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## MEMORANDUM

**TO:** Clients and Friends

**FROM:** Tannenbaum Helpern Syracuse & Hirschtritt LLP

**DATE:** July 8, 2003

**RE:** SEC Hedge Fund Roundtable: A Summary of the Main Themes Discussed<sup>1</sup>

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### Introduction

On May 14-15, 2003, the Securities and Exchange Commission (the "SEC") held a roundtable discussion (the "Roundtable") with representatives of the hedge fund industry to get the industry's input as to what direction the SEC should take with respect to possibly regulating hedge funds. The SEC characterized the Roundtable as the "next step" following its year-long fact-finding investigation of the hedge fund industry. The panelists were chiefly fund managers, auditors, lawyers, academics, and regulators from the futures, brokerage, and state authorities, and they examined the operations of hedge funds and their impact on the market. The format of each of the seven panels was that a senior SEC staff member introduced the particular topics of the panel and then asked the panelists their comments and suggestions. Seven themes dominated the Roundtable: (1) risk disclosure, transparency, and investor education; (2) registered funds of hedge funds; (3) valuation; (4) the role of third parties; (5) performance fees and conflicts of interest; (6) investor suitability; and (7) the regulatory framework to apply to hedge funds. Each theme is discussed below.

### 1. Risk Disclosure, Transparency, and Investor Education

#### A. Risk Disclosure

Robert E. Plaze, Associate Director of the SEC Division of Investment Management, described "disclosure" as information an investor obtains before making an investment. During the Roundtable, the SEC continuously expressed concern as to whether the current level of disclosure is sufficient for investors to understand a hedge fund's investment strategies and whether investors actually understand the risks involved when investing in a hedge fund. When asked by the SEC how should risk be communicated to investors, panelists responded that investors should know how concentrated the trading positions are in particular sectors and how consistent the fund manager's results are month after month.

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<sup>1</sup> This Memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects treated here.

Michael G. Tannenbaum participated as a panelist in the SEC Hedge Fund Roundtable.

Panelists also identified the lack of “timely” disclosure, particularly the disclosure of losses, as an area hedge funds need to improve.

A sub-theme that emerged is the dichotomy between institutional investors and retail investors in their ability to obtain information about a given hedge fund manager and a given product when deciding whether to invest in a fund. While there is a large amount of information on fund managers and hedge funds publicly available to investors according to some panelists, it was agreed that it is not a level playing field between institutional investors and retail investors. Panelists acknowledged that institutional investors are better able to obtain information from fund managers than retail investors. This is due in part because of the leverage institutional investors can exercise and the resources they can utilize but also because institutional investors are professionally managed and as such, professional managers know the right questions to ask.

### B. Transparency

SEC Associate Director Plaze described “transparency” as information an investor obtains so the investor can monitor the performance of a fund and then decide whether to continue his or her investment in the fund. A recurring question expressed by the SEC is whether investors are receiving enough information on an on-going basis so that they can make an informed decision as to whether to remain invested in a particular hedge fund. Another concern the SEC identified is the apparent lack of transparency of underlying investments, particularly illiquid investments, held by hedge funds.

Panelists argued that mandating transparency with respect to a hedge fund’s portfolio may result in having to divulge proprietary trading strategies and research. Too much transparency would have a negative impact on the hedge fund industry because hedge fund managers could lose their competitive advantage and could ultimately result in depressed profits by hedge funds.

Panelist Sandra Manzke of Tremont Advisers suggested that the approach to take is “benign transparency.” Investors should know a fund’s market exposures in particular sectors and the amount of leverage employed. Ms. Manzke believes that investors would benefit if readily accessible data of such kind was available.

A suggestion raised by the panelists is whether there should be a Morningstar for hedge funds. It was agreed by panelists that there is currently an information vacuum regarding hedge funds and that there is a need for information regarding the risks and historical performance of hedge funds so investors can make an informed decision. To improve transparency and to allay concerns regarding proprietary information, it was raised that perhaps hedge fund should send their performance results to an independent third party that serves to aggregate the information provided by fund managers and then make such information available in a user-friendly format.

