THE HISTORY OF HEDGE FUND REGULATION IN THE UNITED STATES

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ABSTRACT

The hedge fund industry in the United States has evolved from a niche market participant in the early 1950s to a major industry operating in international financial markets today. Hedge funds in the United States began as privately held and privately managed investment funds, unregistered and exempt from federal securities regulation. An increasing investor demand for hedge funds and substantial growth of the hedge fund industry resulted in a tectonic shift in the regulatory framework applicable to the industry via the Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act. This chapter summarizes the evolution of the regulatory framework governing the hedge fund industry. It focuses on the registration and disclosure provisions added by the Dodd-Frank Act and several other regulatory innovations, including the Jumpstart Our Business Startups (JOBS) Act and proposals for tax reform of the private investment fund industry.

INTRODUCTION

The hedge fund industry in the United States is continuously evolving and subject to regulatory change. Hedge funds in the United States started as privately held and privately managed investment funds. The originators of the early funds designed the funds to maximize their freedom to employ complex trading strategies by minimizing their exposure to regulation under various federal statutes. Characteristics of early hedge funds included their ability to remain

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unregistered and exempt from federal securities regulation. However, with increasing investor demand and the growth of the hedge fund industry came a major overhaul of the regulatory framework applicable to the industry.

This chapter addresses the evolution of the regulatory framework governing the hedge fund industry in the United States. It explores six topics: (1) the public concern over hedge funds; (2) the regulatory framework originally applicable to hedge funds; (3) the regulatory changes that emerged as lawmakers increasingly focused on the hedge fund industry; (4) the general rules on investment practice that affect hedge funds; (5) the practice of a few funds in voluntarily "going public" and forgoing a regulatory exemption once perceived as essential; and (6) some general investment regulations that substantially affect hedge fund activities, the so called "indirect regulation."

CONCERNS OVER HEDGE FUNDS

Several core features characterize the hedge fund industry. A hedge fund's goal is to earn a superior rate of return on capital contributions for investors through sophisticated trading strategies in securities, currencies, and derivatives. A successful fund manager is paid handsomely. The fund manager takes between a 1 and 2 percent assets under management (AUM) fee and 20 percent of the fund's profits (the carry). A successful manager usually establishes several distinct follow-up funds. If a fund manager earns lackluster returns, the investors pull their capital and are unlikely to support the manager's effort to raise new funds. Historically, hedge funds operate with a relatively short *lock-in*, which is the amount of time an investor must commit money pledged to the fund. Hedge funds that lose money, and a large proportion do, simply wither away. Because of the emphasis on performance, the hedge fund industry may be labeled a "survival of the fittest" industry.

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These characteristics of the hedge fund industry give rise to various concerns over hedge funds. The following concerns have different origins and proponents, pertain to a wide variety of contexts, and can have regulatory implications.

- People who fear concentrations of money see hedge funds as too large. Hedge funds have grown rapidly, both in number and size. They also tend to operate in loose cooperation in a manner similar to wolf packs.
- People who distrust the wealthy elite see hedge funds as the exclusive playground of a very wealthy elite class of investors. These wealthy investors appear to be making double-digit returns unavailable to normal investors.
- People who fear secret conspiracies see hedge funds as insufficiently transparent. Ben Bernanke, former chairman of the Federal Reserve System, has described them as "opaque." If they comply with applicable exemptions from federal securities regulation, hedge funds do not have to disclose their membership or their investment strategies, which depend on speed, cleverness, and leverage.
- People who do not like sharp lenders of last resort believe some hedge funds are vultures, demanding confiscatory terms from those in dire financial situations.
    - People who condemn risk-taking see hedge funds as a form of gambling. Hedge funds can use leverage to generate high returns. They can borrow from banks and other sources to fund their trading strategies. Although many funds earn high returns, a few are spectacular failures, such as Long Term Capital Management (LTCM) in 1998. When their strategies fail, hedge funds can produce losses not only for their members but also for their lenders and counterparties.
- People who suspect fraud in multifaceted financial scenarios find hedge funds too complex. Hedge funds may incorporate *short selling*, which involves the possibility of

making money when a stock or other security falls in price. This strategy raises old prejudices against short sellers, as they often engage in sophisticated trading maneuvers using cutting edge financial products. Because the complex trading maneuvers can take advantage of loopholes in the existing regulatory framework, some see foul play involved. Some troubling incidents of fraud perpetrated by hedge fund operators caused the Securities and Exchange Commission (SEC) to list fraud as one of its primary reasons for its new hedge fund regulations.

- People who are suspicious of "get-rich-quick, guaranteed" sales pitches believe that hedge funds may be duping their own investors with false promises of easy money. Colleges such as The College of Wooster in Ohio have more than 80 percent of their endowments in hedge funds to the consternation of some of their alumni who wonder whether the college officials are overmatched when responding to hedge fund solicitations.
- People who value market stability in the securities and currency markets worry that hedge funds add to market volatility unrelated to fundamental market values and contribute to market bubbles and panics.
- People with positions in traditional operating companies can see "activist" hedge funds as threatening. Some hedge funds take an "activist" investor tack, attempting to influence the incumbent management in blue chip companies such as Time-Warner Inc., Wendy's, McDonalds, Knight Ridder, Inc., and General Motors. These actions have aroused the attention and ire of main street managers and their lawyers.

This combination of concerns about hedge funds – large size, elite investors, lack of transparency, perceptions of predatory behavior, high risk, periodic spectacular failure, and complexity – can foment popular fear of a new breed of shadowy financial players. The populist anti-hedge fund spin almost writes itself: a wealthy, backroom, elite group of investors, driven by selfish greed, takes excessive risks with cheater-style trading strategies that imperil the health of banks, corporations, and the entire economy. Popular fear created pressure for government regulation of the industry.

