IML Conference
Investment Management
Panel IV

Hedge Funds

Jay Baris: . . . to Paul is Barry Barbash who is a partner at Willkie Farr and Gallagher. Barry is also one of the leading practitioners. A friend and a colleague as well. Barry was the division director of the division of investment management from 1993 to 1998 and now is one of the leaders in the investment management bar. Sitting next to Barry is Jeffrey Taback, a partner at Weil Gotshal and Manges. He's the co head of the private equity fund formation practice and represents many many private investment funds and sponsors in connection with the organization and acquisition and disposition of their investments. Also another frequent speaker and participant in the industry. And on the far right is David Vaughan who's an attorney fellow focusing on hedge funds and other fund matters for the Division of Investment Management at the SEC. Previously, David was a partner in the financial services group at Dechert LLP where he worked in investments and hedge funds and investment companies. Another leader in this field. So I'm going to turn it over now to Paul.

Paul: Thank you, Jay. I thought I would start off by giving you just a very brief summary of what's happened in the world of hedge funds because while you've been hearing talk about the Investment Company Act of 1940[1] and the Investment Advisors Act of 1940[2] and perhaps even the Securities and Exchange Act of 1934[3] and the Securities Act of 1933,[4] hedge funds weren't around at that time. Any of the those statutes were passed. Probably the earliest hedge fund is accredited as being A. W. Jones which started in the early 60s. And the term hedge fund comes from the fact that some portion of the portfolio would be

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[1] Investment Company Act of 1940, 15 U.S.C.S. §§ 80a-1 et seq. (2010).
[2] Investment Advisor Act of 1940, 15 U.S.C.S. §§ 80b-1 et seq. (2010).
[3] Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (2010)
[4] Securities Act of 1933, 15 U.S.C. § 77a et seq. (2010)

invested long. In other words, owned and some portion of the portfolio would be invested short. So that there would be a hedge in terms of if the market went up or the market went down. And that concept of hedge fund has stayed with what is broadly now a private investment fund industry. The hedge funds developed under the private advisory exemption from the Advisers Act[5] which said basically if you have fewer than, if you have not greater than 14 clients and you don't hold yourself out publicly as an investment advisor, you don't have to register under the Investment Advisers Act.[6] And they sold interest in their funds under the private exemption under the 33 Act[7] which says if you're not making a public offering you don't have to sell, you don't have to register your interest for sale under the 33 Act[8] and they were excepted from the definition of investment company under the provisions of Section 3(c)(1) of the Investment Company Act[9] which said if you are not selling your securities publicly but you're engaged in a public . . . private offering of your securities and do not have more than 100 beneficial owners. You do not have, you're exempt or excepted from the definition of what is an investment company. At that point in time the industry was not huge. I mean operating under the strictures where you could have no more than a 100 beneficial owners in a domestic fund or no more than a 100 U.S. beneficial owners in an offshore fund which was managed by a U.S. person we had something in the neighborhood of maybe 300 billion in assets under management coming into the mid 90s. In 1996 following the recommendation of the SEC, a study first published at the time that Marianne Smythe who is here was the director of the division of investment management. Wave more, wave more. In fact enacted at the time that Barry Barbash was the director of the division of investment management, Congress passed 3(c)(7)[10] which said there's no limit on the number of persons that can be investors in a 3(c)(7) fund so long

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[5] Investment Advisor Act, *supra* note 2, at §§ 80b-1 et seq.
[6] *Id*.
[7] Securities Act of 1933, *supra* note 4, at § 77a et seq.
[8] *Id*.
[9] Investment Company Act, *supra* note 1, at § 80a-3
[10] *Id*.

as each of those investors met the definition of a qualified purchaser which let's just say means you need to have a lot of money. And at that point in time after that congressional action in 1996 the hedge fund industry grew and it grew significantly. To the point where in 2002 the SEC said we're going to have a study about the implication of the growth of hedge funds. And that followed a round table and a publication of the study and interestingly enough because you read all these things in the newspapers I might as well tell you that that study determined that there are no more bad actors in the hedge fund worlds than there are basically in the financial services world. There's no reason to believe that because you're in a hedge fund you're a bad actor. So following the study that the commission staff produced, the commission decided because of the growth in the assets and because of concerns about investor protection, it was going to propose a rule in which it proposed in 2004 and adopted in 2004 which basically said you have to register as an investment adviser under the private advisory exemption because instead of your fund being looked at as a client we're going to deem each investor in your fund to be your client on a look through basis. Now that was essentially the tool that the commission felt it had to cause registration at that period in time. It was not universally well received among practitioners because nobody ever thought that an investor in a registered investment company was the client of the advisor and let's say it was a stretch but it was a stretch that was available to the commission.

