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The Regulatory Response to Madoff

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In the aftermath of Bernard Madoff's revelation that his investment management business had for years been a ponzi scheme, regulators and commentators have turned to the question of whether and how the present regulatory regime is adequate to protect investors. In that context, many have asserted that hedge funds and/or their managers—and/or their respective activities—should be subject to additional regulation or otherwise to more stringent regulatory oversight.

It is worth considering, then, whether that call for additional regulation is warranted. What is the problem with hedge funds that leads regulators and other commentators to think that hedge funds' activities warrant additional external oversight?

Protecting investors through correcting information discrepancies was the predicate of the regulation that the Investment Company Act of 1940 (the "*Investment Company Act*") imposes on mutual funds and other registered investment companies. The objective behind that regulation was to provide fund investors and prospective investors with information they need to make informed decisions about their fund investments, avoid or minimize investment risk and portfolio losses, and maintain the integrity of investment companies' operations, thereby minimizing fraud and misappropriation of investor assets. If the goal arising from the Madoff fraud is to better protect investors in hedge funds and other private funds,[1] and if hedge funds' operations evince information dispersion problems similar to those leading to the enactment of the Investment Company Act, then looking to the model of regulation established by the Investment Company Act may be an appropriate first step.

The Investment Company Act requires funds registered under that Act, including mutual funds, to comply with certain substantive requirements. Among other things, each mutual fund and other registered investment company must have a majority-independent board of directors, adhere to specific requirements relating to safeguarding portfolio assets, comply with extensive rules in selling its shares, obtain shareholder approval of numerous specified activities and transactions, and maintain and comply with an array of operational policies and procedures. In addition, the Investment Company Act generally requires registered investment companies to value their portfolios on a daily basis using readily available market quotations (or otherwise at fair value, in the board's determination) and strictly limits the amount of leverage a mutual fund may employ. Moreover, mutual funds generally must permit their shareholders to redeem shares whenever the shareholders choose and are also subject to significant SEC filing obligations and disclosure requirements.

And, investment advisers to mutual funds and other registered investment companies must be registered as such under the Investment Advisers Act of 1940, as amended (the "*Advisers Act*"). Under that regulatory regime, an investment adviser must submit a registration application with the SEC (and update the information on that application on at least an annual basis) and comply with the Advisers Act and the rules under that Act.[2] Among other things, a registered investment adviser must appoint a "chief

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[1] Neither Madoff nor his investment advisory firm apparently formally operated any hedge funds. However, several hedge funds — including so-called "feeder" funds — apparently did place capital with Madoff. In addition, Madoff's professed investment strategy was characteristic of certain types of strategies that hedge funds pursue.

[2] This regulatory regime already covers some hedge fund managers (those that either cannot avail themselves of an exemption from that registration or that have become registered voluntarily). It was also the regime to which the SEC subjected hedge fund managers when it adopted the rules under the Advisers

compliance officer" and adopt an array of compliance policies and procedures that are reasonably designed to ensure the adviser's and its associated persons' compliance with federal securities laws, including a "code of ethics" requiring the adviser's employees to submit to the adviser initial and annual securities holdings reports and quarterly reports detailing their transactions in most securities during the preceding quarter. In addition, the SEC staff "examines" each registered adviser approximately every four years. In those examinations, the examiners visit the adviser's premises for several days, ask questions of the adviser's personnel about the adviser's business activities and procedures, and review the adviser's books and records.

It is conceivable that requiring hedge funds to comply with some of the restrictions and obligations the Investment Company Act imposes on registered investment funds could reduce certain risks deemed to arise from hedge funds, particularly those associated with the goal of investor protection. The Madoff fraud, after all, showed that hedge fund investors may fall victim to fraud of grand proportions, and it may seem that regulators should follow suit with the sort of focused and encompassing investor protection measures that have been in place as to mutual funds and other registered investment companies for decades. That conclusion is probably not warranted, however.

