COLUMBIA BUSINESS SCHOOL

CENTER ON JAPANESE ECONOMY AND BUSINESS

PROGRAM ON ALTERNATIVE INVESTMENTS

日本経済経営研究所

# SHOULD HEDGE FUNDS BE REGULATED?

The rapid growth of the hedge fund industry has attracted increasing attention from government regulators. In the United States, for example, the Securities and Exchange Commission (SEC) voted in October 2004 to require many hedge funds to officially register with the Commission beginning in 2006. Actions such as this have led to a widening debate over whether (or to what extent) government should play a role in the development of the hedge fund industry.

To address this issue, The Program on Alternative Investments at Columbia Business School's Center on Japanese Economy and Business sponsored a symposium entitled "Should Hedge Funds Be Regulated?" which was held at New York's University Club in November 2004. U.S. SEC Commissioner Harvey Goldschmid, currently on leave from Columbia Law School, delivered the keynote speech, arguing in favor of the Commission's October decision.

Following Commissioner Goldschmid's address, Program Director Mark Mason moderated a panel of leading experts from the business, government, and academic communities who debated the pros and cons of government involvement in the industry. These panelists included Franklin Edwards, Arthur F. Burns Professor of Free and Competitive Enterprise at Columbia Business School; John Gaine, President of the Managed Funds Association, a leading hedge fund industry group; Sudhir Krishnamurthi, Managing Director of Rock Creek Capital, a Washington, D.C.–based fund of hedge funds; and Nobuyuki Kinoshita, Director at the Financial Services Agency of Japan.

This report covers the keynote address by Commissioner Goldschmid, together with the remarks of the expert panelists and selected exchanges with the audience. Columbia Business School Dean Glenn Hubbard and Center on Japanese Economy and Business Director Hugh Patrick delivered opening remarks, which are also reproduced in this report.

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The Program on Alternative Investments of the Center on Japanese Economy and Business analyzes three sets of alternative asset classes—private equity, hedge funds, and real estate—in Japan and elsewhere in East Asia in international perspective. The Program meets its substantive goals through a combination of research projects and seminar presentations, the latter led by leading practitioners in each of these three alternative asset classes. For information on the Center on Japanese Economy and Business, please visit www.gsb.columbia.edu/japan. For a schedule of upcoming events and other information about The Program on Alternative Investments, please visit www.gsb.columbia.edu/japan/alternatives/.

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# SHOULD HEDGE FUNDS BE REGULATED?

November 17, 2004

From left to right: Mark Mason, Harvey Goldschmid, John Gaine, Sudhir Krishnamurthi, Franklin Edwards, and Nobuyuki Kinoshita

## MARK MASON

**Director, Program on Alternative Investments, Center on Japanese Economy and Business, Columbia Business School**

Good afternoon. I am delighted to welcome you to this afternoon's symposium, "Should Hedge Funds Be Regulated?" It is perhaps an indication of the importance of today's theme that such a large audience, representing the business, government, and academic communities, has chosen to attend. We hope you find the symposium balanced and informative.

It is an honor to introduce Glenn Hubbard, the distinguished Dean of Columbia Business School, who will now offer the opening remarks. Glenn?

## GLENN HUBBARD

**Dean, Columbia Business School**

Thank you, Mark. This past July, in a split vote, the SEC adopted a rule for hedge fund registration. This decision was controversial; I think the Federal Reserve and the Treasury weren't uniformly supportive. I will put myself in that camp as well.

There are some very tough economic questions that no doubt will come up in the discussion today. There are always, of course, a few fraudsters in any industry and in any part of financial services. When one thinks about any sort of regulatory regime, the comparison of benefits and costs in addressing fraudsters is a key issue.

What about retailization and the involvement of the "little guy" through pensions? An interesting question, although pension investments and commitments in hedge funds are just a little more than one percent of the assets of pension funds—far smaller, for example, than pension fund commitments in private equity. I guess one could then ask, might that be the next stop?

Another question from the land of cost-benefit analysis is whether the

*When should the government leave people alone and let markets operate, and when should it impose rules and regulations?*

*—Hugh Patrick*

use of resources to regulate hedge funds is meritorious, as it might drain resources from other areas that are more related to the protection of ordinary investors. Would the regulatory regime that we're now contemplating have prevented some of the bigger problems we've seen in the past in this industry? For example, Long Term Capital Management? The answer is maybe "yes," but more likely "no."

We have a great keynote speaker today, a great panel, and a lot of great questions. So at this point I want to turn the program over to my colleague Hugh Patrick to introduce our keynote speaker.

**HUGH PATRICK**

**R. D. Calkins Professor Emeritus of International Business**
**Director, Center on Japanese Economy and Business**
**Columbia Business School**

Thanks very much, Glenn. It is both my privilege and my pleasure to introduce Harvey Goldschmid, commissioner at the U.S. Securities and Exchange Commission. He has had a distinguished career as Dwight Professor, a chaired professorship at Columbia University's Law School. Over his career, Professor Goldschmid has been an active leader in analysis and policymaking in a range of important areas where government regulation and the private market interact and intersect: trade, antitrust, and, of course, securities regulation.

In my view, Professor Goldschmid epitomizes the idealized role of what a law professor should be. Over his career he's taught and done research that has focused directly on major issues of public policy. Most importantly, he's put his body where his mouth is. He's gone down to Washington and served earlier with the SEC. I think academics have the responsibility to represent the public interest, seeking the public good rather than the vested interests of companies, government bureaucrats, politicians, or anybody else who tries to lobby the public policy process. Professor Goldschmid performs that independent, objective role very well.

Of course, determining what policies best serve the public interest is by no means easy. When should the government leave people alone and let markets operate, and when should it impose rules and regulations? What, specifically, should they be? Once regulations have been imposed and we're in the new world, what does that really mean? How are they implemented and how far do they go? Those are the sorts of issues that we want to address today. We're very fortunate to have Commissioner Goldschmid with us, and, if you don't know where he stands on these issues, you will find out right now. Thank you.

**HARVEY GOLDSCHMID**

**Commissioner, U.S. Securities and Exchange Commission**

It's always a great pleasure to be back at a Columbia Business School event. The comments I make today are my own and do not necessarily represent the views of the Commission, my fellow commissioners or the Commission staff. That's our normal disclaimer. The short form of that is nobody in Washington has to take seriously anything I say today.

This is an important topic. As the panel will indicate afterward, good minds can differ. Glenn Hubbard has already suggested that. But, as for the question, "Should hedge funds be regulated?" my easy answer to that is "yes," at least in the way the SEC wants to do it. On October 26, I was one of three votes, in a three-to-two Commission vote, in favor of registration.

Before I explain my reasons for voting in favor of registration, let me put the hedge fund issues in a larger context—the context of securities regulation reform in response to the corporate and mutual fund scandals of the 1990s and early 2000s. I suspect it would be common ground in this room to suggest that the scandals have been the most serious in the United States since the Great Depression. It should come as no surprise to anyone that this has been the busiest period in the history of the SEC, with the possible exception of the period around 1934, when the Commission was created and new programs and procedures had to be put into effect.

In terms of causation, my bottom line is that the scandals occurred due to a systemic failure. The checks and balances that we thought would be provided by independent directors, independent auditors, securities analysts, commercial and investment bankers, lawyers, and compliance personnel too often failed. As most of you know, during the past two years serious SEC enforcement efforts and rule-makings have come in each of these areas. The rule-makings and the enforcement efforts have involved some combination of increased and timelier disclosure (certainly true for public corporations and mutual funds) and enhanced responsibilities for key actors—for directors, officers, accountants, lawyers, and others in the financial community.

In addition, in institutional terms, the Public Company Accounting Oversight Board (PCAOB) and new "reporting up" rules for lawyers are making a large difference. The PCAOB and the rules for lawyers have changed both the substantive standards and, more dramatically, the way we conduct oversight of accountants and lawyers working with public companies. We've moved from a system of weak state regulation and self-regulation to a federal presence. Now, to varying degrees, there is federal oversight of both professions.

For unregistered hedge fund advisers who have been saying "Why us?" I say, you're not alone. Everybody involved with public corporations, mutual funds, and Wall Street has been looked at, and there's been a tightening across the board.

