New Proposals to Regulate Hedge Funds:
SEC Rule 203(b)(3)-2

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On September 29, 2003, the Securities and Exchange Commission (SEC) issued a report on the "Implications of the Growth of Hedge Funds" (the "Report").[2] The Report raised several issues related to hedge funds and proposed a number of regulatory initiatives that the SEC might take. Its principal recommendation was that the SEC should require most hedge managers to register as investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). On July 14, 2004, after a lengthy period of public comment on the Report, the SEC ("Commission") adopted (by a split vote) Rule 203(b)(3)-2, which implements this registration recommendation, and set a two-month period for public comment before formally adopting the Rule on December 2, 2004.

In support of Rule 203(b)(3)-2, the SEC argues that requiring the registration of hedge fund advisers is necessary to protect "… investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets."[3] The Commission cities two concerns about hedge funds: the growing incidence of fraudulent activity by fund advisers and the "retailization" of hedge fund investments.

This is not the first time that the Commission has noted its concern about the activities of hedge funds. More than thirty years ago, in 1969, the Commission instituted an investigation of the use of leverage and short selling by hedge funds.[4] In 1972 it conducted an economic study of the use of hedge funds by institutional investors.[5] In 1992 the Commission provided the Congress with an analysis of the regulatory treatment of hedge funds under the federal securities laws. And in 1999, in the wake of the September 1998 near-collapse of Long Term Capital

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[2] "Implications of the Growth of Hedge Funds," Staff Report to the United States Securities and Exchange Commission, 2003.
[3] Securities and Exchange Commission, "Registration Under the Advisers Act of Certain Hedge Fund Advisers," 17 CFR Parts 275 ands 279, Release No. IA-2266, File No. S7-30-04.
[4] See The 35th Annual Report, Securities and Exchange Commission (1969), at 18.
[5] SEC, Institutional Investor Study, Report, H.R. Doc. No. 92-64, 92 Cong., 2d Sess. p. xv.

Management Inc. (LTCM) and the intervention of the Federal Reserve in arranging a creditor-bailout of LTCM, the Commission was one of several government agencies to participate in the President's Working Group on Financial Markets, which examined the potential impact of hedge funds on the stability of financial markets.[6]

In defending the Fed's decision to assist LTCM, Alan Greenspan explained:

> [T]he act of unwinding LTCM's portfolio in a forced liquidation [precipitated by LTCM's derivatives counterparties] would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other markets participants who were not directly involved with LTCM ... . Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants ... and could have potentially impaired the economies of many nations, including our own."[7]

The collapse of LTCM, of course, is not the only hedge fund to become financially distressed and to impose significant losses on investors. There have been other failures of large hedge funds with sizeable losses to investors: Askin Capital Management ($420 million), Vairocana Limited $700 million), Argonaut Capital Management ($110 million), Manhattan Investment Fund ($300 million), and the Japanese fund Eifuku ($300) (which had George Soros as one of its investors).[8] Indeed, the average life of a hedge fund is only about thirty-six months. With approximately 8000 hedge funds in existence, we can expect a fair number of hedge funds to cease operations every year, usually because of poor performance. Most hedge fund failures, however, go unnoticed, except by those unlucky enough to have invested in them, because they involve neither fraudulent activity nor a threat to the stability of financial markets.

[6] See Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management—Report of the President's Working Group in Financial Markets, Apr. 1999 ("PWG LTCM Report")

[7] Greenspan, Alan, Chairman, Board of Governors of the Federal Reserve System, Statement Before the Committee on Banking and Financial Services, U.S. House of Representatives, October 1, 1998.

[8] "Eifuku=s Collapse Snares Soros," The Wall Street Journal, Jan. 30, 2003, p. C1, col. 2.