Jeff: Paul, may I interject one second?

Paul: Sure.

Jeff: I'm sure you're going to say it but the important part of that which will be relevant when we talk a little bit later is that that rule is really addressed at hedge funds and that the way that it was addressed at hedge funds was that the definition of a private fund for that purpose was a fund that allowed its investors to redeem within two years of purchasing or interest. So that was the way the commission came up with a distinction between that kinds of private investment vehicle that would be subject to this rule and any other type of investment vehicle because other types of private equity, venture capital, other types of funds don't have two year redemption periods. Those are generally funds with long lockup periods so there was a distinction made back then that just addressed issues of hedge funds.

Paul: Right. I think that the commission, the staff came up that suggestion because it found it very difficult to differentiate between hedge funds, private equity funds and venture capital funds based on the nature of the way in which they invested and so it looked at the fact that there was generally liquidity of less than two years in hedge funds till it adopted the rule and then a lot of hedge funds decided that they would lengthen their liquidity terms so that they didn't have to register.

Barry: I would say that I'm not quite sure that that was the rationale that the staff had and the commission had. I think it was more that they wanted a bright line test that everybody could look to and I think that that's why they picked 2 years, the 2 year test. I don't know that it was necessarily an indication that they couldn't define what a hedge fund was relative to a venture capital fund relative to private equity fund for example.

Paul: OK. We'll talk about that a little bit. Fast forward to today, the hedge fund industry has today, well it peaked prior to the market crash of 2007-2008, something in the neighborhood of $ 2 trillion dollars worth of assets. It's now down to about $1.4, $1.5 trillion in assets. It's a very heavily concentrated industry in the sense that if you take the top 500 or even less than the top 500 you have between 85 and 90% of the assets under management. And that's an industry in which you have probably around 7,000 advisors to hedge funds. And we now once again are faced with the issue of hedge fund registration or hedge fund adviser registration and there's a whole bunch of bills. The administration has submitted a bill to Congress called Registration of Advisers to Private Funds.[11] There are a number of other legislative proposals that we'll discuss

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010).

somewhat. But let me start by asking David, what's the practical impact of this as it relates to hedge funds.?

David: I'm happy to answer that, Paul. Though I'll first have to give the disclaimer which by now all of you could probably say from memory yourselves which is that I'm only expressing my own views today not those of the commission, any individual commissioners or the members of the staff or perhaps other members of the panel either. The bills pending in Congress, the ones getting the most air time would effectively remove the de minimis exemption from the Advisors Act.[12] So having a smaller number of clients would no longer be a basis for exemption. I may have missed it, Paul, but I don't know if we mentioned the rule that was adopted by the SEC was thrown out by the DC circuit as exceeding the SEC's authority in rule making because the redefinition of client was seen as not following the meaning as implied by Congress in the statute. So it was thrown out on the statutory . . .

Paul: I thought, David, it would just be better to have someone from the commission say that.

David: [Laughter] You're supposed to be nice to us. So the court threw that out on a statutory basis so if you think well that was the wrong answer from a policy standpoint then you can make a statutory change so what the bills would basically do is make a change which effectively in effect would reverse *Goldstein*[13] which would be to say that regardless of the number of clients that you have if you have $30 million in management or more you have to register with SEC. And so the advisors to the hedge funds would register under the Advisors Act[14] and be subject to inspection, record keeping and the like but the funds themselves would not register. So those of you who were at lunch today there'd be no direct effect on the funds as Commissioner Aguilar had advocated there should be. One things the bills do do I think all of them contain this is they require record

[12] Investment Advisor Act, *supra* note 2, at §§ 80b-1 et seq.
[13] Goldstein v. Cal., 412 U.S. 546 (U.S. 1973)(superseded by statute as stated in Amador v. McDonald's Corp., 2008 U.S. Dist. LEXIS 107753 (D.P.R. Dec. 5, 2008)).
[14] Investment Advisor Act, *supra* note 2, at §§ 80b-1 et seq.

keeping by the advisor of fund records. The idea being to the extent that advisor registrations were really meant to be indirect representations of parts of what the funds are doing the advisor would have to maintain records to permit that form of regulation one of which is systemic risk recording so that we know what the hedge funds are doing which we don't currently have solid data on and also for investor protection and market integrity, insider trading and things like that. There would be required record keeping.

Barry: One small postscript to that about how the legislation would overturn *Goldstein*. It not only overturn *Goldstein*'s[15] result but it also would provide the SEC the Kanjorski bill[16] would give the SEC the ability to define terms such as client so that what happened in *Goldstein*[17] where the court said that the SEC was bound by the statute and couldn't define client in a particular way, the SEC which has generally had the ability under the Advisors Act[18] to be able to define terms which is a fair grant of authority which the SEC hasn't had under the Advisors Act.[19]

David: It does have it under other of the federal securities laws. I think one of the things if you look back on the original act there weren't really any undefined terms in there. The terms seemed to be self defining. That's not necessarily the case after 69 years of amendments.

