

Statement on Hedge Funds, May 2003

Statement of the Investment Company Institute Securities and Exchange Commission Roundtable on Hedge Funds

April 30, 2003

The Investment Company Institute¹ commends the Securities and Exchange Commission for its initiative in scheduling the May 14-15 roundtable regarding hedge funds, and appreciates this opportunity to comment.² This initiative is particularly timely in light of the hedge fund industry's explosive growth in recent years. Because hedge funds themselves, and a significant portion of hedge fund managers, are unregistered, fact-finding efforts of this kind are necessary and appropriate to provide the Commission additional information upon which to base its regulatory policies.

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A. Introduction

The term "hedge fund" has no precise legal definition. It generally refers to a pooled investment vehicle that, by virtue of certain exceptions under the Investment Company Act of 1940, is not registered with the Commission.

Hedge funds typically avoid registration and virtually all regulation under the Investment Company Act by relying upon Section 3(c)(1) or Section 3(c)(7).³ Moreover, the Commission does not currently require that the sponsor or adviser of a hedge fund relying upon Section 3(c)(1) or 3(c)(7) register with the Commission. Many hedge fund advisers avoid registration under the Investment Advisers Act of 1940 by relying on Section 203(b)(3). That section exempts from Advisers Act registration an adviser that has fewer than 15 clients in a twelve-month period and does not hold itself out to the public as an investment adviser. The Commission has interpreted these requirements in a way that facilitates the reliance on this exemption by hedge fund advisers. Rule 203(b)(3)-1 provides, in effect, that a hedge fund (subject to certain conditions) may be counted as a single client for these purposes. The same rule permits a hedge fund adviser to describe its activities on behalf of the fund in the private placement offering materials, without being deemed to hold itself out to the public as an investment adviser. Accordingly, the Commission's authority over hedge funds is typically limited to enforcing the anti-fraud provisions of the federal securities laws.

Operating within these statutory and regulatory exceptions and exemptions from the regime applicable to registered investment companies and registered investment advisers, hedge funds may engage in any investment strategy. There are no regulatory limits on their trading other than those governing the markets themselves. Often, the investment strategies in which they engage are complex and highly leveraged.

The Institute believes it is very timely for the Commission to consider whether this historical "hands off" approach remains appropriate or should be modified in some fashion. This is because of the significant increase in the number of hedge funds, the number of entities sponsoring hedge funds and the number of individuals investing in or otherwise having exposure to hedge fund investments. In light of the importance that mutual funds and other registered investment companies have assumed as financial intermediaries, the extensive regulation to which they are subject, and the far less risky investment strategies that they typically

pursue, the Institute believes that it is critically important that the Commission's regulations ensure that no investor confuses a hedge fund with one of these highly regulated investment vehicles. Equally importantly, no investor should inadvertently be drawn to investing in hedge funds. Thus, we would urge the continued strict interpretation and enforcement of the private placement requirement as it applies to hedge funds.

The Institute also recommends that hedge fund advisers generally be required to register under the Advisers Act. Adviser registration entails minimal costs and burdens for a hedge fund sponsor, but offers significant public benefits. It would ensure, among other things, that hedge fund investors receive certain disclosures about the fund's adviser, and it would assure the ability of the Commission and its staff to monitor the activities of participants in this large, important and growing segment of the securities market. We discuss each of these points in turn below.

B. The “public offering” prohibition should be maintained and strictly enforced.

Hedge funds, which operate outside the requirements of the Investment Company Act, may be an appropriate investment choice for certain types of investors, but hedge funds lack the investor protections that are vital for the investing public at large. The issue is not the intrinsic value of hedge funds but rather to whom hedge funds may be sold without registration with the Commission and the substantive protections of the Investment Company Act. As the Supreme Court has recognized, investments in unregistered securities are intended to be available only to those investors who are in fact able to “fend for themselves” in the marketplace.⁴ This policy is especially important for investors in pooled vehicles, which present greater opportunities for abuse and conflicts of interest. Indeed, because of the unique investor protection issues raised by pooled investment vehicles, Congress required not only the registration of securities issued by investment companies but also the registration and substantive regulation of the funds themselves under the Investment Company Act. Stringent separation of registered and unregistered funds is thus necessary in order to protect the investors for whom the benefits and protections of Investment Company Act regulation are intended.

The Institute recommends that the Commission seek to identify ways in which it can provide greater assurance of a strict divorce between the broad market in which mutual funds and other registered investment companies operate and that which is available to hedge funds—to minimize the risk of these products being confused with one another and of investors not knowing what they are (or are not) getting. This can be achieved in part by oversight of the sales practices of hedge funds.⁵ It also necessitates upholding the private placement requirement as a key investor protection.

