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Symposium: The Regulation Of Investment Funds

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SYMPOSIUM

THE REGULATION OF INVESTMENT FUNDS*

WELCOME
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WELCOME

DEAN TREANOR: Good morning, everyone. My name is Bill Treanor. I'm the Dean of Fordham Law School. I'm delighted to welcome you to today's Symposium on "The Regulation of Investment Funds," which is sponsored by the *Fordham Journal of Corporate & Financial Law*.

We are very proud to be able to host this really extraordinarily distinguished panel of experts on investment management funds. It's an important and timely topic, when considered in the context of the current political-economic climate and the continuing debate over the role the government should play in the private financial sector.

This is the third Symposium that has been hosted by our student-edited *Fordham Journal of Corporate & Financial Law*, and I'd like to thank the editors and staff of the *Journal* for all their hard work in putting this event together. I'd like to especially recognize Audra White, a 3L, who is in the first row, who is the Symposium Editor of the *Journal*, and who conceived of this program and worked tirelessly to make this day so successful. Audra.

[Applause]

The opportunity for students to plan and execute a program of this magnitude is a crucial component in the excellent legal education experiences that Fordham Law offers to students.

It's especially gratifying for the Law School to have adjunct faculty who represent the best of New York's practicing bar and for them to take time out of their busy schedules, not only to teach our students about the most pressing issues that they themselves are confronting, but to participate in our programs. We are fortunate today to have, to my left, James Jalil, a partner at Thompson Hine, as our Symposium Moderator.

[Applause]

I just have to say I read all the teaching evaluations, and it's always humbling for me to read Professor Jalil's teaching evaluations, they're so good.

Fordham Law School is a school that takes business law very seriously. One of the ways in which we show our commitment to business law is through our Corporate Law Center, which I think is really the finest corporate law center in the country — with apologies perhaps to Mr. West — and our corporate law *Journal*.

The *Journal* is one of the five most cited corporate law journals in the country. It has extraordinary influence. It was cited by the Supreme Court in 2005 in the *Arthur Andersen* case.

The Fordham Corporate Law Center was founded in 2001 to serve as a focal point for excellence and innovation in current and emerging issues in business law and in business.

I'd like to particularly recognize the Executive Director of our Corporate Law Center, who just does a fabulous job and who worked to help put together this Symposium, Ann Rakoff, who's in the back.

[Applause]

Now, in 2009 alone the Corporate Law Center has brought to the Law School such distinguished speakers as William Dudley, the President of the Federal Reserve Bank of New York, and SEC Commissioner Elisse Walter.

Next month the Center is hosting three exciting programs. You can find more details about them on our website. But I just want to call your attention to the very first one, which will be on March 8th, which is our DeStefano Lecture, which will be on "Corporate Accountability, Governance, and Compensation Issues," which will have as the Moderator Judge Sporkin and participants Todd Lang, Gary Naftalis, and Jeffrey Sonnenfeld.

When I teach, I always say there's one or two take-away points that I want to convey to the class. So my take-away points here are (1) Fordham Law is very serious about business law — I want that to sink in; it will be on the pop quiz later; and (2) this is going to be a fabulous, fabulous Symposium about an incredibly timely topic, and we're privileged to be able to host it.

Without any further ado, I think I'm turning matters over to Audra.

[Applause]

AUDRA WHITE: Good morning, everyone.

I'd like to thank all of you for coming here today. I'm very excited to host this Symposium. It was a long time in coming.

I want to thank the Dean for his very kind words and for hosting us here at the Law School today.

I also want to thank everyone in the audience who's a distinguished member of our practicing alumni community. I know we have a lot of alumni here today also.

Most of all, I'd really like to thank Ann Rakoff, whom the Dean also mentioned, the Executive Director of our Corporate Law Center. She has been just instrumental in helping me with everything that went into this event. And also Zachary Slates, who has been there the entire time with everything that I needed. Both of them have really been a tremendous asset in making this possible today.

The Law School is also honored to have my professor, James Jalil, a partner at Thompson Hine, as our Moderator today. He's an adjunct professor of Securities Regulation here at Fordham. Mr. Jalil is a member of Thompson Hine's Executive Committee and is also a member of the Investment Management subgroup at Thompson Hine. Today he brings over 30 years of experience representing hedge funds, investment managers, and registered investment advisers. We're very grateful to have his wisdom on the panel today.

So thank you again and without further ado, I will go ahead and turn it over to Mr. Jalil.

PANEL DISCUSSION

JAMES JALIL: Thank you, Audra.

Thank you and welcome. We have an unbelievable panel today, and I'm personally looking forward to the discussion.

What we're going to do is I'll introduce the panelists and then we're going to have a discussion. Each panelist will make brief remarks, then we'll have a discussion. After the break, we're going to continue the discussion, and then we'll take questions from the audience.

Introducing this panel is a privilege.

To my left, Andrew "Buddy" Donohue is the Director of the Division of Investment Management of the United States Securities and Exchange Commission. For those of you who may not know, that's a very big deal. We're honored to have him here today. He was sworn in by Chairman Christopher Cox in May 2006. He is one of the most senior financial services regulators in the United States, with principal oversight for the over-$40-trillion investment management industry. As Director, Mr. Donohue is responsible for developing regulatory policy and administering the federal securities laws applicable to mutual funds, ETFs, closed-end funds, variable insurance products, UITs, and investment advisers.

