THE SEC HEDGE FUND ROUNDTABLE: A SYNOPSIS

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Panel 1: Hedge Funds – Overview, Role and Structure

I. Hedge Fund Overview

How do hedge funds differ from other private investment vehicles?
Unregistered investment fund, which can be distinguished from a private equity fund because of its greater liquidity.

How do you define a "hedge fund"?
Most hedge funds are similar to proprietary trading activities at large "street" firms. One way to define a "hedge fund" is the privatization of proprietary trading activities.

Do we have a good grasp of the size of the hedge fund market? What is it?
The hedge fund industry had approximately $53 billion in assets in 1998. In 2003, the hedge fund industry has approximately $600 billion in assets.
The vast majority of growth is from institutional investors such as Calpers and the Texas Teachers' Pension Plan.

What types of investment strategies are popular/unpopular?
There are approximately 23 distinct strategies, which can be categorized as either (i) market neutral (ii) event driven and (iii) special situations. Need to categorize so you can measure against peers.

What are the current trends in the hedge fund industry?
Most recently, capital has been flowing out of long/short strategies and into distressed debt and convertible arbitrage strategies. In a survey of 170 managers, 75% were registered as investment advisers, CPOs or broker-dealers. 54% were registered as investment advisers.

Do managers change strategies after their fund is launched?
Managers do not tend to "style drift" because (i) investors are paying high fees for a manager's particular expertise and (ii) investors are becoming more activists and are watching managers more closely, which prevents managers from changing strategy or style.
Most offering memos provide the managers with the flexibility to vary from their stated strategy and style, and to engage in opportunistic trading.

Has there been a transition over the years to increase or decrease the amount of risk hedge funds take on?
Mutual funds are more risky than hedge funds in times of market volatility.
The intelligent use of short sales, leverage and derivatives does not increase risk, but rather manages risk.
When comparing risk need to measure against funds using similar strategies.
S&P 500 has twice the standard deviation of most hedge fund indices.
84% of hedge funds stay within Regulation T when using leverage, compared to banks, which leverage their portfolios 6 to 8 times.

Are hedge fund operations becoming more comparable to mutual funds?
Hedge funds should be considered a separate asset class from mutual funds. An investor's risk decreases and diversification increases if investment in hedge funds is one part of a broader investment portfolio.
Despite hedge funds being less risky than mutual funds, hedge funds should not be made available to the general public because of the difficulty in communicating the complex risks and strategies to less sophisticated investors.

How often does a manager wind up his current fund and form a new fund soon after?
If the reason for the dissolution of the first fund is because of poor performance, it is difficult for the manager to start a new fund, because the hedge fund community is small and word gets quickly around the street.

If a manager does start a new fund, he must disclose his involvement in the former fund.

II. Consultants, Prime Brokers, and Auditors

What type of due diligence process do you go through before recommending a particular hedge fund?
Most fund of funds employ third party investigators as part of the due diligence process on prospective managers.

What services does a prime broker make available to hedge fund clients, e.g., clearance, valuation, settlement, custody, margin financing, risk management, office space, short sales?
The role of prime broker is to allow a hedge fund to have one prime broker that will hold a substantial portion of the fund's assets. The prime broker will then execute the fund's trades either in-house or through any of the brokers on the street.
Prime brokers provide a wide variety of other services to maintain client relationships such as providing office space and capital introduction services.
The prime broker is compensated through (i) execution/commissions (ii) income derived from margin and short sale accounts and (iii) processing or transaction fees if the prime broker trades through another broker.
Most prime brokers do not act as a placement agent or broker for hedge funds.

What is the role of the hedge fund auditor? How often are hedge funds audited and what is the scope of the audit? How do hedge fund audits differ from mutual fund audits? What are the key issues that hedge fund auditors are currently focusing on?
A hedge fund's audit is a substantive audit. A mutual fund's audit is control based.
Hedge funds are not required to do substantive testing at year-end.
Unless a deadline is specified in a fund's documents, there is no deadline for completion of an audit of a hedge fund unless the fund is registered with the CFTC.

III. Hedge Fund Indices and Web-Based Information

Please explain, in general, hedge fund indexes.
Most hedge fund indices are directionally correct. Hedge fund indices are not audited.
Most indices report performance figures net of fees.

IV. Offshore Administrators

What types of services do offshore administrators provide?
An administrator's core services include maintaining books and records, pricing the portfolio and calculating fees.
Administrators provide investor-related services such as compliance with anti-money laundering requirements, processing capital flows and communicating with investors.
The trend is for hedge funds to outsource most of their back office/administrative work.
75% to 90% of new funds use an administrator for both the offshore and domestic funds.

V. State of the Industry

Please discuss the life span of hedge funds.
Anticipated that 9,000 new hedge funds will be created in the next few years.
The advances in technology over the last five years has enabled managers to pursue more complex strategies and permitted better valuation of portfolios.
Guaranteed products are gaining popularity in the U.S.
Risk transparency, rather than portfolio transparency, is becoming more popular.
Average hedge fund life span is 6.5 years.

Panel 2: How Are Hedge Funds Marketed/Distributed

I. Overview of Hedge Fund Marketing

Hedge funds are prohibited from making public offerings. Please provide a general overview of how hedge funds have traditionally marketed their shares. Is the manner in which hedge funds are marketed changing?
Under the current regime, the panel noted that marketing of hedge funds is only permitted on a word of mouth/pre-existing relationship basis.
Given the lack of regulatory change on this front, the panel believed that the marketing of funds has remained largely unchanged.
The panel did note however, there did seem to be more marketers for hedge funds but that using them often creates more problems (i.e., Patriot Act responsibilities, know-your-customer concerns, etc.) than they may solve.

What types of intermediaries are involved? How much is distribution based on relationships and word of mouth? How do hedge funds pay for distribution?
The panel noted that broker/dealers and private advisers were among the types of persons/entities that were looking getting into the business of raising capital for funds.
The panel stated that the payment of a portion of the manager's fees and the direction of commissions were the most prevalent methods of payment for these services.

Generally, how much information about hedge funds is available to investors? Do internet websites and other forms of media reach unsophisticated investors? Do they adequately disclose to investors important information about a hedge fund (*e.g.,* risks, compensation arrangements)?
The panel discussed the fact that large volumes (and real quality) information is generally not available to investors. The panel also noted that this was a real disservice to investors that was caused, in part, by the ban on public advertising and public websites. The point was made that unlike other investments for which the public can rely on the media and internet research, hedge funds are prohibited from having publicly-accessible websites and that this prevented a freer flow of information.
The panel did concede that the fact that hedge fund managers are also more secretive than other investment managers which also prevented this freer flow of information.

