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"Regulating Hedge Funds and Other Private Investment Pools"

Before the Subcommittee on Securities, Insurance, and Investment
of the U.S. Senate Committee on Banking, Housing, and Urban Affairs

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Chairman Reed, Ranking Member Bunning and Members of the Subcommittee:

I. Introduction

Thank you for the opportunity to testify before you today. My name is Andrew Donohue, and I am the Director of the Division of Investment Management at the Securities and Exchange Commission. I am pleased to testify on behalf of the Commission about regulating hedge funds and other private investment pools.[1]

Over the past two decades, private funds, including hedge, private equity and venture capital funds, have grown to play an increasingly significant role in our capital markets both as a source of capital and the investment vehicle of choice for many institutional investors. We estimate that advisers to hedge funds have almost $1.4 trillion under management. Since many hedge funds are very active and often leveraged traders, this amount understates their impact on our trading markets. Hedge funds reportedly account for 18-22 percent of all trading on the New York Stock Exchange. Venture

[1] Commissioner Paredes does not endorse this testimony.

capital funds manage about $257 billion of assets,[2] and private equity funds raised about $256 billion last year.[3]

The securities laws have not kept pace with the growth and market significance of hedge funds and other private funds and, as a result, the Commission has very limited oversight authority over these vehicles. Sponsors of private funds—typically investment advisers—are able to organize their affairs in such a way as to avoid registration under the federal securities laws. The Commission only has authority to conduct compliance examinations of those funds and advisers that are registered under one of the statutes we administer. Consequently, advisers to private funds can "opt out" of Commission oversight.

Moreover, the Commission has incomplete information about the advisers and private funds that are participating in our markets. It is not uncommon that our first contact with a manager of a significant amount of assets is during an investigation by our Enforcement Division. The data that we are often requested to provide members of Congress (including the data we provide above) or other federal regulators are based on industry sources, which have proven over the years to be unreliable and inconsistent because neither the private funds nor their advisers are required to report even basic census-type information.

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2 The National Venture Capital Association (NVCA) estimates that 741 venture capital firms and 1,549 venture capital funds were in existence in 2007, with $257.1 billion in capital under management. NVCA, Yearbook 2008 at 9 (2008). In 2008, venture capital funds raised $28.2 billion down from $35.6 billion in 2007. Thomson Reuters & NVCA, News Release (Apr. 13 2009). In 2007, the average fund size was $166 million and the average firm size was $347 million. *Id.* at 9.

3 U.S. private equity funds raised $256.9 billion in 2008 (down from $325.2 billion in 2007). Private Equity Analyst, 2008 Review and 2009 Outlook at 9 (2009) (reporting Dow Jones LP Source data), available at http://fis.dowjones.com/products/privateequityanalyst.html.

This presents a significant regulatory gap in need of closing. The Commission tried to close the gap in 2004—at least partially—by adopting a rule requiring all hedge fund advisers to register under the Investment Advisers Act of 1940 ("Advisers Act").[4] That rulemaking was overturned by an appellate court in the *Goldstein* decision in 2006.[5] Since then, the Commission has continued to bring enforcement actions vigorously against private funds that violate the federal securities laws, and we have continued to conduct compliance examinations of the hedge fund advisers that remain registered under the Advisers Act. But we only see a slice of the private fund industry, and the Commission strongly believes that legislative action is needed at this time to enhance regulation in this area.

The Private Fund Transparency Act of 2009, which Chairman Reed recently introduced, would require advisers to private funds to register under the Advisers Act if they have at least $30 million of assets under management.[6] This approach would provide the Commission with needed tools to provide oversight of this important industry in order to protect investors and the securities markets. Today, I wish to discuss how registration of advisers to private funds under the Advisers Act would greatly enhance the Commission's ability to properly oversee the activities of private funds and their

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4 Investment Advisers Act Release No. 2333 (Dec. 2, 2004).

5 *See Goldstein v. S.E.C.*, 451 F.3d 873 (D.C. Cir. 2006).