Barry: David, just to clarify though. The bill is a little confusing to me. When it talks about giving the commission the authority to define client differently. Are they even suggesting that they can define client differently within the same statute?

David: No. It's an Advisors Act amendment. I think they're saying. I believe what the statute says is that you can define terms differently for different purposes including specifically the word client.

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[15] Goldstein, 412 U.S. 546.
[16] Private Fund Investment Advisers Registration Act, H.R. 3818, 111th Cong. (2009).
[17] Goldstein, 412 U.S. 546.
[18] Investment Advisor Act, *supra* note 2, at §§ 80b-1 et seq.
[19] *Id*.

Barry: Used in different sections of this title.

David: Correct.

Barry: So suggesting that client can mean one thing in one section and one thing in another section.

David: There are terms in the statute already that mean different things in different sections. For example, there a term person associated with an investment advisor. These are the humans who are regulated along with their employer. And it's defined differently for different purposes. Clerical employees for some purposes are supervised and for other purposes they are not.

Paul: I would say that I would agree that there is precedent for it but as members of the private bar who are effectively the intermediaries between the government and their clients explaining how a term is used one way in one section and another way in another section doesn't make our life particularly easy. Just if you could do it in a different way I advise that you do it in a different way because people like to understand exactly the way the statute is going to operate and as long as client means the fund except when the client doesn't mean the fund it means the investor in the fund. It's hard. But moving on, oh I'm sorry

A QUESTION WAS ASKED FROM THE AUDIENCE WITHOUT AUDIO.

Paul: There's a whole traditional law as to when an entity is going to be respected as an entity and when it's going to be looked through but if you had an entity that had been set up and was making investments on a continuing basis he would be a fund and they would have to you know they would be so considered as a client.

Barry: If you're question is whether something like a family business could be covered under the statute the answer would be yes I think. I don't think there's anything in there that would lead to a different result. There's a history under the Advisors Act[20] of dealing differently with family businesses but in terms of the way the statute works it would seem to cover that.

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[20] *Id.*

Paul: Now we've talked a bit before. Barry suggested that the reason that head fund was defined as an entity that essentially allowed liquidity to its investors in 2 years or less was for clarity. The statutes that are now being proposed are really a combination of investor protection and systemic risk type things and in that connection most of the things that come out including the administration's bill have included all funds which qualify are accepted from the Investment Company Act under 3(c)(7) and 3(c)(1)[21] which I described earlier. The draft bill by Senator Kanjorski exempts venture capital funds. Jeff, what's the reason for exempting venture capital? It's not defined in Kanjorski's draft and what's the difference between venture capital and private equity in these terms.

Jeff: I thought you might ask me that, Paul, and the answer is I can't find any. But let me step back for a second and get to venture capital. I just find it kind of interesting that even in the commissioner's remarks at lunch he kept referring to hedge fund managers registering and in fact some of the legislation that was proposed earlier in the year both in Congress and the Senate were titled Hedge Fund Transparency Act [22]or Hedge Fund Registration Act[23] when in fact when you read the legislation it covers all types of private equity funds. I mentioned just a little while I mentioned before the concept of a private equity fund I think for those who practice in this industry we think of private equity funds including all types of different funds because as Paul said those type of funds rely on 3(c)(1) and 3(c)(7)[24] for their exemption from registration as an investment company. So, and if you see a hedge fund document you see a venture capital fund document you see a private equity fund document that could be a LBO fund, a real estate fund, a mezz fund, a distress fund we can go on and on with different strategies they all look pretty similar to each other, they're all structured pretty similarly, the terms and provisions of them are pretty similar but we have tried to distinguish many times between a hedge fund which in its purest sense has a

[21] Investment Company Act, *supra* note 1, at § 80a-3
[22] Hedge Fund Transparency Act, S. 344, 111th Cong. (2010).
[23] Hedge Fund Registration Act, S. 1402, 110th Cong. (2008).
[24] Investment Company Act, *supra* note 1, at § 80a-3