To illustrate the Commission's regulatory approach and to begin to answer a criticism posed by a very fine paper written by Professor Frank Edwards, let me briefly explain the causes of,


Harvey Goldschmid

and the SEC responses to, the mutual fund scandals. To quote Frank Edwards, "Fraudulent activity occurred in the highly regulated mutual fund industry where the SEC examiners were already inspecting funds and the SEC failed to turn up evidence of the frauds." Now, Frank was kind enough not to cite State Attorney General Eliot Spitzer running ahead of us (on a very good tip) in September 2003, but implicitly—and these are my words, not his—he was suggesting: "Why would SEC inspections or examinations of hedge funds be valuable in the context of the SEC's failure to find out what was happening at mutual funds?"

Step back with me and think about the mutual fund scandals. We have witnessed a grievous breach of trust in the mutual fund area. The seriousness of the scandals can only partially be measured by the money involved. We have roughly quantified shareholder losses at $2 billion in the investigations and enforcement actions we've taken so far; with what's in the pipelines, that number may jump to $3–5 billion. That's a lot, but if you think of Enron, securi-

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> *—Harvey Goldschmid*

ties holders lost $60 plus billion; if you think of WorldCom, $120 plus billion was lost. So the mutual fund scandals were not so much about the money as about the breach of trust in a business in which trust was the core of what was being sold to more than 90 million Americans. The level of what went on in terms of late trading and in-and-out fast trading (abusive market timing) was a special problem no matter how you look at it. What did we do about it?

First, and this is the usual SEC approach in terms of scandals, the Commission moved quickly on a combination of enforcement cases and rule-makings. In terms of rule-makings, the idea was to eliminate the temptations and abuses that went with market timing, late trading, and other practices that we've now prohibited, such as directed brokerage. Then, we worked on enhancing disclosure and mutual fund governance reform.

Getting back to Frank Edward's point, let me use late trading as a way of explaining what SEC inspections can and cannot do. Going into a mutual fund, our inspectors would not have been able to see late trading. Indeed, that information came to Eliot Spitzer through a tip. The papers and documents at the banks, brokers, and funds were fraudulent. They showed the trading had taken place before 4:00 p.m. No inspector could have known that was untrue had he or she looked at the mutual fund itself.

But if we had been going into the hedge funds—there were 30 or 40 or maybe more that were involved in egregious ways—it would have been easy for our inspectors to have seen what was wrong. Using any kind of risk analysis, and looking at how money was being made, it is perfectly clear to me that had we been inspecting hedge funds, we would have picked up the scandals earlier.

Now, you should all understand that late trading is simply looting. Events have occurred after the markets closed at 4:00 p.m., and you know that, as a result, dramatic portfolio changes will occur. In good news situations, late trading allowed hedge funds (and others) to buy at cheap prices. Eliot Spitzer correctly said it was like betting on a horse race after the race has been run. It took no skill, no intelligence, and no financial acumen of any type. It involved corrupt payments to those who facilitated the late trading. That's the basic background in terms of what went wrong in mutual funds, and, obviously, the hedge fund linkage is real.

Let me begin talking specifically about hedge funds by confronting the myth that a rush to judgment has taken place. The new hedge fund adviser rule and amendments were approved by the Commission on October 26. This action was the culmination of a long and serious process. We weighed carefully the concerns of the hedge fund community and others worried about counterproductive effects. We looked at possible less restrictive alternatives, but they were inadequate compared to what I believe is a modest, pragmatic, balanced regulatory approach.

In trying to think through these issues, I asked myself, "Why alter what has been the SEC's largely hands-off approach with respect to hedge funds?" We've always prosecuted fraud, but the question is: "Why intervene now? What compelling public policy concerns would get you there?"

First, we know too little about this dramatically growing industry, and what we do know has alarm bells ringing, at least for me. Eight or ten years ago, hedge funds held roughly $100 billion in assets. In September 2003, an SEC staff report put the figure at $600 billion. When the Commission acted on its proposed rule-makings in July 2004, hedge fund assets were estimated to be $850 billion. Most estimates suggest that there will be a trillion dollars in hedge funds by the end of 2004. Moreover, all of these figures are from industry sources and are unreliable. Some Wall Street estimates have suggested a $1.5 trillion figure. We need accurate information about the aggregate size of hedge funds, about how leveraged they may be, about their trading patterns, etc. More—and more accurate—information will both protect investors and significantly enhance the Commission's ability to protect our securities markets.

Second, there has been a recent increase in cases involving hedge fund fraud, both on hedge fund investors (e.g., involving misappropriation, false valuation, and fraudulent promotion) and on others. Canary and too many other unregistered hedge fund advisers had a corrupting influence (e.g., through "sticky assets" and side payments) on mutual funds that resulted in the late trading and abusive timing scandals.

Finally, there is the issue of retailization that Glenn Hubbard mentioned earlier. Hedge funds are no longer dealing just with the funds of the wealthy. More and more, the general public's savings and charitable funds are being put at risk. Hedge funds are involved with large and sharply increasing amounts from private and public pension funds, funds of hedge funds, and endowments and other charitable institutions. My cab driver in New York yesterday owned the medallion to the cab. He told me that he was about to begin to put money into hedge funds. Under the rules of the game now, plumbers, cab owners, lawyers, and pharmacists all are qualified to invest. I think Frank Edwards is going to try to make a case that that's good, but these are risky ventures and do not make sense for most of those kinds of investors.

*We know too little about this dramatically growing industry, and what we do know has alarm bells ringing.*

*—Harvey Goldschmid*

Now, in terms of cost-benefit analysis, what are the advantages of the kind of regulation of investment advisers to hedge funds being contemplated? One—accurate information about the funds themselves will not be available to investors (e.g., on aggregate size, leverage, etc.). Two—disclosure about the hedge fund advisers will take place. Such adviser information is now generally available to investors who do "due diligence," but now the information will be publicly available. Such disclosure will deter fraudsters from entering the business and save investors separate, costly, duplicative investigations and other "due diligence" expenses.

Why would you want to have "due diligence" investigations repeated time and time again by different investors as opposed to making the information available publicly and all in one place? Three—there will be record-keeping requirements, but, again, not at all onerous. Typical accounting records are already normally kept, and there will be some special requirements from the SEC. But again, these will be very moderate. Four—there will be protection for when the hedge funds keep custody of client assets. Again, it will be a safeguard that's very useful but not very costly.

Five—there will be compliance safeguards. A chief compliance officer and internal compliance programs will be needed. The hedge funds covered will have a minimum of $25 million of assets to be in the federal system. Who would want to invest in a fund without a serious compliance program? The same thing is true of ethical codes that are going to be required.

Finally, there's a good deal of discussion (that goes back to Frank Edwards' earlier point) about whether SEC examinations and inspections of hedge funds would make a difference. Clearly, I think they would have made a big difference in exposing the mutual fund scandals, and I think that's a consensus view of the staff at the Commission. But the examination program is even more important than that. Roughly 40 percent of investment advisers to funds are registered with the Commission today. Five of the eight cases brought against registered advisers in the past three years have come by way of SEC inspections.

More importantly, inspections, and the threat of inspections, bring about accountability and deterrence. I'm not suggesting that inspections are going to catch all fraudsters or that all will be deterred. But, whether one analogizes to tax audits or police patrols, one knows that the risk of getting caught and punished has a significant deterrent effect, particularly on white-collar wrongdoers. The threat of SEC inspections, which are getting more sophisticated, is a real disincentive to wrongdoing.

Now, of course, the issue of the SEC's ability to carry out these examinations and inspections is fairly raised. Again, the figures are soft, and the data are imperfect, so we don't know exactly how many additional inspections will be required. The estimate is for roughly a 12 percent increase in inspections. I'm satisfied that the Commission staff will be able to do the job effectively. We now have serious compliance programs for investment advisers in general (these went into effect in October 2004). Also, we are growing more efficient, more sophisticated, and our risk-based assessment programs and tools will allow the SEC staff to increase its inspection capacity. In the unlikely event that the staff is stretched too thin, the Commission has the ability, if necessary, to raise the current $25 million figure and reduce the number of inspections. In terms of planning time, the increase in inspections does not take effect until February 2006.

