Investor Protection Implications of Hedge Funds

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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for inviting me to testify today to discuss hedge funds generally and the Securities and Exchange Commission's ongoing fact-finding investigation into hedge funds. I appreciate having the opportunity to discuss this important subject with you.

Over the past few years, hedge funds have become more prominent and more popular. Sources have estimated that there are close to 5700 hedge funds operating in the United States today with approximately $600 billion under management. To put this number in perspective, today there are approximately $6.3 trillion of assets under management in the mutual fund industry. In 1990, it is estimated that only $50 billion was under management in hedge funds, demonstrating the rapid increase in a relatively short period of time. There have been frequent reports of high returns of hedge funds that outperform registered investment companies. But, just as frequently, these reports highlight possible areas of concern, such as potential conflicts of interest, questionable marketing techniques, valuation concerns and market impact of hedge fund strategies.

As you know, the SEC staff has been engaged in an investigation of the structure and practices of hedge funds since June 2002. Because hedge funds continue to grow in status and increase the ranks of their investors, our investigation grows more important every day. We at the Commission are still at the fact-gathering stage and have yet to reach any conclusions. But I want to report that we are moving to the next stage of our investigation. As part of the investigation's advancement, the Commission will be holding public roundtables on May 14th and 15th. As I said before this Committee at my confirmation hearing, I believe there are many unanswered questions related to hedge funds, and I am anxious to take a deeper look at both their risks and rewards.

Hedge funds have been around in some form since the establishment of the Jones Hedge Fund in 1949. The term "hedge fund" is undefined, including in the federal securities laws. Indeed, there is no commonly accepted universal meaning. As hedge funds have gained stature and prominence, though, "hedge fund" has developed into a catch-all classification for many unregistered privately managed pools of capital. These pools of capital may or may not utilize the sophisticated hedging and arbitrage strategies that traditional hedge funds employ, and many appear to engage in relatively simple equity strategies. Basically, many "hedge funds" are not actually hedged, and the term has become a misnomer in many cases.

The last time the Commission took a good look at hedge funds was in 1998, when Long Term Capital Management nearly collapsed. As you may recall, LTCM was a Connecticut-based hedge fund whose investment strategy employed a tremendous amount of borrowed money, or leverage. This strategy caused it to suffer approximately $1.8 billion in losses in August 1998 when Russia devalued the ruble.

After LTCM's near collapse, the Commission, along with the Treasury Department, the Federal Reserve and the Commodity Futures Trading Commission, as part of the President's Working Group on Financial Markets, issued a report on the risk management and transparency issues raised by LTCM in particular and of "highly leveraged institutions" in general.[1] The President's Working Group looked at such issues as firms' adherence to their own stated policies, their margin and collateral requirements, their use of leverage and whether it was excessive, and how well their risk models functioned. The Report made serious recommendations that were intended to improve how firms functioned in these areas; and, based on our examination of the major brokerage houses that service hedge funds, many institutions extending leverage to hedge funds seem to have taken these recommendations to heart.

In addition to this examination of risk management and transparency issues, the Commission staff actively supported the work of the *Multidisciplinary Working Group on Enhanced Disclosure (MWGED).* The MWGED and the subsequent *Joint Forum Working Group on Enhanced Disclosure (JFWGED),* which the Commission chairs, both address issues of enhanced disclosure for financial intermediaries (i.e., banks, securities firms,

[1] "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," April 1999.

insurance companies, and hedge funds). The MWGED issued its report in April 2001, and the work of the JFWGED is ongoing, but we believe that many in the hedge fund industry are considering the recommendations of these two groups and continuing to explore ways to improve some of their practices.

Nonetheless, the markets have continued to evolve, and I believe the time has come for us – the SEC and the President's Working Group -- again to review these risk management, transparency and public disclosure issues.[2] As part of the SEC's ongoing investigation into the operations of hedge funds, we are also addressing issues from the perspective of investor protection. These issues include the recent growth of the industry; the "retailization" of hedge funds - meaning the increasing availability of these products and how and to whom they are available; an apparent increase in reported fraud involving hedge funds; and conflicts of interests. Additionally, I am interested in looking into other issues related to the overall market impact of hedge fund practices.

