

# Hedge Fund Registration:

## THE SHORTCOMINGS OF THE U.S. SECURITIES AND EXCHANGE COMMISSION'S "PRIVATE FUND" DEFINITION

By Jonathan P. Straub, Esq.

### Introduction

OVER THE LAST TEN YEARS, institutional and high net-worth investors embraced “hedge funds” as high-return investment vehicles and as a means of reducing the market risk of their overall investment portfolios. The hedge fund industry has experienced exponential growth in the number of funds available, in the variations of the underlying investment strategies and particularly in assets under management. The increasing prominence and flow of dollars into this asset class coincided, as expected, with heightened governmental scrutiny.

Ultimately, this scrutiny culminated in the U.S. Securities and Exchange Commission's (“SEC”) much-disputed rules and amendments<sup>1</sup> mandating that by February 1, 2006, hedge fund managers had to register as investment advisers under the Investment Advisers Act of 1940.<sup>2</sup> However, under the new rules, many private investment funds can escape the registration requirements because the SEC failed to make an important definitional distinction between a “hedge fund” and other similarly structured investment vehicles. Specifically, these other funds fall outside the scope of registration because their partnership language extends the fund's redemption period beyond two years, the threshold of a “hedge fund” as defined by the SEC. As a corollary to longer lockup periods, this new rule serves to decrease liquidity terms to the detriment of the individual investor.



By eliminating this two-year lockup distinction and elucidating a definition grounded in investment characteristics, the SEC can achieve full hedge fund registration and develop appropriate insight into the dynamics of the industry without placing undue burdens on the funds or their investors. Without comprehensive industry data, policy makers are inadequately informed to determine whether additional regulation is warranted and ill-equipped, if necessary, to implement an appropriate regulatory framework.

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### Defining a hedge fund

The memory of Long Term Capital Management's (“LTCM”) infamous collapse in September 1998 serves as an example of the threat hedge funds pose as a source of systematic risk to the capital markets. However, the industry has developed a great deal since the implosion of LTCM and the Federal Reserve-brokered bailout of the funds.

The popular misconception of hedge funds is that they are all inherently volatile investment vehicles—relying heavily on global macro strategies and significant leverage to make large directional bets on stocks. In reality, less than 5% of hedge funds are global macro funds, and these alternative investment strategies may or may not use leverage and short selling to “hedge” the portfolio's exposure to market movements.

In tracing the etymology of the phrase “hedge fund,” one sees the difficulty the SEC faces in defining what it is they seek

to regulate. The hedge fund concept originated from the work of Alfred Winslow Jones, who created a single-strategy fund in 1949 that utilized short selling and leverage to hedge exposure to movements in the equity markets.<sup>3</sup> Today, the amorphous term encompasses a multitude of techniques, with investment return, volatility, and risk varying greatly among the different approaches.<sup>4</sup> These strategies have branched out from their roots in equity trading into futures contracts, commodities, derivatives, and currencies, among others, all of which attempt to generate positive returns in a variety of market environments. Defining the term itself is not a new problem, as it has historically meant different things to different people.<sup>5</sup>

Broadly defined, a “hedge fund” has three characteristics: (a) a pooled investment vehicle (b) that is privately organized and (c) not widely available to the public.<sup>6</sup> These funds are formed as separate accounts or commingled investment vehicles administered by a professional investment management firm. Most frequently, hedge funds are organized as limited partnerships or limited liability corporations having a significant position in securities. While these characteristics should normally trigger registration with the SEC as an “investment company” under the Investment Company Act of 1940,<sup>7</sup> hedge funds typically avoid the “investment company” classification by limiting the number of underlying investors.<sup>8</sup>



exceed the performance of a benchmark, such as the S&P 500 Index, most hedge funds strive for an “absolute” return. This absolute approach attempts to achieve positive returns in all market conditions, with little exposure to the systematic movements of the capital markets.