The pertinent differences between mutual funds and hedge funds for this analysis are (at least) twofold: First, hedge fund investors are different from mutual fund and other "retail" fund investors, both in terms of their financial "qualifications" and in terms of their relationships to the funds in which they invest. At a minimum, hedge fund investors must be "accredited," as defined under Regulation D of the Securities Act of 1933, as amended, and, for many hedge funds, investors must also be "qualified purchasers"—that is, they must own at least $5 million (for individuals) or $25 million (for entities) in "investments." In addition, because hedge funds are offered privately, in many (if not most) cases, investors have relationships with the managers of the funds in which they invest and also have the opportunity to request from those managers whatever information the investors require to evaluate their proposed hedge fund investments. As compared with investors in mutual funds and other publicly-offered investment funds, then, investors in hedge funds generally are able to look out for their own interests and fend for themselves.

Second, hedge funds are essentially defined by their flexibility to pursue the universe of alternative investments, which, in turn, depends on their being generally free from restrictive portfolio investment requirements, such as those to which registered investment companies are subject. That flexibility to make non-traditional investments is widely regarded as the basis of hedge funds' value to investors and to the capital markets. Among other things, hedge funds' diverse strategies offer investors opportunities for portfolio diversification. In addition, by serving as counterparties in myriad financial transactions, hedge funds serve to increase liquidity in the markets. Depending on their investment strategies, hedge funds have played dominant roles as parties to swap and other derivative instrument contracts, as buyers and sellers of illiquid securities and other instruments not readily transferable in open market transactions, as sources of capital to public companies, by participating in those companies' private securities issuances, and as lenders of capital to parties that otherwise may be unable to obtain credit. Hedge funds have also assumed roles as activist shareholders, willing to play activist roles in companies in their portfolios in situations in which smaller investors may not have sufficient incentives or resources to do so. Indeed, hedge funds' value to investors and contributions to the marketplace may explain hedge funds' critics' seeking merely to regulate hedge funds (and/or their managers) rather than to eliminate them completely.

Because of the different relationships and attributes of hedge fund investors (as compared with mutual fund investors) and the role that hedge funds have come to assume in the capital markets, seeking investor

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Act (that the D.C. Circuit Court of Appeals subsequently invalidated) that had required many hedge fund managers to become registered under that Act.

protection through mutual fund-like regulation is likely not the best path to address possible regulatory deficiencies.

Beyond that, investment adviser regulation along the lines of the current investment adviser registration regime arguably would not be particularly effective in detecting and preventing the worst sorts of misdeeds, such as Madoff's. Among other things, effective detection and prevention of "bad acts" requires regulators to actually know about managers' day-to-day activities—for example, to monitor the accuracy of a manager's communications with investors and the validity of its portfolio valuations and to learn whether the manager is improperly trading on information from broker-dealers or other counterparties or whether its employees are taking advantage of transactions contemplated for the manager's clients (which are the funds it manages). But that level of knowledge and oversight is not something the current federal investment adviser regulatory regime contemplates. Adviser examinations historically have occurred only on an infrequent basis, and those examinations have not proven effective in detecting the worst violations. Case in point, fraud allegations are usually brought to the SEC's attention not through its periodic on-site examinations of investment advisers but through investor or client complaints.

This is not to say that there may not be some other type of regulation that would be appropriate to correct whatever information deficiencies may have become apparent in the wake of the Madoff fraud and instances of fraud by hedge fund managers. A few possible regulatory approaches—less comprehensive than the full panoply of Investment Company Act regulations—come to mind. For example, policymakers could require hedge funds and possibly other private funds to appoint independent boards of directors to oversee and review fund transactions or to submit to regulators information about material contracts, risks, service providers, investment strategies and limitations, and so on, on a periodic basis. It may also be that funds' financial sophistication standards, or at least the "accredited investor" standard, is worth revisiting, given that it was established in the early 1980s and has not subsequently been adjusted to reflect inflation or other subsequent developments.[3] Another approach, which some commentators have already proposed, would be to require hedge funds to use independent custodians, brokers, administrators, accountants, and other service providers.