*Disclosure will deter fraudsters from entering the business and save investors separate, costly, duplicative investigations.*

*—Harvey Goldschmid*

The Commission's regulatory approach to hedge funds is meant to be nonintrusive. There will be no interference with their investment strategies, with their operation, with their creativity or liquidity, or with their flexibility. In general, the costs of this regulatory scheme will not be very high. The world is full of thousands of investment advisers who are now regulated, and that regulation has not been burdensome in terms of either time or dollars. Again, roughly 40 percent of the hedge fund industry is already regulated through registered investment advisers.

Hedge fund advisers will be able to continue their current investment programs without SEC interference. Derivative trading, leverage, short selling—all of these will continue without any interference from the SEC. Similarly, there are no portfolio disclosure provisions.

A hedge fund's ability to keep things secret (e.g., trading strategies and portfolio composition) will continue. In terms of what we're doing, hedge funds will be able to continue to charge their clients performance, just as they do now.

There is a modification, a tightening, in terms of who can invest, but the Commission has grandfathered all current investors. After February 2006, you'll need $1.5 million of net worth rather than $1 million, and getting into hedge funds with just $200,000 or $300,000 of income won't be possible, except for those who have been grandfathered. I think that's all for the best. These are not investments that ought to be open to everybody; there is simply too much

*The rule is going into effect, and we're looking forward in a very positive way.*

*—John Gaine*

risk in the kind of trading that's being done.

Let me close on two notes. One, a rational regulatory system responds to warning signals and to substantial and growing risk. This is the context in which the Commission moved ahead on October 26. Given the substantial and growing risk for the millions of investors who are involved in pension funds, in funds of funds, and in other investment vehicles with hedge funds holdings, the SEC simply could no longer turn a blind eye.

Finally, on an optimistic note, please understand that over the past two years serious SEC rule-makings and enforcement efforts have occurred in area after area. Officers and directors, accountants, lawyers, and others in the financial community, now including hedge fund advisers, have been dealt with sensibly and with balance. In general, the scandals of the 1990s and early 2000s have forced us to face serious systemic imperfections, but they've also made it possible for us to bring about healing and reform. My view is that what's been done will allow the United States to maintain its status as the world's leader in corporate accountability, disclosure, and financial integrity.

## Discussion

**Question:** I'm very much appreciative of the comments you made regarding the fact that the business model and functioning of hedge funds will not be interrupted by these regulations, and I would tend to agree for most of the larger, better-capitalized institutions. The question is, "What tax does this impose on the smaller shops, and does that lead to an anticompetitive pressure where the incumbent only gets stronger and can raise fees?"

**Goldschmid:** Antitrust is one of my academic fields, and so entry barriers are very important in terms of my thinking about what we're doing and why we're doing it. That's why I stressed how little we are asking of investment advisers. You start with an investment adviser with $25 million or more in terms of the assets being managed; there's very little in what the SEC is asking that's costly. Indeed, thousands of investment advisers are already out there and living quite easily with what we have imposed. My view is there's no significant entry barrier here at all. Small funds will continue to develop. The large guys will be run even more effectively, and there will be more security for everybody concerned.

**Question:** Do you think there should be a balance struck as we do with most other sophisticated products in the product market—automobiles, firearms, etc.—where the user standard may not just be simply a net worth test but rather a sophistication test, or a hiring of sufficiently sophisticated monitors and intermediaries, as opposed to just simply handcuffing or putting a lot of pressure on the managers?

**Goldschmid:** Well, they have very little handcuffing here, as I see it, and the idea is to let the market decide. However, there will be a slight increase, at least for those not grandfathered, in the kind of wealth you'll have to bring to the table.

**Question:** Would it be correct to say that, in its efforts to register hedge funds, the SEC has primarily been emphasizing investor protection rather than systemic risk concerns? Do you share the Fed's

John Gaine

sense that as long as you're regulating the counterparties to hedge funds, you don't really have to worry so much about the systemic concerns?

**Goldschmid:** I share Chairman Greenspan's high regard for the economic functions performed by hedge funds. Certainly, investor protection is a principal SEC focus. But I am also concerned about market integrity in a broader sense. Consider the fact that hedge funds generally are trading more than others and that we had the problem of hedge fund corruption of mutual funds. It's important to know what we're dealing with; when they get more than $1 trillion, and maybe higher, one ought to understand the impact of hedge funds in an economy like ours. We ought to know what we're talking about in terms of risk, trading techniques, and leverage.

## Panel Discussion

**JOHN GAINE**

**President, Managed Funds Association**

Thank you, Mark. The Managed Funds Association has been very much engaged in a number of issues relating to the hedge fund industry and, in particular, over the last several years with the SEC in their dialogue concerning what to do about hedge funds. I feel a little bit like the Red Sox playing up at Yankee Stadium here, but, hopefully, the outcome will be as good.

Of course, Commissioner Goldschmid is a very worthy advocate. When Mark Mason was kind enough to invite me weeks ago, I said this is really going to be fun, because we can roll up our sleeves and we'll get right down to the merits of a rule, what the policy implications are, what the justifications are, etc., etc. Well, I have it on good authority that Commissioner Goldschmid went to Chairman Donaldson in mid-October and said, "Look, I've got to defend your rule in front of 150 of the brightest people in the country, including Frank Edwards and Dean Hubbard; we've got to adopt it before I go up there so I don't get murdered." So Chairman Donaldson scheduled the vote on the rule for October 26, and it was adopted in a three-to-two vote, which has the effect of tempering my remarks considerably, because I will work cooperatively, fully, diligently, friendly, and professionally as I always have with my friends at the SEC.

If you go to the MFA Web site, you will see a plethora of information outlining our case against regulation. To get into this at this point would be akin to saying that Al Gore is really president of the United States. The rule has been adopted. The rule is going into effect, and we're looking forward in a very positive way.

I am tremendously reassured by Commissioner Goldschmid's reiteration of his statements that, as long as he is around, this registration requirement will be nonintrusive, and noninterfering with the liquidity, the flexibility, or the innovation of the hedge fund market world, because this is really underlying a lot of our concern.

Unfortunately, as Commissioner Goldschmid pointed out, we had Enron—public shareholders taking a bath; WorldCom—public shareholders taking a bath; mutual funds—94 million Americans taking a bath. There was a grievous breach of trust by the mutual fund managers to their investors. I agree with all of that. Why is that different from hedge funds? Hedge funds are an institutional marketplace. Their investors are high net-worth individuals and institutions.

As one lawyer in Washington says, "Every widow in Chevy Chase is an accredited investor." Well, that's right, because if your home is worth $1 million, that makes you an accredited investor. We've asked the SEC to double or triple this criterion and raise the $200,000 annual salary minimum. This will draw a clearer, crisper, more appropriate line, in our view, between the "mom and pop" retail investor and the institutional marketplace. That we do support; the SEC apparently does not.

You're going to hear from Frank Edwards later. I think many of the arguments he has made in his paper are very similar to the kinds of arguments we have been making over the last couple of years at the SEC. This hedge fund initiative was kicked off by former Chairman Harvey Pitt in May 2002 in front of the Investment Company Institute, which is the mutual fund lobbying arm. He said there are three areas of concern: one was retailization; one was the incidence of fraud; and the other was the side-by-side management of a mutual fund and a hedge fund with the obvious conflict of interest potential for allocation to the fund that would give you a better return.

Upon examination, fraud didn't appear to amount to much on the retail side. It doesn't exist. We want to raise the standards for investing in hedge funds, and we think there's plenty of authority to handle that at the SEC.

We had all these Enrons and the environment was bad, so in a sense I think the baby is going out with the bath water. The Commissioner's remarks, as well as those of Chairman Donaldson and others who were proponents of this rule, are reassuring, saying that it really stops here at water's edge. If you speak to Fed Chairman Alan Greenspan or Treasury Secretary John Snow, other financial regulators, and the biggest players on Wall Street, they would have a fit if you started telling them that the hedge funds they invest with on a regular basis were going to have their investment activities chilled. This is the lifeblood of the economy for these large investors; they live and die for it.