different way of looking at the marketplace because in its purest sense a hedge fund invests in public securities and has these redemption features as opposed to every other type of fund which is set up as a mentioned before with commitments from its limited partners that are drawn down by the GPs, there's a term to the fund, when the GP finds an investment opportunity they call down the capital, make the investment, they monitor the investment, they manage the investment and they exit the investment and the fund ends after 10 or 12 years and they go on to the next fund. It's a different construct but the model is sort of the same. So now what you're seeing in this legislation is although people again refer to hedge funds but the legislation itself covers all types of different funds. Private equity and hedge if you wanted to make that distinction. Now what's happened in the Kanjorski bill[25] is that the venture capital folks to their benefit have gotten that the Kanjorski, his staff and whomever else, to put language in this draft bill that gives the commission the authority to define the term venture capital and exempt out the managers of those funds from registration and when you think about what a venture fund versus a small private equity fund or private equity fund again to me there really is not that much difference. The chairman of the National Venture Capital Association testified in front of the committee this week and if you look at his testimony he tried to distinguish venture capital by their size, there are small private equity funds and there are small hedge funds. He tried to distinguish them by the fact that they don't use leverage; hedge funds might use leverage. In fact some hedge funds in the past years have used too much leverage but that's a different question. But in fact the studies show that over 30% of hedge funds don't use leverage at all. Private equity funds, again those LBO type funds really don't use leverage at the fund level. They have the same issues with investors in borrowing money at that level that venture funds do and there's special tax issues related to that. He said venture funds don't cause systemic risk. I think if you take a look at hedge funds and private equity funds and the like an argument can be made with respect to certain of those things that there may not

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[25] Private Fund Investment Advisers Registration Act, H.R. 3818, 111th Cong. (2009).

be very much of a systemic risk that arise from private equity funds for sure and certainly certain hedge funds. And his last argument was that this would be terribly burdensome to the fund managers. Now I'll acknowledge that I have some sympathy to the SEC if I were to say we shouldn't do this because it's burdensome or would require us to hire people. That doesn't seem a very good reason not to register and be regulated but be that as it may the burden is going to be similarly attached to a small venture fund, a small private equity fund and a small hedge fund. So when I think about at least the reasons that were given at the hearing I can't really distinguish between them in terms of why they should be different and either everybody get's caught under this umbrella and in fact the MFA, the Managed Funds Association and the Private Equity Council representing both hedge funds and private equity funds have conceded that registration is something that they have to accept going forward so either everyone gets caught under the umbrella or I think some other limited universe of people get covered under the . . .

Paul: You're not for a leaky umbrella.

Jeff: I'm for a full fledged umbrella.

Paul: Yup.

A QUESTION WAS ASKED FROM THE AUDIENCE WITHOUT AUDIO.

Paul: Bill would not cover . . . It depends I mean I think as to whether or not this bill will cover securitization vehicles. I mean I think you could if you have a fund and it's investing in securities. I mean the issue is going to be if it's investing in securities and it's got an adviser. I think that you could unless you have an exemption. There are certain exemptions with respect to assets that are secured but David do you think that

David: I believe a lot of the buys are of entities, call them advisors, involved in certain types of securitized products, CEOs, COOs. COOs in particular. My understanding is that a lot of them already are registered because the assets they're putting in securitization vehicles are or probably securities and they're choosing them for a fee and so they're taking the view that they're probably an advisor and therefore need to register if they have more than 14 COOs at a time. So my understanding is that quite a few of those people have already registered. When you say securitization though it could be anything I mean some things are securities some things aren't it's going to vary somewhat.

Barry: I thing David's right. I think there are securitization firms that are registered. There are some that aren't. There are certain pools out there securitized pools that rely on the 3(c)(1) or 3(c)(7)[26] exemptions. Some don't. Some rely on other exemptions so all of these bills turn on what kind of legal exemption they're relying on and that's really the story here. One of the issues here people talk about the hedge funds business, the private fund business and you try to get at the essence of what those are. It's those funds that are organized so as to operate outside regulation and that's the aspect of it that distinguishes them so that if you're expanding regulation it would seem that logically you would expand to take in more. Which is essentially Jeff's point.

Paul: Let me just ask you. There's been this discussion. Should advisors have to register? In which case they have to maintain books and records that are sufficient to give you information regarding the activities of the fund that they advise or should funds have to register in which case they'd be registering under the Investment Company Act of 1940. In at least one appearance before the congressional committee it was suggested that that was one alternative. That funds might have to register. What would be the implications for the hedge fund industry, private equity, let's just say the funds industry if they had to operate under the Investment Company Act as it now exists. Barry?