What is your sense as to whether investors are investing in hedge funds that are unsuitable for them? How much due diligence is involved on the part of the investor?
The issue of "suitability" and how a manager should determine whether to permit an investor to purchase an interest in the Fund was the *dominant* point of discussion panel. Views ranged from a "very paternalistic" approach regarding a manager's responsibility to determine an investor's suitability to the view that a manager's job was to provide meaningful, accurate and complete information and to let the investor decided based upon this information whether to invest in a fund or not.
The panel discussed, at great length, how to improve/change/amend the accredited investor standard to better measure an investor's sophistication level. The point became clear that the SEC is interested in making sure that investments are suitable for fund investors, irrespective of whether a given investor satisfies the current (or any future) accreditation standards.

II. Investor Qualifications

Discuss the legal eligibility requirements governing who may invest in hedge funds (3(c)(1), 3(c)(7) criteria). Specifically address the accredited investor standard.
The panel expressed its belief that the two exemptions stem from different historical objectives. The 3(c)(1) exemption stemmed from a desire by the SEC to not regulate small business associations among related or professionally-related persons/entities, while the 3(c)(7) exemption arose from a decision on the part of the SEC to not regulate investors who the SEC believed were able to protect themselves without the benefit of governmental/regulatory protections.

The accredited investor standard was discussed and the two main discussion points were:

1) whether or not the income and net worth tests that satisfy Rule 501 were sufficient tools for determining sophistication; and
2) whether or not the manager of a fund needed to go beyond (and how far beyond) the Rule 501/3(c)(7) tests to determine an investor's sophistication.

What form of suitability review should a hedge fund manager undertake prior to accepting investors into a hedge fund? Is it merely enough for a hedge fund manager to rely on the investor's attestation in the subscription agreement that they meet the minimum eligibility standard, or does the manager have the responsibility to perform greater due diligence? If yes, what type of due diligence?

As noted above, the discussion panel discussed at great length the extent to which fund managers should conduct additional investigations into the appropriateness of an investment in the fund by that particular investor.

The panelists disagreed about whether or not the role of the hedge fund manager included making a determination about whether or not an investor should be offered a chance to invest in a hedge fund or should the hedge fund manager focus on providing adequate disclosure about the risks and rewards of the investment and let the investor, with such sufficient information, make an informed decision.

Possible solutions (i.e., ways to augment the suitability tests under 3(c)(1) and 3(c)(7)) included testing for what percentage of their net worth an investor is investing in the fund, asking for references from the investor, interviewing an investor's accountant and financial adviser and asking for brokerage account statements from investors.

One panelist said we needed to "de-couple net worth discussions from sophistication". The others agreed that "net worths" provided a good starting point.

One panelist noted that it looks at: 1) overall financial state of a potential investor; 2) their investment objectives; 3) their risk profile; 4) liquidity of their assets; and 5) whether they understand the risks.

Has the obligation of a hedge fund manager to ensure suitability arisen now that it is relatively easy for many investors to meet the accredited investor standard? Should hedge funds be looking beyond the accredited investor standard to determine suitability?

There were differences of opinion as to whether or not there was any added benefit to hedge fund managers as a result of the investors being able to reach the accreditation standards established twenty and seven years ago, respectively.

One panelist noted that the high minimum investments of hedge funds was the real barrier to entry for investors, not the accreditation standards and that changing the definition of accredited investor standard would not, in large part, affect the ability of his current investors to remain invested.

All agreed that no matter what the net worth/salary level, it was never going to be a guarantee of sophistication.

III. <u>The Role of the Broker in Selling Hedge Funds</u>

Discuss the suitability requirements relating to the sale of hedge funds and fund of funds by NASD members. The NASD recently issued a notice to members (NASD Notice to Members 03-07, February 2003) that reminded members of their obligations when selling hedge funds and closed-end funds of hedge funds. What has been the reaction of NASD members and others? Finally, discuss the recent action taken by the NASD against a broker regarding its sales practices regarding hedge funds.

The NASD representative on the panel confirmed that the action against the aforementioned broker was started based upon the information obtained during the sweep conducted by the NASD earlier in the year.

The panelists all stated that the question of whether to dig deeper into the background of particular investors varied depending on the source of the investor and the procedures of the particular broker.

All the panelists agreed that the standards were different if the investor "just comes out of the

blue."
The panel noted that the Patriot Act has also inadvertently helped make this process easier because investors and managers now realize that they need to dig deeper into their investors' background.

How do brokers comply with suitability requirements when selling hedge funds? What factors does a broker look at when recommending a hedge fund or a fund of funds to a client? What are the considerations that make a particular client a prospective hedge fund investor?
There was no real answer to these questions.
The panel noted that having investors invest through brokers is, in a way, extremely beneficial because these investors need to satisfy the suitability tests that govern the recommendations of brokers.
The panel did concede the added burden on a manager to make sure the broker/dealer is fulfilling these obligations.

IV. The Role of Other Intermediaries in Hedge Fund Distribution

What are the consultant's obligations to the potential investor to ensure that the recommended hedge fund is appropriate?
The panel discussed the fact that consultants do have an obligation to screen investors, but the panel believes that this does not diminish the duties of the fund manager.
The panel also returned to their earlier points about how it is really the job of the hedge fund manager, the consultants and the brokers to make sure the investors are educated about the risks of investing. The key, in the panel's estimation, is that adequate disclosure (and not just disclosure intended to be used by the manager as a defense in court) is what is needed to help investors make investment decisions.

Do consultants ever agree to raise assets for hedge funds?
The panel noted that consultants do agree to raise assets for hedge funds.

Who pays consultants for their services? How is the payment of fees to the consultant disclosed to the investor?
The panel discussed how managers can have arrangements that cover the compensation of these consultants, based either on a percentage of the fees received by the manager or in the form of additional fees payable by the investors.

We understand that some hedge funds contract with "referral" companies as solicitors to raise money for them. What is the nature of this business? How common is it? Are investors provided with the same type of disclosures that the Adviser's Act requires when registered advisers use cash solicitors? Does such an arrangement lead to the sale of hedge funds to investors for whom a hedge fund is not a suitable investment?
The panel discussed the growing number of firms/entities/persons that attempt to raise assets for funds in exchange for a percentage of the manager's fees. The panel noted that these arrangements may be problematic because it is difficult to determine whether or not the consultant has properly screened investors, however, the manager does retain ultimate discretion to allow the referral to invest in the fund or not.

V. Other Regulatory Issues

What is the appropriate type and amount of information about a hedge fund or hedge fund adviser (if any) that may be provided on an internet website or through other forms of media (*i.e.,* publications, television appearances, directories) without the hedge fund engaging in a general solicitation, or without resulting in an unregistered hedge fund manager appearing to be "holding out" in violation of Section 203(b)(3) of the Advisers Act? What kind of information is available on the internet? Does information available on the internet lead to investments by unsophisticated investors?

The panel noted that all hedge fund manager websites, at the present time, need to have a password. However, as noted above, the panel discussed how publicly available websites about the funds, their risks, their strategies, their returns, etc. could be very helpful to investors to help "demystify" hedge funds.
The panel seemed to say that it was not worth risking being deemed to be holding oneself out to the public to include added information on their sites.

