The Future of Hedge Fund Regulation

Practising Law Institute
One Hour Briefing

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Why the Focus on Hedge Funds?

• Lack of public transparency and regulatory oversight
• Systemic risks to investors, counterparties, and other market participants
  - Assets under management
  - Trading volume and leverage
• Concerns about retailization
• Suspicions of misconduct
• Congressional, media, and public frenzy
CHRONOLOGY OF REPORTS & STUDIES
3 Regulators:

1. **Federally Insured Depository Institution (FIDI):** All institutions with federal deposit insurance

2. **Federal Insurance Institution (FII):** All insurers offering retail products where some federal guarantee is present

3. **Federal Financial Services Provider (FFSP):** All other types of financial services firms (e.g., BDs, IAs, hedge funds, exchanges, and FCMs)

The FFSP would be responsible for creating appropriate national standards for financial capacity, expertise, and other requirements, which must be satisfied to enter the business of providing financial services.
• "Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally."

• "[H]edge funds receive less-direct oversight than other major market participants such as mutual funds, another type of investment fund that manages pools of assets on behalf of investors.

• "Because their participants are presumed to be sophisticated and therefore not require the full protection offered by the securities laws, hedge funds have not generally been subject to direct regulation. Therefore, hedge funds are not subject to regulatory capital requirements, are not restricted by regulation in their choice of investment strategies, and are not limited by regulation in their use of leverage."

- "[H]edge funds and private equity funds are money managers and should be regulated according to the same principles that govern the regulation of money managers generally."

- "At a minimum, Congress must grant the SEC the clear authority to require hedge fund advisors to register as investment advisors under the Investment Advisors Act."

- "If they venture into writing insurance contracts or providing credit to others, hedge funds' activities in these areas need to be regulated according to the principles governing insurance or lending."
Recommendation 4: Oversight of Private Pools of Capital

- Managers of private pools of capital (other than venture capital funds) that have borrowed substantial funds and that are of a specified size should register with an appropriate national prudential regulator.

- The prudential regulator should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management.

- Disclosure and suitability standards should be reevaluated to counter any false impression of lower investment risks resulting from increased regulation.

- The prudential regulator should have authority to establish appropriate standards for capital, liquidity, and risk management for funds that are deemed potentially systemically significant.

- The jurisdiction of the appropriate prudential regulator should be based on the primary business location of the manager of such funds, regardless of the funds’ legal domicile.

- A globally consistent regulatory framework is needed.
International Monetary Authority, *Initial Lessons of the Crisis* (Feb. 6, 2009)

- "The shadow banking system—including investment banks, mortgage brokers/originators, hedge funds, securitization vehicles, and other private asset pools—has long been lightly regulated by a patchwork of agencies, and generally not supervised prudentially."

- "The perimeter of regulation and supervision should be extended to ensure that all activities that pose economy-wide risks are covered and known to a systemic stability regulator with wide powers—be they investment banks or special investment vehicles issuing CDOs of mortgages or insurance companies writing credit default swaps."

- "All institutions within the expanded perimeter should have disclosure obligations to allow the authorities to determine their contribution to systemic risk and to differentiate the intensity of prudential oversight accordingly."

- "In a second layer, all systemic institutions should be under prudential rules (potentially covering capital, liquidity, orderly resolution, and early intervention)."

- "Differentiated layers of oversight should stress incentives—e.g., longer term horizons in decisions, strong governance, and risk management processes, capital charges to favor safer exchange trading environments or robust clearing systems."

- "Regulatory standards and the supervisory process to enforce the regulation need to be strengthened and, in order to minimize regulatory arbitrage, should be based on the risk of the underlying activity rather than on the type of institution undertaking it."

- A "flexible perimeter" of regulation is needed to address systemic changes over time.

- Regulatory oversight should be risk-based, focused particularly on the systemically important and/or higher risk hedge fund managers – possibly with a *de minimis* cut-off.

- At registration, hedge fund managers should provide fundamental information to aid regulators in protecting investors and monitoring systemic risk and risks to counterparties to hedge funds.

- Types of information regulators may require include:
  1. Background of key management and investment personnel; organization and ownership
  2. Assets under management
  3. Business plan
  4. Services offered
  5. Hedge fund investors targeted
  6. Fees charged
  7. Investment related affiliates
  8. Investment strategies utilized
  9. Risk tools or parameters employed
  10. Identification of key service providers, such as independent auditors, sub-advisers and administrators
  11. Conflicts of interest

- The information would provide transparency into the manager's business and should be made available to all prospective clients prior to execution of a subscription or other agreement.