Barry: Well I thing the thrust of what would happen as I understand it and this is the concept I think that Commissioner Aquilar mentioned in brief would be that the exemptions in 3(c)(1) and 3(c)(7)[27] would be conditioned. And effectively if I understand how it would work is what we know as private funds would all

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[26] Investment Company Act, *supra* note 1, at § 80a-3
[27] *Id*.

register under the Investment Company Act[28] and then if they met certain conditions would get exemptions. So in terms of what would happen if hedge funds had to register it really would depend what kind of exemptions they received and that would be presumably under that statutory framework. That would be up to the SEC to determine which provisions of the Investment Company Act would apply and which wouldn't apply. I think actually that applying that kind of provision that kind of ______ where 3(c)(1) and 3(c)(7)[29] are conditioned would be problematic not so much for the funds that are covered by them I think that would depend on the SEC action but if you conditioned 3(c)(1) or 3(c)(7)[30] what would end up is in terms of raising capital you have a lot of entities out there that meet the technical definition of investment company but aren't really what Congress meant to regulate under the Investment Company Act and to the extent they can't rely on another exemption that's exists either under the statute or in the rules of the Investment Company Act they rely on 3(c)(1) or 3(c)(7)[31] so you could have for example a foreign bank that wants to access the capital markets in the United States. That kind of entity from time to time would rely on 3(c)(1) or 3(c)(7)[32] to get money or an insurance company and those kinds of exemptions and those kinds of entities I think it would be really difficult for the SEC to try to figure out how to put all that back together without having too much of an impairment on capital raising. I also think as a general matter in order to deal with the perceived problems out there in terms of record keeping whether you go for the funds and get jurisdiction over the funds or you go for the advisor I think you can do it either way and I would contend you can get the same result by essentially having the advisor subject to registration under the Advisors Act[33] and then decide what your regimes going to be and what information you're going to need. You can pick it up that way. You don't need the funds.

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[28] Investment Company Act, *supra* note 1, at §§ 80a-1 et seq.
[29] *Id*. at §80a-3
[30] *Id*.
[31] *Id*.
[32] *Id*.
[33] Investment Advisor Act, *supra* note 2, at §§ 80b-1 et seq.

Paul: David, will the commission get the information or is the thought that the commission gets the information through the advisor maintaining the books and records?

David: I think that's the idea behind the statutes. If you look at them, you have advisor registration, access by the SEC and recording requirements from the advisor but the records of the funds become records of the advisor so the idea is to get access that way. One of the things that people sometimes worry about is whether the advisors will play games with access to the records or not.

Paul: How does it work? Let's say I mean you're an offshore fund and you have a fund administrator and it's located offshore not subject to the jurisdiction of the SEC and you have an investment advisor located here in the United States does it have to keep duplicate books and records with respect to the administrator? I mean

David: Those are the types of things that I think are left in the statute up to rule making interpretation by the SEC in trying to presumably strike a reasonable balance to say you can have offshore administrators but the advisor in the US has to provide enough access. And I think there has been some looking at that in the past. There'd certainly be a lot more if you had a specific requirement. As far as what does that really mean the advisor can make the documents available to us in New York even if they're normally maintained in Dublin by an administrator. We'll have to work through those issues so they're not unduly burdensome but I think the thing to remember is people are reluctant to make the information available the system won't work very well and it will make those examiners very nervous about that advisor.

Barry: The SEC has models of where it goes after service providers in an indirect way. There are provisions under the Investment Company Acts[34]. I think the commission has the ability and the knowledge of how to come up with those rules.

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[34] Investment Company Act of 1940, 15 U.S.C.A §§ 80a-51 to -64 (West 2010).

Jeff: Paul, just to your question of whether or not private funds that operate under the Investment Company Act of 1940[35]. We told clients for a long long time that if you were if the manager was forced to register that's really not the end of the world. That requires books and records and compliance and things like that that they're been more and more requirements imposed over the last few years but that's really not the end of the world and that won't really change the way you operate your business but to have a fund be it a hedge fund, a venture fund, a private equity fund operate under the strictures of the 40 Act[36], I think that would be very very difficult. I mean that statute operates for mutual funds, it requires independent boards, it requires it has lots of stuff about affiliated transactions and the like. That's just not what private fund investors bargain for when they invest in a private equity fund and I think hopefully depending on how the legislation plays out and the way the SEC and the staff deal with the authority that they're given, if there's information that's required it is something that is information along the lines we've been talking about, about who the funds are, what their assets under our management, a little bit about what the fund does as opposed to having the funds be required to operate under the 40 Act.[37]

David: I think there's two things or one thing to remember in looking at those options that people have talked about. One is do you cause the funds to actually register under the 40 Act[38] and that has a lot of significant implications even if you provide exemptions like you would for a business development company where you sort of put them in the 40 Act[39] and then let them out bit by bit. The other potential way of looking at this not to say that there in the 40 Act[40] and get out but rather say if you're relying on 3(c)(1)[41] you must do x which may or may not be part of what's currently in the 40 Act.[42] For example, 3(c)(1)[43] has no

[35] *Id*.
[36] *Id*.
[37] *Id*.
[38] *Id*.
[39] *Id*.
[40] *Id*.
[41] *Id.* § 80a-3(c)(1).
[42] *Id.* §§ 80a-51 to -64.

minimum eligibility for investors. Even if you're relying on Reg D[44] you can have 35 non-accredited investors keeping in mind these are people making less than $200,000 a year investing in an unregistered vehicle. Some would argue that maybe an exemption that qualified 3(c)(1)[45] to have a slightly higher eligibility standard rather than none might be a better policy decision.