Should the federal securities laws be changed to permit hedge fund managers to publicly advertise their hedge funds, despite the prohibition against publicly offering their securities (*i.e.,* regulate sales, not offers)?
As noted above, the panel discussed the fact that the ban on advertising may actually hurt investors because investors use the internet, other media and publicly available financial information/statements to understand the risks and nature of their investments. The fact that these items are not available to investors about hedge funds, according to the panel, has helped contribute to the "mysterious" nature of hedge funds in the public's mind.

VI. <u>Specific Fund of Funds Issues</u>

For what type of retail investor would a registered fund of funds be an appropriate investment? For what type of retail investor would a fund of funds <u>not</u> be an appropriate investment?
The panel noted that funds of funds provide added protections to investors through their diversification and wide risk spreading.

Are the suitability requirements different for fund of funds than they are for hedge funds?
The panel said there were no legal differences in the requirements to invest in funds of funds.

What procedures are being used by managers to screen investors for registered funds of hedge funds? Is it merely enough that the investor claims that he meets minimum eligibility requirements or investment minimums? Should there be minimum investment requirements? Are investment minimums too low?
As discussed above, while the investment minimum is the greater bar to entry than the minimum eligibility requirements, there was some acknowledgement by the panel that the lower minimum minimums may cause additional concerns. However, the panel discounted the SEC's contention that mass marketing of hedge funds through registered funds was on the rise.

Do you believe that the average retail investor who purchases shares of a fund of funds understands his investment *(i.e.,* how the fund operates, its strategies, what types of underlying funds it invests in, fee structure) and its risk?
The panel seemed to be comfortable that investors generally understood the investment risks associated with the investment strategies of the funds into which they were invested. However, the panel expressed concern that there was not sufficient understanding of the "operational risks" of investing in hedge funds, especially the liquidity issues associated with these investments.

Panel 3: Disclosure, Transparency and Performance Fees

I. Disclosure

The current disclosure regime requires delivery of a private placement memorandum ("PPM") before the initial investment. But investors feel a need to do extensive due diligence. A recent Deutche Bank survey reported that 60% of hedge fund investors surveyed take between 2 and 6 months to complete due diligence and make a hedge fund investment. Many feel the need to hire a consultant and even a private investigator to verify information.

The PPMs the SEC has read describe what the hedge fund manager will do*, e.g.*, event arbitrage, but then typically allow him to make just about any other type of investment he wants. Is this typical? Does this explain why PPMs are not particularly useful?
Flexibility is the cornerstone of the hedge fund industry. Hedge funds managers need a broad mandate to perform well in all markets. PPMs are deliberately drafted broadly giving managers the ability to react to changing market conditions and situations that did not exist at the time the PPM was drafted. This is to the benefit of investors. A concern is that investors will not realize the flexible nature of the investment strategies and objectives. There is a delicate line between what needs to be disclosed and making the document understandable to investors.

Is there a way PPMs could be improved? Or are they just irrelevant to the decision making of most investors? Would you advise or direct investors not to rely on them?
PPMs are useful for investors to get a summary of exposure, but for the typical investor it is hard to understand the details of the investment.

Could you describe the due diligence process?
People are the most important aspect of investing. PPMs miss this. PPMs give deal structure and specifics, but it is possible for an investor to negotiate out of those terms. Backward looking performance information doesn't tell much regarding what might happen in the future. More important is information on what actual positions were taken, not the net return information.
The PPM is the end of the process. Most clients find their own diligence, actual track record, etc., to be more important.
PPMs include two types of disclosure: (i) business – deal parameters, fee structure, business points important to the investor and (ii) legal – tax materials, PATRIOT Act disclosure, CFTC disclosure, qualification requirements.

How important is the conflict of interest section?
Amusing and sometimes serves as an easy way to eliminate managers. Lawyers draft the investment section so broadly as to be useless. Only way to find out is to look at the portfolio position by position.
It is not always possible to look at the positions. Therefore, the procedures and diligence used by the manager in putting together the portfolio become more important.
The importance of the PPM varies from fund to fund. With specialist funds, there is more specific information; generalists need more flexibility.

What is the role of the consultant in getting necessary information for the investor?
Some investors use consultants; some do diligence on their own. Different concerns for each.

Do different types of investors have different disclosure needs?
Depends on who will be making decisions, i.e., a professional gatekeeper or asset allocator versus a typical 3c1 investor. Further considerations: most institutions have fiduciary duties (and are looking to delegate that to managers); 3c1 investors are buying performance, pedigree, strategy and won't be as careful in diligence; and the length of the investment (institutional being long-term, 3c1s chasing performance).

Are different investors able to obtain different amounts of information? The Alternative Investments Association (a European organization) has published a package of guidelines urging that disclosures be made uniformly to all investors. Should the US adopt such a rule?
Investors should treat PPM as a platform on which to base questions to the manager and to judge the manager's reaction. It is normal that the PPM protects manager. Therefore, asking questions and getting information is up to the investor. Usually, managers are willing to go far beyond what limits the lawyer has allowed them to put in the PPM.

Does institutional interest in hedge funds affect the need for disclosure?
That speaks to the openness in the relationship between investor and manager.
Historically, more sophisticated and institutional investors drive the hedge fund market and require greater disclosure. If the market is opened to retail investors, a less sophisticated group, the quality of the disclosure will decline.
Hedge funds are unsuitable for unsophisticated investors regardless of disclosure and access. Hedge funds are manager-dependent. Unsophisticated investors will follow performance and track record, not personnel.
If investors invest directly, it is difficult for unsophisticated investor to select managers and funds. However, quality funds of funds, by buying other people's expertise in combining hedge funds, will work better in the "retail" format. With retail investors, there is too much money dedicated to niche strategies and the idea of an absolute return. The industry may not have the capacity for such investors.
Funds of funds exacerbate the problem of retail investors. To judge only by performance is not enough. Need to understand the fundamentals. There is no simple way to allow retail in.
Retail not appropriate for hedge funds – illiquid investments, hot money chasing performance. Not realistic to say that anyone in the industry really wants to allow retail investors in.

II. <u>Transparency</u>

Investors in hedge funds need to be able to assess the ongoing risks of an investment, particularly one that can involve substantial leverage. The President's Working Group on LTCM recommended greater transparency of hedge fund financial positions--a recommendation that was never enacted into law.

Recently, the Commission has sought to improve the transparency of mutual funds by requiring more frequent disclosure of portfolio holdings. There have been suggestions that hedge fund transparency requires position reporting. Others argue that investors need only quantifiable risk disclosure, but there is no agreement on risk measuring tools.

What kind of transparency do hedge funds provide? Is it uniform? Has it changed over the years as a result of investor pressures?
The need for transparency is strategy-dependent. There has been a marked improvement in the willingness of managers to share information in the last 5-10 years as more institutional investors entered the market, but still not real transparency.
Hedge funds use a different approach than mutual funds and transparency is not as possible. Investments are less liquid, selection is a proprietary issue. Position-level disclosure could be detrimental to the manager. Transparency of risk analysis is possible and important to investors.