Panelists remarked that ultimately there are limits to the effectiveness of transparency to non-professional investors. According to certain panelists, the transparency of trading positions would be meaningless to most investors because the figures and models that would be disseminated would be too complicated.

### C. Investor Education

The frequent discussions on the need to improve risk disclosure and transparency often concluded with the agreement among panelists that better investor education is needed. Panelist James R. Hedges of LHJ Global Investments, LLC commented that investor education should address investors having realistic expectations when investing in a hedge fund.

However, panelists felt that there are practical limits to investor education. Panelists pointed out that what counts ultimately is the quality and character of the people of the investment manager. These qualities can not be quantified and expressed in a table or chart. Rather, it means sitting down with the hedge fund manager and asking the right questions about their business and their product. Perhaps investor education can improve the quality of questions asked but panelists emphasized that there is a “learning curve.”

How to best implement an investor education scheme remained an open question at the conclusion of the Roundtable.

*The popular perception that hedge fund strategies and hedge fund portfolio positions are opaque has become a focal point for reform by regulators based on the sentiments expressed by the SEC. Reform may take the form of the SEC mandating that standard disclosures (positions held in a portfolio, sector concentration, risk factors) must be included in a hedge fund offering memorandum as a means to improve disclosure and transparency. If the SEC does regulate the contents of a hedge fund’s placement memorandum, the challenge the SEC and the hedge fund industry would face is whether the SEC can strike the right balance between disclosure and transparency that would be meaningful to the investor and transparency that would be detrimental to industry competition.*

*The popular perception that hedge fund investment strategies are incomprehensible to the average investor appears to have fostered a paternalistic attitude by the SEC with respect to non-institutional investors. It can be expected that the SEC will undertake an investor education initiative to educate investors about the risks of investing in a hedge fund, the strategies hedge fund managers employ, and the types of questions to ask a hedge fund manager. However, no indication was given at the Roundtable how the SEC would educate investors. Perhaps the SEC will expand their webpage dedicated to hedge funds<sup>2</sup> by posting an online tutorial entitled “Hedge Fund Due Diligence 101” that would provide a step-by-step guide on how to scrutinize a fund manager. Perhaps the SEC will provide workshops and will conduct audio webcasts to educate investors. Given the near certainty that an investor education program will be implemented, the hedge fund industry should monitor this issue closely. Moreover, the hedge fund industry should take a pro-active position to assist the SEC and investors so that an investor education program is balanced and informative rather than being a product based on misconceptions and biases.*

## **2. Registered Funds of Hedge Funds**

The perceived “retailization” of the hedge fund industry is one of the primary reasons behind the SEC’s initiative on whether to increase regulation. Specifically, the recent phenomenon of registered funds of hedge funds have made investing in hedge funds more accessible to a broader range of investors. Currently, the registered funds of hedge funds that have been launched require investors to be accredited investors as defined under Regulation D under the Securities

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<sup>2</sup> See <http://www.sec.gov/answers/hedge.htm>

Act of 1933, as amended,<sup>3</sup> and impose a \$25,000 minimum investment. However, it was acknowledged by both the SEC and the panelists that there are no actual restrictions as to investor suitability. As such, it is conceivable that the general public may be targeted as potential investors in these registered funds of hedge funds and accordingly, the SEC is concerned that registered funds of hedge funds are making it possible for investors who are precluded from investing directly in hedge funds are able to invest in such hedge funds indirectly. The SEC feels that investors in a registered fund of hedge funds may not have the sophistication and knowledge that a typical investor in a hedge fund would have and may not be sophisticated enough to understand the implications of investing in a registered fund of hedge funds.

