

The Role of State Attorneys General on the Hedge Fund Industry

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After last year's federal appeals court decision in *Goldstein vs. Securities & Exchange Commission (SEC)* and the recent pronouncements of the President's Working Group on Financial Markets (PWG),¹ many believe that the driver of increased hedge fund regulation may not be the federal government but instead state officials, including state attorneys general, state securities regulators and state legislatures.

State attorneys general and securities regulators were highly active in the investigations of late-trading and market-timing in mutual funds beginning in 2003, and some have been pushing to act to expand their ability to monitor hedge funds. More state officials may join in this effort if comprehensive federal regulation is not enacted.

In the June 2006 *Goldstein* decision, the court struck down the SEC's hedge fund manager registrations rule. The SEC chose not to appeal the court's decision but instead to pursue other means of protecting investors.

On February 22, 2007, the President's Working Group opined that hedge funds do not require any new regulations or significant changes to current regulations and instead said that risks could be managed through market discipline and pending proposals to raise the bar for investing in these partnerships.

If Congress follows the PWG's recommendations, it would not grant the SEC authority to establish a uniform federal hedge fund regulatory regime. While some members of Congress may continue to push to give the SEC additional authority in this area, it is not expected that any bills with explicit authorization for the SEC to require hedge fund advisers to register will pass in the short term. As a result, some state attorneys general have become more involved in reviewing the activities of hedge funds as well as lobbying for adoption of other hedge fund-related rules.

Narrowly Tailored Definition of an "Accredited Investor"

One of the areas of interest for state attorneys general is the SEC's proposed rule tailoring the definition of an "accredited investor." The proposed rule would define a new category of accredited investor called "accredited natural person," to mean any natural person meeting the requirements of the current definition of accredited person, and would add a US\$2.5 million net worth requirement.² With the comment period now over, the SEC is expected to issue a revised rule in either the second or third quarter of 2007.

While many in the industry have expressed their dismay at these new proposals, many state officials are strong supporters of the SEC's

proposed measures. Massachusetts Secretary of State William Galvin supports the modernized definition of an accredited investor because it would serve as a barrier preventing investment in hedge funds by investors who possess the financial wherewithal to meet the current definition but may lack the financial sophistication needed to understand the nature of such an investment.³ Connecticut Attorney General Richard Blumenthal also has lobbied for an updated definition and believes that the SEC's proposed rule is a critically significant first step in protecting the public. Attorney General Blumenthal's opinion that hedge fund investing should still be limited to a clientele of wealthy individuals and institutions supports the SEC's proposed rule which would reduce the share of households eligible to invest in hedge funds from 8.47 percent to 1.3 percent.⁴ The SEC's expectation of the rule's effect, which Attorney General Blumenthal favors, is that those left eligible to invest would more clearly meet the standard of informed hedge fund participation and would be less susceptible to fraud or to making investments inappropriate for their financial status.

Modified Disclosure Requirements

As the hedge fund industry continues to substantially grow assets under management, many believe increased transparency is essential for investors to be able to assess the amount and type of risk they are taking with their investments and to learn what controls exist to assure that risk strategies are being followed by hedge fund advisers.⁵ One method for achieving more transparency is requiring hedge funds, especially those not registered with the SEC, to provide more complete disclosure of their policies, procedures and practices in their various public documents.

Secretary Galvin and Attorney General Blumenthal have emerged as the most vocal crusaders for hedge fund regulations requiring more disclosure. Secretary Galvin believes in total transparency through disclosure partly because hedge funds are marketed to individuals, some of whom may not fully understand the nature of hedge fund investments.⁶ For the same reason, Attorney General Blumenthal seeks more transparency with respect to disclosure of funds' specific strategies, including instances where the strategy of a fund changes significantly without shareholder notification.

In addition to the efforts of Messrs. Blumenthal and Galvin, former New York attorney general (now Governor) Eliot Spitzer and former California attorney general William Lockyer have focused on the lack of disclosure surrounding market timing activities. Governor Spitzer's activities in this area are well documented and Attorney General Lockyer also took more recent actions against illegal market-timing activity involving hedge funds.

Aside from the legal actions that have been instituted and investigations launched by state authorities, no state has taken steps to institute modified disclosure requirements. However, in response to the PWG's statement that the hedge fund industry does not require any new major regulations, Attorney General Blumenthal has noted that state action will eventually be taken if federal authorities fail to protect investors.⁷

Fees Charged By Hedge Funds

Finally, the level and types of fees being charged by hedge funds also is drawing more scrutiny. One current area of focus at the state level involves "hedge fund hotels," in which investment banks provide office space and/or services such as administrative support to hedge fund advisers.

Specifically, Secretary Galvin is examining whether the trading fees being paid to banks by hedge fund lessees are higher than the average paid to other broker-dealers to compensate the bank for office space and whether the hedge fund lessees are failing to disclose the increased trading fees to investors. Secretary Galvin has begun to take a closer look at these arrangements in Massachusetts by focusing on the nature of the relationships between the space lessors and their hedge fund hotel "guests" and how they may present conflicts of interest.

Two specific situations illustrate potential conflicts of interest surrounding hedge fund hotels. The first situation occurs when a bank enters into a business relationship with a hedge fund lessee and a hedge fund trader trade in ways that put the advisers' interests before those of their investors. The second arises when hedge fund hotels are included among prime brokerage services and soft dollars are paying

for expenses associated with securing office space and support personnel. Thus far, the investigation of hedge fund hotels has been limited to activities in Massachusetts and has not escalated to formal legal action. However, should Secretary Galvin choose to institute formal actions, it would follow that other state attorneys general as well as the SEC could spend more time investigating these arrangements across the industry.

While it is uncertain what the future holds in terms of additional federal regulation, it appears clear that the role of state attorneys general will continue to grow in regulating the hedge fund industry. As a result, hedge fund advisers, especially in the Northeast, should take steps to ensure that their policies, procedures, and controls are in their clients' best interests should these states decide to review their activities. ■

- 1 The President's Working Group (PWG) is an umbrella group comprising the chairman of the SEC, the Secretary of the Treasury, the chairman of the Board of Governors of the Federal Reserve System and the chairman of the Commodity Futures Trading Commission, or their designees. The PWG was created by Executive Order 12631, signed on March 18, 1988 by President Ronald Reagan, and does not actually have the authority to directly issue regulations. *AG Blumenthal: "More Teeth" Needed In Hedge Fund Rules*, CNBC.com (Feb. 22, 2007).
- 2 Release No. 33-8766; IA-2576; File No. S7-25-06: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities and Exchange Commission (Dec. 27, 2006).
- 3 *Hedge Fund Growth Piques State Agencies' Interest*, Securities Industries News, (Apr. 10, 2006).
- 4 "SEC Proposes Amendments to Antifraud and Eligibility Rules for Hedge Funds," www.realcorporatelawyer.com (Jan. 2, 2007).
- 5 *Testimony of Attorney General Richard Blumenthal Before The Senate Committee On The Judiciary*, United States Senate Committee on the Judiciary (Dec. 5, 2006).
- 6 "Hedge Funds Face Pressure to Reform," CNBC.com (Dec. 4, 2006).
- 7 *AG Blumenthal: "More Teeth" Needed In Hedge Fund Rules*, CNBC.com (Feb. 22, 2007).

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