What kind of ongoing information do investors need?
There are three components to risk disclosure: bucketing (where are the risks, how concentrated are they in geography, sector, etc); what-if element (value/risk, stress testing, back testing); and consistency.
Introduce the idea of having a similar model to those used in equity markets (i.e., encompassing 2 components: facets common among many similar securities and the idiosyncrasies of the specific security). Style consistently generates the same types of returns in the same types of environments. There is correlation and consistency in analysis.

It is almost impossible to predict how managers would have acted. Managers' strategies evolve. It is more of a qualitative issue.
Agreed that it is hard to translate transparency for hedge fund investors.
The qualitative is extremely important. Historical returns, risk/return basis, backward-looking information etc., are almost useless.
It is possible to map the risks of managers over time.

III. Performance Fees

One of the defining characteristics of hedge funds is their fee structure, which differs from those of mutual funds.

Could you briefly compare fee structures?
Performance arrangements are treated differently on the US and offshore sides. In the US, they are treated as allocations – basically, a transfer of a percentage of the net appreciation, generally in excess of a high water mark, to the general partner/managing member's account. Some reduce the net amount by paying expenses and management fees first. Therefore, the methodology of determining the net profits becomes important.
High water mark means the fee is only taken if you get above the prior high point of returns. Adjustments sometimes are made if withdrawals from fund when there is a loss-carryforward applicable. The withdrawal carries its pro rata piece of the loss. RIAs are not allowed to take performance fees unless the investors are qualified clients. Performance allocation provides alignment between the manager and the investors.

Why do hedge funds use this type of performance fee arrangement? What is its impact on fund management that distinguishes hedge funds from mutual funds?
The performance fee model distinguishes hedge funds. Profitability equals performance (contrasted favorably to mutual fund fees that are dependent on beating an index). Little profit in the straight management fee. Therefore, manager's compensation comes from performance. The focus is on the value-added.

The hedge fund performance fees would seem to be a structured arrangement to reward risk taking, since there is only an upside of risk for the manager. Why would an investor agree to such an arrangement?
Focus on co-investment by the general partner/managing member. This avoids giving the manager the option of relying only on his fees. Symmetry of interest between the manager and the investor.

The highwater mark also raises some questions. If a manager is managing two funds, one of which he knows will not reach its high water mark, does it concern you that he will concentrate his efforts/ideas on the other fund? How can an investor protect himself?
It is most important to find a manager who is focused and committed to a strategy. Basically, practice is not to invest with a manager with multiple partnerships. The rise of institutional investors and funds of funds, eliminates this problem to a certain extent.

Do hedge fund performance fees operate to assure that the manager's time and effort will be dedicated to the hedge fund instead of other clients *e.g.*, mutual funds? This presents a serious conflict of interest that is not easily resolved. Some suggest imposing restrictions on hedge funds; others suggest lifting restrictions on mutual funds.
The first issue is one of disclosure.
There is also the issue of the fiduciary duty of the manager to his investors. If the manager diverts the best positions based on his performance fees, he may be subject to legal action.

Panel 4: Issues Associated with Valuation, Allocation, Use of Commissions and Personal Trading

I. Valuation

Provide a general overview of the requirements under the 1940 Act for valuing portfolio securities held by mutual funds.
Mutual funds are generally required to use market quotations when they are available. Alternative methods of determining a "fair value" only when market quotations are unavailable. Determining "fair value" may also be appropriate when there is a significant event occurring between the most recent market quotation (i.e., market close) and the valuation; this situation typically arises where primary trading market is overseas.
The "fair value" of a security is the reasonable price that the security could be sold to willing buyer. Fair value is determined by a mutual fund's board of directors. However, as the board is generally not available on a daily basis, the duty may be delegated but it must be subject to strict controls.
The panel generally has a favorable view of the valuation process of the mutual fund industry and feels that there is sufficient oversight and consistency within the industry.

How do valuation methods differ from those used by mutual funds?
Mutual fund and hedge fund valuations are similar in that both do use market quotations where they are permitted by the strategy (i.e., primarily long/short publicly traded equities, with few or no illiquid securities).
Most hedge fund managers view valuation (and the requirements to use market quotation) as one of the areas that strictly applies to them and that there are few distinctions between valuation standards in the mutual fund and hedge fund industries.
Valuation procedures (where market quotes are not available) will vary depending on the size/age of the hedge fund. Newer/smaller hedge funds are less likely to have rigid procedures in place compared to older/larger funds – larger funds are also more likely to have investors demand structured controls (i.e., where ERISA money is invested).

Do hedge funds ever use values other than market quotations when those quotations are readily available? If so, are there any general parameters for doing so?
No, hedge funds will rarely reject market quotes where they are available and such rejection would not be acceptable to most investors.

How do hedge fund managers value securities for which there is no readily available market quotation?
Like mutual funds, hedge funds may be required to determine fair value, and generally this issue arises more often for hedge funds. Although the same standard should apply (i.e., determining the fair value), the methods for doing so are usually less structured than in the mutual fund industry.

What types of hedge funds or hedge fund strategies are most likely to present valuation issues, e.g., mortgage-backed securities, distressed debt, etc.?
The more complicated/illiquid the securities a hedge fund trades, the more control procedures will be needed and expected of investors.

Funds of funds, whether registered or not, have their own valuation issues. The reliability of their prices depends, in large part, on the quality of the prices obtained from the managers of the underlying funds. Do fund of funds managers have the ability to evaluate the accuracy of prices that they get from managers? Will more transparency, and thus, valuation accuracy, evolve as registered funds of hedge funds proliferate?
There was consensus that fund of funds are not typically able to verify underlying funds' positions and therefore do place heavy reliance on the underlying managers.
It was noted that fund of funds have opportunities through due diligence of underlying managers to put pressure on underlying funds to provide more information to third parties – and this trend is

increasing.

II. Auditing Issues

What is the difference in the nature and scope of a mutual fund audit versus a hedge fund audit?
Principal difference between mutual fund and hedge fund audit procedure is that on the mutual fund side auditors are more concerned with understanding and evaluating internal controls, while on the hedge fund side audits are more substantive in nature – often involving 100% testing of valuations – especially with complicated instruments.

How frequently are valuation issues uncovered by annual audits?
All hedge funds must be audited to be "marketable" – generally annually. Fund of funds and certain funds with more complicated or greater percentage of illiquid investments are generally audited more frequently.

What is the prevailing practice of hedge funds with respect to providing audited financial information: (a) to investors; (b) to third parties?
General consensus that all reputable, i.e., marketable, hedge funds do.

Some hedge funds provide audited financial information without specifying the date the audit was performed. What issues does this raise? How could the level of confidence be raised?
Timing of information is relevant. Although not specific to hedge funds, information accurate at the time of valuation can quickly become inaccurate due to a number of events. This is especially true where market quotes are not available, and therefore greater time passes between valuation and "use" of pricing information.
Although not specific to this question, the use of holdbacks was noted as one way of allowing for discrepancies between initial valuations and audits.