The Commission also has been very active in working with our colleagues at Treasury, the Federal Reserve and other financial regulators to

[2] Certainly, we must be cognizant of how the lack of public information about hedge funds also plays a critical part in a hedge fund's investment strategy. Many hedge funds are concerned about third parties uncovering their strategies. For example, an investor knowing that a hedge fund holds a large short position in a security could use that information to the detriment of the hedge fund by trading against that short position.

explore and address the potential use of hedge funds as vehicles for money laundering and terrorist financing. As mandated by the USA Patriot Act, Treasury, the Federal Reserve and the SEC issued a report to Congress that addressed the regulation of investment companies, including hedge funds, as it related to money laundering.[3] Additionally, Treasury, in coordination with the CFTC, the Federal Reserve and the SEC, has proposed regulations that would require certain unregistered investment companies, including hedge funds, to establish anti-money laundering programs.[4]

Differences between Hedge Funds and Investment Companies

In order to fully understand the many questions associated with hedge funds, we must first examine the characteristics that distinguish them from registered investment companies. Unlike registered investment companies, investors in hedge funds usually must commit their money to hedge funds for extended periods of time and cannot redeem an investment without prior notice. In fact, some hedge funds permit investors to redeem only once or twice per year. Moreover, hedge funds are not subject to the diversification requirements imposed on registered investment companies and, therefore,

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[3] "A Report to Congress in Accordance with Section 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)," December 31, 2002.
[4] The proposed regulation was issued September 26, 2002 [67 FR 60617].

may concentrate their portfolios in a handful of investments, thereby increasing their potential exposure to market fluctuations.

Hedge funds typically do not have boards of directors. Hedge funds also do not have to report their results in a standardized format. And, while registered investment companies generally pay an advisory fee based on a percentage of assets under management, hedge funds typically pay both an asset-based fee (typically one to two percent of assets) as well as a performance fee. The performance fee is typically 20% or more of the hedge fund's annual profits (realized or not) but often may be paid only if the hedge fund's performance exceeds a benchmark set forth in the fund's offering documents.

Hedge funds are not subject to borrowing and leverage restrictions that apply to registered investment companies. Thus, a hedge fund may leverage its portfolio beyond the extent that a registered investment company may do so. On the other hand, many hedge funds employ investment strategies with limited or no leverage.

One of the most significant differences between hedge funds and registered investment companies, for our purposes, is that because hedge funds typically are not registered with the Commission, they are not directly subject to examination and inspection by the Commission.

Regulation of Hedge Funds under the Federal Securities Laws

The exclusions from registration under the federal securities laws that apply to hedge funds and their securities offerings are central to the questions that currently surround hedge funds. The exclusions define the investment strategies that hedge funds may pursue, the types of investors who generally may invest in hedge funds, and how hedge fund securities may be sold. Hedge funds are able to avoid regulation by meeting criteria that are laid out in four general exclusions or exceptions: (1) the exclusion from registration of the fund under the Investment Company Act of 1940, (2) the exemption from registration of the fund's securities under the Securities Act of 1933 (3) the exception from registration of the hedge fund manager under the Investment Advisers Act of 1940, and (4) the exception from reporting requirements under the Securities Exchange Act of 1934.

<u>Exclusion from Registration under the Investment Company Act of 1940</u>

Hedge funds typically do not register with the SEC. They rely on one of two exclusions under the Investment Company Act of 1940 to avoid registration. The first exclusion under Section 3(c)(1) of the Investment Company Act limits investors in the hedge fund to 100 persons, while the second exclusion under Section 3(c)(7) of the Investment Company Act, which was added to the Investment Company Act in 1996, imposes no numerical limit on the number of investors.[5] Instead, it generally looks to the size and nature of the investments of an individual. Thus, investors in funds that utilize the 3(c)(7) exemption generally must be "qualified purchasers." Qualified purchasers are defined to include high net worth individuals (generally individuals who own certain specified investments worth at least $5 million) and certain companies. The theory is that wealthy investors do not need the full protections of the registration provisions of the federal securities laws.

