Commentary: Advisers to Hedge Funds May Face New Federal Regulations

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Originally Published in *Traders Magazine* on November 30, 2009

http://www.tradersmagazine.com/news/hedge-funds-regulation-sec-104673-1.html

Public outrage over the high-flying and largely unregulated world of hedge funds has become a thorn in the side of U.S. politicians and regulators. Hedge fund advisers are an easy target for those who wish to prove they are serious about curbing Wall Street excess, and evidence is mounting that hedge fund advisers will face the brunt of the public's outrage in the form of significant new federal regulations.

Until recently, most hedge funds had been fairly adept at avoiding public scrutiny. Last year's financial meltdown, however, together with the string of high-profile Ponzi schemes threw the light of public scrutiny squarely on hedge funds and their managers. The media has not been kind. They portray hedge fund advisers as greedy villains responsible for problems in the financial markets and the overall economy. Not surprisingly, politicians are listening.

In his opening statement on May 7, 2009 before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing on Perspectives on Hedge Fund Registration, Congressman Paul Kanjorski noted that if hedge funds *"want to continue to swim in our capital markets, they must, at a minimum, fill out the forms and get an annual pool pass."*

In October 2009, Congressman Kanjorski introduced legislation calling for, among other things, the federal registration of hedge fund advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). It is interesting to note that Congressman Kanjorski's proposal contains a specific exemption from registration for advisers to venture capital funds. In early November 2009, Senator Dodd, chairman of the Senate Banking Committee introduced similar legislation. Senator Dodd's proposal contained a specific exemption for private equity funds in addition to the exemption for venture capital funds contained in Congressman Kanjorski's proposal.

Although hedge funds, private equity funds and venture capital funds involve significantly different approaches to investing, they are all pools of capital that are legally indistinguishable. However, the proposed legislation singles out hedge fund advisers based on the notion that hedge funds pose more of a systemic risk than other private pools. Representatives of the hedge fund industry agree that some

regulation may be warranted, but they dispute the notion that hedge funds pose a particular systemic risk.

Nevertheless, the proposed legislation demonstrates that legislators do not believe that all private pools should be treated equally. Both proposals contain the same key provision that eliminates the "private adviser" exemption. Currently, the private adviser exemption, section 203(b)(3) of the Advisers Act, is available to an adviser that has fewer than 15 clients and does not hold itself out generally to the public as an investment adviser. This *de minimis* provision was originally designed to cover advisers that were too small to warrant federal attention. This exemption now covers advisers with billions of dollars under management because each adviser is permitted to count a fund as a single "client."

The SEC tried to eliminate this loophole in 2004 by requiring hedge fund advisers to "look through" the fund to count the number of investors in the fund as clients for purposes of determining whether the exemption applies. That rulemaking was overturned by the federal Court of Appeals in 2006, with the result that approximately 800 hedge fund advisers withdrew registrations.

The SEC apparently also believes that hedge funds present a particular risk to our financial system. In July 2009, Andrew Donohue, Director, Division of Investment Management for the SEC, testified before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs. He noted that hedge funds are of particular concern because of their size and leverage. The SEC estimates that advisers to hedge funds have approximately $1.4 trillion under management and, since many hedge funds are very active and often leveraged traders, this amount understates their actual impact on trading markets. Hedge funds are estimated to account for 18-22 percent of all trading on the New York Stock Exchange.

Some representatives of the hedge fund industry dispute the fact that hedge funds pose a systemic risk to capital markets. In October 2009, the Managed Funds Association (the "MFA"), an organization that claims to include the vast majority of the largest hedge funds in the world, testified before a House Financial Services Committee hearing. Richard Baker, the President of the MFA noted that *"… hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were, and remain, substantially less leveraged than banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance."*

The debate as to whether hedge funds pose more of a systemic risk to our financial markets than other private pools may be irrelevant. The force behind proposed hedge fund regulations may be more rooted in the public's hatred of hedge funds than in any true systemic risk. Despite the fact that U.S. equity markets have made

some strides towards recovery, the public continues to call for action. The public's ongoing fascination with hedge fund billionaires and Bernie Madoff and his cronies has made hedge funds part of dinner table conversation and an easy target for politicians.

Indeed, the public's continued obsession and outrage over hedge funds is now finding expression in popular entertainment. For example, HBO's season finale of *Curb Your Enthusiasm* dove head-first into the debate. The episode featured George Costanza as the latest victim of Bernie Madoff. George has had a huge success with the iPhone app "iToilet," but he's lost all his money to Madoff. He schemes to remarry his ex-wife, who had been lucky enough to sell her Madoff shares before he was busted.

Although I am a big fan of Larry David, I don't believe that Larry or his shows will have any impact on new hedge fund regulations. Sorry, Larry. But, I do believe that the public's obsession with hedge fund greed and excess is not going to fade into the mist. Politicians will not be able to ignore the public demand for reform.

Call me cynical, but there is no good policy reason to continue an exemption for venture capital and private equity funds if we are going to require hedge funds to register. But as long as the terms "venture capital" and "private equity" manage to remain unfamiliar to the general public, their lobbyists will find sympathetic legislators and they may avoid the hedge funds' regulatory fate. And, call me even more cynical, it should be easy enough for the things we currently call "hedge funds" to re-brand themselves as "private equity funds" or "venture capital funds" to avoid the regulator's grasp.

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