But the regulatory proposal that has been most widely embraced for tackling hedge fund fraud involves great requiring greater "transparency" of private funds and/or their managers. Calls for hedge fund regulation often center on the notion that hedge funds should disclose details concerning their operations and activities (including in some cases leverage and portfolio positions) to investors, counterparties and

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[3] In late 2006, the SEC proposed to revise Regulation D to establish a new category of accredited investor—the "accredited natural person." As proposed, natural persons would have to qualify as accredited natural persons in order to invest in hedge funds that rely on Section 3(c)(1) of the Investment Company Act to be excluded from the definition of "investment company" as defined in that Act. To be an accredited natural person, an investor would need to be an accredited investor and own at least $2.5 million in "investments." In proposing the change, the SEC cited its concern that hedge fund investors may need additional protections in light of hedge funds' "unique risks" and its perception that the new standard would be a more objective means of determining whether an investor is sufficiently knowledgeable and experienced in finance and business to properly evaluate the investment. In addition, in August 2007, the SEC proposed adding an alternative "investments-owned" standard to the accredited investor definition and establishing a mechanism to adjust the dollar-amount thresholds in the accredited investor definition based on inflation, with the first adjustment occurring in 2012. As yet, the SEC has not adopted either of these proposals.

creditors, and/or regulators so that investors may better evaluate the appropriateness of their investments in light of their particular investment goals and so that other market participants may better evaluate the systemic risks that hedge funds pose. Among other commentaries, the reports of the Asset Managers' Committee to the President's Working Group on Financial Markets have focused on transparency, recommending that hedge funds disclose certain aspects of their operations, business terms, portfolio characteristics, and policies and procedures to investors, counterparties, and/or creditors.

When one parses the arguments for transparency, it becomes evident that different constituencies want different types of "transparency." From the standpoint of investor protection, "transparency" generally seems to refer to how a fund operates, what its performance has been, how its portfolio assets are valued, the terms on which investors may redeem interests, and the extent to which its assets are liquid or relatively illiquid.

This type of transparency is not new for hedge funds and other private funds. Particularly in light of an increasing institutionalization of hedge funds' investors bases, hedge funds and other private funds have routinely disclosed their business terms (the terms on which investors may subscribe for and redeem interests), conflicts of interests to which the manager and other service providers may be subject, valuation policies, investment strategies and goals, and other information arguably material to investors' decisions to invest. Likewise, it has been relatively commonplace for hedge funds and/or their managers to communicate periodically (usually monthly or quarterly) with investors, and those communications typically describe the funds' recent performance and investment outlook.

If funds industry-wide have not voluntarily adopted that level of disclosure, arguably they should. But if some type of disclosure is to be regulatorily mandated—as discussed below, that should be a live question—then there remains the further question of just what categories of information should be required to be disclosed and, perhaps just as important, to whom should it be disclosed.

Regarding the first question, presumably funds should at least disclose the sort of information currently disclosed by hedge funds adhering to the disclosure practices described above. Other possible candidates for disclosure might be funds' portfolio positions and concentrations and, perhaps, the amount of leverage employed.

Evaluating whether regulatorily mandated disclosure would reduce or mitigate fraud, of course, depends on what data or information investors need to make informed investment decisions but do not request or otherwise do not obtain. Perhaps among the most important information, beyond the categories already noted, is information concerning performance returns and the identities of those persons—auditors, administrators, and other service providers—who should have verified those returns and the accuracy of funds' and managers' statements about investment activities.

The parameters of disclosure requirements should not be left to speculation, however. Empirical data would be useful in defining the contours of required disclosure, and, toward that end, exploring prior fraud cases may prove fruitful. That is, policymakers and regulators should take action (if any) based on an understanding of what types of information defrauded investors should have had to avoid the fraud but were not able to obtain or otherwise did not obtain.

As for the second question—to whom should funds be required to disclose information—two possibilities are readily apparent: Funds could be required to make disclosures either to investors only or to both regulators and investors. As discussed above, requiring that certain types of disclosures be made to investors would effectively make mandatory a version—perhaps a more robust and comprehensive version—of the disclosure that funds and/or their managers already frequently provide to investors and prospective investors.