The use of hedge funds is an attractive mechanism for portfolio diversification because the lack of correlation to a traditional performance benchmark can dampen the volatility of the overall investment portfolio. Since varying market conditions require a fund to have flexibility in its investment style to achieve consistently positive returns, a hedge fund partnership agreement will usually authorize the manager to partake in multiple strategies. This flexibility is necessary because it is unlikely that successful strategies in a bull market will also provide positive returns during downturns in the market.<sup>9</sup>

### Recent Growth as Impetus for Registration

Although hedge funds have been around since 1949, the industry experienced its most explosive growth over the past decade. The bull market run of the 1990’s led to tremendous growth in investable assets. But, the subsequent market decline, and expectations of a lower return environment, spurred investors to search for alternative means of achieving higher returns, while also warding off correlation to broad market performance. Hedge funds met both objectives because they had at their disposal a wide array of investment strategies, many of which traditional registered funds were prohibited from employing.<sup>10</sup> Accordingly, sources estimate that the hedge fund industry has grown to approximately 7,000 funds managing almost \$1 trillion in assets, an amount that has increased at a rate of 260% over the past five years.<sup>11</sup> The SEC estimates that this \$1 trillion represents a fifteen-fold increase in the last ten years.

The growth in allocation to this asset class negatively affects its investors. As a greater number of investors chase the top performing funds, individual investors and funds of funds are under increased pressure to secure capacity with top managers.<sup>12</sup> The growth of the industry, coupled with heightened competition for access to prime funds, results in fee structures and redemption terms that are weighted heavily in favor of the hedge fund manager because established managers have more leverage to negotiate the terms of the partnership.

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Hedge funds are also defined by their structure rather than any distinct investment methodology. Just as investment strategies vary from fund to fund, the risk and return characteristics vary greatly as well. Nevertheless, risk aversion is inherently prevalent among large fund managers because of the management fee structure and the fear of mass redemptions as a result of exorbitant losses. Unlike registered investment companies, which tend to favor a “relative” return approach by seeking to

It is in a manager's best interest to secure longer lock-up periods because they are compensated through both an incentive fee tied to performance as well as through a management fee, which is a flat rate based on assets under management at the fund.<sup>13</sup> While a performance-fee arrangement may ensure that the fund manager's interests are closely aligned with those of the fund's investors, the management fee is guaranteed through the life of the investment, regardless of fund performance. Thus, there is a trend towards longer lock-up periods in the industry.

While investors may infer trends of asset growth, this development cannot be corroborated because there is a lack of reliable or comprehensive knowledge of the industry. Hedge funds are under no obligation to report their performance or assets under management to any third party survey or index provider. Additionally, reported numbers suffer from "survivorship bias;" underperformance is a major reason that funds close and those that perform well are more likely to disclose their information to an outside party. Unfortunately, companies that collect fund data merely pass it on without vetting it through a formal verification process. The result is an inadequate source of data with dubious utility.<sup>14</sup>



### Hedge Funds and the Investment Advisers Act of 1940

The SEC's escalating concerns about the rapid growth of the industry are valid as the SEC has no reliable data on the number of hedge funds or their assets under management, and because the estimates that are available vary greatly.<sup>15</sup> This lack of information compelled the SEC to take regulatory action to

understand growth within the industry, to respond to increases in hedge fund fraud enforcement cases and to address the broad

market's direct and indirect exposure to hedge funds. Accordingly, the SEC's new rules seek the following regulatory objectives: (1) to collect a census of information about the industry; (2) to prevent hedge fund related fraud and (3) to limit the retailization of hedge funds.<sup>16</sup> Achieving these objectives is in the best interest of the industry, the investors and the financial markets. However, the rule adopted by the SEC will not achieve these aims.

The Investment Advisers Act of 1940 requires that investment advisers register with the SEC and disclose pertinent information such as disciplinary history and business practices. Almost all hedge funds satisfy the definition of an investment adviser, but most hedge funds have historically avoided registration by relying on the Act's *de minimis* exemption available to investment advisers with 14 or fewer clients.<sup>17</sup> Under old SEC rules, an investment adviser could count each "legal organization" advised by the adviser as a single client.<sup>18</sup> For example, under the old rules, 499 individual investors could form as a "legal organization" a hedge fund. The fund manager did not have to register with the SEC because they viewed the fund manager as having only a single client, the hedge fund itself. Furthermore, any one of those underlying investors could be yet another hedge fund having 499 investors.

