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REGULATION OF PRIVATE FUNDS

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I. Introduction

This memorandum provides a high-level overview of the U.S. debate on the regulation of hedge funds. For purpose of this memorandum, a "hedge fund" may be described simply as a private investment vehicle that (i) issues equity interests without registration under Section 5 of the Securities Act of 1933 (the "**Securities Act**") and (ii) is not registered as an investment company registered under the Investment Company Act of 1940 (the "**Investment Company Act**"). Light regulation of hedge funds provides hedge fund managers with the ability to make economically rational and nimble investment decisions free from the bureaucracy and distorted incentive structures that apply to most other financial institutions. It is largely on the strength of this freedom (as well a lucrative fee structure that attracts talent) that hedge funds have grown rapidly over recent years into a central component of the global financial capital markets. Academics, industry professionals and regulatory authorities overwhelmingly agree that the dynamic hedge fund industry benefits the economy by providing liquidity, bearing risks that others will not, ferreting out market inefficiencies, and providing investment options with low correlations to overall market risk.

Hedge funds are not unregulated entities. Whether or not their investment advisers are registered under the Investment Advisers Act of 1940 (the "**Advisers Act**"), they are subject to anti-fraud provisions of the federal securities laws. The most significant of these is Section 206 of the Advisers Act, which the Supreme Court has construed as imposing on advisers a fiduciary duty towards their clients, and which was recently augmented by new Rule 206(4)-8, which broadens the scope of a hedge fund adviser's fiduciary duties to include direct duties toward investors in the fund. In addition, the operators and advisers of hedge funds that trade commodities must register with the Commodity Futures Trade Commission (the "**CFTC**") and many advisers voluntarily register with the Securities and Exchange Commission (the "**SEC**"). Indeed, it is estimated that in 2006 some 86% of hedge fund advisers were registered with a regulatory body, though it is unclear in light of recent events whether registration of advisers is now trending upward or downward.

Hedge funds are also directly or indirectly subject to a number of other regulations. Depending on their activities, hedge funds may be subject to direct reporting requirements under Sections 12, 13(d) and 13(f) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and U.S. Treasury regulations requiring reporting of large positions in Treasury securities and foreign currencies. They are also subject to ERISA requirements if 25% or more of their equity assets are owned by qualified employee benefits plans. Regulations that indirectly effect hedge funds include bank and broker-dealer margin and capital rules that limit access to leverage, broker-dealer conduct rules that apply to sales practices in marketing hedge fund interests, and broker-dealer short sale and short position reporting requirements.

Nevertheless, the growth of hedge funds has raised numerous calls for further regulation. In the wake of the demise of Long-Term Capital Management, the President's Working Group

on Financial Markets ("**PWG**"), composed of the Secretary of the Treasury and the chairmen of the Board of Governors of the Federal Reserve System (the "**FRB**"), the SEC and the CFTC, issued a report recommending a variety of measures, including increasing disclosure requirements, increasing indirect regulation through tightening counterparty risk management and capital standards for lenders, and facilitating the development of industry best practices. In 2005, the SEC promulgated a rule requiring mandatory registration under the Advisers Act for most hedge fund managers. After the DC Circuit invalidated this rule, the SEC adopted the anti-fraud rule described above and proposed to raise net worth requirements for individual hedge fund investors. Congress has also periodically considered hedge fund regulation, including the Hedge Fund Study Act passed by the House of Representatives in 2006 to request a federal study of the industry and a Senate Judiciary Committee inquiry into stock manipulation by hedge funds. More recently, in 2007 the PWG followed up on the LTCM report with "Principles and Guidelines Regarding Private Pools of Capital" (the "**PWG Hedge Fund Principles**"), which contemplates primarily indirect regulation of hedge funds through other financial institutions.

Finally, in March 2008, the Treasury Department released its "Blueprint for a Modernized Financial Regulatory Structure," (the "**Treasury Blueprint**") which, though it does not focus on hedge funds, includes them within the scope of financial institutions that would be subject to regulation. Notwithstanding the somewhat contrary position taken in the PWG Hedge Fund Principles, the Treasury Blueprint calls for Federal Reserve Board to be given the ability to directly and indirectly obtain detailed financial information from hedge funds (among other financial institutions) as the "market stability regulator" tasked with performing "macro-prudential regulation." Presumably, implementing the Treasury Blueprint would require some form of hedge fund adviser registration with the SEC (as the "Conduct of Business Regulatory Agency") in order to obtain such information.