The SEC asked if it was possible for investors in registered funds of hedge funds to learn more about the underlying managers a registered fund of hedge funds has invested with? Furthermore, the SEC asked how practical it would be to provide such information on underlying managers and what the practical limits are of due diligence a retail investor can conduct on these underlying managers? Panelists responded that investors in these registered funds of hedge funds are “hiring” the investment manager of the registered fund of hedge funds to conduct the due diligence on the underlying managers for them. In other words, as described by panelist Jean Karoubi of the LongChamp Group, Inc., when investing in a registered fund of hedge funds, the investor is buying expertise.

In contrast to the perceived notion that registered funds of hedge funds is a growing trend within the hedge fund industry, some panelists at the seventh panel argued that registered funds of hedge funds are not products of the hedge fund industry. Rather, they are considered to be an outgrowth of the perceived demand of retail investors by Wall Street.

*The continuing evolution of the registered funds of hedge funds industry will probably dictate how the SEC will treat registered funds of hedge funds in the near future. A key determinant will be whether registered funds of hedge funds will lower the bar to invest by permitting non-accredited investors to invest in such a fund. Given the SEC's heightened concerns that the retailization of hedge funds has eroded the barriers that preclude average investors from investing in hedge funds, a shift towards permitting the general public to invest would likely invite greater scrutiny and perhaps result in additional regulatory obligations as a means to protect the general public.*

### **3. Valuation**

The SEC asked a series of questions concerning how hedge fund managers value their portfolios. The discussion on valuation centered primarily on how fund managers value illiquid securities and the role third parties play in the valuation process.

#### **A. Illiquid Securities**

Given that hedge funds invest in illiquid securities to varying degrees, the SEC is concerned with the process of determining the fair value of such illiquid securities. When a security is illiquid, market quotations are unavailable and thus, it has no “market” value. Accordingly, fair value must be used to measure the value of an illiquid security. Douglas Scheidt, Associate Director and Chief Counsel of the SEC Division of Investment Management, asked how do hedge funds

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<sup>3</sup> This presumes that the registered fund of hedge funds is registered pursuant to the Investment Company Act of 1940, as amended (the “Company Act”), and not pursuant to the Securities Act of 1933, as amended.

determine fair value? Moreover, he asked where are the controls in the fair value process? A concern that emerged is that the SEC feels that there is a lack of independent verification of fair value valuations as a check on the integrity of the values reached.

### B. Role of Auditors

The SEC expressed concern regarding the role of auditors in the valuation process. The SEC noted that auditors of hedge funds are not mandated to perform valuations in a particular way. Panelist Joel Press of Ernst & Young LLP noted that the use of GAAP is dominant in the hedge fund industry. Some panelists commented that auditors will not second guess the fund manager and that auditors are not appraisers.

It was also noted that a distinction between mutual funds and hedge funds is that by law, mutual funds are required to do 100% testing of the prices in their portfolio. In contrast, hedge funds are not required to test or confirm 100% of the prices.

*The SEC's concerns regarding the valuation process is a strong signal that the SEC will be scrutinizing the valuation process conducted by hedge fund managers and their auditors. The comparisons made by the SEC regarding the valuation process of mutual funds indicate that the SEC may mandate more formal methodologies on how value is calculated by fund managers and their auditors. Moreover, the SEC may also require auditors of hedge funds to examine a fund manager's controls. In the future, perhaps the SEC will issue guidance in the form of staff interpretations or a release to address this issue.*

*However, a wholesale imposition of valuation rules and practices applicable to mutual funds on the hedge fund industry would likely fail to improve the accuracy of valuating a hedge fund portfolio. Unique to hedge funds is that they may invest in illiquid products. Fair value is a legitimate tool to measure an illiquid investment. As such, fund managers use fair value when valuating their illiquid investments. The SEC will need to be cognizant that certain hedge fund portfolios contain illiquid products, and therefore, in these instances, fund managers employ fair value. Rather than prohibit fair value, perhaps more rigorous objective standards will be imposed as to how to conduct fair value. Cooperation between the hedge fund industry and the SEC on the issue of valuation is essential for reforms on valuation to be effective.*

### **4. The Role of Third Parties**

The SEC questioned panelists on the role prime brokers, auditors, and administrators played in the hedge fund industry. Panelists responded that administrators play an integral role for offshore hedge funds and often value an offshore fund's portfolio. The SEC seemed to be expressing the sentiment that independent third parties provide a check on hedge fund managers. According to Paul F. Roye, Director of the SEC Division of Investment Management, perhaps hedge funds should retain independent third parties to conduct "critical functions."