THE INITIAL U.S. REGULATORY FRAMEWORK

At the beginning of the industry in the early 1950s, organizers of hedge funds designed the funds to be exempt from the public offering registration requirements of the Securities Act of 1933, periodic reporting requirements of the Securities Exchange Act of 1934, registration requirements of the Investment Company Act of 1940, and registration requirements of the Investment Advisers Act of 1940. These exemptions gave United States hedge funds substantial freedom in their investment activities.

The typical hedge fund manager raises money from wealthy individuals and institutional investors using an exemption for “private offerings” under the Securities Act of 1933 and the “safe harbor” provision in Rule 506 of Regulation D. Most early hedge funds satisfied the exemption by marketing themselves only to *accredited investors*, who are institutional investors, insiders, or natural persons with a net worth of over $1 million or income over $200,000 for each of the last two years. Funds using Rule 506 could not use any form of “general solicitation or general advertising.” The SEC applied a “pre-existing, substantive relationship” test when deciding that the general solicitation rule had not been violated.

Moreover, a hedge fund was careful to avoid classification as a financial market player that is specifically regulated by federal legislation. A hedge fund, for example, is not an underwriter, a market maker, or a broker-dealer (market intermediary). A bank or investment subsidiary of an operating company is not a hedge fund. Hedge funds were also careful, by having fewer than 500 investors, to avoid the periodic reporting obligations of Section 12 of the Exchange Act and SEC Rule 12g-1.

The Investment Company Act of 1940, an act that regulates mutual funds, contains the most important regulatory exemption for hedge funds. Hedge funds rely on one of two statutory exclusions in the definition of an investment company. Hedge funds either have fewer than 100 investors or have only investors who are “qualified purchasers” (i.e., individuals who own more than $5 million in investments or companies with more than $25 million in investments). A hedge fund that qualifies for one of these statutory exclusions may use investment techniques that are forbidden to the registered investment companies. The most notable technique that is more freely available to hedge funds than other specifically regulated financial entities is *shorting*, betting on decreases in the value of assets within different classes.

Most hedge fund investment strategies are complex, involving a combination of several coordinated trading positions to make the desired market play. Several of the strategies have common names. In *convertible arbitrage*, for example, a hedge fund goes long in *convertible securities*, which are bonds or shares that are exchangeable for another form of securities, usually common shares, at a pre-set price, and simultaneously shorts the shares. In *merger arbitrage*, a hedge fund buys the target company’s stock and shorts the purchaser’s stock. In *global macro* plays, a fund takes a long position in one country’s currency and shorts the currency of another, which is also done with government debt. In *market neutral* plays, a fund takes offsetting long positions in undervalued companies and short positions in overvalued companies.

Hedge funds can also structure their operations to avoid other regulations. They typically avoid the regulation of “commodity pools” by the Commodity Futures Trading Commission (CFTC). New CFTC rules exempt pools that sell only to sophisticated participants, “accredited investors” under Regulation D or “qualified purchasers” under the Investment

Company Act. Hedge funds avoid regulation under the Employee Retirement Income Security Act (ERISA) by limiting the ownership interest of any employee benefit plan to less than 25 percent of the fund.

NEW REGULATORY DEVELOPMENTS

Historically, hedge funds have operated within the exceptions and exemptions of the Securities Act of 1933 (no public offering is required), Securities and Exchange Act of 1934 (hedge funds are not publicly traded companies), Investment Company Act of 1940 (they are not mutual funds), and, until recently, Investment Advisers Act of 1940 (hedge fund managers are not classified as public investment advisers). However, despite the broad application of exemptions for hedge funds, the general legal framework applicable to financial institutions applied with equal force to the hedge fund industry. The antifraud provisions of the 1933 and 1934 Acts apply to the activities of hedge funds, and state laws against investor fraud apply as well. Hedge fund managers cannot make false statements of material information (or use misleading material half-truths) when dealing with their investors or counterparties in trades. Banking laws also restrict the activities of hedge fund lenders, namely banks, in major respects.

Because of hedge funds' alleged impact on the 1969 bear market, the SEC started to consider ways to bring them under its regulatory authority. Initially, the SEC opined that hedge funds are "dealers" in securities, which could require registration under the Securities and Exchange Act of 1934. However, the SEC continued to provide guidance, mostly in the form of no-action letters, to help investment advisers determine how to count clients to stay exempt from securities regulation. Courts provided very limited and sometimes contradictory guidance.

SEC Rules Requiring the Registration of Hedge Fund Managers

Finally, in 1985, the SEC adopted the investment adviser registration safe harbor in Rule 203(b)(3) under the Investment Advisers Act of 1940. For purposes of an exemption from registration under the Act, the safe harbor provision allowed a limited partnership, rather than each of its limited partners, to be counted as a "client" of a general partner acting as investment adviser to the partnership. Justifying the rule, the SEC reasoned that if an investment adviser manages an investment pool on the basis of the investment objectives of its participants, the entire pool should be viewed as the adviser's client rather than each participant. The rule was aimed at providing investment advisers with greater certainty in determining when they might rely on the safe harbor.

The SEC broadened the scope of the rule in 1997 by including other entities used by investment advisers to pool client assets. Although the 1985 Rule permitted advisers to count each partnership, trust, or corporation as a single client, the 1997 Rule expanded the rule to cover other legal entities. Specifically, investment advisers could count a legal organization as a single client provided the investment advice was based on the objectives of the legal organization rather than the individual investment objectives of any owners of the legal organization. This safe harbor allowed investment advisers to manage large amounts of securities indirectly for several hundreds of investors in several hedge funds.