Paul: Well. You know, once again, let's go back to the fact that there's two kind of congruent themes going on here. Pre *Goldstein*[46] investor protection and protection of markets, trading markets in that sense, was really what was behind registration of advisors to hedge funds. If we look at the administrator's the Treasury's white paper[47] in June of this year and we look at the legislation that's come out beyond that there's certainly a very very strong flavor that we need to have information about hedge funds for systemic risk purposes. And there is a suggestion that some hedge funds if they are considered too big to fail without adverse impact to the financial system that would be considered Tier 1 institutions under that from a prudential regulation standpoint which leads you into situations such as regulation with respect to how much leverage they can have, regulation with respect to capital. Is that where you think we should be going with respect to hedge funds?

Jeff: No.

Paul: Thank you, Jeff.

Jeff: You're welcome. Again, Paul, I think that there are various ways the staff and the Congress want more information about hedge funds, they're going to register the managers, they're going to have books and records recording, they're going to have examinations that will be scheduled from time to time. How often I guess

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[43] *Id.* § 80a-3(c)(1).
[44] Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.501 (1992).
[45] Investment Company Act of 1940 § 80a-3(c)(1).
[46] Goldstein v. Sec. Exch. Comm'n, 451 F.3d 873 (D.C. Cir. 2006).
[47] FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2010), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

will be a question as to how staffed up the staff will get to be able to cover that. But you know they will be able to get information about funds, they will be able to inspect funds and see what's going on. To sort of take that to the next level and say that those funds may in fact create systemic risks and therefore need to be treated as a Tier 1 financial institution with capital requirements and things like that I just think that it is really over-regulating and overdoing where we are at the moment.

Barry: When you look back, Paul, at the last 12 or 18 months certainly it's not been great performance in the aggregate for the hedge fund industry and we've certainly had hedge funds that have had major problems but you haven't had any hedge funds bailed out and you haven't had the system as you've had in the other instances take the hit and put in money.

Paul: It's ironic in the sense after Longtime Capital Management in 1998 you had a lot that was done in terms of best practices with respect to hedge funds and with respect to counterparty risk management of those relating to hedge funds. In some perverse way, that has worked in the sense that hedge funds have not been the cause of financial system being at risk. It was regulated entities that were essentially overleveraged but now we have prudential regulation with respect to hedge funds being proposed but you know it goes around and whatever comes around goes around and that's where we are at this point in time. Let me ask you as we get to this. The last time we went through this in 2004 we ran into an issue that we really hadn't thought out very very well. The private bar as well as the staff. I mean we all sat down and we said hmm what have we done here. It's in these statutes that we come back to it again and that question becomes what do you do with a foreign advisor and if you take a look at the definition of what a foreign advisor is. A foreign advisor is someone who has no place of business in the United States, has fewer than 15 clients in the United States and depending on how David defines that we'll see what the client is for the purpose and has assets under management attributable to clients in the United States of less than $25 million. So if we have an offshore fund set up wherever, Cayman Islands, and you have to invest in securities in China and you employ an investment manager in Shanghai but there are more than 15 institutions, pension funds that have decided that they want exposure to that Shanghai manager. Under this bill, does that Shanghai manager have to register as an investment advisor in the United States? I mean that's what is seems to say and should it? Anybody?

David: Well I think traditionally the view has been that even if you're a sub advisor. If you're the direct advisor or a sub advisor, you still count the clients the same way, look at the clients the same way. So I think as we found under the pre *Goldstein*[48] rule it was interpreted to apply even to a sub advisor or to an advisor of an offshore fund if there was sufficient U.S. interest in that offshore fund. I think the theory being if you're raising that much capital from the United States from the U.S investors we have a regulatory interest in that.

Paul: There's no question about it. But does it discourage that Shanghai advisor from taking funds that have U.S. clients and therefore makes less investment ability, less investment diversification and choices available to U.S. institutions because we have this guy who's in Shanghai, never comes to New York, doesn't know who these clients are, picked by a board of directors, and people invest because they see his track record. And traditionally that has been what we have done. Barry, if you were back at the commission how would you argue this?

Barry: I thinks that there are policy reasons for looking at that situation a little bit differently. I'm not sure that there are policy reasons that the SEC would necessarily accept but I think you can look at it and ask the question whether diversification or other kinds of similar policy goals could be furthered. I think in the environment that we're in right now they probably wouldn't be furthered. I think diversification and all that is an up market kind of concept.