This paper examines the Commission's new proposal to address its current concerns about hedge funds: Rule 203(b)(3)-2, which would require the registration of most advisers to hedge funds with the SEC. The Commission argues that the proposed Rule is a necessary response to its concerns about fraudulent conduct among hedge fund advisers and the growing "retailization" of hedge funds. In the Commission's view, the proposed rule would deter fraudulent conduct by providing the Commission with more information about hedge funds, by giving the SEC the authority to conduct examinations of the adviser's hedge fund activities, by fostering an environment of compliance, by bringing about the more accurate valuation of hedge fund assets, by keeping unfit persons from using hedge funds to perpetrate frauds, and by requiring hedge fund advisers to provide additional information about themselves and their funds to investors and prospective investors (through Form ADV and otherwise). It also would address its concern about the growing retailization of hedge funds by restricting access to hedge funds among less sophisticated investors.

Rule 203(b)(3)-2 and The Current Regulatory Structure

To understand the importance of the proposed Rule 203(b)(3)-2 it is necessary understand the existing regulatory framework for hedge funds. To begin with, there is no precise definition of "hedge fund" under federal securities laws. In practice, the term "hedge fund" generally refers to an unregistered pooled investment, privately organized, not advertised, and administered by professional investment managers, whose securities are privately placed with wealthy individual and institutional investors. As unregistered investment pools they are exempt from the laws and regulations that apply to registered investment vehicles (such as mutual funds) and as a consequence are able pursue investment strategies that differ from many other investment vehicles (which is their primary attraction to investors).

Hedge funds can, for example, trade any type of security or financial instrument, operate in any market anywhere in the world, make unlimited use of any kind of derivatives instrument, engage in unrestricted short-selling, employ unlimited amounts of leverage, hold concentrated positions in any security without restriction, set their own redemption policies without restriction, and are free to charge investors whatever fees they want to and to compensate their managers in any way that seems productive to them and their investors. Hedge funds also have very limited disclosure and reporting obligations to regulators, the public, or their own investors. To the extent that there are limits or restrictions imposed on the investment activities of hedge funds, these derive largely from their contractual relationships with investors and from the market discipline exerted by creditors, counterparties, and investors, and not from legal restrictions or regulation.

In the United States hedge funds are usually organized as limited partnerships in a way that exempts them the 1933 Securities Act's registration requirements, the Investment Company Act of 1940 ("Company Act"), and the Investment Advisors Act of 1940 ("Advisers Act"). To gain an exemption from the Securities Act of 1933 most hedge funds take advantage of the "private offering" (or "private placement") exception under section 4(2) or the related "safe harbor" section under Regulation D of the Securities Act of 1933. This requires that hedge funds restrict their sales of securities (or their limited partners) to only "accredited investors" in order to avoid regulatory requirements that accompany sales to "non-accredited investors."[9]

[9] While Rule 506 does allow them to have as many as 35 "non-accredited" investors, it is not worth it for most hedge funds to involve themselves with such investors.

"Accredited investors" are individuals with incomes of at least $200,000 in each of the two most recent years, or with joint income with that person's spouse in excess of $300,000 in each of those years (and have a reasonable expectation of reaching the same income level in the current year), *or* a net worth, or joint net worth with that person's spouse, that exceeds $1 million at the time of purchase; or are institutional investors with assets in excess of $5 million, or a bank, savings and loan association, a broker/dealer, an insurance company, an investment company, or a small business investment company licensed by the U.S. Small Business Administration. The purpose of limiting investors in private placements (i.e., most hedge funds) to "accredited investors" is that these investors should be sophisticated enough not to need the full protections afforded by federal securities laws.

To be exempt from the Company Act, which regulates mutual funds, most hedge funds rely on the exceptions in section 3(c)(1) and 3(c)(7) of the Act. Under section 3(c)(1), the Act does not apply if a hedge fund does not publicly offer to sell an interest in the fund and has fewer than 100 "persons" (investors). Under section 3(c)(7), the Act does not apply if hedge funds have only limited partners (investors) who meet the criterion of "qualified purchasers." "Qualified purchasers" are individuals or companies who own at least $5 million in investments.[10]

Advisers to hedge funds also typically meet the "private advisor" exemption from federal registration as an investment adviser. This exemption requires that they have had fewer than 15 "clients" in the past 12 months, do not hold themselves out to the public as an investment adviser, and do not act as an investment adviser to a registered investment company or business development company [Rule 203(b)(3)]. Under current regulations, each separate company (or hedge fund, investment partnership, managed account, etc.) that the adviser manages is

[10] Investment Company Act of 1940, sec. 2(a)(51), and SEC Rule 2a 51-1.

considered to be a single client if the manager bases its investment advice to the company on the company's investment objectives as opposed to the investment objectives of the individual company owners.