While I'm up here, I'd also like to bring up, Mr. Commissioner, my seat assignment at the Hedge Fund Roundtable in May 2003. I don't know if you ever remember flying the old 727 jets, but if you get the rear seat, it's like row 38—the seat doesn't go back. Well, they sort of gave me the middle seat of that row between Commissioner Goldschmid and Doug Scheidt—the chief counsel of the Division of Investment Management. I was in a position where I couldn't take a note, I couldn't turn a page. So I had to pretend to be going to the bathroom so I could check my e-mail and see what was going on. Apparently, the case for this rule was made during those periods when I was out of the room, because I don't recall any other time during which the case for this new rule was made.

Anyway, on a positive note, and I am sincere about this and my remarks about Commissioner Goldschmid earlier, I have always been in touch with Paul Roye, who is head of the Division of Investment Management. What we need to insure is education. There is little understood about this industry across the board. Journalists are coming up to speed very quickly. Some of the policymakers are coming up very quickly. We need to sit down with the SEC. I spoke to Paul Roye this morning. We've been approached by the SEC's Risk Assessment Task Force, and I am hopeful that we will be able to engage in a meaningful dialogue, which will result in efficient risk-based audits that will be nonintrusive, as the Commissioner hopes. They will produce the information the SEC feels it needs and, when you graduate with your M.B.A., there will be a hedge fund industry for you to come into and succeed in.

On that note, I'll finish. Thanks for your time.

Sudhir Krishnamurthi

**Mason:** Thank you, Jack. Our next speaker is Sudhir Krishnamurthi, who is a managing director of the Rock Creek Group. As you may know, Rock Creek is a large and reputable fund of hedge funds based in Washington, D.C.

### SUDHIR KRISHNAMURTHI
**Managing Director, Rock Creek Group**

I think many of the arguments and points as to why we need regulation have already been made, and I would like to just go over them, very quickly, just to set the stage so that we can have a more meaningful debate.

The size of the business has grown. It's a trillion-dollar business, which obviously has implications for the rest of the securities industry. Even though the hedge fund industry itself has qualified investors and all that, the point is it is a big elephant sitting in the den. So the rest of the securities industry is going to be affected. That's the reason why you want to make sure that you know what the elephant looks like, very much along the lines the Commissioner was just noting.

The case is that there has been fraud. Now, people have said the level of

*There are about 8.2 million households in the U.S. that have more than $1 million in net worth.*

*—Sudhir Krishnamurthi*

fraud was minimal, but is that because they haven't searched hard and deep enough, or is it that we have searched hard and deep and that's all the fraud we could find? That point is still a little unclear. If one can take the same argument in the insurance industry before Mr. Spitzer got into the brokerage business, for example, there was no fraud, but now, after the investigations, the story is likely different. The question is, have we investigated all that we need to?

It is true that hedge funds are for institutional clients, and I think that's obviously clear, but there are more and more exposures to other clients. Now, is $1.5 million or $1 million a lot of money? Not really. There are about 8.2 million households in the U.S. that have more than $1 million in net worth without including a spouse and private residence. So that's a large number, and that's a number for whom some protection needs to be given, even if the size of the investment is kept reasonably high.

Those are some of the key points. Now, I believe that the kind of frauds that will be perpetrated by somebody in the hedge fund industry would be no different from what some have committed when given the same opportunities in the mutual fund industry or in any financial business. Human nature is what it is. So if there's fraud in one place, there's no reason to believe that there won't be fraud somewhere else. So the two points that I think the Commissioner was making—about compliance and deterrence—were exactly dead on.

The final point is that there are two issues. One is the whole issue of compliance: how expensive is it, and is it really going to be too costly to the industry? In fact, we did this study, and we obviously talked to a large number of hedge funds in the industry (we did this before the October 26 ruling, and we've been doing it since). Most hedge funds will make some fuss about it, but when you really push them, they say the cost of compliance is really, in the larger scheme of things, very small. So I would say it is not the cost but the magnitude of the cost in relationship to the overall size of the business, which is very small.

At the end of the day it is just good business practice. Many of the things that are required under registration or regulation are things that a good business would oversee anyway, things like conflict of interest, voting proxies, whatever. Those are all things that a good financial business would do in any case. Thank you.

**Mason:** Thanks very much, Sudhir. We will now hear from Frank Edwards, the Arthur F. Burns Professor of Free and Competitive Enterprise at Columbia Business School. Frank is an unusually well-qualified scholar to speak on today's topic, given his formal training in law as well as finance.

### FRANKLIN EDWARDS

**Arthur F. Burns Professor of Free and Competitive Enterprise, Columbia Business School**

I appreciate Commissioner Goldschmid's willingness to be here today, because he probably had some idea that he might be running into a free-market bias against regulation. And indeed that is going to be my position today—that the SEC's regulatory initiative on hedge funds is not a good idea. Requiring hedge fund advisers to register with the SEC is unlikely to accomplish much, and it does not pass the required cost-benefit test.

> *Why should far less wealthy taxpayers have to support government regulation aimed at protecting wealthy investors?*
>
> *—Franklin Edwards*

But let me back up a bit and ask why we haven't regulated hedge funds before now. Why do hedge funds enjoy exemptions from the 1933 Securities Act, the 1940 Investment Company Act (ICA), and the 1940 Investment Advisors Act (IAA)? Hedge funds can take advantage of the "accredited investor" exemption from the 1933 Act (or the private placement exemption). To be an "accredited" investor, you need either $1 million of net worth or an annual income of $200,000. Why do we have this exemption? Why have we exempted investment vehicles with only accredited investors? Because we have a philosophy that it should not be necessary to expend taxpayer funds to protect wealthy and sophisticated investors, such as "accredited" investors are assumed to be. These investors should have to take care of themselves.

Hedge funds also are exempt from regulation under the 1940 ICA (mutual funds) for a similar reason: they typically have only "qualified" investors. These are investors with at least $5 million of investments. Under our standard approach to regulating financial markets and financial instruments, investment vehicles with only "qualified" investors are exempt from regulation because these investors are assumed to be sophisticated enough to take care of themselves, and if they aren't, they can at least afford to take the hit. Why should far less wealthy taxpayers have to support government regulation aimed at protecting wealthy investors? There should be better uses for taxpayer funds.

Of course, if we were concerned that some "accredited" investors in hedge funds were not able to take care of themselves, an obvious and straightforward remedy would be to change the accredited investor standard—to raise the requirement to an annual income of $500,000, for example. The SEC does not propose doing this but rather seeks to bring all hedge fund advisers under the umbrella of SEC regulation, no matter what type of investors they may have. This approach is a significant departure from our current policy of not expending taxpayer funds to protect wealthy and sophisticated investors.

The SEC's rationales for pushing such a significant departure are, first, that hedge funds are prone to having a fraud problem, and, second, that there is a growing "retailization" of hedge funds. It must be noted, however, that the SEC does not present much evidence to suggest that fraud in hedge funds is much of a problem. Yes, fraud does occur in hedge funds, but the losses pale in significance compared to, for example, investor losses incurred because of the recent "late-trading" scandals in mutual funds—an industry, by the way, that the SEC already intensively regulates. And the investors harmed in the mutual fund scandals were not the "qualified" investors typical of hedge funds but the low-to-moderate income investors who probably do need regulatory protection. The implication is hard to miss: we might be wiser to devote more taxpayer resources to protecting mutual fund investors than to protecting hedge fund investors.

Further, there are private mechanisms that hedge fund investors can use to protect themselves. They can custodialize assets, for example, as

Franklin Edwards

do mutual funds, and demand that hedge fund managers be monitored by prime brokers, who would be responsible for the valuation of the hedge fund assets. In many ways I think a private market examiner can work better than a government examiner in understanding and monitoring the complex portfolio instruments often used by hedge funds.

Indeed, given the dangers that the SEC warns about, how can we explain the $800 billion already invested in hedge funds? And why should hedge funds be growing so fast if investors are susceptible to being ripped off through fraudulent activities? Are all of these hedge funds investors simply naïve? Or, is it that the risk of fraud is not as great as the SEC would have us believe, or that there are effective private mechanisms by which investors can control this risk? My guess is that investors know more about this risk than does the SEC.