III. Performance Reporting

Persons within and without the hedge fund industry have questioned the accuracy of hedge fund performance and risk-adjusted hedge fund performance statistics. What is your view? Should any changes be considered with respect to the financial statement or performance reporting requirements that apply to hedge funds? Is the standardization of performance reporting possible?
The "Smoothness" of historical hedge fund performances was cited as an example of problems with performance reporting. This is a valuation issue because it is an indication that illiquid securities are not being adequately valued
There is also a concern that there is not sufficient disclosure of illiquidity to investors - concern that while sophisticated investors recognize "smoothness" as a sign of illiquidity other investors do not – apparently even in the hedge fund context.
Smoothness may also result from basing performances on average trading prices supplied by brokers which hides true volatility – this is an area that also needs greater disclosure

Publicly offered closed-end investment companies that invest their assets in hedge funds are also susceptible to inaccurate portfolio valuations. These "funds-of-hedge funds" must provide investors with semiannual financial statements that include, among other things, the current value of each hedge fund in the fund-of-hedge fund's portfolio. Can the accuracy of these current value figures be improved?
Little discussion of this other than noting the semiannual reporting requirements - also noted that these audits are (depending on the nature of the underlying funds, i.e., whether they adopt complicated strategies/illiquid securities etc.) often 100% substantive.

IV. <u>Allocation Issues and Hedge Fund/Mutual Fund Conflicts of Interest</u>

Conflicts of interest may arise when mutual funds and hedge funds are managed by the same manager. For example, a manager may devote more of its time and resources to the hedge fund because the manager has the potential to earn significantly higher fees managing a hedge fund versus the mutual fund. In addition, hedge fund managers often have a significant investment in the hedge fund themselves. These competing interests may cause the manager to allocate investment opportunities in a manner that favors the hedge fund over the mutual fund. Please discuss these conflicts.
The potential conflicts are real, but they are not specific to the hedge fund industry – they would exist anytime that any manager has more than one client and/or trades for own account.
There is a perception that this is one area that the hedge fund industry does not take as seriously as it should (compare to valuation issues).

Can these conflicts be reconciled? If so, how?
The basic test/standard is "basic fairness", and every transaction involving allocation issues must be measured by this – extremely important that top management implement procedures for allocations, must not be left to case by case basis.

What procedures have been designed to identify and resolve these types of conflicts?
No specific remedies were discussed. There are certain "market driven" checks that exist. For example, in the fund of funds context, due diligence often focuses on procedures for dealing with these conflicts and inadequate procedures means that a fund of funds may not invest in an underlying fund. Also noted was that a manager with many separate accounts is often less attractive, even where general performance has been good.

V. <u>Use of Commissions</u>

How do hedge fund managers meet their best execution obligation*?*
There was a general view among the panel that managers have an incentive to ensure best execution on their own – one reason cited was manager's own financial interests. No specific procedures or controls were discussed.

Do hedge funds use brokerage commissions to pay for client referrals? Is the practice adequately disclosed? Are there any soft dollar issues that are peculiar only to hedge funds? How do hedge funds monitor their soft dollar arrangements? Is there adequate disclosure?
Soft dollar issues are greater for start-up funds than they are for more mature funds. Start-up fund managers generally are more willing to go outside of 28(e) and investors in these funds are generally willing to accept it. As fund matures/grows, trend is to come back to 28(e). Presence of ERISA money in larger funds also one reason.
It was also noted that there are pressures in Congress to abolish the safe harbor all together, although there are no specific proposals.

VI. <u>Personal Trading/Fiduciary Duties</u>

What standards of conduct should a hedge fund manager follow when engaging in personal trading activities? Are the fiduciary duties owed to clients well known among hedge fund managers? Are smaller hedge fund advisers typically aware of their fiduciary duties
It was noted in response to this question, as well as elsewhere by the panel (specifically the discussion of allocation issues) that possible conflicts can arise, but that they are not specific to the hedge fund industry.
As for the question of whether fund managers recognized their fiduciary duties, the responses differ with the issues presented. While valuations generally are viewed as an area that managers do recognize and establish standards, it is less evident in other areas. An example given was the use of soft dollars.

Closing Comments:

Hedge funds serve an important role in market liquidity and they are not like the mutual fund industry and accordingly should not be regulated as such. Some of the commentators were of the view that the hedge fund industry has not demonstrated a need for significantly more regulation, and therefore the SEC should adopt the "if it isn't broken, don't fix it" attitude.

Others take the view that regulation of the hedge fund industry should not be modeled on the 40' Act, but that there is a need for more regulation, possibly through modifications to the Investment Advisers Act.

Finally, others recognize that there is a push towards increasing hedge fund regulation, but there is a concern about imposing overlapping regulations, the example cited was existing CFTC regulations (no mention of what it was overlapping with). This panelist was also of the view that the "institutionalization" of the hedge fund industry is having the effect of increasing/improving the industry's standards without regulation, especially with more mature funds.

Panel 5: Hedge Fund Strategies and Market Participation

I. Hedge Fund Trading Strategies and Market Impact

How should a "hedge fund" be defined?
Hedge funds operate subject to market regulations (i.e., the market is regulated and so are the trading strategies). However, hedge funds have more freedom than typical mutual funds to implement their various strategies; but another issue: hedge funds are more likely to be viewed as "tampering" with the public markets.
In general terms: funds gather information and form opinions on the value of securities, and trade if the market has a different view.
Hedge funds move the market in the direction of what managers believe real value to be. This helps to make markets more efficient overall.

In terms of risk, how do hedge fund investment and trading strategies compare with mutual fund investment and trading strategies, which generally are long only strategies or long strategies with a restricted ability to short?
Market "noise" represents risk. Hedge funds trade out the noise, in effect reducing volatility.
Short selling – should it be more regulated? It's probably subject to the most regulation (i.e., borrowing shares, uptick rule) of the various strategies funds use. Hedge funds often use short-selling as an effective investment tool subject to this greater regulation.
Hedge funds are much more active trading vehicles. Most hedge fund strategies are not present in traditional fund management. Risk management becomes harder as hedge funds are generally unregulated.
Hedge funds take conventional wisdom and reverse it – i.e., less risk, less reward – hedge funds will be larger participants in opportunities where there are market inefficiencies. Most hedge funds have strict entry/exit points; most investors do not, which is an example of hedge funds having greater risk management than ordinary investors.
Price volatility of hedge funds is half of ordinary stocks, and volatility of a fund of funds is ¼ of ordinary stocks. Hedge funds that can be seen as even less risky than ordinary mutual funds. This explains increased participation in hedge funds by retail investors.
There is concern that hedge funds create volatility through derivatives and swaps. But derivatives and swaps help contain risk.
Most hedge funds spend time thinking about what other investors are doing – i.e., what mistakes people are making. Hedge funds can profit from those mistakes. Hedge funds try to be the most aware of what's going on in the market.
Hedge funds can be both users and providers of liquidity. There are "net" providers and "net" users of liquidity. Hedge funds are probably net providers of liquidity (i.e., merger arbitrage, etc.).
How risk is defined becomes important. If volatility of returns is the focus, hedge funds can be seen as significantly less risky. But if risk focus is on stock selection, that analysis can change.
A lot of these strategies have to deal with market anomalies and may not be hedged at all. If risk focus is "risk of loss", hedge funds can be seen as more risky, as leverage, in its worst form, can make the risk of loss tremendous. Although, interesting to note, few hedge funds blow-up, considering the number of funds out there and those blow-ups are much smaller in scale than losses generated by mutual funds in the past few years.
Two aspects of risk: (1) risks associated with hedge fund investments and (2) systemic risks.
There are several of these risks. Hedge funds are probably more risky (i.e., relationship between risk level and expected returns). Hedge funds have higher expected returns thus higher risks. Each hedge fund style has its own risks that may not be addressed via volatility.
Another focus of risk is gathering data. Explains the increase in the academic focus on hedge funds.