II. Principle Regulatory Concerns and Responses

The hedge fund debate can be divided into discussions of three principle regulatory concerns: hedge fund investor protection, prevention of frauds on third parties and other activities that are damaging to the integrity of financial markets, and systemic risk.

A. Investor Protection

As the number of hedge funds have grown, so has the number of reported cases of frauds on investors. The number of SEC enforcement cases involving hedge funds (the bulk of which have involved frauds on investors) has grown from just 4 prior to 2001 to 50 by the end of 2004 and 90 by mid 2006. Losses to investors through hedge fund fraud were estimated at U.S. $1.1 billion in 2004. Typical frauds have included misappropriation of assets, ponzi schemes, misrepresentation of performance and/or asset values, falsification of credentials or other reports, and frauds arising from various conflict of interest transactions.

Additionally, given the limited disclosure requirements for hedge funds, their often complex, illiquid and/or opaque investment strategies, the lack of standards for valuing assets and measuring performance and relatively high fees, U.S. regulators and some commentators believe that hedge funds are not appropriate investment vehicles for retail investors. Thus, the

debate over investor protection has frequently be tied to concerns over the possible "retailization" of hedge funds.

However, as SEC Chairman Cox and other regulators have now acknowledged, direct investment in hedge funds by retail investors is not widespread and the potential for such investment in the future can be managed by periodically adjusting net worth requirements for potential investors. Rather, retail exposure to hedge funds tends to occur indirectly through investments by pension plans, registered "funds of funds" and other investment pools managed by professional managers with fiduciary duties. The current consensus view among regulators, as articulated in the PWG Hedge Fund Principles, is that the risks of such indirect retailization can best be addressed through requiring sound practices on the part of the regulated fiduciaries that invest in hedge funds.

Outside of this consensus on retailization, questions remain about the desirability of investor protection regulation, and commentators have suggested a variety of additional regulations, including mandatory adviser registration, credentialing of advisers, mandatory audit and/or disclosure requirements, establishing asset valuation standards, corporate governance reforms (particularly requiring board oversight over the valuation process), mandatory risk management policies and procedures, and requiring various forms of self regulation. Particular questions raised in the current debates include:

- Does the empirical growth of hedge fund enforcement cases reflect (i) a disproportionate risk of fraud in the sector due, perhaps due to unusually severe conflicts of interest and/or hedge fund secrecy, (ii) statistical growth in proportion to the growth of the sector, or (iii) simply reflect the SEC's enforcement priorities?

- Is it a judicious use of regulatory resources to monitor hedge funds for the protection of their investors? These investors are, after all, generally sophisticated and have elected not to invest in heavily regulated mutual funds. Accordingly, shouldn't consumer protection resources be used to focus on retail investments?

- Would hedge fund adviser registration provide an effective deterrent to hedge fund frauds relative to a pure enforcement model, and would the benefits of a registration and inspection regime outweigh the costs in terms of both social costs and allocation of regulatory resources away from other areas?

- Could private alternatives, such as creation of an industry SRO or best practices in areas such as valuations, corporate governance, fees and/or disclosure provide a better balance of fraud prevention and cost than either direct regulatory oversight or a more purely market based approach?

- Does the current emphasis on fiduciary duties of managers of pools that invest in hedge funds create undue litigation and/or enforcement risk for such managers without adequate guidance as to their obligations?

B. Market Integrity Regulation

As with the debate over investor protection, the debate about the need for greater regulation to protect third parties and the integrity of the marketplace in general is driven in large part by the increased incidence and visibility of hedge fund frauds. The most visible controversy in this area to date (albeit one in which the basis for liability was not always clear) was the wave of enforcement actions regarding market timing and late trading. Other activities that have raised particular concern include insider trading, use of false rumors to benefit from short trading, unlawful short selling relating to PIPES transactions, and "empty voting." Though enforcement cases involving alleged harms to third parties and the market have been much less frequent (with the exception of the market timing case) than investor protection cases, the debate in this area tends to be even more public and political, as the prospect of ultra-rich, powerful and secretive hedge fund managers taking advantage of other market participants can quickly raise public outrage.