- The minimum information required should be consistent across firms.

- Registration will provide each jurisdiction access, monitoring, and inspection rights to the managers and its records.
• **Potential ongoing requirements:**
  1. A comprehensive and independent risk management function that considers risks across the whole of the manager’s business, including: market, liquidity, credit, and operational risks;
  2. Stress testing of positions;
  3. A strong independent compliance function supported by sound and controlled operations and infrastructure, adequate resources, and checks and balances in operations;
  4. Robust verification of fund valuations, adequate segregation of responsibilities, and thorough written policies;
  5. Adequate segregation and protection of client fund assets through use of custodians and depositaries;
  6. Annual independent audit of the accounts of the fund manager and/or of each of the fund's managed;
  7. Capital requirements;
  8. Management and disclosure of conflicts of interest;
  9. Strong governance mechanisms for compensation/remuneration structures;
  10. Transparency; and
  11. Disclosure to investors, including risks, the conditions and/or the limits for redemption, the existence and conditions of any side letters and gating structures, the fund's strategy, and performance, including audited financial statements.

• **Possible hedge fund level regulation, including:**
  1. Information on prime brokers, custodians, managers' background, and investment strategy;
  2. Regular data provision to regulators on positions, leverage, and high-level investment strategy; and
  3. Information about relevant risks, particularly counterparty and market risks.

- Systemic Risk Regulator to monitor financial markets broadly, analyze changing conditions in global markets, evaluate risks of practices, and act to mitigate such risks in coordination with other regulators.

- Combine CFTC and SEC into new Capital Markets Regulator.

- Authority to oversee hedge funds and other unregulated pooled products, including to require nonpublic reporting of information such as investment positions and strategies that bear on systemic risk and adversely impact other market participants.
• Private pools of capital, including hedge funds, can be a source of risk owing to their combined size in the market, their use of leverage and maturity mismatches, and their connectedness with other parts of the financial system.

• They or their managers should therefore be required to register with financial authorities and disclose appropriate information to assess the risks they pose.

• Responsibility: National authorities

• Timeline: Implemented within 2 years.
REGISTRATION

Proposed Legislation
Financial Oversight Commission Act of 2009 (H.R. 74)

- Introduced by Rep. Issa and referred to House Financial Services Committee. (Jan. 6, 2009)
- Would establish the Financial Oversight Commission to:
  1. Investigate the financial crisis of 2008;
  2. Consider legislation or other action pertaining to: GSEs; the stock market; the housing market; credit rating agencies; the financial services sector, including hedge funds, private equity funds, and the insurance industry; and the role of congressional oversight and resource allocation;
  3. Identify, review, and evaluate the lessons learned from the crisis relating to the structure, coordination, management policies, and procedures of governmental and nongovernmental entities regarding crisis detection, prevention, and response; and
  4. Report findings and recommendations to the President and Congress within 12 months.
Hedge Fund Adviser Registration Act of 2009 (H.R. 711)

- Introduced by Rep. Capuano and referred to House Financial Services Committee (Jan. 27, 2009)

- Would amend Advisers Act Sec. 203(b)(3) to eliminate registration exception for investment advisers with fewer than 15 clients.
Hedge Fund Study Act (H.R. 713)

• Introduced by Rep. Castle and referred to the House Financial Services Committee (Jan. 27, 2009)

• Would require President's Working Group to conduct a study on growth, benefits, and risks of hedge funds, and to make recommendations for improvements to industry practices and regulation.

• Report on findings and recommendations due 180 days after enactment.
Hedge Fund Transparency Act (S. 344)

- Introduced by Senators. Grassley and Levin and read twice and referred to the Senate Banking Committee. (Jan. 29, 2009)
- Would require private funds with $50 million in assets or AUM to:
  1. Comply with SEC prescribed books and records rules;
  2. Cooperate with SEC information requests;
  3. Make SEC and public disclosure of investors, assets and AUM; and
  4. Comply with AML and Bank Secrecy Act requirements.
- Sen. Grassley clarified that the bill is only intended to restore SEC authority over hedge funds by overturning *Goldstein v. SEC* (D.C. Cir. 2006). Hedge funds will not be forced to disclose the name of every client. (Apr. 27, 2009)
Financial Crisis Investigation Act of 2009 (S. 400)

• Introduced by Sen. Sanders and read twice and referred to the Senate Banking Committee. (Feb. 9, 2009)

• The Oversight Panel of the Troubled Asset Relief Program would be charged with reviewing all aspects of financial regulation, **including hedge funds, private equity funds**, and the markets for alternative investments.
Financial Markets Commission Act of 2009 (H.R. 2253)