Paul: Is an up market concept. Well I think we're facing this in sort of a different way with the European parliament talking about restricting choices for Europeans to be able to invest with American managers and you know as we get into this

[48] Goldstein, 451 F.3d 873.

globalized investment management world the question becomes how do we, we're objecting greatly to what the Europeans are doing in at least opposing in the parliamentary scheme with respect to making it very difficult if not impossible to use a manager who is a U.S. manager at least for the next 3 years and one would hope some thought would be given to this whole thing.

David: I think one of the things to think about in that regard though, the U.S. system lots of advisors overseas are already registered. Now you might say that's duplicative some people would argue that that's duplicative but it doesn't actually stop them from providing service. They simply have to register and they can do that regardless of their location basically. The difference in the European parliament system is as currently proposed or as originally proposed is that you can't provide the cross border services unless your home country meets European standards of regulation as opposed to the entity itself providing services.

Paul: Fair enough. Yes.

A QUESTION WAS ASKED FROM THE AUDIENCE WITHOUT AUDIO.

Jeff: Sponsor's and unlimited partner's perspective, we certainly hope that that's not part of this. One of the biggest things we negotiate these days is confidentiality and forwarding requirements in any fund document. I've just been involved I've been involved with a fund that closed with the Treasury. I can assure you that they know who the limited partners are of that particular fund but hopefully that's going to remain confidential although to the extent it's required by law or other governmental agency it will be disclosed but that's a big issue to deal with from the fund perspective.

David: Keep in mind though that virtually every investment advisor that registered now with individual managed client accounts provides the names of those clients to our examination staff on examination that's subject to confidentiality requirements and not being misused by the SEC staff and I don't believe anyone's ever successfully gotten that information through FOIA[49] because examination related materials are not subject to disclosure under FOIA.[50]

Barry: Not only is it done it's one of those elements of SEC exams these days where the SEC wants to talk to the third parties. Talk to the investors to verify what's going on from an investor protection standpoint so I find it hard to believe that the commission wouldn't contemplate regardless of what the statute was that it could it would know the names of the investors in the various subject to its jurisdiction and to the advisor subject to its jurisdiction.

Jeff: It is one of the points in the Kajorski bill[51] again where it provides that the advisor shall provide the records to investors, potential investors, creditors and counterparties of the fund and I know the Private Equity Council spent a lot of time during their testimony earlier in the week talking about confidentiality concerns about that.

Paul: I think that it's that the commission determines by rule that the advisor shall do it. It's not mandated by the statute.

Jeff: But the typical phraseology though is that the commission may deem necessary or appropriate so.

A QUESTION WAS ASKED FROM THE AUDIENCE WITHOUT AUDIO.

Paul: I think you would find most practitioners would tell you if there's a registered investment advisor with an offshore fund, the commission getting that information today. Commissioner Aquilar talked at lunch about there being a similar fiduciary duty for brokers who provide investment advisory services as there are for investment advisors who do it. There seems to be a push to have a written definition of what that fiduciary standard is. Is there, we've had a long history of defining fiduciary responsibility by court decision and precedent. Do any of you see benefits to there being a new statutory definition of what fiduciary

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[49] Freedom of Information Act, 5 U.S.C.A. 522 (West 2010).
[50] *Id*.
[51] Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. (2009).

standards should be?

Barry: To my mind in the Kanjorski bill[52] one of the issues that comes out is it sets a standard but it talks about that standard according with respect to retail customers which leads to the question what if you don't have a retail customer when that standard's in place. And it strikes me that that's a very difficult position to put financial service providers in. That the standard you meet depends on people you're dealing with. I can't see that that necessarily is beneficial from anybody's perspective to have all different kinds of standards. And I'm not sure I understand why there's a need for a new standard. I thought that the goal here was to get a standard that was the same across the board.

Paul: David, you want to comment on that?

David: I don't know that this is directly relevant to hedge fund managers. I think what they were talking about on Capital Hill as Barry was saying the idea is not to change the current fiduciary duty for advisors at least as I understand it but rather to extend that to broker dealers. If you did sit down and define something there's always a risk you're going to define it differently than it actually exists or would exist under the current system of Kstar and the like.

Paul: I certainly think there's a lot of L-A-W and L-O-R-E as to what is the fiduciary standard and to try and codify it doesn't make a great deal of sense to me. Putting aside whether or not how you could apply it to broker who are providing advisory services.

Barry: During the time I was the division director we put out a rule proposal and all we were really trying to do was codify what investment advisor suitability was. We put out a rule. We thought it was pretty straight forward. We thought that there wouldn't be major objections and we got comments from every direction and the essence of which from every comment was we got it wrong and that we shouldn't be doing it. It's all about how difficult it is but more of that story was how difficult it is to come up with a standard. Nobody's going to like the standard and

[52] *Id*.

everybody is going to like the standard somewhat differently so to try to do it by rule making is extraordinarily difficult.