6 Section 203A(a)(1) of the Act prohibits a state-regulated adviser to register under the Act if it has less than $25 million of assets under management. The Commission has adopted a rule increasing the $25 million threshold to $30 million. *See* Rule 203A-1 under the Advisers Act. The threshold does not apply to foreign advisers. Section 3 of the Private Fund Transparency Act would establish a parallel registration threshold for foreign advisers, which would prevent numerous smaller foreign advisers that today rely on the *de minimis* exception, which the Act would repeal, from being required to register with the Commission.

advisers. Although the Commission supports this approach, there are additional approaches available to that also would close the regulatory gap and provide the Commission with tools to better protect both investors and the health of our markets.

II. The Importance and Structure of Private Funds

Private funds are generally considered to be professionally managed pools of assets that are not subject to regulation under the Investment Company Act of 1940 ("Investment Company Act"). Private funds include, but are not limited to, hedge funds, private equity funds and venture capital funds.

Hedge funds pursue a wide variety of strategies that typically involve the active management of a liquid portfolio, and often utilize short selling and leverage. Private equity funds generally invest in companies to which their advisers provide management or restructuring assistance and utilize strategies that include leveraged buyouts, mezzanine finance and distressed debt. Venture capital funds typically invest in earlier stage and start-up companies with the goal of either taking the company public or privately selling the company. Each type of private fund plays an important role in the capital markets. Hedge funds are thought to be active traders that contribute to market efficiency and enhance liquidity, while private equity and venture capital funds are seen as helping create new businesses, fostering innovation and assisting businesses in need of restructuring. Moreover, investing in these funds can serve to provide investors with portfolio diversification and returns that may be uncorrelated or less correlated to traditional securities indices.

Any regulatory reform should acknowledge the differences in the business models pursued by different types of private fund advisers and should address in a proportionate manner the risks to investors and the markets raised by each.

III. Current Regulatory Exemptions

Although hedge funds, private equity funds and venture capital funds reflect different approaches to investing, legally they are indistinguishable. They are all pools of investment capital organized to take advantage of various exemptions from registration. All but one of these exemptions were designed to achieve some purpose other than permitting private funds to avoid oversight.

A. Securities Act of 1933

Private funds typically avoid registration of their securities under the Securities Act of 1933 (Securities Act) by conducting private placements under section 4(2) and Regulation D.[7] As a consequence, these funds are sold primarily to "accredited investors," the investors typically receive a "private placement memorandum" rather than a statutory prospectus, and the funds do not file periodic reports with the Commission. In other words, they lack the same degree of transparency required of publicly offered issuers.

B. Investment Company Act of 1940

Private funds seek to qualify for one of two exceptions from regulation under the Investment Company Act of 1940 (Investment Company Act). They either limit themselves to 100 total investors (as provided in section 3(c)(1)) or permit only "qualified purchasers" to invest (as provided in section 3(c)(7)).[8] As a result, the

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7 Section 4(2) of the Securities Act of 1933 provides an exemption from registration for transactions by the issuer of a security not involving a public offering. Rule 506 of Regulation D provides a voluntary "safe harbor" for transactions that are considered to come within the general statutory language of section 4(2).

8 "Qualified purchasers" generally are individuals or family partnerships with at least $5 million in investable assets and companies with at least $25 million. The section 3(c)(7)

traditional safeguards designed to protect retail investors in the Investment Company Act are the subject of private contracts for investors in private funds. These safeguards include investor redemption rights, application of auditing standards, asset valuation, portfolio transparency and fund governance. They are typically included in private fund partnership documents, but are not required and vary significantly among funds.

C. Investment Advisers Act of 1940

The investment activities of a private fund are directed by its investment adviser, which is typically the fund's general partner.[9] Investment advisers to private funds often claim an exemption from registration under section 203(b)(3) of the Advisers Act, which is available to an adviser that has fewer than 15 clients and does not hold itself out generally to the public as an investment adviser.