After the fall of LTCM in 1998 and its bailout orchestrated by the New York Federal Reserve Bank, the notion that hedge funds could pose risks that might affect international markets became increasing apparent. Concerns over excessive leverage by hedge funds and a lack of transparency led to increasing demands for new regulation. Central banks, regulatory agencies, and international regulatory committees conducted studies to determine if hedge funds posed a risk to the global financial system. Many of these studies recognized a need for greater disclosure by hedge funds to increase transparency and enhance market discipline.

Eventually, in December 2004, the SEC, using its rulemaking authority under the Investment Advisers Act of 1940, issued a final rule requiring hedge fund advisers to register under that Act. Hedge fund advisers strongly opposed this controversial rule. Without the private adviser exemption, investment advisers were subject to SEC inspections and bookkeeping and record keeping requirements. Without the private adviser exemption, hedge funds were also faced with disclosure requirements and code of ethics requirements resulting in substantially higher legal fees. Members with the industry argued that completing the 35-page Form ADV was unnecessarily costly and burdensome. Registration also allowed the SEC to screen hedge fund advisers for prior convictions or other professional misconduct.

SEC commissioners issued the rule by a rare three-to-two vote. The SEC justified its rulemaking with reference to the growth of the hedge fund industry in combination with the retailization of the hedge fund sector, increased hedge fund risk, and financial loss to investors caused by instances of fraud by hedge fund advisers. It cited among the benefits of this rule more information about hedge fund advisers, deterrence of fraud, curtailment of losses, and improved compliance controls. The SEC maintained that these positive aspects of its rulemaking would benefit mutual fund investors, other investors and markets, regulatory policy, and hedge fund advisers.

The registration requirement precipitated substantial opposition by the hedge fund industry. Eventually, in July 2006, the D.C. Circuit in *Goldstein v. SEC* vacated the hedge fund rule as an instance of arbitrary rulemaking by the SEC. Because the term “client” had not otherwise been defined in the Investment Advisers Act, the SEC had no authority to determine the meaning of the term. Most hedge fund advisers who had registered under the registration rule deregistered. After the *Goldstein* decision, the SEC proposed an increase for the accredited investor standards under Regulation D and dramatically expanded antifraud protection for investors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, hereafter called the Dodd-Frank Act, added a new chapter in the debate on hedge fund adviser registration. Title IV of the Dodd-Frank Act is entitled the Private Fund Investment Advisers

Registration Act of 2010 (PFIARA). PFIARA authorizes the SEC to bring hedge funds under regulatory supervision. The Dodd-Frank Act authorized the SEC to promulgate rules requiring registration and enhanced disclosure for private equity and hedge funds managers. As part of the new rules, the SEC introduced controversial reporting obligations that would require the disclosure of strategies and products used by the investment adviser and its funds, performance and changes in performance, financing information, risks metrics, counterparties and credit exposure, positions held by the investment adviser, percent of assets traded using algorithms, and the percent of equity and debt, among other matters.

The Act mandates hedge fund adviser registration to increase record keeping and disclosure. Under PFIARA, hedge funds with more than $150 million AUM must register as investment advisers and disclose information about their trades and portfolios to the SEC. The Dodd-Frank Act also directs the SEC to set up rules for the registration and reporting of hedge fund managers who were previously exempt from registration. By registering hedge fund advisers, the SEC may collect necessary information to curtail those who operate in the "shadows of our markets," prevent fraud, limit systemic risk, and provide information to investors.

The drafting process for the Dodd-Frank Act was divisive. The legislators supporting the Act wanted the SEC to be able to obtain sufficient information to protect against systemic risk, prevent fraud, and provide investors with useful information about the hedge funds, even funds that are exempt from registration. Those supporting the new hedge fund requirements maintained that years without regulation had ushered in the financial crisis. Others were concerned that the exemptions in Title IV could make the regulation of hedge funds less effective. Legislators opposed to the new regulations alleged that the SEC failed to sufficiently curtail hedge funds under existing law. They argued that hedge funds did not create systemic risk, played no role in the financial crisis, and were irrelevant to the financial system as a whole.

Hedge Fund Mandatory Disclosure

Title IV of the Dodd-Frank Act also requires registered investment advisers to maintain records and any other information that may be necessary and appropriate to avoid systemic risk. Advisers are required to provide confidential reports with respect to certain information related to systemic risk, such as trading practices; trading and investment positions; the amount of AUM; valuation policies; side letters; the use of leverage, including off-balance sheet leverage; counterparty credit risk exposures; and other information deemed necessary.

Title IV of the Act and the SEC rules implementing it increased substantially the level of regulatory oversight of hedge funds by requiring registered investment advisers to file periodic reports with the SEC on Form PF. All registered investment advisers holding more than $150 million in AUM attributable to hedge funds at the end of their most recently completed fiscal year are required to file.

Form PF requires investment managers to disclose information about themselves, the funds they manage, and their investors. Form PF disclosure requirements include a breakdown of the net asset value (NAV) that the investment manager manages, including the percentage of the reporting fund's NAV that was managed using high-frequency trading strategies. Form PF requires investment advisers to disclose the five trading counterparties to which the reporting fund has the greatest net counterparty credit exposure and the dollar amount owed to each creditor. It also requires that the manager identify changes in market factors and their effect on the portfolio's long and short components as a percentage of NAV. Additional disclosures include any information about the counterparties' collateral and other credit support posted to the respective reporting funds, as well as trading and clearing mechanisms subject to liquidity constraints and the duration of those constraints.