It should be noted, however, that many hedge funds also are regulated by the CFTC. They must register with the CFTC as a "commodity pool operator" (CPO) if they intend to invest in or trade one or more futures or options contract on a regulated commodity exchange. The Commodity Exchange Act (CEA) subjects CPOs and their advisers (CTAs) to regulation, but not the commodity pools themselves. Once registered, CPOs and CTAs must also comply with the rules of the National Futures Association (NFA), avoid conflicts of interest and protect customer funds, provide written disclosure to prospective investors of the risks of investing in commodity interests, adhere to restrictions on advertising, satisfy record keeping and reporting requirements, and subject themselves to periodic inspections of their activities by the NFA.

Advisers to hedge funds are not exempt from common law remedies for fraud, as well as claims for fraudulent manipulation under section 10(b) and Rule 10b-5 of the Securities Act of 1934. Typically, prior to investing in a hedge fund in a private placement, investors are given for review and agreement an offering memorandum and partnership agreement. These documents provide investors with information about the potential risks associated with the fund and serve as a notice of *caveat emptor*. They also form the basis for possible contractual law remedies at a future date.

Hedge funds, like other investment funds, are subject to various regulatory reporting requirements. The SEC requires the reporting of all stock positions that exceed five percent of any class of securities issued by a publicly traded company. The U.S. Treasury requires all traders to report large positions in certain foreign currencies and in Treasury securities; and, if hedge funds hold positions in exchange-traded derivatives they are subject to “large trader” reporting requirements. Finally, probably half of the hedge funds in the world are “offshore funds” -- unregistered funds organized outside of the United States, generally in favorable tax jurisdictions such as the Cayman Islands.

How Does Rule 203(b)(3)-2 Affect Hedge Fund Investors?

Rule 203(b)(3)-2 amended the existing private adviser exemption under Rule 203(b)(3) by changing the definition of “client” in a way that would require most hedge fund advisers to register under the Advisers Act. Specifically, it would require that each owner of a “private fund” (and each individual investor) be counted as a client. As previously discussed, under existing rules a hedge fund (or limited partnership) was treated as a single “client,” even though the hedge fund might have dozens of investors (or limited partners). Under the new Rule an adviser to a single hedge fund with 15 or more limited partners (investors) would now be viewed as having more than 14 clients, and would be required to register under the Advisers Act, unless it had no more than $25 million under management.

Rule 203(b)(3)-2(k) also contains a special provision for advisers to hedge funds in which registered investment companies (mutual funds) invest: hedge fund advisers would have to count all investors in those mutual funds as clients. Without this provision, an advisor could advise a hedge fund which had fourteen or fewer mutual funds as investors without registering, even though each of the mutual funds might have thousands of individual investors.

An important consequence of requiring registration under the Advisers Act is that the minimum net worth requirement for hedge fund investors (specifically clients of “3(c)(1) hedge funds”) would effectively be raised to $1.5 million from the current $1 million (which is the “accredited” investor net worth requirement that clients of “3(c)(1) hedge funds” must meet to satisfy the private placement exemption under Rule 506 under the Securities Act of 1933.) This would occur because registered advisers who receive performance-based fees (as almost all hedge fund advisers do) are required to have only “qualified clients,” who are defined as investors having either $750,000 invested with the Adviser or a net worth of more than $1.5 million (Rule 205-3)(b)).

