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U.S. Regulation of Hedge Funds Cresting

In 2012, we will see a wave of regulation begin to crest over the U.S. hedge fund industry. While the U.S. Securities and Exchange Commission (SEC) gave the industry an initial reprieve by delaying the implementation of Title IV of the Dodd-Frank Act from July 21, 2011, the final implementing rules will go into effect on March 30, 2012. By that date, all hedge fund managers with more than $150 million in assets under management (and all of those with more than $100 million that also manage non-fund separate accounts) will have to be registered with the SEC under the Investment Advisers Act of 1940 (the Advisers Act). Advisers Act regulation is primarily oriented toward fiduciary principles and full disclosure (rather than prescriptive or prudential regulation), and many registered hedge fund managers have flourished under the Advisers Act. Nonetheless, regulation will represent significant new compliance burdens and a cultural shift for much of the hedge fund industry.

In particular, regulation will bring much closer scrutiny through SEC examinations and enforcement investigations and actions. The SEC has been stung by criticisms that it did not stop the Madoff fraud and did not prevent the failures of Bear Stearns and Lehman Brothers. As a result, the SEC has been trying to re-establish its reputation as a tough regulator, and relatedly, it is concerned that it will lose support if another Madoff were to go uncaught or another major investment firm were to fail. Thus, it has focused its examination program on emerging risks that it tries to identify from its analysis of managers' filings and disclosures and of publicly available data, as well as from a more sophisticated system for sifting through the myriad of tips, complaints and referrals that come to the agency. In addition, the SEC has organized within its Division of Enforcement a number of specialized units focused on what it deems to be high-risk groups, including an Asset Management Unit, which as its name suggests is focused on investment advisers and particularly fund managers. Both the examiners and the enforcement lawyers are focused on hedge fund managers, and they are working together more closely than they have in the past, meaning that examinations now have a greater chance of ending in an enforcement action.

In the past two years, the SEC has taken a series of enforcement actions against fund managers with several themes in common. The SEC, often in conjunction with the criminal authorities, has brought dozens of insider trading actions against fund managers in the past two years, including a series of actions against hedge fund managers, most prominently in the *Galleon* case. The agency also has brought a series of actions against fund managers on charges that they made investments that were inconsistent with the investment strategies and/or risk factors that they described to their investors or clients. The SEC has also taken action against hedge fund managers on charges that they abused side pockets to conceal losses or misappropriations, indicating that the SEC will continue to probe side pockets, gates and other mechanisms for addressing illiquid assets. The SEC will certainly continue to take actions along these lines.

Moreover, the Asset Management Unit and the examination staff have organized a number of joint initiatives designed

to scrutinize, and if violations are found, to prosecute, high-risk managers. For instance, under the Aberrational Performance Inquiry, the SEC staff uses risk analytics to evaluate hedge fund returns; performance that appears inconsistent with a fund's investment strategy or other benchmarks leads to further scrutiny. This initiative recently culminated in a number of enforcement actions against fund managers based on allegations of fraudulent valuations and other misrepresentations. Similarly, there are initiatives focused on potential violations by hedge fund promoters and placement agents, as well as on managers with weak compliance programs.

In addition, Dodd-Frank tasked the SEC with the collection of data from hedge fund managers to assist the U.S. Financial Stability Oversight Council in monitoring for systemic risk. To implement these provisions, the SEC recently adopted Form PF, which becomes effective in phases in 2012. All hedge fund managers with more than $150 million in fund assets will have to complete and file Form PF annually, disclosing to the SEC a variety of information regarding size, leverage, investor types and concentration, liquidity, and fund performance, as well as information about fund strategy, counterparty credit risk, and use of trading and clearing mechanisms. Managers with more than $1.5 billion in hedge fund assets will have to file quarterly and disclose a host of additional information, including information aggregated across fund regarding exposures by asset class, geographical concentration, and turnover by asset class, and for each fund with at least $500 million in assets, information relating to that fund's exposures, leverage, risk profile, and liquidity.

These filings will be extremely burdensome, and for an industry where managers have long closely guarded their investment strategies and positions, they will represent a new degree of openness and a leap of faith: while the SEC is required by law to keep this information confidential, Congress is not. In a notorious incident in 2011, a U.S. Senator released similar data obtained by the U.S. Commodity Futures Trading Commission (CFTC) in order to publicly identify traders that he believed were manipulating energy prices—an accusation that, needless to say, the traders contested vigorously.

As if this were not enough, early in 2011, the CFTC proposed rescinding two exemptive rules upon which the large majority of private fund managers that trade in futures have long relied to avoid registration with and regulation by the CFTC as commodity pool operators. While not required to do so by Dodd-Frank, the CFTC stated that it was motivated by the spirit of that law to bring managed futures funds into the regulatory spotlight, and it seems likely to follow through on this proposal in early 2012. More cynical observers see a regulatory turf battle, as the CFTC does not want to lose jurisdiction over the entire hedge fund industry to the SEC. Whatever the agency's motivation, hedge fund managers that use futures (and swaps, which become subject to CFTC jurisdiction after the CFTC completes applicable Dodd-Frank rulemaking) face the prospect of dual registration and duplicative regulation.

While it is impossible to predict precisely how high this regulatory wave will be or where it will crash, there is no doubt that it is building in force. The next several years will see the SEC, and quite possibly the CFTC, develop a regulatory regime that will change the shape of the hedge fund industry.

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