Form PF is also intended to improve the SEC's understanding of reporting funds' liquidity, exposure, and assets. Accordingly, Form PF requires investment advisers to disclose the time increments needed to liquidate a certain percentage of the reporting funds' portfolio, the dollar value of long and short positions in each asset class, the value of turnover by asset class, the types of creditors and the market value of borrowings from them, and the aggregate value of all derivative positions for each advised fund. Finally, Form PF requires disclosure of the reporting fund's restrictions (if any) on investor withdrawals and redemptions and other information pertaining to investor liquidity, such as the percentage of NAV.

In light of the highly sensitive nature of these required disclosures and the complexity of the reporting requirements, Form PF created substantial challenges for the hedge fund industry. For example, the disclosure of counterparty credit exposure is sensitive information that often cannot readily be determined by the individual fund managers. Hedge fund advisers have traditionally opposed enhanced transparency of the funds they manage, arguing that the mandatory hedge fund disclosure requirements in Form PF could inappropriately burden the hedge fund industry. Some of the most controversial disclosure requirements in Form PF include the reporting of risk metrics, strategies and products used by the investment adviser and its funds, counterparties and credit exposure, performance and changes in performance, financing information, percentage of assets traded using algorithms, and the percentage of fund assets held in equity and debt instruments.

Despite these challenges, the hedge fund industry has quickly absorbed the impact of Form PF (Kaal 2014, 2016a, 2016b). The hedge fund industry seems to be adjusting well to the registration and disclosure requirements under the Dodd-Frank Act, and the impact of the registration and disclosure rules appears to be much less intense than the hedge fund industry initially anticipated. The majority of hedge fund advisers incurred less than $10,000 to prepare their initial data reporting to the SEC, with the cost of subsequent annual Form PF filings at about half the initial cost (Kaal 2014). Larger hedge fund advisers, required to file quarterly, faced substantially higher compliance costs, both for their initial data reporting and for subsequent quarterly filings. However, Kaal's data analysis indicates that the data reporting requirements for hedge fund advisers in Form PF and the corresponding SEC forms can be further improved (Kaal 2016b). The majority of SEC-registered hedge fund advisers identified the ambiguity of Form PF data reporting requirements as the most pressing issue (Kaal 2016b). Kaal shows that the cost of hedge fund manager registration under the Dodd-Frank Act brings increasing returns to scale for the industry (Kaal 2016a).

In the aftermath of the enactment of the Dodd-Frank Act, the SEC has made a concerted effort to enforce the Dodd-Frank Act provisions by increasing examinations and enforcement actions. In its enforcement efforts, the SEC emphasized the allocation of investment opportunities among private investment fund advisers' clients, the equitable allocation of expenses among investment advisers' portfolio funds, and fund advisers' personal investing and outside business activities. Notable enforcement actions against private funds from 2012 to 2015 include actions for misallocation of expenses, undisclosed conflicts of interest, and inflating the values of certain illiquid assets that hedge funds and private funds hold. SEC enforcement actions included enforcement of Rule 206(4)-7, which requires funds to adopt, implement, and annually review compliance policies. Failure on the part of advisers to specifically tailor a compliance program for their business has led to large penalties.

Undisclosed conflicts of interest became an examination and enforcement priority in 2015. The SEC settled charges with private investment managers who received accelerated portfolio company monitoring fees from sales and initial public offerings (IPOs) of portfolio companies and who failed to disclose conflicts arising from the manager's conversion of portfolio company monitoring fees that could have partially been offset.

The allocation of investment opportunities among private investment fund advisers' clients became another SEC enforcement focus. In particular, different fee structures among private fund advisers' portfolio funds can influence advisers' allocation incentives. The SEC also is concerned over practices that may result in advisers improperly favoring some limited partners over others. For example, some limited partners in a fund are also co-investors with the fund itself in investment opportunities. If such private fund advisers' practices are not adequately disclosed, co-investments can often be problematic. For example, a fund may give potential co-investors a co-investment opportunity in exchange for a future fund commitment or an increase in a fund commitment. This scenario can be especially problematic if a fund's governing documents would otherwise prohibit such an allocation or allocation policy.

Another core SEC enforcement area concerns the equitable allocation of expenses among funds. In particular, the SEC voiced concern over whether regular co-investors and employee/executive funds and other preferred clients are contributing their respective pro rata portion of fund expenses. In one case, the SEC settled charges with a private fund adviser who had inappropriately allocated broken-deal expenses to co-investors and who did not disclose such misallocations in the funds' marketing materials or limited partnership agreements.

SEC enforcement actions against hedge funds and their advisers include a variety of serious charges against funds that terminate short of trial in settlements. The charges indicate SEC enforcement priorities. For example, the SEC settled charges with a private fund manager over the use of fund assets that had not been authorized under the funds' operating documents and charges with a private fund manager over the manager's receipt of a higher discount rate for manager-related legal services than the discount rate received by its funds for deal work. The SEC also entered into a formal consent order against private fund managers based on misallocation of compliance costs to their private funds rather than to the managers.

Other notable SEC settlements include the settlement of charges with a private fund adviser to a registered fund for the adviser's failure to manage and disclose a senior trader's conflict of interest pertaining to the trader's outside business interests. In another case, the SEC settled charges against a private fund adviser who did not disclose a loan by a client to one of the adviser's senior executives before investing other clients' funds with different and inconsistent terms.

