

## Solicitation of investors

The SEC did not relax its prohibition of soliciting funds from accredited investors – defined as an individual with \$200,000 in income or \$300,000 in joint income if married or \$1,000,000 in net worth. It did draw a dichotomy between “accredited investors” as defined, and “qualified purchasers” under Section 3(c)(7) of the Investment Company Act. The latter class of investors includes individuals with \$5 million, or institutions with \$25 million in investable assets. The SEC staff stated: “There seems to be little compelling policy justification for prohibiting general solicitation or general advertising on private placement offerings of Section 3(c)(7) funds that are only sold to qualified purchasers.”

The SEC remains focused on the first class of “accredited investors” and has indicated through its recommendations and actions that it will continue to scrutinize any public representations and solicitations of investors via websites, or even statements in the press by hedge fund principals.

## US funds in a global market

As the hedge fund industry continues to expand in Europe and Asia, many US managers are seeking distribution to non-US investors. This cross-border extension raises a number of significant taxation and regulatory issues.

The impact of the USA PATRIOT Act and the general security climate in the US – post 9/11 – has placed a large burden of Know-Your-Client (KYC) and anti-money laundering (AML) compliance on hedge fund managers. These strict requirements add to the overall back office compliance burden of a fund manager and have had a chilling effect on overseas investor solicitation efforts. Many US fund managers will seek cross-border investors, but many will avoid them and be content to only accept US-domiciled institutions and individuals. As registered investment companies enter the market for funds-of-funds, KYC and AML compliance will shift to them, where compliance procedures are well established. While efforts are well underway to develop a global GAAP, with encouraging

progress on IFRS, there can be a dilemma for American funds trying to come to grips with local accounting standards as well as regulations in this transition phase.

London has emerged as the beachhead for American funds seeking a presence in Europe and to capture funds invested in traditional products. Service providers, ranging from prime brokers to law firms to accounting firms, are establishing London operations to support this trend.

## Conclusion

With financial regulatory reform and the general issue of transparency high in the political debate, no one should be surprised if hedge funds and the universe of alternative investments come under further scrutiny in the coming months.

Scrutiny does not mean the hedge fund business is going to wither, as this is a growth industry. We anticipate there will be further “mainstreaming” of hedge funds into the flow of the American financial sector. Funds-of-funds structures will continue to be adopted by investment companies who seek to offer hedge fund attributes to the retail investor. Institutional investors will also continue to embrace asset allocation to hedge funds, particularly as more compliance and risk management controls become more transparent and acceptable to their investment committees.

The hedge fund industry has an excellent opportunity to adopt best practices and self-monitor its operations if it follows the recommendations of the SEC and proactively gets in front of the leading issues. The adoption of compliance measures will place a burden on smaller funds, which in turn will rely more heavily on broker-dealers to assist them in managing their back office operations. Larger fund complexes will have an advantage in satisfying the SEC’s requirements and the compliance burden could result in pressure on smaller independent funds, with funds banding together to share common back office services as an economising measure.

One cannot underestimate the influential role of the mutual fund industry in regards to how the hedge fund industry will evolve and be regulated. The sharp dichotomy between the transparent and opaque world of public and private funds has increased pressure on regulators and rule makers to level the playing field. The veil is lifting, and as it does, a new era in investment management will begin.

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# Lifting the veil on American Hedge Funds

by Mark J. Casella, Partner

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**A former backwater of investment management, hedge funds have become a significant factor in asset management. Restricted to the participation of an elite few, they have been receiving more and more attention. This comes from regulators, rule makers, such as FASB and the AICPA, tax authorities, prosecutors, the press, and traditional long-only managers seeking to deploy hedging techniques – disproportionate to their current (although rapidly growing) size. Issues raised by the Securities and Exchange Commission (SEC) in 2003 gave US hedge fund managers the opportunity to take pre-emptive action. Meanwhile, mutual funds will increasingly be investors, competitors, and standard-setters for hedge funds.**

Hedge funds and other alternative investments (for both individual and institutional) are squarely out of the shadows and under the microscope of investor interest. This is due to a growing awareness of their unique attributes, market flexibility, as well as explosive growth in their numbers. In addition, there is increasing attention by regulators seeking disclosure and protection for a new class of retail investors unaccustomed to the risks and responsibilities associated with hedge fund participation.

