



Hedge Fund Regulatory Outlook For 2009

Hedge funds brace themselves for more regulation in the US

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It does not take a clairvoyant to recognize that the present economic crisis and serious scandals in the hedge fund investment community will give rise to a great deal of political attention, regulation and oversight in the future. The timing of new regulations may be debatable, especially with a new administration, and the value of the new rules can and will be debated for sure, but the simple answer to the question of whether or not there will be new regulations is without doubt: yes. This article examines some of the possibilities and considers the impact on the hedge fund industry.

Registration of the adviser

Registered investment advisers are subject to a host of rules and regulations that do not apply to their non-registered counterparts including periodic inspections by the SEC.

During 2004, the US Securities Exchange Commission sought to require almost universal registration of hedge fund managers. Recognizing that investment advisers were (and still are) exempt from registration under the Investment Advisers Act of 1940, as amended, by the application of section 203(b)(3) in particular, if the investment manager provided investment advice to less than 15 "clients" during a rolling 12 month period, or managed less than \$25 million, the SEC's approach was to re-define the term "client." It would change the term from referring to a hedge fund as a single client (as the law was in 2004 and still is) to counting instead each underlying investor in what is called a "private" fund as a single client. Obviously that way the investor number would trip the 15 count (the 203(b)(3) registration threshold) rather quickly. The SEC approach was challenged in *Goldstein vs SEC*, and in fact overturned putting the Commission back to square one, the court decision holding that the SEC did not have the power to interpret the statutory meaning of "client" in that manner and that such a change would need to come from Congress through the legislative process.

That's where we stand today. There can be little doubt that Congress will act in some form and do so soon to give the SEC the result it had hoped for before the Goldstein decision. Likely this will be by way of a revision of the term "client" or it may perhaps be by way of an outright overhaul of the entire Advisers Act. It is too early to tell, but one way or the other, many believe that a universal registration of hedge fund managers will surely come to pass during 2009.

Impact of registration on the adviser

If past is prologue and if the SEC after two additional years of experience, feels its 2004 concepts still make sense and seeks to carry them forward, as will likely be the case, the industry can look forward

to requirements such as the need to maintain a prescribed set of books and records requirements, periodic SEC on-site inspections, delivery by the adviser to a prospective customer of a detailed brochure (on a form now called an ADV) containing biographical data about the adviser and its principals, the fees to be charged, conflicts of interests, affiliations, method of doing business to name a few, and restricting performance based fees from being charged to certain clients. In addition, using the 2004 proposals as a guide, a registered investment adviser will need to hire a chief compliance officer, adopt a written compliance program (dealing with principal trading, advertising, the use of side letters, custody rules, et al) and a code of ethics. They may also have to meet a stringent solicitation rule relating to compensating a finder for introducing a client to the adviser, requiring among other things that a written disclosure be provided to and acknowledged by the client. The foregoing is not all inclusive by any means.

Registration of the hedge fund

The approach in the US has been to register the investment adviser, not the hedge fund. That may change, thereby imposing on hedge funds compliance principles that currently exist for mutual funds (i.e., those funds that are marketed broadly and are registered under the Investment Company Act of 1940, as amended). Many of these principles, such as the need for an independent board of directors, separation of powers between the broker and the custodian and the adviser, a limitation on leverage, limiting shorting in certain cases, an enhanced level of disclosure, to name a few, may resonate well in today's environment.

In some quarters, diversification or rather the lack thereof, has caused a great deal of concern and economic pain. Regulators may impose diversification standards on the hedge funds of the future. The Company Act can be used as a precedent for this as well.

We'll see of course, but many of these limitations would be quite problematic for hedge funds given that the investment strategies of most call for leverage and shorting and fee arrangements that use performance arrangements, to say nothing of the considerable expense of maintaining a registered mutual fund compared to a hedge fund.

One thing is certain: registration of the adviser or of the fund will be costly, it will interfere with the growth of the hedge fund industry and it will be difficult for newer advisers to jump the hurdle created by these requirements. A balance between the investing public on the one hand and the adviser on the other will need to be found. That is where the debate will surely be centered.

Leverage oversight

Many believe that one of the "roots of all evil" is the use of excess leverage by hedge fund managers, citing the distressed credit market, the sub prime collapses and the like. The US Treasury issued a "blueprint" which suggested oversight of leverage by establishing a "Mortgage Origination Commission" with quality control functions such as licensing of mortgage providers. Along with these initiatives will likely come new Federal Reserve regulations with regard to margin loans and an imposition of the "up-tick" rule when short selling, meaning that to sell a share short there needs to be an up tick in market price first. This was the rule for many years but was repealed several years ago; it will presumably be reinstated, and soon.

Nature of the investor

We may see higher standards for investors in hedge funds. Currently the basic standard for an investor in a privately placed hedge fund – the accredited investor standard – calls for a \$1 million net worth or an income level of at least \$200,000 for two years preceding the investment, and the same for the year of the investment. This standard dates back to the 1960s, was never indexed for inflation and frankly may not be high enough. There are other higher standards in use today, from which to choose, i.e., the qualified purchaser (QP) standard. It calls for an individual to have investable assets (not net worth, assets) of at least \$5 million to qualify for certain investments. For entities the financial standard is considerably higher (\$25 million) unless each individual owner qualifies as a QP in their own right. The regulators have some options here and we may see a change in this regard.