Auditors were a target of comments by both the SEC and by certain panelists. The SEC solicited questions regarding the role of auditors in the auditing process. The SEC raised the idea that perhaps the role of auditors should be expanded with respect to hedge funds. Certain panelists expressed the view that the role of auditors should be closely examined. Certain panelists noted that in the instances of fraud committed by hedge fund managers, auditors had signed off on the financials and failed to assess the internal controls of the hedge fund.

*If SEC Director Roye's comment that hedge funds should retain independent third parties to conduct "critical functions" becomes the SEC's prevailing position, then the SEC will likely encourage hedge funds to employ a third party to conduct "critical functions" to serve as a check on the fund manager as a form of best practices. As such, it could become the norm among U.S.-domiciled hedge funds to have an administrator.*

## **5. Investor Suitability**

### A. Revise the Accredited Investor Standard?

Traditionally, hedge funds have been investment vehicles for financially sophisticated investors. However, inflation and higher incomes make it possible for many more people to become eligible to invest in hedge funds who otherwise would not have qualified to invest in a hedge fund. The SEC asked panelists whether the accredited investor standard should be revised by raising the net worth and income standards given that the standards were established in 1982. Moreover, should the exception of permitting up to 35 non-accredited investors to invest in a private placement be eliminated? Certain panelists responded by agreeing that the current accredited investor standards are outdated and need to be raised.

Panelists also remarked that income is a proxy for suitability. Certain panelists felt that a net worth test or an income test by itself is not an accurate indication of an investor's financial sophistication or an investor's ability to understand the complexities of a hedge fund's investment strategies.

### B. Determining Investor Eligibility

The SEC also questioned panelists as to who is doing the due diligence to determine whether an investor is eligible to invest in a hedge fund. Elizabeth G. Osterman, Assistant Chief Counsel of the SEC Division of Investment Management, asked if hedge funds are pro-actively determining the suitability of their investors? Panelists responded that it is the hedge fund industry's practice to rely on affirmative representations that such an investor meets the applicable standards. Moreover, panelists stated that hedge funds rely on broker-dealers and pre-existing relationships as a means to vet potential investors.

The SEC seems concerned that fund managers are not doing enough to verify the suitability of investors. The SEC raised the possibility that hedge fund managers may be required to verify independently the financial information provided by potential investors. SEC Chairman William H. Donaldson asked panelists what is the obligation to the ultimate investor? Also, should the SEC be doing something for the ultimate investor?

*Due to the perceived retailization of hedge funds, it can be expected with great certainty that the SEC will require hedge fund managers to vet potential investors before allowing them to invest in their funds. The SEC will likely want fund managers to demonstrate that they have conducted their due diligence by obtaining financial materials to support the representations made by a potential investor.*

*Furthermore, hedge fund managers should expect the SEC to state that even if they rely on third parties, e.g. broker-dealers<sup>4</sup>, to pre-screen investors for suitability, ultimate responsibility for*

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<sup>4</sup> See Notice to Members 03-07 (February 2003). Such a position would be consistent with other legislative initiatives passed in recent years that permit a financial institution to delegate compliance to a

*investor suitability rests on the fund manager. Accordingly, to satisfy the burden, industry practice could dictate that certified bank statements and brokerage account statements are to be collected from potential investors when assessing whether a potential investor qualifies to invest in a fund.*