Are there only a few significant failures of funds?
Yes, only a few significant failures. When a hedge fund fails, the question is "who cares"?, the markets in general should care. The SEC and markets should take airplane crash approach: one agency focuses on the causes, details, etc. of the failure. One agency investigates and files a

public report. This will put a lot of information about funds/risk management in the public domain. This can help address systemic risk.
There exists the risk of strategies, but risk of limited partnerships should be considered (i.e., less liquidity, control, etc.). Sudden changes in value of securities can be ascribed to various factors – i.e., nature of investors, etc. Arbitrageurs can step in and provide liquidity and assume risk – this spreads risks to more sophisticated investors. Also, with so many investors pursuing different strategies, the markets are seeing less correlation among investors. The idea of regulation identifying and deciding which systemic risks should be regulated can be a slippery slope.

Are practices in the industry improving after Long Term Capital Management? Have there been improvements in counterparty risk management?
Yes, there have been improvements, but everyone implements them at different stages/rates in the risk analysis process.
Systemic events may be model-driven, but we should consider institutional risks as well. The system can be sensitive to interest rate shocks, availability of credit, etc. The "system" has become broad and should be considered beyond hedge funds themselves.
But, hedge funds will never be the dominant form of investor in a market. Hedge fund profits are captured by mispricings, which cannot be sustained forever in somewhat efficient markets. So, hedge funds may already contain the seed of their own demise. There are limits to scale. Also, hedge funds, are "marginal" investors – i.e., they effectively set the price of a security by committing capital to the belief in their valuation. But, if the marginal investor steps back or changes opinion, the price will change. Thus, hedge funds are bound to have some relationship to price movements. This can be help market efficiency but can also increase volatility.
There is a limit to how much hedge funds can affect markets. More information in and of itself can contribute to volatility to a greater extent.
Volatility can be a good thing. It means there is a lot of price discovery going on in the market.
A lot of other investors (i.e., GE Capital, Ford) create bigger derivatives/liquidity issues than do hedge funds.
The riskiness of leverage depends on how it is used. It has to be viewed relative to the nature of the instruments/strategies traded. With focus on efficiency, leverage becomes more important.
The risks of derivatives have been closely studied and analyzed. That level of risk analysis should be applied to other instruments/issues – i.e., what should prime brokers be doing to analyze risk?

How clear are the risks of investing to retail investors? Are the risks properly communicated? We seem to have 2 tiers: (1) people with access to information who are interested in hedging and (2) retail investors who do not understand hedging or have access to information. Is it caveat emptor?
Investors generally chase returns, there is not much retail investor focus on risk management or volatility.
In considering accreditation standards, SEC should consider adding educational requirements for investors.
The qualified investor standard can be seen as paternalistic. How do you reconcile costs of learning by experience with benevolent care of investors by regulators? It’s very important to make sure that hedge fund managers have significant investments in these funds: it controls, use of leverage; increases focus on risk management, etc.

Do hedge funds contribute to market efficiency through their active trading, short selling, and identification of arbitrage opportunities?
Hedge funds' use of market inefficiencies helps make the markets more efficient, but lack of transparency is an issue.

II. <u>Short Selling</u>

Hedge funds often employ short selling. Are short selling strategies manipulative?
Short-selling operates under additional rules. Short sales are monitored very closely. It can be

very difficult to manipulate the overall market through short sales. The overview is, if stock sellers are issuing false reports/information, that is actionable in and of itself.
Prohibiting short sales is very bad for the markets. Also, two-sided market reduces volatility and increases liquidity.
Short sales make the market stronger and more efficient. On balance, short sales benefit price discovery.

III. Hedge Fund Reporting and Disclosure

Is it in the best interests of U.S. and global markets to improve hedge fund transparency and disclosure in order to monitor the market impact of hedge funds? If so, what type of transparency and disclosure is appropriate? When will increased transparency help?
It depends on the particular strategy employed. We need a two pronged approach: (1) minimum transparency requirements for each position and (2) educating hedge fund managers as to who accesses and uses the information and how to protect themselves.
To create sustainable growth hedge funds need to provide strategy transparency but not position transparency. Risk transparency is the best solution – it protects hedge fund managers but also gives investors useful information as opposed to just names of stocks held/sold.
There is a need to balance investors' demand for transparency with trading strategies.
One solution: Working with third parties – i.e., hedge fund mangers provide information regarding their strategies and portfolios to third parties which can be accessed by investors in an aggregate form to analyze the risks of various strategies.
Transparency comes at a cost. Providers of liquidity can be saddled with additional costs that they will pass over to investors.

Does lack of transparency have negative effects on market efficiency?
Not really, risk management is important, but difficult for investors to use on a daily basis. Hedge funds' use of market inefficiencies helps make the markets more efficient, but lack of transparency is an issue. To a certain extent, it involves a cost/benefit analysis. How much cost do we incur in exchange for transparency? Is it worth it? The additional costs to the hedge fund industry can be significant. Can the industry sustain the cost? The huge increase in costs would be damaging. We could rely on intermediaries (i.e., auditors) to provide risk controls without disclosing positions/strategies.

IV. Hedge Fund Leverage and Risk Management

We understand that prime brokers devote tremendous resources to monitoring risk and the leverage of their hedge fund clients. Can you explain how prime brokers monitor those areas and what processes and benchmarks they use to do so?
Prime brokers should watch leverage on a continuing basis. Current numbers indicate that most funds are not highly leveraged. Prime brokers can use 3 screens: (1) do we understand the people, the fund, their structure?; (2) credit people review on macro level; and (3) prime brokers focus on day-to-day position review/portfolio management of the particular fund.
If there is a credit problem or concentrated positions, prime brokers should let the air out slowly to limit losses. Excessive regulation can create costs that are too great relative to benefits of increased regulatory oversight.

Panel 6: Enforcement/Fraud Concerns

I. Enforcement Actions

While hedge funds are generally thought of as being "unregulated", the SEC, the CFTC and state regulators have brought enforcement actions against hedge funds and/or their managers. What types of activities have been targeted by these enforcement actions and how frequently have they been brought?