Recently, some have called on the Commission to abandon its prohibition on general solicitation or general advertising by hedge funds.⁶ For current purposes, it should be sufficient to answer that Congress specifically decided to prohibit any public offering when it adopted

Section 3(c)(7), as part of the National Securities Markets Improvement Act in 1996.⁷ While the Commission's interpretations of the private placement requirement have evolved and provided some flexibility at the margins,⁸ we believe any fundamental change in policy should require Congressional action, which the Institute would strongly oppose. Repealing or materially weakening the private placement requirement—for example, by authorizing advertisements for hedge funds in media of general circulation—would engender widespread investor confusion and undermine public confidence in the key investor protections that characterize the regulated market.⁹ The numerical and qualified purchaser eligibility requirements under the Investment Company Act serve a similar purpose.

In addition to enforcing the private placement requirement, the Commission and its staff should focus on whether certain products and arrangements are being improperly used as conduits for ineligible persons to invest in hedge funds. In recent years, there has been concern that sponsors of hedge funds have sought to attract less sophisticated investors, the so-called “retailization” of the market.¹⁰ It is important that the Commission enforce the current rules for products and arrangements that simply pool investments by otherwise ineligible investors for purposes of investing in hedge funds.

The recent introduction into the market of registered closed-end funds that invest in underlying hedge funds provides a means by which some otherwise ineligible investors can be exposed to hedge funds. It is important to note, however, that unlike the conduit structures noted above, these registered funds of hedge funds are themselves subject to comprehensive regulation, and SEC oversight in areas such as valuation, under the Investment Company Act. Moreover, registered funds of hedge funds, by investing in a portfolio of underlying hedge funds, also offer investors a different risk/return profile than a direct investment in any of the underlying hedge funds.¹¹ At the same time, registered funds of hedge funds are, at least for the most part, not appropriate investments for most retail investors. As such, it is important that there be strict regulation of sales practices of persons selling these funds, including, in particular, requiring careful attention to suitability standards. (Most funds of hedge funds limit their investors to accredited investors (to avoid the costs of registration under the Securities Act) or qualified clients as defined in Rule 205-3 under the Advisers Act (because the fund of funds charges a performance fee).) As noted above, the NASD has issued a notice to members

on sales practices in connection with the offer and sale of shares of registered funds of hedge funds; the Institute strongly supports strict SEC and NASD regulation of sales practices involving these funds.

C. Investment advisers to hedge funds should be required to register.

While the general investing public should not have access to information on hedge fund offerings, we believe the Commission and its staff should. One consequence of the current “hands off” approach is a lack of sufficient information upon which to base sound regulatory policies.¹² Undoubtedly, hedge funds have grown in importance as financial intermediaries and they provide liquidity and efficiencies to the market, but the problems to which they potentially may give rise are difficult for the Commission to police.

Requiring the investment advisers to hedge funds to register under the Advisers Act would address this deficit and provide a mechanism for the Commission to monitor potential fraud or manipulation. Trade allocation practices—a traditional focus of Commission oversight in the investment adviser arena¹³—provide a good example. It is unlikely that most private investors or the Commission itself could determine whether an unregistered adviser to a hedge fund was misallocating trades or consistently favoring one account over another. No one but the unregistered adviser itself may have access to the information necessary to judge whether allocations are being made in a fair and equitable manner. Inspection authority for the Commission, which registration of hedge fund advisers would provide, would help ensure oversight of practices in this area.

Establishment of a registration requirement is possible through rulemaking, and does not require legislation. The Commission adopted Advisers Act Rule 203(b)(3)-1 in 1985¹⁴ and substantially revised it in 1997.¹⁵ It intended the rule to provide a safe harbor, in light of ambiguity about who was a “client” under the Advisers Act following *Abrahamson v. Fleschner*.¹⁶ We believe the Commission has broad authority through the rulemaking process to interpret the Advisers Act and that it may change its interpretation after due consideration and administrative process.¹⁷

Incremental regulation of hedge fund advisers in this manner would have minimal or no impact on their legitimate operations. The anti-fraud provisions of Section 206 of the Advisers Act (including limitations on principal and agency cross trading) already apply, as do broad principles of fiduciary duty under the statute.¹⁸ If required to register, these advisers would become subject to more specific requirements of Advisers Act rules with regard to matters such as advertising, certain disclosure items, proxy voting and record keeping. Most if not all of these additional requirements simply constitute good business practices or implement the anti-fraud provisions already applicable to unregistered advisers.

It should also be noted that many jurisdictions other than the United States require hedge fund managers based there to register. The United Kingdom currently has a registration requirement and, by contrast to other less regulated centers in the EU, London has seen rapid growth in its hedge fund industry.¹⁹ Thus, registration of hedge fund advisers would not seem to be burdensome or problematic.