### Shortcoming of the New Rules

The SEC implemented its regulatory scheme by amending the *de minimis* exemption of the Investment Advisers Act, requiring hedge fund advisers to look through any "private fund" under their management and count each investor, or owner of an interest or share in the fund, as a separate client of the adviser. Investment advisers may no longer count any "private fund" as a single client; rather, they must view each underlying investor as a single client counting towards the 14 person threshold.<sup>19</sup> However, the change does not apply to all funds, but rather only those deemed to be a "private fund." Under the new rules, the SEC now defines a "private fund" on the basis of three characteristics:

- ① one that would be subject to regulation under Section 3(a) of the Investment Company Act of 1940, but for the exemption to that definition provided under either Section 3(c)1 or 3(c)7 of that Act;

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- ② one that permits its investors to redeem any portion of their investment or ownership interest in the fund within two years of the initial investment or purchase of such interest; and
- ③ one that offers its interests based on the investment advisory skills, ability, or expertise of the investment adviser.<sup>20</sup>

Thus, the registration requirements under the Investment Advisers Act extend only to investment funds with short-term liquidity rights, explicitly excluding private equity and venture capital funds under the supposition that the nature of these investments results in long-term capital commitments.

The obligations of registration do not require affected hedge funds to reveal their investment strategies, disclose portfolio holdings, or prohibit the use of leverage in their portfolios. As most private investment funds satisfy the criteria of elements (1) and (3) above, the sole point of distinction between those private funds required to register and those exempted private funds is the two-year redemption period.

**The current requirements of registration are not particularly arduous to hedge funds, but they are ineffective. In its new rules, the SEC makes no attempt to regulate based on the type of holdings or strategies employed by hedge funds, instead it identifies the redemption period as the defining characteristic of a hedge fund.**

Based on this differentiation, it necessarily follows that the SEC believes there will be no meaningful correlation between the firms with a minimum two-year period of investment and those firms that the SEC felt warranted registration.

Unfortunately, the SEC gives no regard to the recent trend of longer redemption periods imposed by top quartile hedge fund managers. By tying registration to the lock-up period rather than to an underlying investment strategy or type of security, the SEC creates a loophole allowing funds to avoid registration. Hedge fund managers are taking advantage of this oversight. Registration is an administrative and financial burden on the firm and provides no direct benefit to funds or their investors. Thus, the number of new registrants has not approached SEC expectations, as large and small managers alike are not registering, opting instead to extend their lock-up provisions beyond two years or by closing the fund to new investment dollars.<sup>21</sup>

The SEC's decision to include the lock-up loophole has proved disadvantageous to investors as well. Since the loophole leads to more stringent liquidity provisions, it will not curb fraud at an early stage. Deceptive activity may incubate longer before it comes to the attention of investors since an individual investing today will not be able to withdraw funds for at least two years. Furthermore, the scope of the new rule is intended to apply to all hedge funds, thereby allowing the SEC to finally perform a comprehensive survey of the industry. In its current application, however, many funds will escape this industry census because of the loophole.

### Defining the Solution

The SEC could improve the affects of compliance by changing the definition of a "private fund" under § 275 203(b)(3)-1 to emphasize a fund's portfolio characteristics instead of its redemption period.<sup>22</sup> A definition focused on core investment characteristics, such as the marketability of securities held within the portfolio or frequency of trading, would provide

the appropriate level of clarity the industry needs in defining the term "hedge fund." For example, if a fund contained a designated level of marketable securities it would then qualify under the Act as a "private fund."<sup>23</sup> Such distinctions would also allow the SEC to meaningfully distinguish between the traditional hedge funds and private equity/venture capital funds beyond a metric based on the requisite period

of investment, which has proved inadequate. Furthermore, it would be much more difficult for a manager to change its fund's investment strategy than it would be to adjust the redemption period. Such a monumental shift in strategy could ultimately lead to mass redemptions in the fund.

