oversight of the securities markets. I hope that, under the leadership of Chairman Christopher Cox, we will deliberate very carefully before undertaking any additional hedge fund regulation and that we will do so only with an appreciation for the beneficial role of hedge funds in the market and an appreciation of the costs on investors that any new regulation would entail.

The mission statement of the New England Legal Foundation, an organization of which Professor Lane-Reticker was a trustee, states: "We . . . oppose laws and regulations which have no rational likelihood of achieving their stated purpose, even if the purpose of the law or regulation is not one to which we object."[68] So do I. The hedge fund advisor registration mandate is just such a regulation.

Thank you all for your attention. You have been a very gracious audience. I look forward to hearing your thoughts about hedge funds or other areas that interest you during the upcoming discussion.

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[67] *See id.*

[68] New England Legal Foundation Website, http://www.nelfonline.org/about.htm.