## **6. Performance Fees and Conflicts of Interests**

It was noted that hedge fund managers typically charge a performance fee of 20% of the net profits. Panelists discussed the underlying rationale behind the performance fee.<sup>5</sup>

According to the panelists, a key characteristic of hedge funds is that the manager's interest and the investors' interests are aligned. A fund manager has a vested interest to manage a successful fund and to be rewarded for two reasons. First, a fund manager's personal capital is generally invested in the fund. According to the panelists, investors expect fund managers to invest their own personal capital in the fund as a form of comfort that the fund manager's own fortunes are tied to his franchise. As such, investors feel good knowing that the fund manager has a vested personal stake in the hedge fund and therefore has an incentive to succeed. Second, a fund manager's compensation is directly tied to the growth of assets of the fund; a fund manager's capital account grows as the fund's assets grow. Panelists described the fund manager's performance fee structure as generally employing a high water mark mechanism. A fund manager does not receive a performance fee unless the fund has produced a net profit. Moreover, if there are losses, a performance fee will not be earned until prior losses are recouped and the fund exceeds the previous highest net asset value.

The SEC's primary concern with respect to performance fees is the potential for conflicts of interests when a fund manager manages a hedge fund that charges a performance fee side-by-side with a mutual fund that does not charge a performance fee. The SEC believes that there is the possibility that a fund manager may allocate the best trades and investments to the hedge fund so that the fund manager can earn a performance fee -- typically 20% of the net profits -- at the expense of the mutual fund and its investors. As a follow-up, the SEC also questioned whether fund managers have implemented control procedures to inhibit improper allocations.

Other questions on performance fees the SEC raised were whether fund managers should be restricted in their ability to charge a performance fee and whether there is adequate disclosure to investors regarding the performance fee structure.

*Given the SEC's concerns on performance fees earned by fund managers in situations when fund managers manage several funds, this issue will likely result in regulation. Regulation may materialize by requiring hedge fund managers that manage several funds simultaneously to justify why certain trades were allocated to one fund over another fund. Essentially, fund managers may be required to adopt procedures that identify conflicts of interests in instances*

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third-party but ultimate responsibility for compliance remains squarely on the financial institution. For example, a financial institution may delegate compliance with the USA PATRIOT Act with a third-party. Nevertheless, the financial institution remains solely responsible for its compliance with the Act. See e.g. Financial Crimes Enforcement Network; Treasury; Securities and Exchange Commission; Customer Identification Programs for Mutual Funds; final rules. 68 Fed. Reg. 25131-25149, 25139-25140 (May 9, 2003); Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Mutual Funds; interim final rule. 67 Fed. Reg. 21117-21121, 21119 (April 29, 2002).

<sup>5</sup> Michael G. Tannenbaum was a panelist on the third panel on "Issues Associated with Hedge Fund Disclosure, Transparency and Performance Fees."

*when a fund manager would earn a higher performance fee in one fund over another fund and then sterilize the potential taint by demonstrating that there was a justifiable reason why a trade was allocated in favor of one fund over another fund.*

## **7. The Regulatory Framework to Apply to Hedge Funds**

The regulation of hedge fund managers is not without precedent. In fact, it is the norm in most mature financial systems. Panelists from France and the United Kingdom stated that fund managers located in these jurisdictions must be qualified and demonstrate fitness by undergoing training and competence requirements.

Panelists pointed out that despite the popular perception that hedge funds are unregulated, hedge funds are in fact subject to the same laws and regulations as other financial institutions. For example, even though most fund managers are not registered as investment advisers with the SEC, all fund managers are subject to the anti-fraud provisions under the Investment Advisers Act of 1940, as amended. Also, a large number of fund managers are registered commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”) with the Commodity Futures Trading Commission (the “CFTC”) and the National Futures Association (the “NFA”). Additionally, the rules that regulate trading apply equally to hedge fund managers. For example, panelists discussed the applicability of the short selling regulations on fund managers.

