CHAPTER 1

Hedge Funds: Overview and Regulatory Landscape

The Managed Fund Association

Too many people believe that hedge funds are unregulated investment vehicles. This is not so at all. In fact, this has been a hot topic in recent years—do they need more regulation? Less? None? This chapter does not take a position either way. It attempts to illuminate the United States' current regulatory framework as of the Spring, 2003. It first describes hedge funds and then addresses the relevant regulations.

WHAT IS A HEDGE FUND?

A hedge fund is an investment vehicle. A.W. Jones launched the first modern hedge fund in the late 1940s. Some investment historians place the roots of hedge funds in the 1930s. Regardless of the specific date, hedge funds are rather new concepts in the investment world. Since their advent, they have varied dramatically in terms of scope, strategy, and philosophy. Their heterogeneity makes definitions difficult. People's misconceptions about them get in the way of a clear understanding.

The most famous as well as most misunderstood hedge fund was probably Long Term Capital Management (LTCM), which first shot to fame due to its "all-star" cast of founders. It plunged to infamy through its near default on a massive portfolio in 1998. So was born the modern view of hedge funds as maverick, risky, and aggressive investment vehicles.

This view does a great disservice to the hedge fund industry. LTCM had unique players who made unique plays. Most hedge funds are much smaller, and use much less leverage. After LTCM's failure, the President's Working Group on Financial Markets (PWG) undertook a prolonged study of the issues. Fortunately, the PWG issued a positive definition of a hedge fund: A pooled investment vehicle that is privately organized, administered by a professional investment management firm (the hedge fund manager), and not widely available to the public.

Most importantly, hedge funds offer investors innumerable investment alternatives for diversifying portfolios. They are not meant to be anyone's sole investments. They increase market liquidity, provide shock absorption in volatile markets, mitigate price swings, and reduce bid/ask spreads.[1]

These pooled investment vehicles are often organized as private partnerships that reside offshore for tax and regulatory reasons. The managers frequently receive fees based on performance. They are generally unregistered investment vehicles whose advisors may or may not be registered. This is why people believe that hedge funds are unregulated. There is a difference between "unregistered" and "unregulated." The regulatory landscape is perpetually changing, so it is quite difficult to create a simple snapshot. This chapter tries to include anticipated changes that could affect the market.

HEDGE FUNDS: UNREGISTERED, BUT NOT UNREGULATED

Paul Roye, the director of the Division of Investment Management of the U.S. Securities and Exchange Commission (SEC), recently stated: "Hedge funds generally are referred to as unregulated investment pools. This may conjure up images of some maverick managers doing as they please. However, hedge fund managers who take this attitude do so at their peril." This discussion will focus first on which hedge funds and hedge fund managers are exempt from registration, and seconds, on the regulations they do face.

Hedge Funds and Registration

Hedge funds can bypass many regulations by avoiding registration under the Investment Company Act of 1940 (Investment Company Act), the Investment Advisors Act of 1940 (Investment Advisors Act), the Securities Act of 1933 (Securities Act), and the Securities Exchange Act of 1934 (Exchange Act). Exemption from one category does not necessarily exempt them from others. And while hedge funds are free from registration with the SEC, those that use futures and trade commodities are registered with the Commodity Futures Trading Commission (CFTC), which wields great power under the Commodity Exchange Act (CEA). Hedge fund managers must

[1]For more information on the nature of hedge funds and the uniqueness of LTCM, see *Hedge Funds: Issues for Public Policy Makers*, published by Managed Funds Association, April 1999.

also pay attention to the securities and investment advisor laws of their states and the states and countries where their investors may reside.

Investment Company Act

Investment companies have to register under the Investment Company Act and abide by its regulations. This Act delineates a number of exceptions to the definition of an investment company, thereby exempting such entities from some, but not all, regulations. Hedge funds can qualify for one of two major exceptions to the definition of an investment company by limiting either the number or type of investors so long as the fund is not proposing to make a public offering of its securities.

Section 3(c)(1) of the Investment Company Act A hedge fund is not an investment company for the purposes of the Investment Company Act if it has less than 100 beneficial owners and does not publicly offer its securities. Before 1997, if a company owned less than 10% of a hedge fund's securities, that company was considered one beneficial owner of that fund; otherwise, the Investment Company Act would have "looked through" that company to all its respective investors so that each investor in the company would be considered an individual owner of the fund for purposes of 3(c)(1). Since 1997, after the National Securities Market Improvement Act of 1996, a company can own more than 10% of a hedge fund's securities and still be considered one beneficial owner of the fund, so long as the value of that company's securities in the fund is less than 10% of the company's total assets.