However, by contrast to the investor protection context, the issue with respect to market integrity regulation is more purely one of effective deterrence and enforcement. While investor protection is fundamentally a principal-agent problem (and the regulatory question is the extent to which regulation is necessary as a supplement to investor monitoring of advisers' conduct), in the area of market protection, the economic incentives of hedge fund investors and managers are essentially aligned. Thus, the debate in this area is primarily about the social and enforcement costs of adviser registration and other forms of regulatory monitoring to prevent improper activities versus the prevention benefits. Secondarily, some commentators have suggested that fee reforms could reduce frauds and other have suggested increasing internal oversight through corporate governance reforms. Additionally, the use by sophisticated market participants of strategies such as "empty voting" that are potentially harmful to third parties raise questions as to the need for new substantive regulation in particular areas.

C. Systemic Risk

Hedge fund "systemic risk," or the risk that hedge fund losses could spread to third parties and therefore threaten the stability of the broader financial system, has been the primary concern of the Department of the Treasury and the FRB, and has been most directly addressed in the pronouncements of the PWG. In addition to the sheer size of some funds, hedge funds are seen as particular sources of systemic risk for at least two reasons:

- heavy use of leverage and derivatives by some hedge funds, along with active trading strategies, and/or investments in structured, illiquid, or otherwise volatile positions may make such funds relatively fragile and vulnerable to liquidity shocks;

- hedge funds may be vulnerable to simultaneous failure, either through "contagion" or due to "herding" leading to multiple funds with similar risk exposures.

When large and/or multiple hedge funds are overwhelmed by market or liquidity shocks, the risks they have assumed are discharged back into the market, potentially exacerbating

instability in the market as a whole. Hedge fund failures can impose direct losses on counterparties with credit exposures as well as create indirect losses for a wide variety of other market participant through the rapid sell-off of assets. Market failures occur to the extent that such risks are hidden or the third parties are otherwise unable to act to protect themselves from such risks.

In the 2007 PWG Hedge Fund Principles, the principle U.S. regulators articulated a view that market discipline by creditors and counterparties, rather than direct prudential regulation by the government of hedge funds, is the most effective mechanism for limiting systemic risk, although the Treasury Department somewhat dissented from that view in the subsequent Treasury Blueprint. The PWG noted that by limiting their own exposures to losses from hedge fund defaults, counterparties can prevent domino effects that create systemic risk. Moreover, the financing terms that counterparties provide to hedge funds can be an important constraint on the leverage that hedge funds employ and their risk management strategies more generally. Therefore, the PWG advocated indirect regulation as best way to protect against systemic risk, calling for creditors to (i) undertake enhanced due diligence of hedge fund counterparties' risk management systems, (ii) do rigorous stress testing of collateralized credit exposures, and (iii) require hedge funds to provide quantitative and qualitative information regarding net asset value, performance, market and credit risk exposures, and liquidity. The PWG also called for the development of hedge fund industry best practices in risk management, asset valuations, and disclosure policies, but did not call for direct regulation in this area.

The PWG Hedge Fund Principles effectively advocate that regulators require credit counterparties to hedge funds to force fund managers to disclose significantly more sensitive information than they are required to disclose through arms-length negotiations today. Moreover, in light of recent events, the Treasury Blueprint expressed a renewed desire to increase the amount of information that the regulators themselves can obtain about hedge funds through the other entities that they regulate. While lax counterparty risk management strategies may be partially responsible for the amount of information production that exists today, it is also presumably partially the result of more structural factors such as competition among hedge fund counterparties. The central questions raised by the PWG Hedge Fund Principles are therefore how the primary regulators of the financial institutions that deal with hedge funds expect to create conditions for the entities subject to their jurisdiction to obtain such enhanced information, and the extent to which, and the standards by which, such entities may be subject to liability for failure to do so. Alternatively, to the extent that direct regulation of hedge funds as advocated in the Treasury Blueprint is considered, it raises questions as to how broad a license to inspect hedge funds and regulate their activities is necessary and appropriate to limit systemic risk.