### Conclusion

The current requirements of registration are not particularly arduous to hedge funds, but they are ineffective. In its new rules, the SEC makes no attempt to regulate based on the type of holdings or strategies employed by hedge funds, instead it identifies the redemption period as the defining characteristic of a hedge fund. One of the primary goals of the new registration requirements was to develop a census of the industry. Nevertheless, the poorly constructed language of the rules fails to achieve the Commission's one true aim—quantifying

the size and scope of this rapidly growing segment of the financial markets.

A conclusive “hedge fund” definition based on a fund’s underlying portfolio would prevent hedge funds from skirting registration. The SEC should revisit its recent amendments to the Investment Advisers Act and use the opportunity to

define a hedge fund based on its portfolio’s core investment characteristics rather than its redemption rider, a trait ancillary to the true nature of a private fund. Such a definition would allow the SEC to fully quantify the burgeoning state of the industry and determine whether any further regulation is justly warranted. **BLB**

## ENDNOTES: Jonathan P. Straub, Esq.

<sup>1</sup> See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279) (requiring of certain private investment pools registration with SEC). “The rule and rule amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission’s ability to protect our nation’s securities markets.” *Id.*

<sup>2</sup> 15 U.S.C. § 80b (2000).

<sup>3</sup> See Philipp Cottier, *The Origin of Hedge Funds*, The Hedge Fund Center, available at [http://www.hedgefundcenter.com/wrapper.cfm?article\\_type=basics&content\\_id=222&content\\_type=articles&aff\\_id=0](http://www.hedgefundcenter.com/wrapper.cfm?article_type=basics&content_id=222&content_type=articles&aff_id=0) (last visited 12/5/2005) (describing Jones’ strategy of combining a long term stake in equity positions with short term positions to reduce market risk from the long positions, which “shifted most of his exposure from market timing to stock picking”).

<sup>4</sup> See *What is a Hedge Fund?*, About Hedge Funds, Magnum Funds, at <http://www.magnum.com/hedgefunds/abouthedgefunds.asp#hedgefund> (last visited 11/20/2005).

<sup>5</sup> See Andrew Holt, *Regulating Hedge Funds Won’t Work*, Portfolio International, Oct. 1998, at <http://www.magnum.com/hedgefunds/articles/1998/981000hf.asp> (highlighting the statement of Dion Friedland’s, chairman of Magnum, a Bahamas-based hedge fund specialist, in response to the U.S. Treasury Department’s call for hedge fund regulation. According to Friedland, “the problem is the word ‘hedge funds’ is used to describe any fund other than a conventional mutual fund or unit trust, money market fund or bond fund . . . It’s a bit like calling all the animals in the zoo crocodiles . . . There is an enormous disparity in styles and they cannot be compared with each other, because they are very different”). The term hedge itself implies that the fund employs hedged positions, which may not always be the case.

<sup>6</sup> See Hearing before the House Banking Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, 1999 Leg. (Mar. 3, 1999) (statement of Lewis A. Sachs, Treas. Deputy Assist. Sec. (Govt. Financial Policy)), available at <http://www.treas.gov/press/releases/rr2991.htm> (outlining primary hedge fund characteristics).

<sup>7</sup> See 15 U.S.C. § 80a-3(a)(1)(A) - (C) (2000) (defining scope of an investment company).

<sup>8</sup> See 15 U.S.C. 80a-3(c)(1) & (c)(7) (2000). See also Staff of the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Fund*, at 11-13 (September 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter *Implications of the Growth of Hedge Fund*] (explaining that funds designated 3(c)(1) are limited to no more than 100 investors, all of whom must be considered “accredited investors,” defined as a natural person whose individual net worth, or joint net worth with spouse, at the time of purchase exceeds \$1 million or individual income in excess of \$200,000 or joint income in excess of \$300,000 in each of the last two years, or an entity owning over \$5 million in discretionary investments. Funds designated as 3(c)(7) are usually limited to 499 investors, all of whom must be considered “qualified purchasers,” defined as a natural person having \$5 million in investments or an entity owning and investing on a discretionary basis over \$25 million. Technically, a hedge fund relying on this exemption may have an unlimited number of qualified purchasers, but they limit the pool to 499 to avoid the registration and reporting requirements of the Securities and Exchange Act of 1934).