Section 3(c)(7) of the Investment Company Act A fund that limits its sales only to "qualified purchasers" and does not publicly offer its securities is also excluded from being considered an investment company. Qualified purchasers include an individual (or an individual and his or her spouse, if they invest jointly) with at least $5 million in investments; specified family-owned companies with at least $5 million in investments; trusts established and funded by qualified purchasers, so long as a qualified purchaser makes the trust's investment decisions; and any person acting for his or her account or the account of other qualified purchasers who own and invest more than $25 million.

Investment Advisors Act

Hedge fund managers are investment advisors as defined by the Investment Advisors Act. Most large investment advisors are required to register with the SEC. They must follow myriad regulations, such as extensive record-keeping requirements and restrictions on performance-based fees. Some hedge fund advisors register under the Investment Advisors Act, but many avoid it with the private advisor exemption under Section 203(b)(3).

Section 203(b)(3) exempts advisors who have fewer than 15 clients and who neither hold themselves up as investment advisors nor act as investment advisors to an investment company registered under the Investment Company Act or a company that has elected treatment as a "business development company" under the Investment Advisors Act. For the purposes of Section 203(b)(3), the SEC promulgated Rule 203(b)(1)-1, which defines a limited partnership or a limited liability company as a single client, so long as that partnership or company is investing for its own benefit rather than the individual benefits of its owners. Rule 203(b)(1)-1 allows many hedge fund managers to enjoy an exempt status.

Securities Act

Section 5 of the Securities Act mandates that securities be registered with the SEC before they are sold, unless they are exempt. Most hedge funds qualify for exemption under Section 4(2) of the Securities Act, which exempts "transactions by an issuer not involving any public offering." A similar concept is found in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. Section 4(2) is confusing, and in 1982 the SEC adopted Regulation D to provide a safe harbor for certain offerings. Regulation D offers two ways for an issuer to use the safe harbor. First, the issuer cannot use any general solicitation, such as newspaper articles, advertisements, seminars, or circulars. Web sites can be used to attract solicitation if certain procedures are used.[2] The second way involves the nature of purchasers. Issuers relying on Regulation D cannot offer or sell securities to more than 35 non-accredited investors.

Exchange Act

Any person who is "engaged in the business of effecting transactions in securities for the account of others" qualifies as a broker–dealer who must register with the SEC under Section 3(a)(4)(A) of the Exchange Act. People who receive transaction-related compensation and/or hold themselves out as brokers, or as assisting others in completing securities transactions, must register as broker–dealers under Section 15(a) of the Exchange Act, and follow all its rules. Hedge funds are able to avoid those regulations by

[2]See *IPONET*, SEC No-Action Letter (July 26, 1996). The SEC issued 2 no-action letters to Lamp Technologies, Inc. (May 29, 1997 and May 29, 1998) that bring the use of websites for broad solicitation by hedge funds under Regulation D's safe harbor, if the hedge funds had previous relationships with the potential investors solicited.

taking advantage of the broker–dealer exemption under Section 3(a)(5)(C) for entities trading securities solely for their own accounts and by not holding themselves out to the public as broker–dealers.

Commodity Exchange Act ("CEA")

If a hedge fund trades futures and options contracts on a futures exchange, the CEA considers the fund a commodity pool. The operator of that pool, the hedge fund manager, is then subject to regulation as a commodity pool operator (CPO) under the CEA. The CEA has no registration-exemption scheme equivalent to those under the Investment Company Act, the Investment Advisors Act, or the Exchange Act. Although the hedge fund operators who qualify as CPOs are required to register, they may be exempt from some disclosure and reporting requirements, depending on the nature of their investors.

State Securities Laws

Most states have their own regulatory structures for investments and investment services offered within their borders. Hedge fund operators need to know the regulatory schemes of each state in which they operate, because exemption at the federal level does not necessarily equate to exemption at the state level. Some states are adopting the federal government's exemption model. California, for example, has recently adopted regulations that incorporate a "private advisor" registration exemption similar to the federal exemption in Section 203(b)(3) of the Advisors Act.