In addition, because hedge funds often trade futures as well as securities, many managers are required to register as commodity trading advisers and commodity pool operators with the Commodity Futures Trading Commission. Potential concerns about duplicative regulation, however, have been allayed. Congress recently exempted advisers primarily trading securities from CFTC registration and commodity trading advisers trading primarily futures from registration with Commission.²⁰ In effect, a hedge fund manager would register with the regulator responsible for its primary trading activity. While no exemption yet exists from commodity pool operator registration for a hedge fund manager primarily trading securities, the CFTC has proposed rules that would grant such an exemption and has provided temporary no-action relief from registration while the rule proposal is pending.²¹

As a practical matter, if hedge fund advisers were required to register with the Commission, the qualified client (or qualified purchaser) standard would apply to every fund with a performance fee.²² Hedge fund investors generally would be limited to those individuals with a net worth of \$1.5 million or investable assets of \$5 million. If a hedge fund’s adviser is unregistered, it need not observe any minimum net worth requirement with respect to investors who pay performance-based compensation. As a result, the minimum accredited investor test—i.e., \$200,000 of annual income—often applies to investors in their funds. In light of the importance of ensuring that only sophisticated investors participate in hedge funds, these higher eligibility requirements would appear to be appropriate.

For these reasons, in our judgment, requiring hedge fund advisers to register under the Advisers Act would be a positive, if limited, step. It should be kept in mind, however, that this incremental regulation concerns only the adviser to the hedge fund, and not the fund itself. The stark differences at the product level between hedge funds and mutual funds and other registered investment companies would remain. Put differently, registration of the adviser should not be confused with registration of the fund under the Investment Company Act. Therefore, if the Commission moves to require the registration of hedge fund advisers, it should assure that hedge fund investors receive clear and prominent disclosure that the fund itself is not registered nor regulated under the Investment Company Act.

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,912 registered open-end investment companies ("mutual funds"), 554 registered closed-end investment companies, and six sponsors of registered unit investment trusts. Its mutual fund members have assets of about \$6.254 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders.

² See Roundtable Discussions Relating to Hedge Funds, 68 Fed. Reg. 15,488 (Mar. 31, 2003).

³ Section 3(c)(1) excludes from the definition of "investment company" for almost all purposes under the Act any issuer that is not making a public offering and has outstanding securities beneficially owned by not more than one hundred persons. Similarly, Section 3(c)(7) excludes from the definition of "investment company" for almost all purposes under the Act any issuer that is not making a public offering and has outstanding securities owned exclusively by persons who were "qualified purchasers" at the time they acquired the securities. "Qualified purchasers" generally include individuals with \$5 million in investable assets and entities with \$25 million in investable assets. See Section 2(a)(51)(A) and Rules 2a51-1, 2a51-2 and 2a51-3 under the Investment Company Act. Most hedge funds rely on Rule 506 of Regulation D under the Securities Act of 1933 to avoid engaging in a public offering within the meaning of Sections 3(c)(1) and 3(c)(7) and to avoid being required to register the securities they issue under the Securities Act. Rule 506 requires, among other things, that the interests in the hedge fund be sold only to "accredited investors" and up to 35 non-accredited but sophisticated investors. "Accredited investor" generally includes individuals with an income of \$200,000 per year (or \$300,000 in joint income with their spouse) or a net worth of \$1 million (which is redundant for 3(c)(7) funds in almost all cases). The rule also prohibits any "general solicitation or general advertising" with respect to the fund, including offers made through periodicals and generally available Internet sites. See Rule 502(c).

⁴ SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) [hereinafter, Ralston Purina].

⁵ See, e.g., NASD Reminds Members of Obligations When Selling Hedge Funds, NASD Notice to Members 03-07 (Feb. 2003) [hereinafter, NTM 03-07]. See also [Press Release](#), NASD, NASD Fines Altegris Investments for Hedge Fund Sales Violations (Apr. 22, 2003).

⁶ See The Federalist Society, [The First Amendment and Securities Laws](#). As an alternative to lifting the ban entirely, the SEC, in its "Aircraft Carrier" release, offered a proposal that would expand the permissibility of Rule 135 notices for both public and private offerings, thereby allowing issuers to provide limited notice of their proposed offerings or business transactions. See SEC Release 33-7606A (Nov. 13, 1998). See also Stanley Keller, From the Chair, The Securities Reporter (ABA), Summer 2001, at 3 (discussing the ABA's Task Force on the Future of Securities Regulation proposal to "[r]etain Regulation D, without limitation on 'general solicitation' or limitation to use by issuers").

⁷ See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 209(a)(4). Like Section 3(c)(1), Section 3(c)(7) was adopted with language specifically requiring issuers relying on the Section not be engaged in a "public offering" of securities.