Given these enforcement trends and in light of SEC guidance in public statements, the hedge fund industry can expect new or proposed regulations, increased SEC enforcement actions against hedge fund managers, longer and more intrusive SEC examinations, and increasing challenges in obtaining waivers from bad actor restrictions on fundraising. The Department of Treasury's proposed rule targeting investment advisers' filing and reporting requirements about money laundering, Form ADV disclosures, and the definition of "accredited investor," among other non-final rules in 2015, provide a taste of possible future developments for the hedge fund industry.

Taxation of Hedge Funds

A new front on hedge fund regulation opened in 2007 when Fleischer (2008) suggested a link between hedge funds' above average profits and a scheme of tax avoidance. The hedge fund itself is a limited partnership or a limited liability company that does not pay an entity tax; tax obligations "flow-through" to the equity members. At issue is the tax treatment of the payments to the fund manager. Typically, the fund manager is compensated with a fee based on 2 percent of the fund's AUM and a profit allocation equal to 20 percent of the fund's return, the so called "carried interest" or "carry." The government levies a long-term capital gains tax (LTCG) of 20 percent on the carried interest for profits on securities held more than one year in the fund, an amount that is much lower than the basic levy of 40 percent on ordinary income tax. The LTCG tax benefits are crucial to the returns of private equity, venture capital, and real estate investment funds advisers whose funds hold portfolio company stock longer on average than do hedge funds. A substantial proportion of hedge fund adviser fees will also be affected, however.

According to Fleischer, the fund managers were taking advantage of a tax loophole to receive effectively a manager's salary without paying rates that ordinary citizens had to pay on salary income. His position has garnered substantial political support. Several bills have been introduced in the U.S. Congress to eliminate the loophole. Should Congress change the tax treatment of hedge fund managers, the returns to hedge fund advisers and their investors are likely to fall markedly. Hedge funds' popularity will be severely tested.

Hedge Funds Can Advertise Generally

In 2012, Congress passed the Jumpstart Our Business Startups Act (JOBS Act), which substantially affected hedge fund practice in soliciting investors. The JOBS Act directed the SEC to lift the decades-old ban on general solicitation and general advertising (GSGA) that applied when companies or funds made private securities offerings under Rule 506 of Regulation D. Accordingly, on August 29, 2012, the SEC proposed rules to implement Section 201 of the JOBS Act. Under the SEC's Rule 506(c) Proposing Release, proposed Rule 506(c) for the first time allowed GSGA in a Regulation D offering. The SEC adopted the proposed rules on July 24, 2013, and they became effective on September 23, 2013.

New Rule 506(c) creates uncertainty for hedge fund advisers considering GSGA. Section 201 of the JOBS Act gives the SEC discretion regarding the methods used to determine that the issuer took reasonable steps to verify the accreditation of purchasers. Although the SEC required under new Rule 506(c) that GSGA be accompanied by "reasonable steps" to verify that investors are accredited, it did not change the definition of accredited investor and, importantly, the SEC did not provide a firm or "bright line" rule for the content of GSGA. A *bright-line rule* is a clearly defined rule or standard, composed of objective factors, which leaves little or no room for varying interpretation. The rule's intent is to produce predictable and consistent results in its application. Hedge fund advisers are now free under implementation of the SEC's

JOBS Act to communicate with investors and the public. Since September 23, 2013, they can advertise, talk to reporters, and speak at conferences. Yet, very few hedge fund managers are actually engaging in less restrictive communications with potential investors.

The ability to engage in GSGA under new Rule 506(c) creates substantial opportunities for hedge funds. Under new Rule 506(c), issuers can engage in GSGA if they satisfy the requirements of new Rule 506(c) and will not be subject to the prohibition against general solicitation in Rule 502(c). To qualify, all purchasers of issuers' securities must be accredited investors and issuers must fulfill the investor verification requirement, demonstrating that the purchasers of the securities are accredited investors. Because offerings subject to the prohibition against general solicitation in Rule 506(b) are an important source of capital for issuers, Rule 506(b) will continue to be available in addition to new Rule 506(c) offerings. Under the so-called "bad actor" amendment, an issuer cannot relying on the new Rule 506 exemption if the issuer or any other person covered by the rule has been criminally convicted or subject to certain SEC cease-and-desist orders, court injunctions, and restraining orders.

The investor verification requirements in new Rule 506 are a major departure from prior practices and were a controversial part of the legislative history of Title II of the JOBS Act. The initial proposal for the predecessor to the JOBS Act, the Access to Capital for Jobs Creators Act (ACJCA), did not include investor verification requirements. The intent of ACJCA was to remove the prohibition on general solicitations in offerings to accredited investors. However, because of concerns over self-certification, misstatements by prospective investors about accreditation, and possible sales to unaccredited investors, GSGA were conditioned on issuer verification of the accredited investor status of purchasers. The revised bill passed the House on November 3, 2011 and was later integrated into the JOBS Act as Title II.

In implementing methods for verification of investors, the SEC recognized that the amendment to Rule 506 required sufficient flexibility to accommodate different types of issuers and investors. For issuers using GSGA, the SEC cites examples of reasonable steps to verify accredited investor status: the nature and terms of the offering, the amount and type of information the issuer has about the prospective investor, and the nature of the prospective investor and the type of the accredited investor status claimed by the prospective investor.