Exemption from Registration under the Securities Act of 1933

Importantly, both of these exclusions require hedge funds to sell their securities in non-public offerings. Thus, most hedge funds rely on one of a handful of exemptions under the Securities Act in order to avoid making a public offering. In order to be classified as a non-public offering, the hedge fund securities may not be offered for sale using general solicitation or advertising. Additionally, hedge funds generally sell their securities only to those who qualify as "accredited investors." The term "accredited investor" includes individuals with a minimum of $200,000 in annual income or $300,000 in annual income with their spouses, or a minimum of $1,000,000

[5] Although there is no specific numeric limitation on the number of investors in a Section 3(c)(7) fund, the federal securities laws generally require any issuer with 500 or more investors and $10 million of assets to register its securities and to file public reports with the Commission. Most hedge funds do not wish to register their securities, and therefore they stay below the 500 investor level.

in net assets. It also includes most organized entities with over $5,000,000 in assets, including registered investment companies.[6]

Because these limitations under the Securities Act apply at lower levels than the "qualified purchaser" exemption for 3(c)(7) funds, these 3(c)(7) funds may only be offered or sold to investors who are qualified purchasers as well as accredited investors. Other hedge funds, that do not qualify as 3(c)(7) funds, may be offered and sold to accredited investors, whether or not they are also qualified purchasers. Finally, a fast-growing group of funds of hedge funds are registered under the Securities Act and may be publicly offered and sold.

Exception from Registration under the Investment Advisers Act of 1940

Managers of hedge funds meet the definition of "investment adviser" under the Investment Advisers Act of 1940 because they are in the business of providing investment advice about securities to others. Under this Act, an investment adviser with fewer than 15 clients that does not publicize itself generally as an investment adviser is not required to register with the Commission. Because Commission regulations count each hedge fund, rather than each investor in the hedge fund, as one client, some hedge fund

[6] This exemption also permits a private issuer to sell to up to 35 non-accredited investors, but in that case, those investors must be "sophisticated" persons – meaning that they must be capable of evaluating the merits and risks of their investment – and the issuer must provide disclosure to those investors comparable to that in public offerings.

managers may not be required to register with the Commission.[7] Unregistered advisers are not directly subject to the Commission's examination and inspection program. But, it is important to note that all hedge fund managers – whether registered as investment advisers or not -- are subject to the antifraud provisions of the Investment Advisers Act.

Exception from Reporting Requirements under the Securities Exchange Act of 1934

Hedge funds generally are not subject to the reporting requirements of the Securities Exchange Act because they are operated so as not to trigger registration of their securities under that statute. However, if a hedge fund holds large public equity positions, the manager, like any other large institutional manager, must publicly disclose those positions. This disclosure, however, does not necessarily provide significant insight into any particular hedge fund's portfolios or strategies because the manager is permitted to aggregate all clients' holdings into one report. In addition, disclosure is not required of short and debt positions.

[7] We understand that some hedge fund managers voluntarily register with the Commission because some investors, particularly many foreign investors, prefer their managers to be registered. Others register because they also advise registered investment companies, which are required to be advised only by registered investment advisers.

The Commission's Investigation of Hedge Funds

Our investigation has been primarily focused on the investor protection implications of the growth in hedge funds. Once we have concluded that work, we plan to share our conclusions with other members of the President's Working Group so that we jointly can consider whether to review other market issues, including market impact, leverage and counterparty risk. Furthermore, let me assure you that the SEC will continue to use the full extent of its authority to examine the risk assessment policies and procedures of broker-dealers, especially those of the larger firms, which are more likely to have counterparty exposure to hedge funds or otherwise be exposed to risk from hedge fund investments. Because many of these firms are affiliated with other types of financial institutions, such as banks, that may also have hedge fund exposure, firms' credit practices may also be subject to examination by other financial regulators. While our current investigation is not yet complete, I want to share with you some of the issues on which we have been focusing, including (1) conflicts of interest, (2) retailization, (3) prime brokers, and (4) fraud.