To limit the scope of Rule 203(b)(3)-2 to only advisers to hedge funds, the Commission defines a “private fund” as companies or funds that: first, would be subject to regulation under the Investment Company Act (ICA) but for the exceptions provided by either section 3(c)(1) or section 3(c)(7) of the Company Act; second, permit investors to redeem their interests in the fund within two years of purchasing them (i.e., have less than a two-year “lock-up”); and, third, are offered with investment strategies that are based on the skills, ability or expertise of the investment adviser. This definition excludes advisers to most other business organizations, such as insurance companies, broker-dealers, and banks, as well as advisers to private equity funds and venture capital funds. While the SEC acknowledges that other private funds, such as private equity and venture capital funds, are similar to hedge funds, it defends its definition on the grounds that it has not encountered significant enforcement problems with advisers to such funds, in contrast to its experience with hedge fund advisers.

Fraudulent Activity by Hedge Fund Advisers

With respect to the Commission’s concern about fraudulent conduct by hedge fund advisers, there are three issues: is the amount of fraud in the hedge fund industry excessive (or disproportionate to the size of the industry), will the proposed Rule 203(b)(3)-2 be an effective deterrent to fraudulent conduct, and should the SEC attempt to protect hedge fund investors in general, since most are either wealthy individuals or institutions?

First, there is little evidence that fraud is a significant problem in the hedge fund industry. In support of its regulatory initiative, the Commission cites its enforcement actions against 46 hedge fund advisers (registered and unregistered) during the past five years, in which hedge fund advisers engaged in fraudulent activities. This number, however, constitutes a very small percentage of the 2,600 enforcement actions initiated by the Commission during the same period. In addition, after examining this issue in 2003, the SEC staff concluded that there is "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."[11]

By its discussion of hedge fund participation in the recent scandals involving mutual funds late trading and inappropriate market timing, the Commission nevertheless suggests that fraud may be a growing problem in the hedge fund industry. It is notable, however, that this fraudulent activity occurred in a highly regulated industry – mutual funds, where all of the implicated mutual funds and their advisers were already registered and SEC examiners were already inspecting these mutual funds. Despite this intense regulation, the SEC failed to turn up any evidence of the fraudulent activities until others brought it to the SEC's attention. Of course, there is no way for any of us to look into the future and discern whether there will in fact be a substantial increase in fraudulent conduct by hedge fund advisers in future years.

Second, Rule 203(b)(3)-2 is unlikely to be an effective deterrent to fraud. In the 46 hedge fund fraud cases cited by the Commission, the implicated hedge fund advisers were either too small to be required to register under Rule 203(b)(3)-2 or were already registered with the Commission (or had ignored the requirement to register). Specifically, 20 were too small to be covered by the proposed rule, 8 were already registered with the SEC, and 5 should have been

[11] 2003 Staff Hedge Fund Report, supra note 1, at 73.

registered under the current rules but were not. Further, as discussed above, adviser registration and even greater regulatory oversight failed to prevent the recent rather blatant fraudulent activity in mutual funds.

Thus, while the intent underlying Rule 203(b)(3)-2 – to deter fraud – is laudatory, there is no compelling evidence that fraud is either a significant problem in the hedge fund industry or that the proposed rule would be an effective deterrent to fraudulent activity.

Third, even if we were to have some concern about the potential growth of hedge fund fraud, it is not clear that, from a cost-benefit perspective, it would be socially productive for the SEC to expend taxpayer dollars protecting hedge fund investors. Individual hedge fund investors are by and large much richer and more financially sophisticated than are mutual fund investors, and there are many fewer hedge fund investors than there are mutual fund investors. Mutual funds have over 90 million investors and manage over $7 trillion, while hedge funds have perhaps 200,000 relatively well-off and sophisticated investors and manage perhaps $800 billion. It seems fairly obvious that the potential social benefit of protecting mutual fund investors is likely to be much higher than protecting a much smaller number of hedge fund investors, who are typically more knowledgeable and better able to tolerate risk and investment losses.