The SEC also argues that there is a trend toward the "retailization" of hedge funds—or that less wealthy and sophisticated investors are gaining access to hedge funds through innovative investment vehicles. If this is the concern, a straightforward response would be to raise the "accredited" investor standard so that less sophisticated investors would be excluded. But the SEC does not propose this. Alternatively, another approach (not discussed by the SEC) might be to embrace the concept of greater investor access to hedge funds, but only under a certain institutional structure that would provide some protection for less sophisticated investors.

Instead, the SEC proposes to require the registration of virtually all hedge fund advisers, arguing that this would provide the necessary investor protection at little or no cost. Any hedge fund adviser, incidentally, can already register with the SEC any time he or she wishes to; and many have already done so. Presumably, hedge fund advisers would register if they believed that investors wanted them to and that it was cost effective to do so—that the attraction to investors would generate sufficient profits to offset the cost of SEC regulation. For example, institutional investors (such as pension funds) may prefer to deal only with SEC-registered hedge funds. But what does that imply about the thousands of hedge fund advisers who have not chosen to register? An obvious possibility is that there are in fact costs associated with registration or that many hedge fund investors do not really care whether advisers are registered with the SEC. I don't accept the idea that all or most of the hedge fund advisers who have not registered are all just scoundrels or that all of the hedge fund investors invested with unregistered advisers are just naïve about the risks.

In my view, the SEC's proposal also fails to satisfy the required cost-benefit calculation. The SEC seems to start with a different paradigm from mine, which is that if there is little or no cost associated with regulation, let's regulate. I start philosophically and ideologically at the other end of the spectrum: if there are little or no benefits, we should not impose regulation on markets. Admittedly, underlying my philosophy is a view that there are embedded costs to all regulation and government interference with private markets. As such, I want to be sure that there are significant and important benefits from regulation. It's a difference in philosophy, but an important one. It requires the SEC to make the case that there are likely to be important benefits from requiring hedge fund adviser registration. Otherwise, it should not be extending regulation. In my view, the SEC has not met this test.

An argument made by Commissioner Goldschmid today that I had not really focused on before is that wrongdoing in mutual funds (such as the recent scandals) would be easier for the SEC to police if the SEC also policed hedge funds. This may be right. If the SEC had been looking at hedge funds, it might have picked up on the fact that some hedge funds were just trading mutual funds, which would have raised a "red flag"—how could it be so profitable to trade in and out of mutual funds? But to argue that we must regulate hedge funds to protect mutual fund investors seems like a stretch. If we can't protect mutual fund investors by regulating mutual funds directly, we clearly have a problem that needs to be addressed directly. Further, where do we draw the line: do we have to regulate all investors in mutual funds, or just some? And, if just some, which ones? To go down this path takes us far afield from whether hedge funds need to be regulated.

Finally, I think the right mindset with which to approach regulating hedge funds is that we should be trying to make hedge fund investments more, not less, available to investors. The SEC appears to have the opposite view—that the objective should be to further restrict the availability of hedge funds. I believe there is evidence to support the view that hedge funds offer investors different investment strategies that can be used to increase diversification and enhance risk-adjusted returns. One possibility is to permit a broader distribution of "funds of hedge funds" under an institutional structure that provides protection for smaller, less sophisticated, investors. The task should be to determine exactly what that institutional structure should be. What disclosure regulations or risk controls would be needed? As far as I can determine, neither the SEC nor anyone else is thinking along these lines, which is unfortunate.

While I do not agree with the SEC on hedge fund regulation, I want to say that I remain a big fan of the SEC. For example, I think the SEC's recent proposal to increase shareholder access to the election of corporate directors is a good idea, and I hope it persists in making this happen. Indeed, I can't help wondering why the SEC is using up any political capital on its proposal to regulate hedge fund advisers when it has so many other very important initiatives going that promise much greater benefits.

In conclusion, I want to again thank Commissioner Goldschmid for his willingness to be here today and to engage us in discussion.

**Mason:** Thanks very much for those comments, Frank. Our next speaker is Nobuyuki Kinoshita, a senior official at Japan's Financial Services Agency who has also served in the Japanese Ministry of Finance. All too often the U.S. debate over hedge fund regulation has failed to take into account any significant international dimensions, and so we are particularly fortunate to have the opportunity to hear from a representative of another of the world's leading economies on this topic. I might add that Mr. Kinoshita is currently a visiting fellow at the Center on Japanese Economy and Business.


Nobuyuki Kinoshita

### NOBUYUKI KINOSHITA
**Director, The Financial Services Agency of Japan**

Thank you, Dr. Mason. I am currently a visiting fellow at Columbia University, sent by the Japanese Government, having a long career as a financial regulator and lawmaker, now in the Financial Services Agency, and formerly in the Ministry of Finance. Today I will make a small contribution based on my personal experience and my way of thinking as a Japanese policymaker. Please note that my speech does not represent the views of the Japanese Financial Services Agency.

Please keep in mind that the status of the Japanese Financial Services Agency (FSA) is different from that of the U.S. SEC or other governmental organizations. First of all, the FSA covers both the securities industry and institutional investors such as trust banks and life insurance companies. Additionally, I suspect that Japanese households' confidence in and psychological reliance on the government may be stronger than that of American households vis-à-vis their government. Furthermore, the tension between the FSA and the financial industry in Japan may be higher, especially with banks.

When we talk about the regulation of hedge funds, we should first of all discuss what the purpose of regulation is. In this context, we can consider two different purposes. The first is the protection of individual investors and the establishment of trust in the capital markets, and the other is the maintenance of financial markets' stability. When we consider these two purposes, we should be careful to avoid distortional side

*The target for us should be building the proper infrastructure for the various types of investment activities.*

*—Nobuyuki Kinoshita*

effects on financial markets as much as possible.

Next, we should discuss how to regulate hedge funds and consider two different types of measures. The first type is direct measures, such as regulations based on the Securities and Exchange Law and the Investment Adviser Law. The second type is indirect measures, such as regulations based on the Banking Law and the other regulatory laws of institutional investors. When we consider these two types of measures, we should be careful to maintain the consistency of the targets with the original purposes of the legislation.

Based upon this framework, I will first give a brief explanation of the Japanese situation, and then I will make some comments regarding the regulation of hedge funds in the United States. In Japan, we can find a growing demand for investment services like hedge funds. A considerable percentage of institutional investors are interested in investment in hedge funds, including funds of hedge funds. The amount of money invested by hedge funds in the Japanese capital market has been increasing year after year to several billion dollars. Furthermore, in connection with the industrial recovery, the importance of alternative investments is widely acknowledged nowadays. We are making efforts to gain a better understanding of hedge funds' activities.

However, a large part of the investments are supposedly made through foreign legal entities. We suspect there are various reasons for this situation, such as differences in business practices or the avoidance of regulations, but also the structure of the Japanese legal system, which must be an important factor. The target for us should be building the proper infrastructure for the various types of investment activities.

The first problem for policymakers when talking about hedge funds is the definition. We can point out the general characteristics of hedge funds, such as the performance fee, the unique investment strategy, including high-leverage, and lack of regulation to some extent. The "performance fee" feature is connected with managers, "investment strategy" can be connected with funds themselves, and the "regulation" feature is the theme of today's symposium. However, there is no single definition of a hedge fund we could quote as the definition in lawmaking.

When we take a bird's-eye view of the Japanese legal system, we see the strong civil law tradition adopted from Continental Europe, especially Germany. The system requires precise definitions of what is and what is not allowed. The forms of legal entity are fixed by legislation, such as civil law. We also have strict discipline in which a crime must be defined in an article of a law. The purpose of this discipline is the protection of people from arbitrary actions and punishments by the government. We follow this discipline in financial regulation laws as well, including the securities and exchange law and the investment adviser law, because the ultimate basis of these regulatory laws is legal punishment.

I want to focus on the first purpose, the protection of investors. In the Securities and Exchange Law, the concept of "securities" is defined in the very first part. Then the law prescribes all measures to protect investors who invest in these securities and, hence, regulates the related industry that provides services concerning the transactions of securities. The securities are defined one by one, following the concept of basic laws, such as civil law, trust law, company law, and law concerning several types of unions. Recently, we added the law for collective investment vehicles, which I believe will contribute to the development of an asset-backed securities market in Japan.