Accountability and best practices

The President's Working Group on Financial Markets is in the process of putting forth a set of best practices for hedge fund managers and investors aimed at increasing the level of accountability on both sides. The latest report calls upon a hedge fund manager to adopt a set of best practices that speak to issues such as asset valuation, risk management, compliance, and conflicts of interest. Look for these principles to be embodied in the Working Group's Fiduciary's Guide (for the manager) and in an Investor's Guide, for the investor. It should also be noted that industry groups such as AIMA have spent a good deal of time on various aspects of best practices for hedge fund managers and that work will be proven quite helpful.

SEC and CFTC consolidation

The utility of having two regulators, the SEC for securities and Commodity Futures Trading Commission (CFTC) for futures, will certainly be reviewed this year and there will likely be a consolidation of the two agencies. This is not without some issues: the CFTC (through its self regulatory organization, the National Futures Association or

NFA) has a principles based approach (similar to the FSA in the UK for example) that seems to work well with its registrants. To be sure, given the size of the futures industry compared to its securities industry counterpart, the scope of the NFA is much reduced and perhaps easier to police and regulate. Nonetheless, the SEC's approach in recent years has been enforcement oriented and seems to be less amenable to assisting registrants in dealing with business issues. The question on the floor, therefore, is which culture will survive. We'll see soon enough.

ERISA

About a year or so ago Congress relaxed the rules imposed on hedge funds that accept investment from pension plans regulated under the Employee Retirement Income Security Act (ERISA.) As a result, it became easier for hedge funds to stay under the Department of Labor's (DOL) radar and its so called 25% plan asset rule. That may be reversed this year thereby imposing on hedge funds and their investment advisers that accept ERISA investors all sorts of compliance principles from a fiduciary bonding, to a limitation on fee arrangements, to self dealing, prohibited transactions, and DOL reporting and audit, to name a few. These are burdensome and expensive and the penalties associated with failing to comply are quite extreme. One result may be a freezing of ERISA plans out of the hedge market altogether, and this is an important policy issue for Congress to consider before changing these rules. Another result may be a significant reduction in the level of (or need for) offshore investing, by tax exempt investors at least.

And speaking of offshore jurisdictions...

The Obama administration has made it clear that it intends to support Bill S 681, called the "Stop Tax Haven Abuse Act" and thereby focus on a number of offshore jurisdictions including Caymans, Bermuda, BVI (likely falling within a new definition of "offshore secrecy jurisdictions") as to relevant tax aspects and information reporting and disclosure aspects. This would presumably be coordinated with changes that may be afoot with regard to anti-money laundering. The Act would amend the Internal Revenue Code (Code) relating to tax shelter activities to: (1) establish presumptions against transactions involving offshore secrecy jurisdictions; (2) deal with money laundering concerns that inhibit US tax enforcement; (3) extend the status of limitation with regard to review of tax returns involving offshore secrecy jurisdictions; (4) adopt rules re tax withholding and information about beneficial owners of foreign-owned financial accounts; and (5) disallow tax advisor opinions validating transactions in offshore secrecy jurisdictions. The Act, if passed, would amend other federal statutes to impose a penalty for failure to disclose holdings or transactions involving a foreign entity and expand anti money laundering rules.

Taxation

Judging from what is already on the legislative tax calendar, new US tax initiatives will be the subject of great debate this year. In addition to the Stop Tax Haven Abuse Act, we may see a new tax on an adviser's performance or incentive fee (the "carried interest") especially in the context of deferral left in offshore jurisdictions. At present, the interest is taxable in the same manner as an investor would be taxed on profits and gains and only when the value is recognized for income tax purposes.

There has already been a quantum shift in the ability of managers to defer income, especially in offshore jurisdictions. This has come about by way of the adoption of a new rule under the Internal Revenue Code, section 409A, which limits the amount of the deferral, the methodology by which such deferral can occur and the length of time of the deferral and lastly proscribes certain reporting requirements.

A tax (called the tax on unrelated business taxable income or UBTI) on otherwise tax exempt investors (foundations, charities, pension plans et al) will likely be changed. Currently, investment strategies that generate profits through the use of leverage create UBTI and become taxable to such investors if the investment is made in a partnership vehicle, typical in the US hedge fund market. For such reasons, many tax exempt investors have gravitated to investing in non-US jurisdictions where the use of corporate vehicles is more typical. Such arrangements do not generate UBTI that passes to the tax exempt investors. This will likely change, probably not to prohibit such investments but rather to eliminate the tax altogether as being not within public policy.

Conclusion

We will continue to see changes in regulation that will be driven by the economic climate and by the hedge fund scandals, but also by the change in the political landscape, moving as it is from a Republican to a Democrat philosophy. And if those were not enough, add the impact of an ever expanding global marketplace, and we can readily conclude that this will be an interesting year, to say the least. **THFJ**

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BIOGRAPHY

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Tannenbaum is a founding partner of Tannenbaum Helpert Syracuse and Hirschtitt LLP where he heads the firm's Financial Services, Private Funds and Capital Markets Group. He regularly advises clients as to private funds, hedge fund and private equity arrangements and SEC and tax implications and is active in the firm's Hedge Fund Litigation group.