

SEC Hosts Roundtable Discussions Concerning Hedge Funds

On May 14-15, 2003, the Securities and Exchange Commission ("SEC") hosted a roundtable in Washington, D.C. to discuss a number of issues relating to the operations of private, unregistered investment pools, commonly known as "hedge funds." The roundtable discussions were part of the SEC's formal fact-finding investigation of the hedge fund industry, which it began in May, 2002, with a view to determining whether the current regulatory scheme for hedge funds is adequate. The SEC had raised concerns about what it perceived as increased enforcement actions involving hedge funds, marketing efforts directed at ordinary retail investors, and other conflict issues arising in connection with the operation of hedge funds. The SEC's investigation also appeared to be spurred on by Congressional inquiries in recent months regarding the operation of hedge funds.

The SEC assembled a wide array of hedge fund industry participants for its roundtable discussions. In addition, representatives from the mutual fund industry and other regulatory bodies (including the NASD, the CFTC, the Financial Services Authority of the United Kingdom, and the Commission des Opérations de Bourse in France), participated. The importance of the roundtable discussions to the SEC was underscored by the fact that all five SEC commissioners were present on both days for most of the discussions. In

addition, there was participation by the directors of all of the SEC's key operating divisions.

This alert summarizes certain key issues discussed during the roundtable. The SEC's focus on these areas suggests that if regulation were to result from the SEC's investigation of the hedge fund industry, it likely will be in one or more of these areas. Hedge fund sponsors, therefore, should reexamine these elements of fund operations to determine whether changes should be made to address genuine SEC concerns.

Marketing of Hedge Funds

A focal point of the discussions was the manner of marketing and distributing hedge funds.

The SEC sought to determine whether there was evidence to support its perception that hedge funds were being marketed to retail investors, for whom these investments might not be suitable. The SEC identified what it saw as two emerging trends. First, it noted that hedge funds were now accessible to a broader pool of investors who, because of inflation and higher incomes today, had in the recent past attained accredited investor status but did not appear to have the financial sophistication to invest in hedge funds. The SEC asked whether it should raise the accreditation standards to further delimit the eligible pool of hedge fund investors.

Second, the SEC noted that hedge funds were becoming accessible to a broader segment of the investing public with the advent of registered funds of hedge funds that had lower minimum investing limits than the traditional hedge fund. The SEC asked whether allowing investors to participate in hedge funds through this format would be consistent with investor protection and the public interest.

Several panelists asserted that the SEC was mistaken in its belief that hedge fund sponsors were seeking to make their products available to the retail investor. These panelists stated that new investors in hedge funds in recent years were for the most part institutions, including employee benefit plans, who were disappointed with the market-correlated returns of mutual funds and wanted better returns for their constituents. The panelists noted that the push towards use of alternative investments for retail investors, particularly in the form of registered funds of hedge funds, was an initiative of the mutual fund industry. They asserted that the impetus was a combination of a few factors affecting the mutual fund industry today, including significant losses in recent years in their fund offerings, defections of star portfolio managers to the hedge fund industry, and constraints imposed by antiquated mutual fund regulations, particularly restrictions on the ability of mutual funds to employ leverage strategies.

Few panelists believed that raising the accreditation standards would ensure a better fit between the complexity of hedge fund investing and hedge fund investors. Some took the opportunity to question the SEC's use of an investor's net worth or income level as a measure of financial sophistication, noting that there is not a necessary correlation between an investor's financial position and financial sophistication and that the SEC should therefore consider other investor eligibility measures. Other panelists noted that raising the accreditation standards would not necessarily delimit the pool of eligible investors since the investment minimums for most hedge funds already effectively raise these standards for investor participation. Yet others observed that since the accreditation standards have not been revised for some time, this might be a good time to reexamine these requirements but expressed concern about the effects any increase in these standards might have on small business capital formation. There was not a clear sense of the SEC's leaning on this issue.

Various panelists expressed the view that allowing a broader pool of investors to participate in hedge funds through registered funds of hedge funds could be consistent with investor protection and the public interest. They asserted that this format affords important protections to retail investors that might not be available through direct investing in hedge funds. For example, the panelists noted that managers of registered funds of hedge funds typically perform extensive due diligence in connection with making investments in the underlying funds, and perform important oversight functions (such as risk management and portfolio inspection) in maintaining these investments. In addition, it was noted that because registered funds generally invest in several hedge funds, retail investors are afforded the benefits of

portfolio diversification. Further, it was noted that because registered fund shares generally are sold through intermediaries, the sales are made in circumstances that require the intermediaries to make suitability determinations, consistent with NASD requirements. Finally, the panelists noted that in the circumstances of registered fund sales, there would be an obligation to ensure that investors receive adequate disclosure about the risks of investing in these funds. The SEC appeared receptive to these arguments and to the notion that registered funds of hedge funds should be made available to retail investors with appropriate controls.

The SEC asked whether it should consider relaxing its longstanding prohibition on general solicitation or general advertising in connection with the marketing of hedge funds, particularly internet offerings. A few panelists observed that given the widespread availability of information on the internet about hedge fund offerings today, it is difficult for issuers to limit access to this information only to persons with whom they have a substantial pre-existing relationship. The SEC appeared receptive to considering this issue. Indeed, one senior SEC staff person expressed the view that the SEC should consider relaxing the prohibition on general solicitation and general advertising to allow public offers of hedge funds to be made. In return, the SEC could exact from the industry important investor protections, such as requiring hedge funds to conduct annual audits, get third-party valuations of their portfolio of assets, and provide standardized returns with perhaps a minimum amount of mandatory disclosure. Sales of hedge funds would continue to be restricted only to qualified persons. This approach, according to the SEC staff person, would benefit investors because it would make information about these products more readily available to them and,

thus, would provide a better basis than currently exists for investors to understand these products.