As mutual fund companies, investment banks and brokerages seek to enter what has traditionally been an industry dominated by boutiques, there will be wider marketing of hedge funds and funds-of-hedge-funds to the mass affluent retail segment. Regulators and fund managers are finding themselves grappling with an entirely new set of issues. While regulatory attention has been diverted by the after-market trading scandals afflicting the mutual fund industry, we expect continued and intensified interest from regulators and rule makers in hedge fund structures, reporting practices, and tax issues throughout this year.

As a result of the influence of the United States in setting financial precedents, developing regulatory and taxation structures, influencing the cross-border flows of global capital, this article focuses on the significant regulatory and tax-related events of last year and the prospects of change this coming year within the US market.



## The state of the hedge fund market

**2003 was the year hedge funds ceased to be the exclusive domain of the ultra-wealthy and became more accessible to a wider audience of investors. This relaxation of access has led to the long-anticipated move towards registration and disclosure. This is a move that many have expected for years, especially in the highly publicized wake of recent hedge fund meltdowns. By May, the SEC was meeting with representatives from the hedge fund industry to determine what changes and amendments were needed to be made to existing regulations to make hedge funds “safer.” Details on the SEC proposals that emerged from these meetings are discussed in this article.**

## “Retailization” of the hedge fund market

**Hedge funds have traditionally only been open to high-net-worth individuals and their family offices and institutional investors. The high bar for admission to a fund has also served to keep operations cloaked. Now, as more and more investors seek to play, regulators and rule makers are taking notice.**

These funds have vastly reduced minimums from the traditional hedge fund minimum of \$1 million in net worth or \$200,000 in annual income. The best indicator of retail investors trying to gain access to the beneficial attributes of hedge fund investments is the creation of more funds-of-hedge-funds. Retail investors are notably attracted to their ability to protect capital in bear markets, a capability accentuated by the recent relatively poor performance of long-only funds. Investors want the downside protection that hedge funds purport to offer.

Mutual fund companies, in particular, are drawn to these investments. An increase in the number of mutual fund companies entering the hedge fund market, either through direct management of hedge funds or the creation of funds-of-hedge-

In 2003, many institutions began to offer hedge fund pools, or funds-of-hedge-funds, to their clients. While the \$600 billion in assets managed by hedge funds are insignificant in comparison to those managed by mutual funds, the entry of investment companies into the formerly closed world of hedge funds is having a profound effect on hedge fund practices, bringing more disclosure of fees and relationships, and more governance than ever known.

Institutions are challenged by hedge funds on a number of fronts. At one level, there is the challenge of retaining top talent, those who used the downsizing of the sector during the bear market to strike out and set up funds. Investment profes-

sionals frustrated by the limitations of “long-only” strategies and institutional compliance requirements were easily wooed by the more dynamic and potentially personally lucrative world of hedge fund management. Institutions that consider adding alternative investment opportunities to their offerings are finding themselves challenged by the regulatory/reporting disconnect between their historical practices and the unique operating environment of typical hedge funds. Conflicts between product strategies – going short in one fund while being long in another – will make the institutional move into alternative investments far from a simple proposition.

conflicts in managing both long only and short capable leveraged funds. Recent SEC recommendations have attempted to head off these concerns; however, we can expect further uncertainty and discussion throughout this year.

The marketing of alternative investments is an especially sensitive area. Traditionally, hedge funds have not sold their investments in any overt way, at least not on the retail scale that a mutual fund would. Marketing brings on claims and disclaimers. This year, we expect a significant focus on marketing practices and disclosure standards for retail hedge funds and funds-of-hedge-funds. The SEC has issued recommendations for the presentation of hedge fund brochures and has asked fund advisers to register with them and then to send investors a statement disclosing conflicts of interest, risk management measures deployed by the fund, valuation procedures used for the securities held by the fund, and all applicable lock-up periods for investors. Such a brochure or statement would need to be updated regularly and made available to investors on an ongoing basis.

The American mutual fund industry is pressuring the SEC to look more closely at the practices of the alternative investment world, partially because their investments are so closely regulated and scrutinized, and because they wish to adopt some alternative investing best practices. With competition always keen for investment dollars, the mutual fund industry wants to remain competitive with the alternative investment world.