Institutional investors, such as pension funds, which invest in hedge funds also are guided by sophisticated professional fund managers, who are monitored by the funds that employ them and have fiduciary duties to those funds. They should be expected to provide their own due diligence when dealing with hedge fund advisers and to put in place whatever contractual protections they need, or to abstain from engaging in hedge fund investments entirely. Further, pension funds are already subject to oversight by either the Department of Labor or by states, in the case of public pension funds.

The "Retailization" of Hedge Funds

The Commission's concern about the "retailization" of hedge funds stems from its concern that retail investors may be exposed to inappropriately risky investments and potentially large losses. It points to three potential problems. First, the rise in individual incomes and wealth over the years has resulted in more individuals being able to qualify as accredited investors and therefore gain access to hedge funds (specifically, 3(c)(1) funds). Second, increased investment by pension funds and other institutional investors in hedge funds has resulted in the "indirect" retailization of hedge funds. And, third, the potential proliferation of publicly-offered, registered, "hedge funds" would make hedge fund investments available to more retail investors.

Registered "hedge funds" are closed-end (mutual) funds registered under the 1940 Investment Company Act which pursue hedge fund investment strategies (more often a fund-of-(hedge)-fund strategy). Publicly-offered, registered, hedge funds are those that have registered their securities under the 1933 Securities Act. At year-end 2002 there were forty-two registered hedge funds. Only thirteen had registered their securities under the 1933 Securities Act permitting them to publicly-offer their shares; the others had not done so. In principle, there are no "net worth" or income restrictions on the customers that publicly-offered, registered, hedge funds can take.

An example is Oppenheimer Tremont's Market Neutral Fund, which is similar to a mutual fund but pursues a funds-of-(hedge)-funds investment strategy. The Fund offers its securities publicly, and requires a minimum investment of only $25,000. Nevertheless, Oppenheimer Tremont, like most of the registered funds, still requires its investors to have a net worth of at least $1.5 million so that it can charge performance (or incentive) fees. All advisers to registered funds must be registered under the 1940 Investment Advisers Act. As a consequence, to be able to charge performance fees the fund must have only “qualified clients” -- investors with a net worth of at least $1.5 million or who have $750,000 under management by the fund’s adviser.[12]

Is the retailization of hedge funds a problem? The Commission’s concern that the accredited investor standard has become too easy for even unsophisticated investors to meet has some basis. This standard has not been adjusted for many years and is arguably now too low. But the simplest and most cost-effective remedy would seem to be to raise the accredited investor standard, perhaps by the same amount that consumer prices (household incomes) have increased since the last time it was set. Requiring the registration of hedge fund advisers is a circuitous and costly way to change the accredited investor standard. The Commission’s concern about the indirect retailizaton of hedge funds through institutional investors is, in my view, a “red herring” for the reasons discussed earlier. Lastly, its concern about the potential proliferation of publicly-offered, registered, hedge funds seems unwarranted. But to the extent that this is a problem, the Commission already has the ability to address this issue directly through its regulatory powers over mutual funds (and registered hedge funds).

In particular, the Commission might want to explore additional disclosure requirements for registered hedge funds in order to provide investors with greater transparency with respect to the risks associated with hedge fund investments.

Why Restrict Access to Hedge Funds? An Alternative Policy Approach

The underlying thesis for restricting hedge fund investments to only sophisticated, wealthy, investors is that hedge fund investment strategies are inherently risky, and that the risks

[12] Investment Advisers Act of 1940, sec. 203(b)(3), Rule 205-3.

associated with hedge fund investments either are not transparent to investors or cannot be understood by unsophisticated investors. In contrast, there are virtually no restrictions on investor access to mutual funds. Instead, there is extensive SEC regulation of mutual funds directed at protecting mutual fund investors. For example, mutual funds have extensive reporting and disclosure requirements, a specified governance structure which imposes fiduciary duties on managers and directors, and various portfolio restrictions to limit a fund's risk-taking, such as limits on the fund's leverage and short-selling. Implicitly, therefore, the presumption must be that the benefits to investors in allowing unlimited access to mutual fund investments are greater than the costs associated with regulating mutual funds.