1. Conflicts of Interest

Side by Side Products

Investment advisers to registered investment companies increasingly are offering hedge fund investments to their clients — both to satisfy clients who are seeking alternative investments, and to provide opportunities for their most talented investment managers who otherwise might defect to higher paying positions with hedge funds. The result, that the advisers manage hedge funds alongside registered investment companies, raises the potential for conflicts of interests.

For example, hedge fund managers often have large stakes in the hedge funds that they advise and/or they collect performance fees from their hedge fund clients. Consequently, there is the potential that a hedge fund manager may be tempted to favor its hedge fund clients over its registered investment company clients in allocating lucrative trades.

Hedge fund investments may be managed differently than they are in a registered investment company. For performance and other reasons, a hedge fund manager may determine to sell a security short in a hedge fund's portfolio, while holding the same security long in a mutual fund's portfolio.

I stress that these types of potential conflicts are the same as those that exist for any investment adviser that manages both registered investment companies and private client accounts.

Valuation

Other potential conflicts of interest are inherent in hedge funds alone. Registered investment companies must price their portfolio securities at market or, if there is no market, at their current "fair value" – determined in good faith by the fund's board of directors. Hedge funds are not subject to these requirements. Thus, for example, hedge funds may determine that the appropriate price of a security is its inherent price, a price that looks to the future. Or it may substitute its determination of the value of a security for a market price.

These valuation determinations are, of course, subject to the antifraud provisions of the federal securities laws, but otherwise they are permissible. Ultimately, it may be impossible for an investor to know the actual value of a hedge fund's portfolio securities.

2. "Retailization" of Hedge Funds

Another primary focus of our investigation involves the "retailization" of hedge funds.

"Middle Class" Hedge Funds

I earlier mentioned the term "accredited investor." This qualification is the standard measure used by some private hedge funds to determine who may invest in their offerings, and it is a hedge fund's basis for meeting the standards of one of the four general exemptions from registration. The monetary amounts used to determine accredited investor status essentially have remained the same since 1982. With the sustained growth in incomes and wealth in the 1990's, however, more investors meet this standard, despite recent economic downturns. Although the Commission is not aware of any systematic investor losses or other failures caused by the current accredited investor standard, we could of course consider adjusting it, if appropriate. A global change to the standard, however, could impact significantly the availability of securities registration exemptions to other companies. In particular, we would carefully consider the effect of any adjustment to the standard on the opportunities for small business capital formation before proposing any change.

In addition, the Internet has changed forever how companies communicate with their current and prospective investors. Just plugging the term "hedge fund" into any search engine will elicit hundreds of responses. If hedge fund sponsors fail to follow the law, every investor with access to the Internet could easily obtain materials that could constitute an offering of securities to the public, triggering registration and other requirements under the securities laws. Appropriate regulation of Internet offerings is a challenge for the Commission, as it is for other regulatory agencies. The Commission staff watches how the Internet is used to offer securities to the public, including offerings by hedge funds. Our policy goal is to strike a balance between encouraging use of the Internet for legitimate capital formation and at the same time preventing fraud and abuse. If we become concerned that our rules and guidelines need to be changed, or enforcement action needs to be taken, to prevent abuse by hedge funds or others engaged in purported capital formation activity, we will act accordingly.

Funds of Hedge Funds

Registered investment companies that invest all, or substantially all, of their assets in an underlying pool of hedge funds are another means of increased availability of hedge funds to public investors. These funds are a recent phenomenon, evolving from the laws governing the structure of 3(c)(7) funds. The Commission's Division of Investment Management has seen a boom in these funds. In the summer of 2002, the first fund of hedge funds became eligible to sell its securities to the public. Subsequently, there have been 17 other funds of hedge funds cleared for the public market. All of these funds currently are subject to fund-specific minimum investment requirements of at least $25,000. But, there is currently no federal requirement for a minimum investment, and it is possible that funds might seek to lower this requirement making these types of funds available to a greater number of investors with even less capital. These possibilities also implicate the need to focus on suitability determinations and sales practices of those marketing hedge funds.