Conflicts of Interest

The SEC raised questions about various aspects of hedge fund operations that might give rise to potential conflicts of interest, and asked about the controls currently in place to eliminate or minimize these conflicts.

Of particular concern to the SEC here was the method of valuing a hedge fund's assets. The SEC observed, in this regard, that improper valuations could lead to the payment of incorrect fees to hedge fund managers to the extent these fees are based on the value of portfolio assets. In addition, the SEC noted that improper portfolio values could lead to dilution of the values of existing investors in a hedge fund when an investor withdraws from the fund or when an investor purchases interests in the fund. Several panelists indicated that a hedge fund manager does not have any material incentive to improperly inflate the values of portfolio assets since the manager's interest is aligned with those of an investor's because of the significant investment of the manager's own capital in its funds. In addition, various panelists stated that because of increased participation by institutions in recent years, hedge fund managers are increasingly using the services of third-party providers to value portfolio assets. It was not clear, however, that the SEC was satisfied with the current level of controls over the hedge fund valuation process. Indeed, there were later suggestions by SEC Chairman William Donaldson that this is an area that regulators should examine.

The SEC also raised concern about potential conflicts that might arise in connection with the allocation of trades and the assessment of performance fees for managing hedge

funds. In particular, the SEC asked whether a hedge fund manager that also advises other accounts, such as a registered investment company, might have an incentive to favor a hedge fund over these other accounts because of the performance fee it receives for managing the hedge fund. Certain panelists responded that the typical hedge fund manager does not also advise a registered investment company or other accounts, and that the manager, in any event, must observe its fiduciary duties to ensure the fair treatment of all its clients. Other panelists noted that because a hedge fund manager invests significantly in the hedge funds it advises, the manager does not have an incentive to act in a way that would be to the detriment of these funds.

Finally, the SEC solicited comment on potential conflicts that might arise with respect to use of commission dollars in operating hedge funds. One panelist explained that smaller managers are willing to enter into arrangements that are not covered by the safe harbor of Section 28(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). However, as the managers become larger and provide services to large institutional clients, this panelist noted, they often are required by these institutional clients to stay within the Section 28(e) safe harbor. As before with respect to other conflicts, the panelist again noted that the fact that the manager often has its own capital invested in a hedge fund that it advises minimizes the likelihood of abusive practices in the use of commission dollars.

SEC Registration of Hedge Fund Managers

On various panels throughout the roundtable, the SEC raised the question whether investors in hedge funds would be better protected if hedge fund managers were required to regis-

ter under the Investment Advisers Act of 1940 (the "Advisers Act"). The SEC indicated, in this regard, that approximately one-third of all hedge fund managers are currently registered with the SEC. Other roundtable participants noted that a high percentage of all hedge fund managers were subject to some form of regulation, either as persons registered as CPOs or CTAs with the CFTC, or as registered broker-dealers.

Several panelists were not supportive of mandatory SEC registration of hedge fund managers. A few expressed the view that if SEC registration were required, hedge fund managers would likely move offshore to escape SEC regulation. These panelists noted that there did not appear to be problems with the hedge fund industry to justify imposing this form of regulation on hedge fund managers. A few panelists suggested that perhaps a middle ground, such as voluntary Advisers Act registration, might be appropriate, particularly since many large managers are registering in any event for business reasons, such as in order to serve as investment advisers to pension plans and other institutional clients. Practically everyone acknowledged that if registration were required, it would provide benefits in terms of giving the SEC access to a manager's books and records in the context of SEC examinations and inspections, and providing clients and others with a database of information about managers (and other service providers). Not everyone, however, was convinced that these benefits outweighed the related costs of SEC registration.

Conclusion

It is not clear, from the roundtable discussions, that the SEC has garnered the information necessary to support greater regulation of hedge funds. Still, however, SEC Chairman Donaldson has suggested, in recent

Congressional hearings on the hedge fund industry, that there might likely be additional regulation imposed on the industry. For example, Chairman Donaldson has hinted at the possibility that the SEC might be considering recommending registration of hedge fund managers, so that the SEC could have access to the managers' books and records to examine, among other things, the valuation of hedge fund assets. The SEC is expected to issue its report, containing recommendations for legislative or regulatory action, in Fall 2003.

Given the likelihood of additional hedge fund regulation and the specter of increased SEC enforcement action in light of the spotlight currently placed on the industry, hedge fund managers should reexamine fund operations to ensure that appropriate controls are in place. The managers should pay particular attention to the following areas in light of SEC concerns:

- *Qualification of investors:* Are fund managers taking the steps necessary to form a reasonable belief that investors in hedge funds they sponsor meet the applicable qualification standards? Is there a due observance of suitability requirements in effecting hedge fund offers and sales?
- *Prohibition on general solicitation and general advertising:* Are fund managers taking the steps necessary to restrict the dissemination of hedge fund offering materials only to persons with whom they have established a substantial pre-existing relationship?
- *Risk disclosure:* Do the offering memoranda and other disclosure documents used in the marketing of hedge funds, including funds of hedge funds, adequately disclose the risks of investing in these vehicles?
- *Asset valuation practices:* Are there written procedures for valuing fund assets? Are third-party service

providers used to value fund assets in order to provide a degree of independence from fund managers in determining asset prices?

- *Trade allocation practices:* Are there written procedures for allocating trades among the fund and other advisory clients of a fund manager to ensure that all clients are treated fairly?

For additional information about the SEC's hedge fund roundtable and its likely effect on hedge fund regulation, please do not hesitate to contact members of our Investment Management Group. The full transcript of the roundtable discussions, as well as a recording of the full two-day event, is available on the SEC's website at www.sec.gov.

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