But there are also potential benefits in allowing investors greater access to hedge funds. In particular, hedge fund investment strategies provide greater diversification opportunities and can result in higher risk-adjusted returns for investors.[13] This is an important reason why more sophisticated investors are attracted to hedge funds. For example, during the recent "bear" stock markets around the world in 2000-02, hedge fund investors generally fared significantly better than stock and bond (or mutual fund) investors.[14] Had more investors been able to diversify into hedge funds during this period, they too might have been able to avoid the substantial losses incurred by most stock mutual funds (which predominately hold long positions in equities). Thus, legal restrictions on investor access to hedge funds impose clear costs on investors in the form of forgone risk-adjusted returns.

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[13] See Franklin R. Edwards and Stav Gaon, "Hedge Funds: What Do We Know?" Journal of Applied Corporate Finance, Vol. 15, no. 4 (Summer, 2003), pp. 8-21, Table 4, which shows that the correlations between stock returns and the returns on some hedge fund strategies are often low; and Franklin Edwards and Mustafa Onur Caglayan, "Hedge Fund and Commodity Fund Investments in Bull and Bear Markets," The Journal of Portfolio Management, Vol. 27, no. 4 (Summer, 2001), pp. 97-108.

[14] Ibid., Table 3, p. 13. If the performance of hedge funds pursuing a particular investment strategy is measured by the average risk-adjusted returns earned by these funds (i.e., their Sharpe ratios), most hedge funds would have out-performed an investment in either the S&P 500 stock index or the JPM U.S. Bond Index during the 1990-2002 period.

Such restrictions also may distort the flow of investor capital resulting in market inefficiencies and reduce liquidity in some markets, increasing transactions costs. Indeed, one explanation for the success of hedge funds is that they are able to exploit market inefficiencies in financial products and markets that are not "mainstream" markets. Restricting the flow of capital into hedge funds may perpetuate these inefficiencies.

A critical presumption that underlies the current policy of restricting access to hedge funds is that all hedge fund strategies are "too risky" for most investors. This may not be true. For example, the return volatility (the annualized standard deviation of monthly returns) of "funds of hedge funds" was on average less than half the volatility of returns on either the S&P 500 stock index or the U.S. Government Bond index during the period 1990-2002.[15] Many other hedge fund strategies had lower return volatilities as well. Recognizing that there may be both data and other problems associated with obtaining accurate measures of the risks associated with hedge fund strategies, the foregoing results should at least give pause to those who support a wholesale policy of restricting investor access to all hedge funds.

Rather than focusing exclusively on restricting access to hedge funds as a way of protecting investors, the SEC should explore ways to make at least some hedge fund strategies *more* available to investors. In particular, it could explore the feasibility of permitting investor access to funds of hedge funds, and in developing disclosure standards and possibly other regulations sufficient to safeguard investors in these funds. Such a policy would reap the benefits of more widespread investor access to hedge funds while at the same time providing reasonable protections for unsophisticated investors. Publicly-offered, registered, hedge funds are one way of doing this, but may not be the most efficient way. But rather than fearing the

[15] Ibid. These lower return volatilities also occurred in both bear and bull periods in the stock market.

growth of such funds, the SEC should focus on how to expand access to hedge funds in a way that still provides appropriate protections for unsophisticated investors.

A case in point is the SEC's regulation of a registered fund of hedge funds. While these "retail" funds are subject to the same regulations as any other closed-end mutual funds, it is not clear that the effectiveness of these regulations will be the same. First, mutual funds are subject to substantial disclosure requirements directed at making their investments and risk exposures transparent to investors, but when applied to registered hedge funds these requirements may not provide the same level of transparency. What will registered "hedge funds" be able to disclose about the hedge funds they hold in their portfolios? They probably will only be able to disclose the magnitude of their holdings in each of the hedge funds and the strategies pursued by these funds. Hedge funds typically do not wish to disclose more detailed information for proprietary reasons. It remains to be seen what disclosure the SEC will require under the new rule requiring registration of hedge fund advisors.