Accredited investors have to fit into one of the categories of persons who qualify as accredited investors or the issuer has to reasonably believe that they do. New Rule 506(c)(2)(ii) provides four non-mandatory and nonexclusive investor verification methods. The Income Test relies on the income stipulations reported on IRS forms for the most recent two years as well as written representations from purchasers pertaining to their reasonable expectation of reaching the required income level to qualify as an accredited investor. The Net Worth Test is based on a review of three months of documentation pertaining to assets, a report from a national credit reporting agency, and a written declaration from the investor that all liabilities required to make a determination of net worth have been disclosed. Third Party Verification is possible via a written stipulation from a qualified third party confirming that the third party has taken reasonable steps in the three months before the investment to determine that the purchaser is an accredited purchaser. For purposes of the Third Party Verification Test, permissible third parties include registered investment advisers, broker-dealers, licensed attorneys, or certified accountants. Lastly, new Rule 506(c)(2)(ii) allows issuers to show accredited investor status of previous purchasers of an issuer's securities in a Rule 506(b) offering before the effective date of Rule 506(c) by obtaining a certification from such purchaser that the individual qualifies as an accredited investor.

Whether the investor verification requirements are workable is questionable. Fearing possible liability for investor misrepresentations of their personal wealth, most hedge funds that raise money from individuals continue to use the old Rule 506 rather than Rule 506(c). New Rule 506(c) will generate considerable uncertainty for the hedge fund industry and its lawyers until the SEC finalizes the rules pertaining to verification requirements for new investors and provides sufficient guidance. A clear and comprehensive definition of issuers' "reasonable steps" to verify investors' accreditation seems especially important. Without appropriate SEC guidance, issuers will have difficulty ascertaining if their verification attempts at the time of the sale of securities made GSGA permissible.

Another major concern with the amendment to Rule 506 is the possible increase of sales pressure and the associated downsides. Commissions generated by selling private placements exceed commissions from selling all other kinds of investments. The industry has successfully resisted the Financial Industry Regulatory Authority's (FINRA) efforts to cap commissions at a maximum of 15 percent. Addressing the suboptimal results generated by increased sales pressure with increased disclosure obligations, such as an obligation to file all 506 sales documents with FINRA or the SEC, may burden issuers inappropriately. Litigation-based enforcement, on the other hand, may not encapsulate all offenders equally and/or appropriately.

GENERAL RULES ON INVESTMENT PRACTICES AFFECTING HEDGE FUNDS

Besides the SEC's rules that are specific to hedge fund operations, other laws exist on general investment practices. These laws are not specific to hedge funds, but they include and therefore affect hedge fund operations.

Short Selling

Hedge funds' primary market advantage has been that they could use trading strategies that "short" the market. The traditional method of shorting the market is to borrow stock, sell the borrowed shares, hope the price drops, and repurchase shares at a lower price for return to the lender. A trader can also short the market by using derivatives. For example, an investor can short shares by purchasing a put option on the shares, selling a future or forward contract on the shares, or engaging in a swap contract as the counterparty paying the return on the shares. Unlike hedge funds, registered investment companies, such as mutual funds, are permitted to short sell but must cover any open short positions by setting aside cash or other liquid securities.

Short selling has been controversial. Two primary arguments exist against the practice. The first argument is the long-standing disdain for those who profit when others are suffering – a short seller makes money when asset values decline. Most investors are “long” and benefit when asset values rise. Managers of firms do not like short sellers, who have a financial incentive to discover and reveal the company’s dirty laundry. Second, those who short the market engage in market manipulation. Unscrupulous short traders in railroad stocks at the turn of the century spread false negative rumors about companies to drive their stock prices down. Bribing journalists to print the lies was part of their modus operandi. Angry speculators responded with “corners,” the purchase of so many shares that short sellers could not cover their positions.

Governments responded by attempting to regulate or even prohibit short selling. Until the 1850s, short selling was illegal in the United States. After the Great Depression, U.S. regulators curtailed it. Section 10(a) of the Securities Act of 1934 authorizes the SEC to regulate short selling, and the Investment Company Act of 1940 severely restricts the ability of mutual funds to short. The SEC responded to the authority to regulate by promulgating the “uptick” and “zero-plus-tick” rules, which prohibit the short selling of a stock on a United States exchange except at a price higher than the price of the last trade or at a price equal to that of the last trade if the previous price change was positive. In February 2010, the SEC adopted a new short sale price test restriction, which is commonly referred to as the “alternative uptick rule.” The purpose of the alternative uptick rule is to restrict short selling from further driving down the price of a stock that has dropped more than 10 percent in one day compared to the closing price on the previous day. The SEC is now experimenting with repealing the rule for widely traded stocks.

Other legal constraints affect short selling. The Federal Reserve Board's Regulation T requires a margin of 50 percent on short sales as well as long positions in stock. Short sale prohibitions also exist relating to specific market transactions. For example, Rule 105 of SEC Regulation M prevents traders from covering short positions entered into before the effective date of a public offering with securities obtained in the public distribution. Rule 14e-4 prohibits turning short tenders into public tender offers.

Hedge funds are unaffected by the restrictions on mutual funds, can use derivatives to avoid the margin requirements, and pioneered procedures that reduce the direct costs of shorting. The funds used their ability to short by designing combination long/short trading strategies ─ hence the name "hedge" ─ that enables them to make very sophisticated and nuanced bets on the price movements in the trading markets. Hedge funds' emergence as short sellers can be viewed as positive, eliminating some of the market overpricing due to the high costs of short selling. Some point to the success of hedge funds as evidence that mutual funds should be given more freedom to short, arguing that government should avoid regulations that subject hedge funds to the same rules against shorting that apply to mutual funds.

Market Manipulation and Vote Buying

Different forms of market manipulation, including vote buying, can affect hedge funds. An illegal practice applied by hedge funds that has garnered a fair amount of media coverage is *naked shorting*, which occurs when a trader sells stock it does not own or has not borrowed. The SEC has recently moved to tighten up its rules on naked shorting. Similarly, so-called *vote buying*, which involves hedge funds buying shares before a record date to vote them and using offsetting short positions to eliminate the economic consequences of their votes, has attracted some attention.