⁸ In the 1930s, the private placement requirement was interpreted narrowly. See SEC Release 33-285 (Jan. 24, 1935). The Commission and its staff have interpreted the requirement over time to keep up with developments in communications technology, such as the Internet. See, e.g., Lamp Technologies, Inc., SEC No-Action Letter (May 29, 1998); Lamp Technologies, Inc., No-Action Letter (May 29, 1997) (the "Lamp Letters"). See also Use of Electronic Media, Securities Act Release No. 7856, at 35 n.88 (Apr. 28, 2000) (noting that the Lamp Letters apply only to 3(c)(1) and 3(c)(7) issuers).

⁹ See, e.g., Letter from Rep. Edward J. Markey (D-Mass.) to SEC Chairman Arthur Levitt (Dec. 18, 2000) [hereafter, the "Markey Letter"]. Rep. Markey, among other things, stressed the importance of the private placement requirements in his letter. SEC Chairman Levitt, in his response, noted that, "[t]he Commission believes that these prohibitions and limitations are appropriate to protect unsophisticated investors." Letter from SEC Chairman Arthur Levitt to Rep. Edward J. Markey (D-Mass.) (Jan. 29, 2001).

¹⁰ In the Markey Letter, Rep. Markey expressed concern that the eligibility requirements for hedge funds might be circumvented by such practices as brokers pooling assets from ineligible investors for investment in hedge funds.

¹¹ The SEC staff has taken the position that establishing a registered fund to invest most of its assets in a single underlying hedge fund, i.e., to serve as a conduit for investing in such hedge fund, would be inconsistent with the Investment Company Act. See, e.g., Cornish & Carey Commercial, Inc. SEC No-Action Letter (June 21, 1996). The Institute strongly agrees with the staff's position and urges that it be strictly enforced.

¹² The near-collapse of Long Term Capital Management in 1998 pointed up the dearth of information about the extent and systemic implications of the leverage used by such funds. Recent concerns about market manipulation have underscored the lack of information on the nature of their short-selling practices. See The President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (Apr. 1999). See also Henry Sender, Hedge Fund Inquiry by Spitzer is Turning to Credit Derivatives, Wall St. J., Feb. 7, 2003, at C7.

¹³ Registered advisers, including by definition every investment adviser to a registered investment company, are subject to comprehensive regulation of conflicts of interest and trading issues. A growing number of fund advisers also advise hedge funds, and the Commission and its staff have sought to alert advisers to the conflicts that may arise. However, these potential conflicts are not new, nor are they unique to hedge funds. See Hearing on Recent Developments in Hedge Funds Before the Senate Comm. on Banking, Housing and Urban Affairs, 108th Cong. (Apr. 10, 2003) (statement of SEC Chairman William H. Donaldson, stating that the potential conflicts of interest in managing hedge funds alongside mutual funds “are the same as those that exist for any investment adviser that manages both registered investment companies and private client accounts”). It is our understanding that advisers to mutual funds that also manage hedge funds have adopted a variety of policies and procedures in order to address potential conflicts between the registered funds and the hedge funds that they advise.

¹⁴ See SEC Release IA-983 (July 12, 1985).

¹⁵ See SEC Release IA-1633 (May 15, 1997).

¹⁶ 568 F.2d 862 (1977). The Court held that the general partner of an investment partnership was an investment adviser, and that the limited partners could have a private right of action claim against the adviser for fraud under Section 206 of the Advisers Act.

¹⁷ See Advisers Act, § 211.

¹⁸ See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963). The Supreme Court recognized the fiduciary duty of investment advisers, particularly in the context of fraud under Section 206, after Congress extended Section 206 to unregistered investment advisers in 1960. See Pub. L. No. 86-750, §§ 8, 9, 74 Stat. 887 (Sept. 13, 1960).

¹⁹ Peter Astleford & Dick Frase, London, the Financial Services and Markets Act and the Need for Authorisation, in *Starting a Hedge Fund - A European Perspective 7* (ISI Publications 2002).

²⁰ See Commodity Futures Modernization Act of 2000, H.R. 5660, § 251(d) (codified as Section 4m(3) of the Commodity Exchange Act) and § 209(b)(3) (codified as Section 203(b)(6) of the Advisers Act), respectively.

²¹ See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, 68 Fed. Reg. 12622 (proposed Mar. 17, 2003) (to be codified at 17 C.F.R. pt. 4).

²² Under Rule 205-3, a registered investment adviser must “look-through” a 3(c)(1) fund in determining that performance based compensation is paid only by qualified clients. While the general prohibition on performance fees in Section 205 does not apply to 3(c)(7) funds, the eligibility requirements to invest in a 3(c)(7) fund are generally higher than the qualified client standards in Rule 205-3.