Second, it is not clear how registered funds of hedge funds will value the hedge funds held in their portfolios. Valuation of the investments held by hedge funds is typically done by hedge fund managers themselves. Further, in many cases these valuations are notoriously difficult because of the complexity and illiquidity of hedge funds' portfolios. Third, while mutual fund regulation also limits the leverage and short-selling of the registered hedge funds, there are no such constraints on the portfolio hedge funds. These funds can go short without limit and use as much leverage as they wish to. Thus, applied to registered hedge funds, the current mutual fund regulations may not have the same effectiveness.

This is not to say that we necessarily need more regulation of registered hedge funds, but only that we may need a different approach to regulating registered hedge funds. The objective should be to make “retail” hedge funds more available to investors in a way that still provides adequate protections for unsophisticated investors.

What kind of regulation might we consider? Three regulations seem worth considering. First, there should be diversification requirements for funds of funds. Exactly what these should be is open to debate. I would suggest that retail hedge funds should not be permitted to invest more than five percent of their portfolios in any single hedge fund or investment vehicle, and that they should not be permitted to have more than ten percent of their portfolio assets managed by the same investment adviser (which assures that a fund will have at least ten independent fund advisers). Second, there should be regulations to limit potential conflicts of interest. Specifically, advisers to retail hedge funds should be independent from the advisers that manage the hedge funds in which they invest. Third, there should be increased disclosure requirements. Past fund performance should be reported using a standardized reporting framework, and quantitative measures of a fund’s potential risks should be disclosed, such as measures of value-at-risk for its portfolio and the results of various stress tests. In addition, there should be disclosure of all fees, with examples to illustrate the effect of these fees on fund performance.

But whether or not you agree with these specific policy initiatives, there needs to be some analysis and discussion among regulators, industry representative, academics, and other policy makers about what are the appropriate regulatory policies for “retail” hedge funds.

Regulatory Costs

There also will be costs associated with Rule 203(b)(3)-(2): additional administrative and legal costs to hedge funds and therefore to hedge fund investors, additional regulatory and supervisory costs to the SEC, and “opportunity costs” to investors because of the further restriction on investor access to hedge funds. Higher regulatory costs also have the potential to reduce competition in the hedge fund industry by creating a "regulatory" barrier to the entry of new, small, hedge funds. In particular, large, established, hedge funds may favor greater regulatory oversight as a way of cementing their market position against competition from new funds and managers. I have not, however, emphasized these costs because I believe that the SEC failed to meet its initial burden of demonstrating that there is a clear problem in the hedge fund industry, which can be effectively addressed by Rule 203(b)(3)-2.

Conclusion

The SEC has required hedge fund advisers to register with the SEC in order to address two perceived problems in the hedge fund industry: an increase in fraudulent conduct by hedge fund advisers, and the "retailization" of hedge funds. The SEC, however, does not make a convincing case that these are in fact significant problems, and that, if they were, the proposed registration of hedge fund advisers would be an effective response to them. As such, Rule 203(b)(3)-2 does not, in my opinion, meet the required cost-benefit test for the adoption of a new regulation.

The Commission's focus appears to be on protecting investors from the risks associated with hedge funds by restricting investors' access to hedge funds. In specific, Rule 203(b)(3)-2 indirectly raises the net worth requirements for investors to be able to invest in hedge funds. In contrast, I believe the Commission's primary objective should be make hedge fund investment *more* accessible to investors in ways that provide the appropriate protection for less sophisticated investors. There are significant benefits to investors being able to participate in hedge fund investment strategies. Rule 203(b)(3)-2 does nothing to advance this agenda, and goes in the opposite direction by further restricting investors' access to hedge funds.

The Commission should explore ways to provide investors with greater access to "funds of hedge funds," and should work on determining what the appropriate hedge fund disclosure standards and regulations should be to provide the appropriate level of protection for less sophisticated investors who invest in such funds. Fostering the growth of publicly-offered, registered, funds of hedge funds is one way of doing this, but may not be the most efficient way.