The SEC has brought 30 enforcement actions against hedge funds and/or their managers in the last five years and has seen a steady increase in the number of these actions over the last couple of years. Generally, SEC enforcement actions have targeted "basic, blatant fraud" or material misrepresentations regarding the performance of the fund, the value of the fund's positions, the investment strategies to be utilized by the manager and the manager's qualifications. Some enforcement actions have uncovered outright theft or Ponzi schemes. Most fraud cases uncovered by the regulatory agencies involve "friends and family" fraud and involved less than $5 million. The CFTC has brought 54 enforcement actions against hedge funds in the last five years ("not a huge part of the CFTC's enforcement program"). Most of these actions have targeted the type of fraud discussed above and have involved unregistered managers. Over the last 5 years, the SEC and CFTC have collectively brought a total of 3,300 different enforcement actions, only 84 of which, or approximately 2%, involved hedge funds. Presently, there are 9 state enforcement actions against hedge funds and/or their managers, most of which involve fraud in advertising, exaggerated performance claims and Ponzi schemes.

How is fraud generally detected in the hedge fund arena?

Fraud is usually detected as a result of investor complaints rather than from examinations. The consensus among the regulators is that periodic examinations deter funds and their managers from committing fraud but that no such deterrent exists for unregistered funds and advisers.

Are there types of fraud unique to hedge funds or is hedge fund fraud similar to the fraud associated with other kinds of investment products? Is disclosure regarding conflicts of interest adequate to apprise investors of potential fraud resulting from such conflicts?

The types of fraud detected in connection with hedge fund products (relating to, generally, false advertising, exaggerated performance numbers, etc.) are similar to the fraud associated with other investment products. As the fund community grows, conflicts of interest disclosure is becoming increasingly important. An example is where the hedge fund manager is also associated with the broker-dealer through which the fund's trades are directed. Investors should be aware of such conflicts. The problem of non-disclosure is more rampant among unregistered managers who are not required to provide investors with an updated Form ADV, Part II or other disclosure concerning their business activities. The suggestion was made to update Form D to more accurately reflect that a hedge fund is the issuer of securities.

II. Examination/Disclosure Issues and Due Diligence

Confidentiality has long been a cornerstone of hedge funds but does it impede investors' ability to detect fraud?

Investors may conduct ongoing due diligence of hedge fund managers through the analysis of performance databases, reports and conversations with prime brokers. Investors should look for certain red flags, such as if the manager does not have an audit, the audit is late or the auditor has flagged an issue concerning the operation of the fund. Retail investors do not have the resources or industry contacts that large institutional investors have to investigate manager qualifications and character or to hire a firm to conduct such due diligence and are therefore less likely to obtain "hidden" information regarding the fund or manager .

Can outside service providers, such as administrators, prime brokers or auditors, assist investors in the due diligence process?

Yes, but certain kinds of fraud may almost never be committed by the hedge fund manager alone

(i.e., sending false statements to investors, valuation fraud) and might also involve auditors or other service providers. Investors should be wary when the results of an auditor's examination are inconsistent with the information that is provided to investors on an ongoing basis. Most investors do not have the sophisticated software required to analyze information provided by prime brokers. The suggestion was made to send confirmations of the fund's transactions to investors to provide greater transparency on an ongoing basis.

What recourse do investors have if a hedge fund manager intends to commit fraud? Approximately what percentage of hedge funds have problems that should concern investors or regulators? How can an individual investor get information about the character and integrity of a portfolio manager? Can the individual investor ask the manager to speak to other investors in the fund?
An investor may access the SEC's direct link to other regulatory databases, the SEC complaint line and may speak to other investors. Individual investors generally do not have the resources of large institutional investors and can not afford to pay high fees for due diligence.
The typical investor will have no way of knowing whether the manager intends to commit fraud. The type of fraud may be difficult to detect. An example of this is the case involving Michael Berger, where he fooled the auditors by rigging a fax machine so the performance information being transmitted to the auditor via facsimile appeared on the administrator's letterhead as if it came from the administrator but in reality was his own creation. An analysis of 150 hedge fund managers revealed that 25% of them had some kind of issue (falsifying performance numbers, exaggeration, error) that should be brought to investors' attention. 5-10% of these cases revealed more serious background omissions on the part of the manager, including criminal convictions and bankruptcy filings. However, ADP, a resume checking service, indicated that more than 40% of the resumes it reviewed were inaccurate in some fashion, so the hedge fund industry may be doing well by comparison. Another investigation reviewed the backgrounds of approximately 400 hedge fund managers. In approximately 10 to 15% of these cases some red flag appeared regarding the manager's background.

What are the other benefits of regulatory examinations?
Examinations generally lead to more disclosure and deter fraud. The SEC can obtain information through examinations, while private investors cannot. One suggestion was to amend Section 10(b) of the Securities Exchange Act to permit private litigants to sue managers.

How valuable are the regulatory agencies' databases in providing hedge-fund related information to investors?
Most hedge fund managers that operate large hedge funds are registered as commodity pool operators with the CFTC. Accordingly, the CFTC database may be used as a due diligence tool by investors. The suggestion was made to coordinate the databases of the regulatory agencies to provide investors with "one stop shopping".

What percentage of hedge fund managers are registered with the SEC or CFTC?
Approximately 33% of hedge fund managers are registered with the SEC. 55 of the top 100 managers are registered with the CFTC and are subject to examinations every 2 ½ - 3 years.

III. Conclusion

What could be done from a regulatory standpoint to protect investors?
Educate investors and require managers to clearly define their intended strategies and the associated risks. Revise the existing standards for accredited investors. The SEC should more closely examine service providers for complicity in hedge fund manager fraud. Managers should be required to register with a "credentialing agency". The relatively low number of fraud cases do not justify any major regulatory overhaul. There should be a new exemption vehicle other than Rule 506. All managers should be required to register as investment advisers with the SEC. Funds should no longer be allowed to accept up to 35 non-accredited investors.

Panel 7: Assessment of Current Regulatory Framework

I. Hedge Fund Regulation in Other Jurisdictions

How are hedge funds regulated in France?

Currently, the French regulatory authority permits only other investment funds to invest in hedge funds. Funds of hedge funds are available to investors in France. An initial subscription of 10,000 Euros is required to invest in such funds of funds. A manager of a hedge fund is required to be registered with the regulator. France soon will be adopting regulations permitting professional investors to invest in hedge funds and providing for a new type of UCITS that may engage in some alternative investing.

How are hedge funds regulated in the United Kingdom?

The funds themselves are not regulated; however the managers are regulated. The U.K. is not a common domicile for funds because of unfavorable tax treatment. Hedge funds may not be listed on a U.K. exchange.

If you are a manager or promoter of a hedge fund, you must be authorized by the Financial Services Authority ("FSA"). This entails meeting the FSA's competence and training requirements, being subject to FSA supervision and complying with their regulatory regime.

However, the FSA uses a risk-based approach to supervision and since hedge funds are not likely to impact retail customers they are put in the low risk category. Consequently there is less FSA supervision of hedge fund managers than of other managers. The FSA does prohibit marketing of hedge funds to retail investors.