However, we have no legal concept of limited partnership, so that the transactions of equities of those partnerships are at the margin of the coverage of the Securities and Exchange Law. Market participants should consult us, for example, by requesting a no-action letter.

On the other hand, we have an established regulation system for securities investment, including collective investment vehicles. A fund manager is regulated by special duties for investors such as fiduciary duty, strict obligations of accountability, and control by the authority. In the case of public offering, additional regulations are enforced, such as public disclosure and the limit of leverage. We believe that the regulation system has a positive effect for the development of the market by helping establish the confidence of actual and potential investors.

As for advisers, we have the Investment Adviser Law. Those who want to advise securities investors as professionals register with the authorities as securities investment advisers. A securities investment adviser provides cash collateral and is subject to special duties for investors, such as fiduciary duty, strict obligations of accountability, prohibition of particular actions such as loss compensation, and supervision by the authorities. We believe the regulation of advisers also has a positive effect by cultivating the trust of actual and potential investors.

Through these laws, we regulate securities investments, including what hedge funds are concerned with in order to protect investors, although we have no specific regulation for hedge funds—partly because of the definition problem. Managers of hedge funds must register and obey the regulations if the conditions of these laws are applicable to them. The target for us is not a single issue such as regulation of hedge funds but building the proper infrastructure for various types of investment activities.

Currently, a considerable amount of investment activity in Japan is conducted from abroad through offshore legal entities or by foreign advisers. This phenomenon can be partly attributed to differences in business practices or the avoidance of regulation, but we believe the Japanese market can develop in a stronger and sounder manner by establishing a more flexible legal system. As the first step, we have already introduced the Limited Liability Investment Union as an additional investment vehicle in which equities can be treated as securities as defined by the Securities and Exchange Law. Furthermore, we are now discussing the introduction of a comprehensive legal system to protect investors and hence to establish confidence in the investment services industry.

Next, I will focus my speech on the second purpose, the maintenance of financial markets' stability. Hedge funds are frequently referred to as a source of systemic vulnerability or market dislocation, because of their high leverage and huge amount of investment. On the other hand, I know many who argue that hedge funds provide liquidity to the markets.

In this connection, we have the regulation of banks and other institutional investors such as insurance companies. The purposes of these regulations are the protection of depositors or insurance policyholders through the sound and proper management of these institutions. The stability of financial markets can be achieved as an extension of the original purpose of the regulation.

In Japan, we have an established regulation system based on the Banking Law. We have risk management supervision, capital adequacy ratio, limits on exposure, and limits on stock holdings. We also have strong supervisory measures such as the improvement order and inspection and systematic regulations for other institutional investors such as insurance companies.

As for implementation, we have established an off-site monitoring system for financial institutions based on a computer system, in addition to our inspection activity. We watch the risk position of an institution as a whole continuously through our system. The target for us is not an individual or specific exposure, but we monitor risk concentration as well. We collect risk-related data from every financial institution, make up a database of all financial institutions, analyze the data using our own software, and give feedback on the data to each financial institution. We have a special task force for the computer system of off-site monitoring, consisting of financial, engineering, and information technology experts. We have periodic consultations with management directors of financial institutions based on this information, as well as financial reports and results of on-site inspection of financial institutions.

> *We should weigh and maintain a balance between the effectiveness and the burden of the regulation.*
>
> *—Nobuyuki Kinoshita*

These regulations might have the effect of restraining excessive exposure of financial institutions' investments, including those in hedge funds, although we have no specific regulation for investment in hedge funds. As for possible future amendments, I am personally not so eager to introduce new regulations focused solely on financial institutions' investments in hedge funds. It might have the side effect of causing a distortion in the capital markets, and it would be technically difficult. Of course, the proprietary trading of financial institutions should be carefully monitored. The purpose of the monitoring should not be the restraint of specific exposure such as that to hedge funds but the maintenance of the sound risk position of an institution as a whole. Anyway, this issue is not limited to hedge funds but also related to all high-leveraged investments. This issue has been discussed on international stages, such as the Basel committee.

Next allow me to give my personal comments on the regulation of hedge funds in the United States, based on my personal experience as a policymaker. When we consider a new regulation, we consider the purpose of the regulation. In the case of the regulation of hedge funds, it partly depends on whether investors are sophisticated enough not to need protection.

As for measures to regulate hedge funds, we should weigh and maintain a balance between the effectiveness and the burden of the regulation. The objects, the contents, and the tempo of introduction of the regulation are important balancing measures. The factors to be considered for maintaining the balance depend on the situation of concerned market participants. In the case of the regulation of hedge funds, the balance is supposed to be quite delicate. If the result is excessively strong, the investment services currently provided through hedge funds would shrink or go abroad. If it is too weak, or if the government would not have enough resources to enforce the regulation, the new regulation arising from the registration system would be abused by unscrupulous firms as being a certification from the government.

According to my personal experience, the overall reliance on government is still high, especially among retail households in Japan. Regulation in Japan appears to give a false impression of governmental approval to whatever is being regulated. Therefore, I think that we should be careful to avoid abusing the use of regulations by making a halfway one. Once we decide to regulate, the regulation should be effective in law and implementation.

However, it depends on the significance of related factors that might be totally different in the United States. I imagine that the U.S. SEC and other institutions struck a balance between costs and benefits of the regulation after a careful examination of various factors in this country.

As a conclusion to my presentation, I would like to mention possible international impacts of the U.S. regulation of hedge funds. Investment activities through hedge funds are widespread in the international capital markets, not only the markets of industrialized countries like Japan, but also smaller and developing markets. If the United States introduces regulation of hedge funds, measures by which the U.S. maintains a balance between the effectiveness and burden of the regulation, this will have an important influence on international markets.

Therefore, the discussion regarding hedge funds in the United States should also reflect the consideration of the impact on the operation of small and developing economies. At the same time, consistency between the regulations in industrialized countries is even more important. Otherwise, regulatory "shopping" would occur, and a distortion would be caused by the capital flow outside the country. We have had international discussions on similar kinds of issues at international conferences supported by several organizations such as the International Organization of Securities Commissions.

Thank you very much for your attention.

## Discussion

**Goldschmid:** I have two quick comments, first on Mr. Kinoshita's presentation, and then on John Gaine's remarks. International issues related to hedge funds are very important and complex. You'll see in the SEC adopting release on hedge funds a very sophisticated set of provisions dealing with international funds. Some of the oversight that we'd apply to the U.S. funds will not be applied for international funds. We're very careful and work hard to make sure we don't cross lines or create special problems for funds in other countries.

> *Some of the oversight that we'd apply to the U.S. funds will not be applied for international funds.*
>
> *—Harvey Goldschmid*

John, I didn't mean to suggest that the corrupting influence of hedge funds exempts or somehow makes easier or better the reaction of the mutual fund managers. We've been very hard on mutual funds—and their wrongdoing managers—in terms of disgorgements, bars, and civil penalties. Those who were corrupted, or assisted the corruption that occurred, had to suffer. To make deterrence and accountability work, we've had to be hard.

You hear in John's comments a kind of decency and constructiveness. His group has indicated it will work with the SEC on a sensible regulatory scheme in terms of monitoring. That's just the kind of constructive attitude and insight that will make this system as effective as we want it to be.

Frank Edwards is obviously an old and highly respected friend—even when we differ. And he's right on about at least two of the three things he mentioned in terms of shareholder access to the proxy and mutual fund governance. On hedge funds—yes—it was another one of those areas that would create controversy, and we understood that. But it was the potential for harm if the SEC failed to act that I keep emphasizing. Yes, we are trying to protect investors, but it's also the magnitude of harm that could be created in a trillion dollar plus business that keeps jumping to mind. It's the amount of trading that hedge funds are doing. It's the corrupting role they played in what went wrong in mutual funds, and it's the need for us to understand what's going on in terms of the integrity of our markets.