<sup>9</sup> See *Implications of the Growth of Hedge Funds*, supra note 8, at 33.

<sup>10</sup> Unlike registered funds, Hedge funds are not limited in their ability to utilize leverage or short-selling strategies, which can potentially generate positive returns in a declining market environment. By short-selling, the investor sells

shares without owning them, anticipating that they will be bought back at a future date at a lower price in the expectation that their price will drop.

<sup>11</sup> United States Securities and Exchange Commission, *Open Commission Meeting*, available at <http://www.sec.gov/rules/final/ia-2333-trans.txt> (2004) (“While no one knows for sure, it is estimated that in the last five years, that hedge fund assets have grown by 260 percent, with assets of approximately \$870 billion in approximately 7,000 funds, and some predict that hedge fund assets by the end of the year will reach one trillion dollars. In the last year alone, hedge fund assets have grown over 30 percent. Hedge funds are one-fifth the size of equity mutual funds, and are growing at a much faster rate”).

<sup>12</sup> See Susan I. Barreto, *All Shook Up*, Accredited Investor, December/January 2005 at 13.

<sup>13</sup> See U.S. Securities and Exchange Commission, *Hedging Your Bets: A Heads Up on Hedge Funds and Hedge Funds of Funds*, available at <http://www.sec.gov/anmswers/hedge.htm>. A hedge fund with \$1 billion under management is more likely to be satisfied with a 1.5% management fee on assets than is one managing \$50 million. The dynamic could also be bringing down the industry’s overall performance as larger managers would be more inclined to employ capital preservation strategies designed to protect guaranteed revenue streams.

<sup>14</sup> See Harry M. Kat, *10 Things That Investors Should Know About Hedge Funds*, *J. of Wealth Management*, Spring 2003, at 72-73.

<sup>15</sup> See *Implications of the Growth of Hedge Funds*, supra note 8, at 1 n.2.

<sup>16</sup> See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,061-064 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279) (explaining some of the objectives for promulgating the rules).

<sup>17</sup> See 15 U.S.C. § 80b-3(b)(3) (defining an exemption to registration). See also *Implications of the Growth of Hedge Funds*, supra note 8, at 21 (“That section excludes from registration investment advisers that have had fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered investment company.”).

<sup>18</sup> See *Implications of the Growth of Hedge Funds*, supra note 8, at 21 (“[A]n adviser may count a legal organization as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual objectives of its owners.”).

<sup>19</sup> See 17 C.F.R. § 275.203(b)(3)-2(a) (“For purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)), you must count as clients the shareholders, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an “owner”) of a private fund as defined in paragraph (d) of section 275.203(b)(3)-1, unless such owner is your advisory firm or a person described in paragraph (d)(1)(iii) of section 275.205-3.”).

<sup>20</sup> See 17 C.F.R. § 275.203(b)(3)-1(d)(1) (2004) (defining a private fund).

<sup>21</sup> See Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, *Wall St. J.*, Nov. 10, 2005, at C1 (citing several prominent firms that avoided registration, including SAC Capital Management, Citadel Investment Group, Eton Park Capital Management and Lone Pine Capital).

<sup>22</sup> See Letter from Board of Trustees, The Greenwich Roundtable, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, (Sep. 15, 2004), available at <http://www.sec.gov/rules/proposed/s73004/greenwich0915.htm> (commenting “on the proposed rules concerning registration of hedge fund managers”).

<sup>23</sup> See *id.* “A requirement tailored along these lines will separate hedge funds from venture capital and private equity funds, but will not encourage behavior that is clearly disadvantageous to investors.”