• Introduced by Reps. Delahunt and LaTourette and referred to the House Financial Services and Agriculture Committees. (May 5, 2009)

• 7 member Financial Markets Commission would:

1. Examine the causes of the financial and economic crisis;
2. Investigate the role, if any, of any government or non-governmental entity, including the SEC, CFTC, the banking agencies, any SRO, and any financial or commercial corporation, partnership, or entity;
3. Have authority to hold hearing and issue subpoenas; and
4. Be required to report its findings within 1 year.
REGISTRATION
Views of Key Players
• **Ben Bernanke**, Federal Reserve Board Chairman, at the Council on Foreign Relations (Mar. 10)
  – Systemic risk regulator to monitor, assess, and, if necessary, address potential systemic risks within the financial system, including by identifying possible regulatory gaps.

• **Mary Schapiro**, SEC Chairman, Testimony before the Senate Banking Committee (Mar. 26)
  – "We are considering asking for legislation that would require registration of investment advisers who advise hedge funds, and possibly the hedge funds themselves."
Timothy Geithner, Treasury Secretary, Testimony before the House Financial Service Committee (Mar. 26)

- "[W]e should require that leveraged private investment funds with assets under management over a certain threshold register with the SEC to provide greater capacity for protecting investors and market integrity."
- All private funds advised by an RIA should be subject to investor and counterparty disclosure requirements and regulatory reporting requirements.
- Regulatory reporting should include reporting, on a confidential basis, information necessary to assess whether the fund or fund family is so large or highly leveraged that it poses a threat to financial stability.
- Regulatory reports would be shared with the systemic regulator, which would then determine whether any hedge funds could pose a systemic threat and should be subjected to prudential regulation.
Views of Key Players, cont'd

• **Richard Ketchum**, FINRA Chairman and CEO, Testimony before the Senate Banking Committee (Mar. 26)
  
  – "Where we can identify these regulatory gaps that compromise investor protection and pose risk to the financial system, they should be thoughtfully filled. One example is hedge funds. Hedge funds play a significant role in the financial system, but they are an unregulated part of it. The absence of transparency about hedge funds and their investment positions is a concern."

• **Barney Frank (D-MA)**, House Financial Services Committee Chair, Reuters Global Financial Regulation Summit (Apr. 28)
  
  – "We will give [the SEC] explicitly that authority" to register hedge funds.

• **Luis Aguilar**, SEC Commissioner, 2009 North American Securities Administrators Association Public Policy Conference (Apr. 28)
  
  – "There are enormous areas of the securities markets that lack appropriate regulation, including over-the-counter derivatives, hedge funds, and municipal securities — all because, simply stated, the SEC lacks authority. In addition to closing regulatory loopholes, Congressional action is also needed to provide the SEC with an adequate funding basis."
Views of Key Players

• **Elisse Walter**, SEC Commissioner, Mutual Fund Directors Forum (May 5)
  - "There are important products and market actors, such as hedge funds and much of the over-the-counter financial derivatives market, that are beyond effective oversight by regulators."

• **Troy Paredes**, SEC Commissioner, 13th Annual STA Conference (May 6)
  - "[T]he demands of the Investment Company Act are reasonable and appropriate, in part because not every fund is subject to them. Hedge funds, private equity funds, and venture capital funds, for instance, are permitted to structure themselves to take advantage of certain valid exclusions that were explicitly included in the Act. To deny such private pools of capital the current investment flexibility they have would be costly. Such funds are central to promoting market efficiency and capital formation and allow investors the chance to participate in a host of investment opportunities. I am concerned that features of the regulatory regime that allow for optionality, flexibility, and ultimately innovation and growth are included among the "gaps" that some advocate should be closed."
PLUS REGULATION
Registration + Regulation

- Registration without additional authority "would not be sufficient." . . . "We need the ability to inspect and examine, we need the ability to require the maintenance of books and records and some further rulemaking authority. . . . It would be good to have rulemaking authority. It's good to have flexibility to respond to crises as they emerge." SEC Chairman Schapiro, Reuters Global Financial Regulation Summit (Apr. 27, 2009)

- "[F]rom my perspective, FINRA is uniquely positioned to build an oversight program for investment advisers quickly and efficiently." FINRA Chairman and CEO, Rick Ketchum, New York University Pollack Center for Law and Business (May 1, 2009)
Possible Elements of Regulation

- Filing and updating registration forms
- Licensing of individuals
- Inspection and exams – SEC and possibly SRO
- Regulatory reporting
- Investor and counterparty risk disclosure
- Custody requirements
- Procedures for solicitation and advertising
- Proxy voting policies and procedures
- Requirements for an advisory contracts
- Books and records; email retention and review
Pension Security Act of 2009 (H.R. 712)