Stepping back on the sometimes-controversial reform steps that have been taken over the past two years, think about the potential cost of the public distrust that had developed in 2001–2002. If you go back to the time of our greatest financial scandals during the Great Depression, shares on the New York Stock Exchange fell from $90 billion to just under $16 billion, and they didn't recover for a very long time. The activity of the Commission has made an enormous difference in the willingness of our public to believe in the integrity and the fairness of U.S. markets. So you can see, I take a certain pride in what the SEC has accomplished.

**Mason:** Thank you, Harvey. Before taking questions from the floor, I hope you don't mind if I leverage my position as moderator to ask a few questions of some of the panelists myself. Let me start with Jack. Jack, as I understand it, not all of your members are against the rule that was just passed by the SEC. First of all, is that true, and if it is—are there any discernable patterns? Is it the case, for example, that larger hedge funds that are members of the MFA are not so clearly opposed to the new rule as compared to other of your members? What's the situation within your own membership?

**Gaine:** Our position was that one should be free to decide whether to register with the SEC. If you're interested in ERISA money, a registered investment adviser becomes, by definition, an investment manager under ERISA, which I believe serves to reduce certain liability, which would make it a very attractive part of your business model. You'd look at the cost of SEC registration versus the benefits, as Dr. Edwards believes, and you'd say that there are some benefits. You could increase your investor base, and that made sense.

We have members who have made that choice and registered. So the issue was *mandatory* registration by the SEC, and on that issue there was a consensus. Then there was a majority who felt very strongly that registration did not make sense at all. While I can't give you a survey, we're not against voluntary registration.

*We're not against voluntary registration.*

*—John Gaine*

**Goldschmid:** The reason hedge funds are so successful, having gone from $100 billion to $1 trillion, in relatively few years, is because the model does make sense, at least for certain investors. It's not the model that's the problem and it's not the model we're regulating; nothing the SEC has done in its rule-making will interfere with short selling or arbitrage or anything else. The SEC does, however, need limited oversight to deter fraud and understand larger problems that could be developing.

**Gaine:** Your numbers could be right. I know that some of the largest hedge funds are in fact registered, but it comes back really to the role of government. I think it was Mark Anson, the chief investment officer for CALPers, who said he invested in 17 hedge funds. Nine are advised by registered investment advisers; eight are not.

## Audience Questions and Answers

**Question:** Mr. Kinoshita, in many ways, if I understand it correctly, your registration is close to what we've proposed. Until now we've said in effect that hedge funds are special and we would not have registration, but what we're doing I suspect will put us in the same place.

**Kinoshita:** Yes, it is true. We have the suitability rule in our securities exchange control but not such a specific regulation. I suppose we do not find any reasons to regard investment in hedge funds as extraordinarily risky beyond the self-responsibility principle.

**Mason:** I would like to ask Sudhir a question. Presumably, one of the ways that a reputable fund of funds such as Rock Creek adds value is to conduct detailed, in-depth due diligence of specific hedge funds that you might invest in. Is it fair to say that this new measure would in no way create information or provide you with information that you wouldn't have found out on your own?

**Krishnamurthi:** Would it put us out of business? The answer is perhaps "no." I think John said it right; we do a lot more due diligence than perhaps any SEC audit could ever hope to accomplish. We have many more resources, and our investors expect that of us.

There are two things that, as a fund of funds, we don't have. One is that we cannot call unannounced. We have to announce ourselves before we go. The SEC has the option of doing an audit on very short notice. The second is that the only deterrence we have is the ability to pull out money. We cannot criminally prosecute. I think those are the two areas where I think the SEC definitely has a little bit more clout, and it can prosecute criminally and make it a lot more difficult for the hedge fund managers. And that does create the deterrence and the accountability in terms of making the system workable, although notice there's some cost saving in this, too. The more due diligence you do, the better, so far as I'm concerned, and certainly we're not going to interfere. We encourage it to no end.

**Patrick:** On that point, I'm not a detective or a cop or even have a good nose for it, but Elliot Spitzer and Chairman Greenspan have said that we do not discover fraud on audit. I think if you can't prosecute, you can be a tipster. If you find fraud you can go to the SEC. That hedge fund that you were looking at is subject to the antifraud rule of the Advisors Act. The SEC can issue a formal order of investigation. Staff members can be in there tomorrow and follow up on whatever tip you give them because that is the thinking among that group. I know Commissioner Goldschmid disagrees. I don't know; the view there among these people is that a tip, a disgruntled employee, or a disgruntled significant other or spouse or something is how you get these things uncovered, not through routine examinations.

> *We do a lot more due diligence than perhaps any SEC audit could ever hope to accomplish.*
>
> *—Sudhir Krishnamurthi*

**Goldschmid:** It's obviously a mix of a whole bunch of things that creates effective inspection and enforcement systems. That's why I indicated that five of the eight cases that the SEC brought against registered advisers came about because of Commission inspections. They came about because of OCIE (the SEC's Office of Compliance, Inspections, and Examinations), and the number of times that occurs is real for broker dealers, for mutual funds, for others. Eliot Spitzer, of course, doesn't really have the capacity to do a large number of inspections. But inspections are an important part of the whole mix. They go with tips. They go with whistle-blowers. I have the world's greatest respect for Alan Greenspan, but he doesn't put 15 auditors into numerous banks because he thinks they can't discover things. I incorporate by reference my prior discussion of why SEC inspections have powerful deterrent effects.

**Question:** I manage a small Japanese equity hedge fund in New York. I started my hedge fund one year ago, after working at a Wall Street investment bank for 25 years. I went to a reputable law office last week for a seminar on compliance with respect to everything we have been discussing. There are an incredible number of regulatory requirements, and what you're advocating in these regulations will mean an enormous amount of compliance` costs and legal fees to an entity like mine. I'm almost debating whether I should continue on, because I honestly want to be fully compliant with every regulation there is, but the cost of start-up is enormous. This would be a great business for lawyers, but for an entity like mine, it is absolutely devastating. Do you categorize the degree of compliance requirements depending on the size of entities?

**Goldschmid:** It's an important statement, but be careful of the lawyers, if I can put it bluntly. There's nothing that you're being asked to do that's terribly onerous. We know that roughly 40 percent of investment advisers to hedge funds are currently registered, and there are thousands of small investment advisers out there who are regulated under present law. They're paying an average of roughly $45,000 to be able to comply. There is some danger that lawyers are going to make this seem more onerous than it really is, so you want to be careful in terms of the advice you are getting.

Realistically analyzed, there is nothing in this regulation that should put a small investment adviser for a hedge fund out of business or create an entry barrier that is significant. Come down and ask the SEC staff how to do it.

**Question:** I just have to say something in defense of the New York lawyers. Having represented probably close to a hundred hedge funds, I would say we have equal numbers of registered and unregistered funds. I think the start-up hedge funds, as you point out, don't have to register until $25 million, but it's the funds between $25 million and $100 million that aren't making enough from their basic investment management fee to cover the start-up cost of compliance. Once they know what they're doing, perhaps the ongoing cost is not as significant. But I think what was really underestimated was how much time, effort, and education it is costing. So you're starting a great business, but not for the lawyers. To be perfectly honest, lawyers don't want to get into the nitty-gritty of how everyone keeps their e-mails. We advise on these kinds of things, but there's a whole business springing up now of compliance people, outside people who will advise on compliance, but the initial cost of making the code of ethics, making the compliance manuals, getting someone within a small adviser who is going to be the compliance officer and take the responsibility is very big for that fund that's in the $25- to 100- million range. My question is: "Why the rush to pass it so quickly?" Our firm looked at the actual draft, and we saw so many ambiguities in it.

*The SEC has a continuing program that works with the financial and business communities to clear up ambiguities.*

*—Harvey Goldschmid*

**Goldschmid:** In terms of why we moved ahead, acting was consistent with sound public policy. We had done this over a period of several years. There was a report, then a proposal, and then comments were taken. In the final release, I think, you'll find a fair amount of guidance. The SEC has a continuing program that works with the financial and business communities to clear up ambiguities. We publish answers to questions that are commonly asked. We give "no action" letters in areas where there's been some ambiguity. In terms of a compliance date, it's February 2006. So there's a long lead time in terms of what's being done. There's plenty of room for questions, no action letters, reactions, more guidance, if needed.