HEDGE FUND REGULATION

Registered securities, investment companies, and investment advisors must follow many rules that most hedge fund operators would view as burdensome and prohibitive to conducting their business. However, hedge funds are subject to other regulations, such as antifraud provisions. Plus, after the tragedy of September 11, 2001, hedge funds, among others, face mandated antimoney-laundering programs for the first time.

Hedge fund regulation can be put into five categories: antifraud provisions, antimoney-laundering requirements, CFTC regulations, Employee Retirement Income Security Act of 1974 (ERISA), and other miscellaneous legal considerations.

Antifraud Provisions

Hedge funds and hedge fund managers, both registered and unregistered, are subject to the extensive antifraud provisions of the Securities Act (Section 17), the Exchange Act (Section 10 and Rule 10b-5 promulgated thereunder) and the Advisors Act. The antifraud provisions apply to any offer, sale or purchase of securities, or any advisory service of such offer, sale or purchase. Furthermore, hedge funds must not engage in activities detrimental to market integrity, such as market manipulation and insider trading.

Antimoney-Laundering Requirements

In the wake of the terrorist attacks on America, Congress began work on the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act), which President Bush signed into law on October 26, 2001. Revelations that some of the terrorist activity was funded by money that had been laundered through a variety of financial vehicles resulted in Title III of the USA PATRIOT Act, entitled the "International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001," which required all financial institutions to establish an antimoney-laundering program by April 24, 2002. Section 352 of the USA PATRIOT Act states that each program should include at least internal policies; procedures and controls; a compliance officer; an ongoing employee training program; and an independent audit function.

As defined in the USA PATRIOT Act, the term "financial institution" includes, among other things, any entity that is "an investment company,"[3] and any entity that is registered (or required to register) as a CPO or a commodity trading advisor (CTA) under the Commodity Exchange Act.[4] Although it is not entirely clear whether the reference to an investment company could be construed to include a hedge fund excepted from the definition of investment company under the Investment Company Act, the Treasury Department has suggested that hedge funds are covered by the USA PATRIOT Act, and they must adopt and implement antimoney-laundering programs.

[3]The reference to "an investment company" in this definition is not expressly limited to registered investment companies; as a result, it is unclear whether the definition is intended to include unregistered, private investment funds, i.e., funds excepted from the definition of "investment company" under the Investment Company Act of 1940. This ambiguity may be resolved by the investment company study to be undertaken by the Secretary of the Treasury, the Federal Reserve Board, and the Securities and Exchange Commission by October 26, 2002, pursuant to Section 356(c) of the USA PATRIOT Act. This requires these agencies to report on recommendations for effective regulations to apply the currency reporting and related requirements of the Bank Secrecy Act to registered investment companies as well as certain funds excepted from the definition of "investment company."

CFTC Regulations

Regulation of hedge funds under the Commodity Exchange Act applies to the hedge fund managers, not the funds. So, only CPOs and CTAs need comply.

Hedge Fund Managers as CPOs Under the CEA, a CPO is any person engaged in the business of soliciting or accepting funds from others for the purpose of trading commodity futures contracts in connection with a commodity pool, which is any investment trust, syndicate, or similar entity that invests its pooled funds in commodity interests. Most hedge fund managers who use futures and options on futures qualify and must register. However, the CFTC has adopted three rules that relieve hedge funds from the requirements of disclosure, reporting and recordkeeping. The manager must file notice to apply these. In addition to this existing relief, Managed Funds Association (MFA)[5] is promoting a new rule (Proposed Rule 4.9) that would provide CFTC registration relief for certain funds.

Disclosure Relief CFTC Rule 4.7 relieves a hedge fund manager registered as a CPO from the requirement of providing a CPO Disclosure to each customer, so long as the offering memorandum is not misleading. To qualify for the exemption under Rule 4.7, the hedge fund manager can sell ownership in the fund only to Qualified Eligible Participants (QEPs) and must file a simple exemption form with the CFTC. Rule 4.7 defines QEPs as, among others, registered commodities and securities professionals; accredited investors under the Securities Act who have an investment portfolio of at least $2,000,000, $200,000 on deposit as commodities margin, or both; and non-U.S. persons.

A registered CPO primarily involved in securities might consider seeking disclosure relief under Rule 4.12(b), which concerns disclosure, particularly

[4]Section 321 of the USA PATRIOT Act expands the definition of "financial institution" in the Bank Secrecy Act to include "any futures commission merchant, commodity trading advisor, or commodity pool operator registered or required to register under the Commodity Exchange Act." As a result, any CPO or CTA managing a hedge fund would be required to comply with Section 352 of the USA PATRIOT Act.