Leverage

Most hedge funds are heavily leveraged. In essence, a fund increases its returns on deployed capital by using borrowed money alongside its own or by using various derivative contracts rather than holding the underlying securities. The amount of leverage used by a hedge fund depends on its investment strategy. For example, arbitrage funds are more likely to use heavy leverage than activist funds. The President's Working Group on Financial Markets (1999) finds that a majority of hedge funds were leveraged at less than two to one but that some were leveraged at more than 30 to one.

No legal limits exist on hedge fund leverage. In contrast, registered investment companies – mutual funds – may use leverage, but they operate under direct limits. An open-end mutual fund, for example, must borrow only from a bank and is subject to a 300 percent asset coverage test. Closed-end investment companies have less restrictive limits. All investment companies may invest in derivatives that are inherently leveraged only if the company "covers" the transaction by setting aside liquid assets in an amount equal to the potential liability or exposure created by the transaction.

Any limits on a hedge fund's use of leverage come from the market discipline provided by creditors and counterparties. If a hedge fund takes substantial risks, its creditors should respond by increasing interest rates or reducing the availability of credit to the firm. Counterparty discipline comes through increased credit terms either directly, through trading, credit limits or initial margin, or indirectly, through credit spreads on transactions. Moreover, lenders and counterparties are subject to legal limits on risk exposure. Legal regulations affect the potential lenders and counterparties of hedge funds.

Hedge funds can create leverage by borrowing funds or by engaging in derivative transactions with counterparties. When borrowing money, lenders are subject to specific limits. A broker-dealer extending credit to a hedge fund must comply with the margin requirements in Regulation T issued by the Board of Governors of the Federal Reserve System. Banks loaning money to hedge funds must comply with general limits under federal treasury regulations. An FDIC-insured bank, for example, may not make a loan of more than 15 percent of its asset value to any one borrower. More importantly, banks are subject to minimum capital requirements based on the risk characteristics of their assets, which include loans to and transactions with hedge funds. Finally, bank supervisors monitor individual banks' lending activities for risk appetite and risk management. Therefore, the regulation of these counterparties can affect hedge funds.

HEDGE FUNDS AS PUBLIC ENTITIES

Since the mid-2000s, leading hedge and private equity funds have been listing subsidiaries on public exchanges or sought public listings through other avenues. Although such IPOs are rare among hedge funds, they are an important move into the public trading markets with large implications for the industry. IPOs of hedge and private equity funds suggest that the historic contours of the hedge fund industry as privately-held and managed investment funds, unregistered and exempt from federal securities regulation are slowly changing as the industry becomes a more mainstream part of finance. Other relevant trends, such as the increase in alternative mutual funds and mandatory registration of private fund advisers under the Dodd-Frank Act, suggest that hedge funds' prior exclusive reliance on private offering exemptions for raising capital could become less important as the industry evolves.

Some leading hedge and private equity funds have sought public listing opportunities. In 2004, a very successful private equity firm formed a publicly traded affiliate, the Apollo

Investment Corporation (AIC), to invest in middle-market companies. AIC is structured as a business development company and does not invest in companies controlled by Apollo's private equity funds. The move opened the door to other hedge funds, engaged in private equity firm activities, to investigate raising money from public investors in publicly registered offerings. In 2006, Apollo formed AP Alternative Assets, a Guernsey-domiciled, publicly-traded, private equity closed-end limited partnership that does invest alongside Apollo's' main private equity funds and hedge funds. In March of 2007, Blackstone Group, the largest alternative asset investment firm in the world, sold a 12.3 percent stake in the firm for $4.13 billion. In July 2007, a rival private equity firm, Kohlberg, Kravis, & Roberts, filed its own IPO; it listed shares in October of 2009 of an affiliate that owns 30 percent of the company.

INDIRECT HEDGE FUND REGULATION

Leading governmental bodies and academics discuss indirect forms of regulation of hedge funds through the regulation of financial institutions that interact with hedge funds (Kaal 2011). Such proposals are unlikely to become legally binding.

Most bank exposure to hedge funds occurs from counterparty trading and other derivative activities. Banks take the opposite side of swap transactions on currency or interest rates, for example. Counterparties manage their risk exposure to hedge funds through due diligence, collateral, credit limits, reporting requirements, and monitoring. Banks establish risk profiles they are willing to undertake and develop risk management procedures. Bank examiners supervise the safety and soundness of the bank's activities. Concern over "excessive" leverage by hedge funds, however, is likely to lead to the heaviest pressure for new regulations for hedge funds. Discussions of any direct regulation of hedge fund leverage usually collapse when the participants get to the details. Balance sheet leverage is not an adequate measure of risk and would encourage avoidance behavior with off-balance sheet strategies.

Alternatives, such as *value-at-risk*, which is a ratio of potential gains and losses to net worth, offer more meaningful measures of risk but have severe measurement problems. Any attempt to directly regulate leverage would likely be conservative, due to measurement problems, and put major limits on hedge funds' ability to provide market liquidity. Direct regulation could also increase moral hazard costs as lenders and counterparties may relax their vigilance in reliance on the government rules.

The capital adequacy requirements for banks that deal with hedge funds are a form of indirect regulation on hedge fund activity through the regulation of financial institutions that interact with hedge funds. The U.S. banking system is designed to guard against bank failures because individual depositors need protection and the risk of system-wide contagion from any one bank failure is too great. Hedge fund failures, on the other hand, are a normal and expected part of the hedge fund business. With banks competing to deal with hedge funds, some banks, responding to competitive pressure, could agree to financial terms that jeopardize their solvency. To protect against bank failures, the government establishes minimum levels of acceptable risk that apply to all banks. Bank capital adequacy rules and the examiner system are designed to establish a floor on bank risk.