I am concerned about small advisers. But I suspect by the time small advisers really have to comply, there will be computer programs and other things. It's not all that complex; its not all that difficult; there ought to be relatively easy forms for people to follow and computer programs to use.

**Question:** I teach at Rutgers University. Quite frankly, I find myself very troubled by a lot of what I've heard today. First of all, and I don't mean this to be personal, but the record of the SEC with regard to mutual fund behavior certainly doesn't comfort me with regard to what it might find with regard to hedge funds.

Secondly, I think there is a point in life where individual investors

*Once you have regulation, it is natural for regulators to tinker with it and try to make it better.*

*—Franklin Edwards*

acquire enough assets that they are assumed to be capable of taking responsibility for their actions. If that size is not appropriate at the present time, then it ought to be raised.

Thirdly, I'm troubled by the fact that all this might do is push the business offshore. It seems to me that unless there is some international agreement to provide some type of compliance or regulated requirements, all that's going to happen is that the business is going to leave the country, and the result is that you really will have accomplished nothing except to come down hard on the people who are new in this business, and I have a certain amount of sympathy for them.

But I do think that the underlying issue that really troubles me is the idea that people have to be protected from themselves, and if they're in unsophisticated institutions or pension funds, then there ought to be regulations applied to them across the board and not with regard only to hedge funds, because they could just as easily lose their shirts investing in real estate, salad oil, or anything else.

**Goldschmid:** *Caveat emptor*—buyer beware. You take it at your risk. This was often the thinking roughly a hundred years ago. We just don't think that way today. Sophisticated buyers may well need disclosure and protection from fraud. In terms of hedge funds, even if one were willing to use *caveat emptor* in its strongest form, it wouldn't prevent me from being concerned about the macro impact of hedge funds on the nation's economy, about the amount of trading hedge funds are doing, about their leverage and risk, etc.

As for hedge funds going offshore, I think that's just illusory, unreal. The issues raised here as to the small investment advisers and entry barriers are worth thinking about again. For big funds, the SEC's regulatory scheme is nononerous. You'd have to be irrational, or a fraudster, to put it bluntly, to want to go offshore because of what we're imposing. It's much too mild.

**Gaine:** I want to make one short comment on that. The SEC, Division of Investment Management, did a 50th-anniversary study of the Investment Company Act of 1940 and published it in 1992 or 1993. Included in there was a recommendation that Congress should adopt what eventually became Section 3(c)(7) of the 1940 Act, which is the provision that Frank Edwards alluded to, that for an individual with $5 million in invest-

From left to right: Glenn Hubbard, Franklin Edwards, Harvey Goldschmid, Hugh Patrick, and Mark Mason

ments then, you didn't need "protections of the federal securities laws." I can see it in the upper right-hand corner of your report, which is about 700 pages.

So Congress, as recently as 1996, has recognized this, that maybe there are better ways to do it, but that wealth, income, net worth, etc. serve as some proxy for something. Maybe it's because you can take the hit, maybe you know something, maybe you can afford to hire somebody, but it has been recognized, and I think we should be somewhat responsive as to what Congress wants.

If I could just finish on one quick story. Larry Summers, when he was secretary of the treasury, is in the middle of giving a speech. So some guy in the back stands up and says, "If you're so smart, why aren't you rich?" and Summers said, "Well, if you're so rich, why aren't you smart?" I think there's something to that, and whether this is the best proxy or not I don't know, but it's the only one we've had. We've worked with it for years.

**Mason:** Frank, one of the things I thought was very helpful in your paper was that you took a long-term perspective on the past development of the financial services industry and government regulation. I wonder if you have any thoughts looking forward? Is it your instinct that this is the first of many measures that will be imposed on the hedge fund industry, or do you feel that we've seen the end of it with this rule?

**Edwards:** All of my experience with regulation suggests that the registration of advisers will certainly not be the end of it. I think Harvey said it as well as I could say it. Once you have regulation, it is natural for regulators to tinker with it and try to make it better. And that usually means more regulation, not less.

**Goldschmid:** I'll make one final remark. Jack Gaine and I really are in the same place. I don't think regulation ought to go further in this area. I think this model works for hedge funds. I don't want to regulate derivatives, and I don't want to regulate other things. I don't think the SEC is going to do it, although I suspect I'll be back at Columbia before anyone thinks about it again. The idea of being able to tinker and straighten things out can be deregulatory as well as regulatory.

If you want to think about a deregulatory world in the context of the present Commission, we are now looking at the 1933 Act concerning new issues. What we've proposed will heavily deregulate and prevent a lot of wheel-spinning, waste, and interference with speech and other things that have been out there. The trick to government is not always to regulate further. As Jack said, in terms of hedge funds, we've come to the water's edge, and that's as far as I want to go.

**Mason:** We've now come to the end of our symposium. Please join me in thanking our speakers for sharing their time and wisdom with us this afternoon.

オルタナティブ・インベストメント(代替投資)シンポジウム
**ヘッジファンドは規制されるべきか？**

(抄訳)

2004 年 11 月 17 日、オルタナティブ インベストメント プログラムの一環として、日本経済経営研究所は『ヘッジファンドは規制されるべきか？』と題するシンポジウムを開催、基調講演者として米国証券取引委員会委員であるハーベイ・ゴールドシュミット氏を迎えての催しとなった。10 月 26 日に同委員会は、賛否両論に分裂したなかわずかな票差でヘッジファンド登録義務付けを主眼とする規則を採択。ヘッジファンド業界代表者やコロンビア大学教授陣及び日本の金融庁からの出席者を含んだシンポジウムのパネルは、この新規則の本質や、そもそもヘッジファンドを規制する必要があるのかという点、また各国、特に日本の対ヘッジファンド投資への影響などを討論した。

ゴールドシュミット氏は、委員会の投票では賛成票を投じているが、同規則の採択は 90 年代後半から 2000 年代前半に起きた一連の投資信託および企業スキャンダルを受けたものと言及。現在では1兆ドル産業となったヘッジファンド業界の急速な成長、また小口個人投資家や年金基金にもヘッジファンド投資への関心が広まっている点を鑑みて、ヘッジファンド側の自主報告やファンド・オブ・ファンズおよびその他ヘッジファンド投資機関による独自のモニタリングのみに頼るのはもはや限界、と述べた。新規制は、ヘッジファンド側に米国証券取引委員会への登録、事前予告なしの定期的監査受け入れとオペレーションの透明性強化を求めている。ゴールドシュミット氏は、新規制は、導入により発生するコストは低くヘッジファンド側もそれぞれの『企業秘密』を保持できる一方、不正行為の発見だけでなくアカウンタビリティと不正抑止効果も生み出す重要な手段であると強調した。

シンポジウム参加者の中には、証券取引委員会がデュー・ディリジェンスを要請すれば自らはそのデュー・ディリジェンス行う必要がなくなるのを見て、規制を歓迎する向きもある一方で、規制の利点を疑問視する声もあがった。そのような慎重派からは、ヘッジファンドに投資する投資家の傾向として、少なくとも 5 百万ドル以上の資産を保有しておりヘッジファンドの活動状況を自らモニタリングできるほど投資事情に精通しているとの指摘がなされた。投資家自身がヘッジファンド側にアカウンタビリティを求めるようにするべきでは？　投資家自身が資産を信託化するなり、ヘッジファンドをモニターする公認投資アドバイザーを雇うなりするべきでは？　小口投資家に関して言えば、投資信託以外で分散投資する手段を制限してしまうことは正当か？また中には、規制の内容が、機関投資家が全体的リスク・ポジションを適正に維持することを求めるのではなく、特定の、例えばヘッジファンドなどへのエクスポージャーを制限することを焦点とすることを疑問視する声もあった。

米国のヘッジファンド規制が、各国にあたえる影響も考慮すべき、との指摘もなされた。国際的資金の流れの歪みを防止するために、特に先進国間の規制には一貫性を持たせることが望ましい。最後に、日本では、『規制』をその規制の対象である活動・団体に対する政府の『お墨付き』と誤解する傾向があるため、規制を行うのであれば効果的に実施されることが重要であり、米国においても留意されるべきであるとの言及がなされた。


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