[5]MFA, located in Washington, D.C., is a membership organization dedicated to serving the needs of the professionals who specialize in the global alternative investment industry—hedge funds, funds of funds, and private and public managed futures funds. MFA has over 600 members, which represent a significant portion of the $500 billion invested in alternative investment vehicles around the world. MFA members, including many of the largest international financial services conglomerates, are based in the U.S. and Europe.

performance information, to investors. Under this rule, the hedge fund manager need not disclose any performance information. However, he or she must file with the CFTC and provide prospective investors a disclosure document. Managers often can use the offering memorandum for nonaccredited investors in accordance with Regulation D to satisfy the CFTC requirements; otherwise, the manager might need to supply a CFTC supplement.

Reporting Relief Rule 4.7 also provides an exemption for the required certified annual report under Rules 4.22(c) and (d). In lieu of the extensive reporting requirements of Rules 4.22(c) and (d), managers under 4.7 need only supply an uncertified annual statement to the CFTC and the National Futures Association (NFA). This must contain at least a Statement of Financial Condition as of the close of the fiscal year and a Statement of Income (Loss) for that year. Hedge fund managers seeking disclosure relief under Rule 4.12(b) cannot avail themselves of the annual report relief under Rule 4.7.

Recordkeeping Relief CPOs qualifying for relief under CFTC Rule 4.7 are exempt from the extensive recordkeeping requirements of Rule 4.23.

Proposed Rule 4.9 Currently, unlike any SEC relief, no registration relief exists for CPOs with the CFTC. Proposed Rule 4.9 would provide CFTC registration relief for CPOs who operate funds only with qualified investors.

Hedge Fund Managers as CTAs The Commodity Exchange Act defines a CTA as anyone who, for profit, advises others about trading in commodity futures and options on futures. At least two exemptions exist for them. First, under Rule 4.14(a)(4), managers only provide trading advice to the pool or pool for which they are registered; they are exempt from registering as CTAs. Second, they need not register as CTAs if they have fewer than 15 clients in 12-month period and do not advertise themselves as CTAs. This is of limited use because each investor in each fund is counted as a client.

ERISA

If at least 25% of a fund's assets consist of ERISA assets, the entire fund is considered "plan assets" under ERISA. It is subject to numerous restrictions and prohibitions under ERISA. Most hedge funds simply ensure that their ERISA assets remain below the 25% level.

Other Miscellaneous Legal Considerations

Antifraud provisions, antimoney-laundering programs, CFTC regulations, and ERISA requirements are the four major categories of regulation affecting unregistered hedge funds and hedge fund managers. Hedge fund managers must be vigilantly aware of other regulations and restrictions that could affect them.

State Securities Laws All exemptions from registration or regulation by the SEC and the CFTC are the result of federal laws. Every state has developed and promulgated its own system of regulation for hedge funds that conduct business or offers securities within its borders. While many states have adopted structures that mirror the federal system, each has its own nuances.

The Exchange Act Aside from antifraud provisions, the Exchange Act has other regulations that might affect hedge funds and managers. For example, they might be subject to the beneficial ownership requirements of Section 13(d) of the Exchange Act, which affects any person who is the beneficial owner of more than five percent of any class of voting securities registered under the Exchange Act. If a hedge fund or manager qualifies as such a beneficial owner, he or she must file reports with a number of entities, including the SEC, and report all positions that meet the five percent threshold. Some of the specific reporting requirements can be found under SEC Rule 13d-1.

Taxes All hedge funds, hedge fund managers, and hedge fund investors must consider the tax burden based on the structure of the fund. For example, funds structured as limited partnerships are not considered taxable entities, but the partners in the funds must consider income, deductions, and realized gains and losses from the partnership, even if they don't receive any income from the partnership. Many funds are based offshore for tax benefits.

CONCLUSION

Hedge fund managers cannot assume that their unregistered status equals an unregulated one. The regulatory framework provides specific parameters in which each hedge fund must conduct its business if it is to be an unregistered fund. The laws specifically dictate who must or must not register. It is not voluntary. Critics of hedge funds should understand that unregulated hedge funds don't exist. Of course, hedge funds and hedge fund managers do receive great benefits from registration exemptions. These give them tremendous ability to operate the funds in a much more effective and productive manner. However, no matter what their status in the industry, all hedge funds have restrictions and limitations.