• Introduced by Rep. Castle and referred to House Committee on Education and Labor. (Jan. 27, 2009)

• Would require pension plans to disclose in annual report investments in hedge funds, including name of fund and amount invested.
INDUSTRY BEST PRACTICES
Managed Funds Association (2009)

MFA, *Sound Practices*

7 Key Components

1. Disclosure and investor protection
2. Valuation
3. Risk management
4. Trading and business operations
5. Compliance, conflicts, and business practices
6. Anti-money laundering
7. Business continuity and disaster recovery
MFA, *Sound Practices*
Disclosure & Investor Protection

• Disclosure framework: PPM, audited financials, performance, ongoing investor communications
• Material information, including scope of operations
• Conflicts of interest
• Disclosure to counterparties
• Participation and responsibilities of investors: due diligence questionnaire
MFA, *Sound Practices*  
Valuation

- Framework and governance
- **Written policies and procedures**
  - Designate responsible person(s)
  - Identify pricing sources
  - Adopt accounting standards (*e.g.*, GAAP, IFRS)
  - Establish and maintain internal documentation
  - Determine policies for valuing hard-to-value assets
  - Address side pockets
- **Implementation**
MFA, *Sound Practices*

Risk Management

- Appoint Chief Risk Officer
- Identify categories of risk (*i.e.*, liquidity, leverage, market, counterparty credit, operational, and legal & compliance)
- Develop risk profile for each fund
- Conduct periodic reviews of risk management, monitoring, and management procedures
MFA, *Sound Practices*
Trading and Business Operations

- Internal systems and controls
  - Develop an integrated framework to manage trading and operations
  - Develop a cash management and collateral management framework
  - Develop core infrastructure and operational practices
  - Develop and implement best execution procedures
  - Develop and monitor systems for core accounting practices
  - Develop and monitor IT practices

- External controls
  - Conduct due diligence on counterparties
  - Select and monitor reputable key service providers

- Develop and implement practices for OTC derivatives and complex products
MFA, Sound Practices
Compliance, Conflicts, & Business Practices

- Establish a top down culture of compliance
- Encourage employees not to “go it alone”
- Appoint a Chief Compliance Officer and dedicate resources to compliance
- Adopt and implement written compliance policies and procedures, including a *Code of Ethics*
- Train and educate personnel
MFA, Sound Practices
Anti-Money Laundering

• Pro-actively adopt and implement a written AML program consistent with the USA Patriot Act

• Tailor program to the business and operations of the manager, including nature and location of investors, relationships with third parties, and AML rules of non-US jurisdictions

• Designate AML compliance officer

• Conduct on-going employee training

• Use independent audit function to test programs and recordkeeping
MFA, *Sound Practices*

Business Continuity/Disaster Recovery

- Create business continuity, contingency, and succession plans in the event of a natural disaster, market disruption, terrorist attack, loss of key personnel, or business emergency
- Detail mission-critical systems
- Identify personnel to achieve objectives
- Replicate technology systems
- Train and test at least annually
- Designate personnel responsible for regulatory reporting and compliance
SHORT SELLING UPDATE
Proposed Legislation

• To require the Securities and Exchange Commission to reinstate the uptick rule on short sales of securities. (H.R. 302)
  – Introduced by Rep. Ackerman and referred to House Financial Services Committee. (Jan 8)
  – Would direct the SEC to (1) reinstate the uptick rule, Rule 10a-1; (2) rescind the prohibition against applying certain price tests to short sales; and (3) reinstate pre-Regulation SHO short sale price test restrictions

• A bill to require the Securities and Exchange Commission to reinstate the uptick rule and effectively regulate abusive short selling activities. (S. 605)
  – Introduced by Sen. Kaufman and referred to Senate Banking Committee. (Mar. 16)

• Stock Market Recovery Act of 2009 (H.R. 1406)
  – Introduced by Rep. Kirk and referred to House Financial Services Committee (Mar. 10)
  – Would direct the SEC to reinstate the uptick rule.
Proposed Amendments to Regulation SHO

• Release No. 34-59748, 74 FR 18042 (Apr. 20, 2009)
• Short Sale Price Test and Circuit Breaker Restrictions
• Comments due: June 19
Price Test

• *Market-Wide, Permanent Approach*

• *Proposed Modified Uptick Rule.* A market-wide short sale price test based on the national best bid.