It was also noted by panelists that investor demand by institutional investors is driving the hedge fund industry’s shift towards investment adviser registration with the SEC. Nevertheless, despite the applicability of U.S. securities laws and regulations and the industry-driven shift towards registration, throughout the Roundtable, the SEC remained committed to soliciting comments as to how to conduct oversight over hedge fund managers.

### **A. To Combat Fraud**

A factor driving the SEC’s consideration whether to regulate hedge funds is fraud committed by fund managers. A key question the SEC raised is whether there is a need for inspection as a means to deter fraud: should the SEC be given inspection authority to attempt to detect and to prevent fraud in the hedge fund industry? Stephen M. Cutler, Director of the SEC Division of Enforcement, noted that during the past five years, there has been a “steep increase” in the number of fraud cases involving hedge funds. These cases involved “blatant fraud,” misappropriation, and ponzi schemes. In contrast to the SEC’s findings, according to panelist Partick J. McCarty, General Counsel of the CFTC, there have been very few incidents of hedge fund fraud involving commodity pools. The CFTC’s figures show that on average, the CFTC has brought ten enforcement actions against hedge fund managers registered as CPOs and CTAs over the last four years.

Furthermore, panelists also pointed out that percentage-wise, the number of fraud cases brought against fund managers is low considering that there are approximately 6,000 hedge funds currently operating. As such, certain panelists feel that the low figures suggest that fraud in the hedge fund industry is not endemic.

The potential divergent paths the SEC and the CFTC may be taking with respect to hedge funds was highlighted at the seventh panel on the “Assessment of the Current Regulatory Framework.” SEC Director Roye noted that the CFTC is taking a liberal approach toward hedge fund regulation. Panelist Jane K. Thorpe, Director of Clearing and Intermediary Oversight of the

CFTC, explained that the CFTC feels comfortable to liberalize the regulations because audits of registered CPOs and CTAs have shown that the deficiencies detected rarely raise to the point of disciplinary action. According to Ms. Thorpe, the level of regulation should be appropriate to the risks. In the case of hedge fund managers that are registered CPOs and CTAs, since audits have shown a low possibility of serious violations, then there is no need to subject them to extensive regulation.

## B. If Regulation – How?

If the SEC decides to regulate hedge funds by perhaps requiring hedge fund manager to register as investment advisers with the SEC, panelists raised questions regarding the viability of such an endeavor. Panelist Armando Belly of Soros Fund Management LLC commented that registration has costs in terms of time and money. What would be the costs? What will be the benefits? Furthermore, panelists asked whether the SEC has the resources to regulate hedge funds since the inspection and monitoring of hedge funds will require more staff and more auditors.

Panelists expressed a word of caution that too much regulation would restrain the entrepreneurial spirit of the hedge fund industry. Panelists described hedge fund managers as unique and dynamic in the sense that they want to create their own culture and work environment and to utilize their own proprietary trading strategies.

*There is a strong likelihood that all hedge fund managers will be required to register as investment advisers with the SEC. Under the FSA regime, U.K. fund managers and not the fund itself is regulated. U.S. fund managers should expect the SEC to adopt a similar approach given the SEC's unwavering focus on fund manager conduct and operations during the Roundtable. The question is will the SEC subject fund manager to "Investment Adviser Lite"<sup>6</sup> or to all of the rules and regulations under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The "Investment Adviser Lite" approach would be a regulatory scheme modeled after the CFTC position that minimal regulation of a pool operator, i.e., the fund manager, is required when its investor are sophisticated. Under the CFTC regime, hedge fund managers that are CPOs have traditionally filed for 4.7 relief on the condition that their investors are qualified eligible persons.<sup>7</sup> By filing for 4.7 relief, a fund manager that is a CPO is relieved of most of the onerous obligations applicable to registered CPOs.<sup>8</sup> Perhaps if investors in a hedge fund are at the minimum qualified eligible persons and qualified clients<sup>9</sup> or are qualified purchasers<sup>10</sup>, then relief akin to 4.7 relief would be available to hedge fund managers that are registered investment advisers. Rather than become subject to all rules under the Advisers Act, perhaps registered fund managers would be required to comply with only a few key provisions under the Advisers Act while remaining fully subject to the anti-fraud provisions. It remains to be seen whether the SEC would adopt such a position.*