Paul: Let's move on to something also that Commissioner Aquilar talked about and is in the I emphasize draft bill[53] by Representative Kanjorski. No bill has been introduced that bears his name on this bill but it is a draft bill which he is exposing for comment and he talks about the SEC being self funding and in the investment advisory area by collecting fees from registered investment advisors which presumably could be done based on assets and their management category of investment management services whatever. Granted there's a great deal of flexibility in the bill as to how these things could be done. One of the issues I think we all recognize is that today there may be what 450 in OC give or take and something like 11,000 institutions to examine so the odds are not terrible in OC's favor. Even if you assume Kanjorski's bill[54] is able to raise money and Congress is going to fund which he has particular levels of funding for the SEC in his bill. The question I have is that there's been a lot of discussion as to whether there should be an SRO with respect to hedge fund advisors or investment advisors. The SRO __________ especially seems to think there should be. When you get to the custody proposal there is use of outside well let's say the accountants with respect to surprise examinations on custody to determine whether or not assets are in place potentially with an affiliated custodian to use SAS reviews. I wonder if the panel could give their views as to whether one it's likely there's going to be an SRO or two how likely is it given its resources the commission is going to have to rely more on outside parties to do certifications and reviews with respect to those who are subject to the commission's jurisdiction. Barry, you want to start?

Barry: The issue it's much easier it seems in life to give the SEC greater authority. It's much harder to come up with the resources. Resources have been an issue for as long as I can remember for the SEC. You mentioned, Paul, that the Kanjorski

[53] *Id.*
[54] *Id.*

bill[55] it provides self funding for the SEC. That notion is not a particularly new one. It's not revolutionary. It's one that's been around for a long time. In fact, it was one that was talked about in great detail in the early 1990s and around 1993, 1994 sometime around at that point Congress essentially rejected it and that rejection is what caused the SEC staff and the commission to take a different tack and propose that in the advisors area you had the split between the federal government and the state government as a way to try to deal with resources. So whether we would see self funding it seems to be a mechanism that legislators or at least certain legislators have a hard time with. So then you come down to other alternatives because one way or another as Commissioner Aquilar said if you have greater regulatory authority but can't enforce, can't examine for it, it's not going to be worth a lot and there needs to be some way of getting greater resources. So if you come down from self funding eventually you come to the question of a self regulatory organization. Maybe it's an SRO that does just examinations, doesn't do rule making because the SEC could continue to do rule making. I think it's a necessary question that needs to be asked. I don't know what happens. I do hope that if we go down the path of having more legislation that puts more responsibilities on the SEC that the SEC one way or another gets more resources. It's not fair otherwise.

Paul: David, do you have anything you want to add? Jeff?

Jeff: I would just agree with Barry. I think one of the risks we run here when we impose a significant amount of new regulation on these entities without the resources to back that up is that we have a false front for everybody. Everybody thinks now that the SEC has got jurisdiction over these funds and managers that all of sudden everything is wonderful. We've certainly seen that not to be the case in the past and there's no reason to expect that if the staffing doesn't improve and the resources don't improve we're going to see that in the future. So finding another alternative to that if in fact we're going down this road seems to me to be something that deserves a considerable amount of consideration.

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[55] *Id*.

David: The only thing I would comment on in on the custody side of things. If you look at part of the proposal we've always used audits as one of the mechanisms comprising custody under the Advisors Act.[56] I think if you look back over the problems there have been in the industry, the blow ups, the fraud and things like that. We've typically found that it was a breakdown in either the quality or the actual existence of the auditor. So one of the things you try if you're relying on the auditor which are not regulated at the state level end up having to propose you're going to regulate them through the PCAOB to make sure that they're really substantive and quality audits being done so it's hard to completely outsource any kind of compliance.

Paul: I would agree with everything that's been said but add we've just come through a significant fear of a financial meltdown and there is widespread understanding I believe of the lack of resources so I'm a little bit more optimistic that the SEC is going to get self funding and congressional support than let's say in the mid 90s when it came up because I think it's a different time and besides it just feels likes it moving in that direction. With that, Jay, we're finished. Any questions?

Jay Baris: There will be no questions. [Laughter]. Motion to adjourn.

Jeff: So moved.

Jay Baris: We ask that everybody stay put. We're going to make up some of the minutes that we are missing by moving them to our next panel, our next remarks. But thank you very much Paul and everybody. It was very interesting.

[56] Investment Advisers Act of 1940, 15 U.S.C.A. §§ 80b-20 to -21 (West 2010).