How do some other countries approach hedge fund regulation?

Most countries permit private sales of hedge funds to institutional investors. In most countries, managers of hedge funds must be registered or qualified with the regulatory authority. The U.S. is the exception in not requiring registration.

Switzerland permits sales of certain types of hedge funds to the public if certain conditions are met.

Hong Kong and Singapore permit sales of hedge funds to the public if disclosure requirements are met.

Italy, Ireland and Luxembourg allow sales of registered funds of hedge funds, and this seems to be the trend that many countries are moving towards.

II. Hedge Fund Regulation in the United States

How does the CFTC regulate hedge funds?

The CFTC regulates the managers of funds that invest in commodities and futures, it does not regulate the funds themselves. There are approximately 1800 registered commodity pool operators ("CPOs") in the U.S. The CFTC has delegated the responsibility for regulating CPOs to the National Futures Association which conducts examinations. Approximately 50% of CPOs rely on the exemptions provided pursuant to Rule 4.7 which provides fund managers with relief from certain reporting and other requirements.

Why has the CFTC proposed additional exemptions from registration for commodity pool operators?

This is part of the CFTC's risk-based approach to regulation. Even if a CPO is unregistered, it will remain subject to the anti-fraud provisions of the Commodity Exchange Act. Historically, the CFTC has received few complaints against CPOs relying on Rule 4.7 and has brought only 2 disciplinary actions against such CPOs. Therefore, in their experience the additional exemptions for hedge fund CPOs are warranted.

The disclosure requirements of hedge funds are driven by the anti-fraud rules of the federal securities laws. Currently, is there an appropriate level of disclosure by hedge funds?

California Public Employees Retirement System ("Calpers") believes that disclosure needs to be improved, and they are most concerned about funds failing to disclose their losses in a timely manner (e.g. Beacon Hill). Even more common is hedge fund managers smoothing out their returns (they parcel out losses over time). Calpers believes that more disclosure is needed and it should not be left to the discretion of the managers. Calpers believes that fund managers have much more bargaining power than investors regarding investment terms. Therefore it is basically take it or leave it – the investor doesn't have the bargaining power to force such disclosure.

Others would like to see more prosecutions of hedge fund managers who commit fraud. Many managers refuse to report their performance to Tremont, especially when a fund's performance is poor. The industry should adopt standardized reporting requirements.

The Managed Funds Association stated that the existing anti-fraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisors Act cover hedge fund managers and are sufficient to address hedge fund disclosure requirements.

Others believes that the current disclosure system is satisfactory and that it follows the 1933 Act's disclosure requirements in drafting offering memoranda for hedge funds. They set forth a fund's investment program fully in the offering memorandum. They believe that sophisticated investors know which questions to ask a fund manager. The number of instances of fraud committed by hedge fund managers is remarkably low. Since the Long Term Capital Management incident, the industry has moved away from riskier practices – for instance now there is lesser amounts of margin lending by prime brokers.

Others supported the position that there was a need for standardized reporting by hedge funds of their performance and fees.

Is there a growing demand for hedge funds to comply with AIMR performance reporting standards?

No, and very few hedge funds report their performance according to the AIMR standards. The reason for this is AIMR is still grappling with how leveraged performance should be reported.

How are best practices guidelines being embraced by the hedge fund industry?

In the U.K. they are actually termed "sound" practices rather than "best" practices. They are meant to be a guide for new entrants to the industry. There hasn't been much feedback in the U.K. yet because there are not many fund start-ups at the present time. The Asian countries are currently developing sound practices guidelines. These guidelines are less likely to be useful in the U.S. which has a more mature hedge fund industry.

The Managed Funds Association has published guidelines for hedge funds which are available on its website. The MFA has not conducted a survey as to how much these guidelines are followed, but they believe that they are used frequently, especially the valuation guidelines.

Are the Regulation D standards for accredited investors at the appropriate level?

It was agreed that the standards are unsatisfactory as a means of determining the financial sophistication of an investor. One panelist stated that the accredited investor standards should be eliminated entirely and replaced by regulations that would provide retail investors with better access to information about hedge funds. Others felt that the standards should be re-examined and the income requirements raised.

What about the restrictions on advertising or making information about hedge funds publicly available. Should we eliminate these restrictions and instead just prohibit the sale of hedge funds to unaccredited investors?

Yes, the public offering prohibitions restrict the free flow of information. Hedge fund managers should be able to give interviews to the media without suspending the sale of their funds. The fact that information about hedge funds would be publicly available would not cause the "retailization" of hedge funds. The regulatory emphasis should be on the purchasers not the offering process – others felt that having unlimited publicity about hedge funds would be troubling.

Registered funds of hedge funds are allowing retail investors to access hedge funds indirectly. Is this a positive or negative development?

The investment manager and the Board of the fund of funds has to safeguard the interests of the retail investors in such funds. The layering of fees in funds of funds needs to be addressed. Overall, however, these are good products.

Retail investors now want something besides long-only investments products. The registered funds of fund are a way to provide this, but they require appropriate risk disclosures.

An alternative to registered funds of funds would be to loosen the investment restrictions imposed on mutual funds by the Investment Company Act of 1940. This would allow traditional mutual funds to pursue other strategies such as short selling and prevent portfolio managers from leaving the mutual fund firms to start hedge funds.

Should there be mandatory registration of hedge fund managers under the Investment Advisers Act of 1940?

No, registration should not be mandatory, because it will force some managers offshore. There is already a move within the industry towards voluntary registration because some institutional investors are requiring it of the hedge fund managers that they invest with. Registration is not that burdensome.

Before making registration mandatory, we need to assess its costs and benefits. It would cost the managers time and money and also would require a large expenditure of public funds because the SEC would need to hire more examiners. Instead, regulatory resources should be focused on the areas where there are problems. If a hedge fund manager is registered with the CTFC, it should not also be examined by the SEC because it is subject to very thorough NFA audits (others pointed out that the SEC audit would look at different aspects of a manager's business than a NFA audit.). Many panelists felt that the case has not been made for mandatory adviser registration. Others disagreed because it is through the inspection of registered advisers, that the SEC is able to detect fraud and other problems. There is a deterrent effect from being subject to SEC examination. The SEC should be given some credit that it will be able to conduct inspections using its limited resources in an effective way. It would not be effective to require registration of hedge fund managers, but not conduct examinations. If the U.S. requires Advisers Act registration of non-U.S. advisers acting as managers to funds currently offered in the U.S. then many of these funds will be closed to U.S. investors.

One approach that has been suggested would be to eliminate some of the constraints on mutual funds. Should this be considered?

Yes, because there is a public policy interest served by allowing more investors to invest in products following alternative strategies such as shorting. But others questioned whether the dollar amounts invested by mutual funds would be too large to support the alternative investment strategies used by hedge funds.

Would allowing mutual funds to charge performance fees stop the "brain drain" that is occurring in mutual fund companies?

Yes, there should be more flexibility in compensation. However, within a mutual fund company there could be cultural conflicts if some portfolio managers receive performance fees while others do not.

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