If funds and/or managers were required to make these disclosures to the SEC or other designated regulators, there would arise some additional considerations and questions. The primary one is whether any or part of the disclosed information would be publicly available and, if so, how that information might affect private funds' status as private offerors of their interests: Would, for example, a private fund's disclosure to the SEC of information about its business terms, performance, and investment strategies and activities eliminate the "private" character of the fund's offering, with the effect (one among many) that the fund would need to become registered as an investment company under the Investment Company Act? Even if the information were not to be made available to public—which would require regulators to rely on an exemption from that disclosure under the Freedom of Information Act ("*FOIA*")—might the public be able to challenge that reliance and perhaps succeed in nonetheless requiring disclosure? Recent experience demonstrates that that result is a viable possibility: Forms SH, on which "institutional investment managers" (which includes certain hedge funds managers) must disclose their clients' short selling activities are not, under the SEC's "interim temporary final rule" that implemented the disclosure requirement, to become publicly available, with the SEC relying on FOIA exemption in order to take that position. However, members of the public have challenged the confidentiality that permitted by FOIA's exemptions, and it is within comprehension to expect that similar requests would arise in connection with other disclosures that funds or their managers may be required to make to regulators. To be sure, the prospect of public disclosure is more or less ominous depending on the information sought to be disclosed. Information relating to investment strategies and positions is arguably the most sensitive.

In this context it is also worth considering the question of whether the requirement to disclose—whether to investors only or also to regulators—would deter hedge fund managers' activities. As with any regulation, disclosure requirements would carry compliance costs, arising from, among other things, understanding the disclosure requirements, ensuring compliance with them, and responding to or otherwise addressing regulators' monitoring of that compliance. For some managers, those costs may exceed the benefits of continuing their businesses. In addition, to the extent managers are concerned that others may discover the ingredients to their "secret sauces" as a result of their disclosing information about their activities and the activities of the funds they manage, managers may have fewer incentives to pursue those activities. The more the information disclosed is of the "sensitive" type, the greater that risk becomes.

To the extent policymakers set about to formulate proposals that might require augmented disclosure, then, they should do so based in part on data about the likely effects of those requirements on hedge funds' and managers' activities. After all, much as investors may need to be protected, there remains a role for private funds in the capital markets and, particularly in light of the precipitous decline in their number and assets in them that commentators have forecasted for months, it would be worth ensuring that the hedge fund industry remains viable.

The best means of obtaining this data is not obvious, however. Beyond conducting surveys of hedge fund managers about those managers' likely reactions to heightened disclosure (which may be of questionable reliability), researchers might evaluate the effects of the implementation of existing disclosure regimes. One example in this regard may be state FOIA laws that members of the public have used to require certain public entities, such as public pension plans and university endowments, to disclose information about their investments in venture capital and other private equity funds, including information that may reasonably be deemed proprietary commercial information of those funds.[4]

[4] In response to those disclosure requirements, some private equity fund groups, in addition to resisting complying with those disclosure requests, began declining capital from public investors.

Policymakers should consider something else as well: If the Madoff fraud pointed out deficiencies in regulations applicable to private funds and/or their managers, that fraud itself, much better than additional regulation, may well be the answer to any perceived regulatory gap. After all, arguably investors that invest in hedge funds and other private funds, more than perhaps investors placing capital into mutual funds and other Investment Company Act-regulated funds, generally understand that hedge funds and other private funds are not subject to the extensive regulation that the Investment Company Act imposes on mutual funds and other regulated investment funds and that the responsibility for understanding the nature of their fund investments and the associated risks belong solely to the investors and/or their representatives.

Accordingly, it is at least conceivable that, in the wake of the Madoff and other frauds, investors may substantially increase the procedures they follow in understanding their investments and the managers in charge of them. They may deploy more time toward, and employ more diligence in, assuring themselves that the funds in which they have invested or may invest use independent custodians and other service providers, understanding the investment strategies pursuant to which their capital will be managed, and making investment decisions based on their own analyses and evaluations. In short, before mandating that funds and/or their managers comply with disclosure requirements, policymakers should consider the prospect that these investors and other market participants may, through heightened diligence and deeper research, themselves be the correction to perceived information problems and their own best defense in avoiding becoming victims of future frauds.

Toward that end, policymakers should consider whether data can be obtained that suggests how, if at all, investor practices may be changing after Madoff. One approach in this regard may be to survey investment managers regarding questions investors are asking, and another would be to survey investors themselves. Ideally, through those surveys, policymakers might gather data sufficient to learn what information investors are most interested in obtaining and how they would use or are using that information.

Obtaining that sort of data would be productive first step before moving forward with additional "investor protection" legislation and rulemaking. If policymakers proceed to a further step of mandating disclosure, then, as discussed above, that project should involve its own data gathering. The aspiration of investor protection legislation, after all, is to correct information imbalances and not to eliminate the benefits arising from hedge funds' roles in the markets.

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