Funds of hedge funds raise special concerns because they permit investors to invest indirectly in the very hedge funds in which they likely may not invest directly due to the legal restrictions. Because of the influence that accompanies the large size of their investment, registered funds of hedge funds can compel the underlying hedge funds to provide more information to investors than they would typically get. However, even funds of hedge funds do not get the same volume and frequency of information as investors in a registered investment company or mutual fund.

3. Prime Brokers

The growth in the number of hedge funds has also highlighted another aspect of the hedge fund industry that we need to better understand. Hedge funds generally use one or more broker-dealers, known as “prime brokers,” to provide a wide variety of services.

Prime brokerage is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades for substantial retail and institutional customers who are active market participants. Prime brokerage involves three distinct parties: the prime broker, the executing broker, and the customer. The prime broker is the broker-dealer that clears and finances the customer trades executed by one or more executing broker-dealers at the behest of the customer. The prime broker is responsible for all applicable margin and Regulation T requirements for the customer.

Generally, customers, such as hedge funds, believe a prime brokerage arrangement is advantageous because the prime broker acts as a clearing facility for the customer's securities transactions wherever executed, as well as a central custodian for all the customer's securities and funds.

Prime brokers offer certain other services to hedge funds that are typically offered to other substantial customers such as margin loans and risk management services, but prime brokers may also offer other services that are particularly directed to their hedge fund customers. For example, some prime brokers provide “capital introduction” services to hedge funds. These services, which range from sponsoring investor conferences to arranging individual meetings and preparing informational documents, are aimed at bringing hedge fund managers together with potential investors. We are looking into these services and the way they are disclosed to investors.

4. Hedge Fund Fraud

Fraud is, of course, always a primary concern to us. I emphasize that I do not intend to imply that hedge funds or their managers generally engage in nefarious or illegal activities. I have no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else. Nevertheless, there have been complaints by some issuers that hedge funds have acquired large short positions in their stocks and have then attempted to drive the share price down through the issuance of highly critical and allegedly inaccurate reports on their finances.

The Division of Enforcement will continue to investigate allegations of manipulative short selling by hedge funds as it deems warranted. From a regulatory perspective, the Commission recognizes that, while short selling can add important benefits to the market, such as facilitating liquidity, hedging, and pricing efficiency, it also may be used as a tool for manipulation. In this regard, the Commission will consider amendments to existing short sale regulation, as necessary, to curb potential manipulation by all market participants, including hedge funds, without unnecessarily restricting liquidity.

More generally, we have recently experienced a sharp increase in the number of hedge fund frauds that we have investigated and that have resulted in enforcement action. In fact, last year we instituted twice the number of enforcement actions against hedge funds or their managers than we instituted in any of the four previous years.

Examples of charges filed by the Commission include:

making false or misleading statements in offering documents;
misappropriating assets;
market manipulation in a variety of guises;
reporting false or misleading performance, including with respect to valuation of securities;
insider trading; and
fraudulently allocating investment opportunities.

These charges generally are not unique to hedge funds. But hedge funds present us with a unique challenge. Because hedge funds typically are not registered with us, we are limited in our ability to detect problems before they result in harm to investors or the securities markets.

Market Impact

In addition to the risk management and transparency issues addressed by the President's Working Group and the investor protection aspects that the Commission has been primarily focused on to this point, I believe the Commission's investigation should explore other market impact issues specifically in the context of hedge funds because of the substantial assets under their management. We would, of course, consider these market impact issues with other members of the President's Working Group. The Commission already aggressively enforces the anti-manipulation provisions of the federal securities laws. It may be that there are other, more subtle or nuanced results of hedge fund activity that merit attention.