*Alternatively, if hedge fund managers are required to register with the SEC and if such registration subjects fund managers to all applicable regulations under the Advisers Act, then fund managers should expect to comply inter alia with the following obligations:*

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<sup>6</sup> "Investment Adviser Lite" is not a concept that was raised at the Roundtable. The term "Investment Adviser Lite" is a descriptive term that we are using as a counterpoint to the full applicability of the Adviser Act.

<sup>7</sup> See Rule 4.7(a) of the Commodity Exchange Act, as amended (the "CEA")

<sup>8</sup> See Rule 4.7(b) of the CEA.

<sup>9</sup> See Rule 205-3(d)(1) of the Advisers Act.

<sup>10</sup> See Section 2(a)51 of the Company Act.

- *Annual update of the Form ADV Part I and II*<sup>11</sup>;
- *Recordkeeping requirements (books and records in their connection with activities as a registered investment adviser)*<sup>12</sup>;
- *Custody of client cash and securities*<sup>13</sup>;
- *Personal trading rules*<sup>14</sup>;
- *Proxy voting policies and procedures*<sup>15</sup>;
- *Advertisement and performance results*<sup>16</sup>;
- *Regulation S-P (privacy)*<sup>17</sup>; and
- *Adoption and maintenance of a written compliance policy and procedures manual incorporating all the applicable rules and regulations under the Adviser Act.*<sup>18</sup>

### **Final Remarks of Chairman Donaldson**

SEC Chairman Donaldson said in his closing remarks that hedge funds play an important role and that they provide legitimate, lucrative investment opportunities. Now, he believes that it is an appropriate time to review whether the hedge fund industry should be regulated. Chairman Donaldson felt that the review of the hedge fund industry is perhaps entering “the most critical phase yet.” As such, Chairman Donaldson requested the SEC staff to prepare a report that should include recommendations whether regulatory or legislative action is needed to regulate the hedge fund industry. Interestingly, Chairman Donaldson did not set any deadlines for such a report. Among the issues Chairman Donaldson wants addressed is to find a way to ensure that hedge fund investors are adequately protected. Chairman Donaldson also invited the hedge fund industry to submit papers and comments on hedge funds because the discussion on hedge funds “does not end with the close of the Roundtable.”

*The hedge fund industry should accept Chairman Donaldson’s invitation to submit papers and comment in order to continue the dialogue with regulators. By being vocal, the industry has the opportunity to influence further rule making.*

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<sup>11</sup> See Rule 204-3 of the Advisers Act.

<sup>12</sup> See Rule 204-2 of the Advisers Act.

<sup>13</sup> See Rule 206(4)-2 of the Advisers Act.

<sup>14</sup> See Rule 204-2(a)(12) of the Advisers Act.

<sup>15</sup> See Rule 206(4)-6 of the Advisers Act.

<sup>16</sup> See Rule 206(4)-1 of the Advisers Act. See e.g. Investment Company Institute, SEC No-Action Letter (September 23, 1988); Clover Capital Management, Inc., SEC No-Action Letter (October 28, 1986).

<sup>17</sup> See “Privacy of Consumer Financial Information (Regulation S-P),” Release No. IA-1883 (June 22, 2000).

<sup>18</sup> See Securities and Exchange Commission; Compliance Program of Investment Companies and Investment Advisers; proposed rules. 68 Fed. Reg. 7038-7050 (February 11, 2003). Note that this is currently a *proposed* rule.

If you have any questions or comments regarding the SEC Hedge Fund Roundtable or about the regulations applicable to hedge funds, please feel free to contact:

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