Section 203(b)(3) of the Advisers Act contains a *de minimis* provision that we believe originally was designed to cover advisers that were too small to warrant federal attention. This exemption now covers advisers with billions of dollars under management because each adviser is permitted to count a single fund as a "client." The Commission recognized the incongruity of the purpose of the exemption with the counting rule, and adopted a new rule in 2004 that required hedge fund advisers to "look through" the fund to count the number of investors in the fund as clients for purposes of determining whether the adviser met the *de minimis* exemption. This was the rule overturned by the appellate court in the *Goldstein* decision. As a consequence,

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exception was added in 1996 and specifically anticipated use by private funds.

9 Private funds often are organized as limited partnerships with the fund's investment adviser serving as the fund's general partner. The fund's investors are limited partners of the fund.

approximately 800 hedge fund advisers that had registered with the Commission under its 2004 rule subsequently withdrew their registration.

All advisers to private funds are subject to the anti-fraud provisions of the Investment Advisers Act, including an anti-fraud rule the Commission adopted in response to the *Goldstein* decision that prohibits advisers from defrauding investors in pooled investment vehicles.[10] Registered advisers, however, are also subject to periodic examination by Commission staff. They are required to submit (and keep current) registration statements providing the Commission with basic information, maintain business records for our examination, and comply with certain rules designed to prevent fraud or overreaching by advisers. For example, registered advisers are required to maintain compliance programs administered by a chief compliance officer.

IV. Options to Address the Private Funds Regulatory Gap[11]

As discussed below, though there are different regulatory approaches to private funds available to Congress, or a combination of approaches, no type of private fund should be excluded from any new oversight authority any particular type of private fund. The Commission's 2004 rulemaking was limited to hedge fund advisers. However, since that time, the lines which may have once separated hedge funds from private equity and venture capital funds have blurred, and the distinctions are often unclear. The same adviser often manages funds pursuing different strategies and even individual private funds often defy precise categorization. Moreover, we are concerned that in order to escape Commission oversight, advisers may alter fund investment strategies or investment terms in ways that will create market inefficiencies.

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10 *See* Rule 206(4)-8 under the Advisers Act.

11 Commissioner Casey does not endorse the approaches discussed in sections IV. B and C.

A. Registration of Private Fund Investment Advisers

The Private Funds Transparency Act of 2009 would address the regulatory gap discussed above by eliminating Section 203(b)(3)'s *de minimis* exemption from the Advisers Act, resulting in investment advisers to private funds being required to register with the Commission. Investment adviser registration would be beneficial to investors and our markets in a several important ways.

1. Accurate, Reliable and Complete Information

Registration of private fund advisers would provide the Commission with the ability to collect data from advisers about their business operations and the private funds they manage. The Commission and Congress would thereby, for the first time have accurate, reliable and complete information about the sizable and important private fund industry which could be used to better protect investors and market integrity. Significantly, the information collected could include systemic risk data, which could then be shared with other regulators.[12]

2. *Enforcement of Fiduciary Responsibilities*

Advisers are fiduciaries to their clients. Advisers' fiduciary duties are enforceable under the anti-fraud provisions of the Advisers Act. They require advisers to avoid conflicts of interest with their clients, or fully disclose the conflicts to their clients. Registration under the Advisers Act gives the Commission authority to conduct on-site compliance examinations of advisers designed, among other things, to identify conflicts

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[12] The Private Fund Transparency Act includes some important although technical amendments to the Advisers Act that are critical to the Commission's ability to collect information from advisers about private funds, including amendments to Section 204 of the Act permitting the Commission to keep information collected confidential, and amendments to Section 210 preventing advisers from keeping the identity of private fund clients from our examiners.

of interest and determine whether the adviser has properly disclosed them. In the case of private funds, it gives us an opportunity to determine facts that most investors in private funds cannot discern for themselves. For example, investors often cannot determine whether fund assets are subject to appropriate safekeeping or whether the performance represented to them in an account statement is accurate. In this way, registration may also have a deterrent effect because it would increase an unscrupulous adviser's risk of being discovered.