Banks' lending practices and counterparty credit risk management allow them to influence hedge funds. Banks play a prominent role in financial markets and facilitate hedge fund investments as market makers, creators of complex financial products, or lenders, among other roles. Because of their interaction with hedge funds, banks are uniquely positioned to use the threat of cutting off future lending to improve a hedge fund's behavior. Indirect regulation through capital adequacy standards could also address issues of systemic risk because capital adequacy standards will not only regulate and alter credit standards of banks, but also counterparty credit risk and, thus, hedge funds' level of leverage.

Another form of indirect regulation on hedge fund activity could be a disclosure rule that requires all public companies, particularly those that are financial institutions, such as banks and insurance companies, to include a summary of their direct material exposure to hedge funds and other highly leveraged financial institutions. Such a rule would be designed to protect the investors of public companies. The disclosure requirements of the publicly-traded lenders and counterparties would require that such companies make information demands on hedge funds necessary to gather the data required.

Disclosure requirements on hedge funds' counterparties and lenders are subject to several shortcomings and open questions. As a practical matter, whether the authorities could collect such an enormous quantity of highly sensitive information in sufficient detail and with sufficient frequency (at least daily) to be effectively informed about liquidity risk in particular market segments is unclear. Also unclear is how the authorities could use the information, or whether they would have the authority to direct hedge funds or other large financial institutions to reduce positions. If several funds had similar positions, how would authorities avoid giving a competitive advantage to one fund over another in using the information from the database? Perhaps most important, would counterparties relax their vigilance if they thought the authorities were monitoring and constraining hedge funds' risk-taking? A risk of any prescriptive regulatory regime is that, by creating moral hazard in the marketplace, it leaves the system less rather than more stable.

A system in which hedge funds and other highly leveraged market participants submit position information to an authority that aggregates that information and reveals it to the market would probably be unable to address the concern about liquidity risk. Protection of proprietary information would require so much aggregation that the value of the information to market participants would be substantially reduced. Timeliness of the data would also be an issue.

A public database of nonproprietary information could provide the public with a general picture of hedge fund activity without creating the false impression that the authorities were engaged in prudential oversight of hedge funds. Such a public database might demystify hedge funds, but it would not address the central policy concern that opacity creates liquidity risk.

The present SEC rules do not provide specifically for disclosures about exposure to hedge funds. SEC rules could provide for such disclosures in the Management Discussion and Analysis (MD&A) or Description of Business segments of the periodic financial statements. Such disclosure would be consistent with existing SEC financial disclosure philosophy. Investors of publicly-traded companies ought to have all material information disclosed in ways that are meaningful to intelligent investors.

Relaxing the Regulation of Mutual Funds

The staff of the SEC, in its September 2003 report on hedge funds (SEC 2003), ended by suggesting that the SEC explore enabling registered investment companies, mutual funds, to use some hedge fund strategies. For example, mutual funds through so-called "alternative funds" have begun to create funds that short the market (Kaal 2016c). The staff noted that hedge funds had more freedom to short the market, engage in more leverage, and use more innovative organizational structures than mutual funds. Discussions of the advantages of hedge fund short selling and leverage are previously noted. The third category, namely organizational structure, deserves separate mention. The staff noted that registered investment companies cannot use many organizational features available to hedge funds.

The lock-up used by hedge funds is prohibited to open-end investment companies that must honor redemption requests within seven days. Open-ended investment companies may hold no more than 15 percent of their assets in illiquid securities. Yet, closed-end investment companies do not issue redeemable securities and may hold illiquid securities, but they cannot engage in continuous offerings and often have trouble raising additional assets. Most importantly, investment advisers to investment companies may not charge an investment company a performance fee. Hedge funds rely heavily on performance fees, up to 20 percent of a fund's capital gains and appreciation, to provide fund advisers with incentives to produce absolute returns to the fund.

The restrictions on investment company short selling, leverage, and organizational structure create a substantial disincentive for such companies to engage in so-called *absolute return investment strategies*, which are strategies that are independent of the aggregate value of the market. Conversely, most investment companies buy and hold specific types of securities and investors judge their returns by whether they best a passive benchmark index. Mutual funds that want to engage in "absolute return" strategies must be fund of funds (FOFs), holding a portfolio of hedge funds. All but a very few of such FOFs are available only to institutional or wealthy investors. Other countries give their investment companies more trading freedom. Staying competitive in the global financial markets requires continuously reassessing whether the trading restrictions on U.S. mutual funds, investment companies, make sense in the modern markets.

SUMMARY AND CONCLUSIONS

For more than 70 years, financial economists have decried the lack of independent shareholder involvement in the management of public firms and the lack of swift capital reallocation in American industry. Hedge funds play a major role in both of these functions. The United States is in a period of high-stakes experimentation over how to regulate these unique and powerful funds. While the overall effects of enhanced hedge fund regulation are not as immense as hedge fund industry representatives had predicted, some evidence exists that enhanced rules under the Dodd-Frank Act increase the cost of compliance for the industry. Higher compliance costs can lead to barriers to entry for new market entrants and can also accelerate the consolidation of the industry.

DISCUSSION QUESTIONS

1. Explain why some perceive hedge funds as controversial.
2. Discuss several methods available to governments to regulate hedge funds.
3. Explain the role of the Dodd-Frank Act in regulating hedge funds.
4. Identify several long-term implications of heightened hedge fund regulation.
5. Discuss possible ways to curtail the effects of heightened hedge fund regulation.

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