## SEC registration

**In 2003, the most important regulatory changes came from the SEC. In May, they convened a Hedge Fund Round-table, in which representatives from many hedge funds participated. Furthermore, the SEC reviewed 65 hedge fund advisers who manage approximately 650 hedge funds that are worth over \$160 billion in assets. This review included on-site visits and interviews with hedge fund advisers.**

In late September 2003, the Commission released a report, “Implications of the Growth of Hedge Funds.” This report presented the Commission’s findings and offered some recommendations for regulators to thwart potential abuses in the hedge fund industry.

One of the most important recommendations is an amendment to the Advisers Act, specifically Rule 203 (B). The SEC staff has voiced its concern that they may only interview and examine a hedge fund adviser when there is evidence of fraud or misconduct. The way the Adviser Act is written, an adviser only needs to register with the SEC when they advise more than 15 clients. A limited partnership (LLC), the preferred structure for most hedge funds, counts as a single client, therefore exempting most hedge fund advisers from having to register with the SEC. The Commission’s staff have requested an amendment to Rule 203 (B)(3)-1 to require advisers to “look through” the LLC or limited partnership and treat each investor as a “client.” If adopted, this amendment would have the effect of requiring most hedge fund advisers to register with the SEC. This appears to include non-US advisers with more than 15 US clients even if they are already registered in their home locations. The implications of this double registration and higher costs have caused some disquiet in the UK and elsewhere.

The SEC staff did recommend a threshold (\$25 million) be placed for assets under

management to permit managers of very small funds to remain unregistered, and furthermore, to distinguish private equity and venture capital funds – and other structured private funds – to continue to exempt those funds from registration.

If Rule 203 is amended, and hedge fund advisers are required to file and register, the net effect will be that the adviser will also need to provide various disclosures about themselves and their businesses to their clients, including the fund’s individual investors.

Once registered with the SEC, a hedge fund manager will be bound to follow certain protocols, including maintaining and enforcing written policies to deter improper trading. Policies will also need to be promulgated by the adviser to ensure they will use their vote in the best interest of the fund. These are only some of the likely repercussions on hedge funds. Other changes will affect compliance procedures and the appointment of a compliance officer, carried interest, and definitions of what constitutes a “qualified investor” if the manager receives a carried interest. Registered hedge fund advisers would have to disclose any cash paid to consultants or broker-dealers, and disclose the nature of any relationship between solicitors and the adviser.

The use of so-called “soft dollars,” the provision of research, back office clearing, capital introductions, even office space by prime brokers to hedge funds, is likely to come under more scrutiny this year. The SEC will be exploring in depth the relationship between brokerages and hedge funds to determine if soft dollar relationships might be inhibiting investors from receiving the best possible executions.

It is vital to remember that “non-registered” does not mean non-regulated. The SEC may seek to impose its recommend-

ed changes on the hedge fund industry not through formal rule making but by bringing enforcement actions against the most shocking offenders, and thereby, bringing other funds into compliance through the threat of legal action. The SEC will not be alone. Rule makers, ranging from Congress to FASB and the AICPA, are studying funds. Prosecutors and attorney generals will be quick to act as well.

## Funds-of-hedge-funds

**The funds-of-hedge-funds industry is poised to explode. As it gains popularity and as a main vehicle for “retailization,” one can expect much more scrutiny on how a fund-of-hedge-fund affects the transparency of the underlying individual hedge funds.**

In October 2003, the SEC proposed three new rules under the Investment Company Act of 1940 regarding the ability of an investment company to acquire shares of another investment company. The proposal would broaden the ability of a fund to invest in other funds, but the most notable impact may be the requirement that the expenses of the component funds be aggregated and shown as an additional expense in the fee table of the funds-of-funds. The pass-through effect of a fund-of-funds structure on fees, and the light that is cast on formerly private relationships between fund advisers, prime brokers, solicitors and consultants, will cascade down and have a net reforming effect on individual fund practices. This may prove unsettling for many fund managers accustomed to working “in the dark,” yet should, in most cases, be offset by the infusion of new investors into their funds.