A grant of additional authority to obtain information from and perform on-site examinations of private fund advisers should be accompanied with additional resources so that the Commission can bring to bear the appropriate expertise and technological support to be effective.

3. Prevention of Market Abuses

Registration of private fund advisers under the Advisers Act would permit oversight of adviser trading activities to prevent market abuses such as insider trading and market manipulation, including improper short-selling.

4. Compliance Programs

Private fund advisers registered with the Commission are required to develop internal compliance programs administered by a chief compliance officer. Chief compliance officers help advisers manage conflicts of interest the adviser has with private funds. Our examination staff resources are limited, and we cannot be at the office of every adviser at all times. Compliance officers serve as the front-line watch for violations of securities laws, and provide protection against conflicts of interests.

5. *Keeping Unfit Persons from Using Private Funds to Perpetrate Frauds*

Registration with the Commission permits us to screen individuals associated with the adviser, and to deny registration if they have been convicted of a felony or engaged in securities fraud.

6. *Scalable Regulation*

In addition, many private fund advisers have small to medium size businesses, so it is important that any regulation take into account the resources available to those types of businesses. Fortunately, the Advisers Act has long been used to regulate both small and large businesses, so the existing rules and regulations already account for those considerations. In fact, roughly 69 percent of the investment advisers registered with the Commission have 10 or fewer employees.

7. *Equal Treatment of Advisers Providing Same Services*

Under the current law, an investment adviser with 15 or more individual clients and at least $30 million in assets under management must register with the Commission, while an adviser providing the same advisory services to the same individuals through a limited partnership could avoid registering with the Commission. Investment adviser registration in our view is appropriate for any investment adviser managing $30 million regardless of the form of its clients or the types of securities in which they invest.

B. Private Fund Registration

Another option to address the private fund regulatory gap might be to register the funds themselves under the Investment Company Act (in addition to registering their advisers under the Advisers Act). Alternatively, the Commission could be given stand-alone authority to impose requirements on unregistered funds. Through direct regulation of the funds, the Commission could impose, as appropriate, investment restrictions or diversification requirements designed to protect investors. The Commission could also regulate the structure of private funds to protect investors (such as requiring an independent board of directors) and could also regulate investment terms (such as protecting redemption rights).

C. Regulatory Flexibility through Rulemaking Authority

Finally, there is third option that in conjunction with advisers' registration may be necessary to address the regulatory gap in this area. Because it is difficult, if not impossible, to predict today what rules will be required in the future to protect investors and obtain sufficient transparency, especially in an industry as dynamic and creative as private funds, an additional option might be to provide the Commission with the authority that allows for additional regulatory flexibility to act in this area. This could be done by providing rule-making authority to condition the use by a private fund of the exceptions provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act. These conditions could impose those requirements that the Commission believes are necessary or appropriate to protect investors and enhance transparency.[13] In many situations, it may be appropriate for these requirements to vary depending upon the type of fund involved. This would enable the Commission to better discharge its responsibilities and adapt to future market conditions without necessarily subjecting private funds to Investment Company Act registration and regulation.

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[13] For example, private funds might be required to provide information directly to the Commission. These conditions could be included in an amendment to the Investment Company Act or could be in a separate statute.

V. Conclusion

The registration and oversight of private fund advisers would provide transparency and enhance Commission oversight of the capital markets. It would give regulators and Congress, for the first time, reliable and complete data about the impact of private funds on our securities markets. It would give the Commission access to information about the operation of hedge funds and other private funds through their advisers. It would permit private funds—which play an important role in our capital markets—to retain the current flexibility in their investment strategies.

The Commission supports the registration of private fund advisers under the Advisers Act. The other legislative options I discussed above, namely registration of private funds under the Investment Company Act and/or providing the Commission with rulemaking authority in the Investment Company Act exemptions on which private funds rely, should also be weighed and considered as the Subcommittee considers approaches to filling the gaps in regulation of pooled investment vehicles.

I would be happy to answer any questions you may have.