• *Proposed Uptick Rule.* A market-wide short sale price test based on the last sale price or tick.
Circuit Breaker Restrictions

- **Security-Specific, Temporary Approach**
- **Circuit Breaker:** A circuit breaker that would either:
  - *A Proposed Circuit Breaker Halt Rule.* Ban short selling in a particular security for the remainder of the day if there is a severe decline in price in that security.
  - *A Proposed Circuit Breaker Modified Uptick Rule.* Impose a short sale price test based on the national best bid in a particular security for the remainder of the day if there is a severe decline in price in that security.
  - *A Proposed Circuit Breaker Uptick Rule.* Impose a short sale price test based on the last sale price in a particular security for the remainder of the day if there is a severe decline in price in that security.
SEC Roundtable

• **Purpose:** to examine short sale price test and circuit breaker restrictions

• **3 Panels:**
  1. Market Changes and Investor Confidence; Are short sale price tests or short sale circuit breakers necessary or effective?
  2. Bid versus Tick versus Circuit Breakers; Bid versus Tick versus Circuit Breakers.
  3. Lessons and Insights from Empirical Data; Short sale price tests and short sale circuit breakers by the numbers.
Rule 10a-3T and Form SH

- Interim final temporary Rule 10a-3T requires certain "institutional investment managers" to report on Form SH certain specified information concerning their short sales of and short positions in Exchange Act section 13(f) securities, other than options.

- Absent SEC action, sunsets August 1.
Rule 10a-3T and Form SH, cont'd

Who Must Report?

• An institutional investment manager who exercises investment discretion with respect to accounts holding section 13(f) securities, if:

  1. At the end of the most recent calendar quarter it was required to file a Form 13F (i.e., the manager exercised investment discretion with respect to accounts holding section 13(f) securities having an aggregate fair market value on the last trading day of any month of the prior calendar year of at least $100,000,000), and

  2. It effected a short sale in a section 13(f) security, other than options, during a Sunday to Saturday calendar week.

GIBSON, DUNN & CRUTCHER LLP
What information must be reported on Form SH?

• Managers are required to report for each 13(f) security and for each calendar day of the reporting period:
  – The gross quantity of shares sold short;
  – The start of day short position; and
  – The end of day short position.
Definitions of "Short Sales" and "Short Positions":

- "Short sale" has the same meaning as under Rule 200(a) of Regulation SHO.
- "Short position" is the aggregate gross short sales of an issuer's section 13(f) securities (other than options), less purchases to close out a short sale in the same issuer. It is not net of long positions.
  - If a manager sells a security that was loaned to another person, and a bona fide recall is initiated within T+2, the sale should be treated as "long".
  - Options and short sales of options are not reported, unless the manager:
    (1) exercises a put option and is net short for purposes of Regulation SHO; or
    (2) effects a short sale as a result of assignment to it as a call writer, upon exercise.
Rule 10a-3T and Form SH, cont'd

Public Availability of Information:

• The SEC will treat Forms SH as nonpublic "to the extent permitted by law."

• Filers do not need to submit a FOIA confidential treatment request, but should instead label their reports as NONPUBLIC (in bold, capitalized letters) per Form SH's instructions.
Exceptions to the Reporting Requirements.

• Manager has not effected any short sales of section 13(f) securities during the relevant reporting period.

• Short positions or short sales are de minimis.
  - De minimis means (a) during the reporting period, the start of day short position, the gross number of securities sold short during the day, and the end of day short position constitute less than 0.25% percent of the class of the issuer's section 13(f) securities issued and outstanding, and (b) the fair market value of the start of day, the gross number of securities sold short during the day, and the end of day short position is less than $10,000,000.
  - The analysis is made on a per column and per day basis, and the manager may report "N/A" for any data element where the exception is available.
Rule 10a-3T and Form SH, *cont'd*

- **Formatting Requirements; Required Information.**
  - Certain information must be submitted in XML tagged data format with additional identification within the data file; i.e., the date, the filer's CIK, the identity and CUSIP number of the issuer, the short position at the start of the day, the number of securities sold short on that day, and the short position at the end of the day.
  - The report must contain a signature block for the person signing on behalf of the manager and additional information about the report type and managers covered.

- **3 Form SH Reports.**
  - Entries Report: used if all of the information an institutional investment manager is required to report is included in the Form SH filing;
  - Notice: used if all of the information a manager is required to include is reported in another manager's report; and
  - Combination Report: used if a portion of the manager's entries are filed in the manager's report and a portion are reported by another manager.

- **Timing.**
  - Form SH is due on the last business day of the calendar week subsequent to a week in which reportable short sales were effected.
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