Among the matters that I believe we should look at is the impact of hedge fund trading. There is nothing inherently nefarious about hedge fund trading strategies, including short selling. However, they may disproportionately affect the market or certain issuers. This is a special concern because we don't know enough about the activities of these hedge funds.

I think we need to determine whether the information firewalls of hedge fund industry participants are adequate and whether information flow within or among hedge fund managers is an area that merits attention. Our understanding is that prime brokers' policies include strict information firewalls, but there may be other aspects of information flow that should be considered.

The nature of managers' returns on hedge funds, either through investments in the funds or through carried interests, also may affect trading behavior. While some of the resulting issues relating to risk-taking are properly issues of disclosure and investor protection, it is also possible that there are resulting market impacts that merit attention, and I believe our investigation should consider that possibility.

The Progress of the Investigation

Our current investigation is proceeding well. The Commission's Division of Investment Management, alongside our Office of Compliance Inspections and Examinations, has been gathering information on investor protection issues to assist the Commission in its investigation and in preparation for the roundtables in May. The staff has obtained and reviewed documents and information from 67 different hedge fund managers representing over 650 different hedge funds and approximately $ 162 billion under management.

The staff has also visited and engaged in discussions with a number of different hedge fund managers. When the staff visited these managers, they inquired into various aspects of their business, depending on their size and level of sophistication. The staff talked to brokerage, compliance, risk management, legal and other operational personnel of multi-billion dollar complexes with dozens of employees, as well as to their portfolio managers. At the other end of the spectrum, the staff visited hedge funds where one employee serves as marketer, portfolio manager, trader, operations officer and risk manager.

Aside from our inquiries directed to specific hedge funds, the staff has met with a variety of experts in their respective fields to get their perspectives on the hedge fund industry. In addition to legal and accounting experts, the staff has spoken with chief investment officers, risk managers, prime brokers, representatives from foreign regulators, trade industry representatives and hedge funds consultants. Also, a number of foreign jurisdictions are revisiting their approaches to hedge funds, and we continue to benefit from discussions with our foreign counterparts.

Hedge Fund Roundtable

As you know, we are taking our investigation to the next step. As part of this we have scheduled two full days of hedge fund roundtable discussions to take place in Washington on May 14 and 15. These discussions will focus primarily on the investor protection issues mentioned earlier. Leading experts in the world of hedge funds will provide their views on hedge funds and the issues that concern us. In addition, we will solicit comments from the general public to secure their views. At the end of this process, my current goal is to produce a report that will summarize what we have found and where we should go. I believe we should make public what we've found and what conclusions we've reached.

Investor Education Efforts

Before I close, I'd like to tell you about efforts that we and others are making to provide the public with tools to help to evaluate the potential risks of hedge funds and funds of hedge funds. Since the creation of the Commission's website at www.sec.gov , we have used the website to educate and alert investors to issues relating to securities. Among other things, the website generally discusses hedge funds and funds of hedge funds. We have also used that website to provide investors with a laundry list of questions that they should ask before investing in these products.

In addition, Commission staff developed a website advertising a simulated hedge fund, Guaranteed Returns Diversified, Inc. ("GRDI" or "greedy", for short). This website demonstrates how easy it is to be taken in by false statements and seeks to sensitize investors to their vulnerability. The Commission's website provides a link to the fake scam, although we've discovered that most are finding it by surfing the Internet looking for quick and easy returns. Since we launched this website on February 13, 2003, we have had over 70,000 hits on it!

Finally, the NASD has increased its efforts to ensure that investors are not steered to unsuitable investments. At the beginning of this year, the NASD issued a Notice To Members that reminds broker dealers of their obligations when selling hedge funds and funds of hedge funds. These obligations include steps to ensure that proper disclosures are made to customers about these products and that broker dealers consider the suitability of these products for their customers.

Conclusion

In conclusion, let me assure you that our goal in this exercise is to determine how we can better protect investors and our securities markets. By working together, I believe that we can achieve this goal.

Thank you again for inviting me to speak on behalf of the Commission and the investing public. I would be happy to answer any questions that you may have.