What I personally admire about Buddy Donohue is he comes to the Commission with an industry background. Prior to becoming Investment Management Director, Mr. Donohue was Global General Counsel for Merrill Lynch Investment Managers. In that position, he oversaw the firm's legal and regulatory compliance functions for over $500 billion in assets including mutual funds, fixed income funds, hedge funds, private equities, managed futures, and exchange funds.

Prior to Merrill Lynch, he spent more than a decade as Executive Vice President, General Counsel, Director, and member of the Executive Committee for OppenheimerFunds. He brings over 30 years' experience in the financial services industry to the Commission.

He is a graduate of New York University School of Law and graduated with honors from Hofstra University in 1972. He has three children and three grandchildren.

Welcome, Buddy.

To his left, we're really privileged to have one of the giants in the legal industry. Paul Roth is a founding partner of Schulte Roth & Zabel, a member of the firm's Executive Committee, and Chair of the firm's Investment Management Group. Paul's more than forty years of experience in the private investment funds area includes representation of hedge funds, private equity funds, offshore funds, investment advisers and broker-dealers in connection with fund formations and compliance, securities regulation, and mergers and acquisitions. He does it all. He's truly a giant in the industry, a household name to the bar, and we are privileged and honored to have him here today.

Paul is on the Advisory Board of Harvard Law School's Center on Lawyers and the Professional Services Industry, and a member of Harvard University Faculty of Arts and Sciences' Task Force on the Undergraduate Experience. He is a past president and member of the board of Harvard Law School Alumni Association, and also is on the Citizens Committee for New York City and the NAACP Legal Defense and Educational Fund.

He is quoted extensively in the media in connection with hedge fund and investment manager matters. He's a *magna cum laude* graduate from Harvard College in 1951 and a *cum laude* graduate of Harvard Law School. He was awarded a Fulbright Fellowship to study abroad. So we're honored to have Paul Roth here.

To his left, it is a personal privilege to introduce Matthew Siano.

Matthew Siano is Managing Director and General Counsel of Two Sigma Investments, a global investment manager specializing in quantitative arbitrage investing across a broad range of asset classes. Two Sigma currently manages numerous hedge fund and private investment pools with over $3 billion in third-party assets under management. As Two Sigma's General Counsel, Mr. Siano is responsible for the firm's legal, regulatory and compliance matters and is head of its legal and compliance departments. Prior to joining Two Sigma, Mr. Siano was an associate at the firm of Seward & Kissel, where he specialized in investment management matters.

Mr. Siano graduated *cum laude* from the College of William and Mary and is a graduate of Fordham Law School.

I bring this as a personal privilege because Matt was a student of mine, and for any teacher there's no greater joy than to see a student blossom and succeed as Matt has done. So it's a privilege to welcome Matt back to Fordham — no longer as a student, but as a colleague. Thank you.

As an adjunct professor, I sometimes am given the honorific "Professor Jalil," which I do not merit. Our next panelist merits that title. Professor Verret is a rising star as a legal scholar in the securities, corporate, and investment management areas.

He received his JD and MA in Public Policy from Harvard Law School and the Harvard Kennedy School of Government. While in law school, Professor Verret served as an Olin Fellow in Law and Economics at the Harvard Program on Corporate Governance under the guidance of Professor Lucian Bebchuk.

Professor Verret has served as law clerk for Vice-Chancellor John Noble of the Delaware Court of Chancery. Prior to joining the faculty at Mason Law School, Professor Verret was an associate in the SEC Enforcement Defense Practice Group at Skadden, Arps.

He has written extensively on corporate law topics, including a recent paper, "Delaware's Guidance," co-written with Chief Justice Myron T. Steele of the Delaware Supreme Court. His academic work has been featured in the *Yale Journal on Regulation, The Business Lawyer*, the *Delaware Journal of Corporate Law*, the *University of Pennsylvania Journal of Business Law*, and the *Virginia Law and Business Review*. Professor Verret was recently selected by the Northwestern Law School Searle Center on Law, Regulation, and Economic Growth for a 2009-2010 Searle-Kaufmann Research

Fellowship.

Professor Verret also has been active in testifying before Congress, particularly in 2009 on the Obama Administration's financial regulatory reform proposals. He is a frequent guest in the media in discussing corporate and regulatory matters. So we're honored and pleased to have a real professor here today.

Finally, but not least, is my friend Holland West. Holland West is Of Counsel to the law firm of Shearman & Sterling, with more than 30 years of experience on Wall Street in financial and legal matters.

Previously, Mr. West was a partner at Shearman & Sterling and head of its global hedge fund, private equity, derivatives, and structured finance practices; as well as a partner at Cadwalader, Wickersham & Taft as head of its asset management and derivatives practices; and Assistant General Counsel at Goldman Sachs advising on capital markets, derivatives, and commodity businesses.

Mr. West is experienced in diverse investment management matters and has represented an international clientele for over 30 years. He is one of the flowers of the bar and brings his experience and his wisdom to us today. So thank you very much, Holland, for being here with us.

With that, I'd like to begin with Buddy Donohue to make some remarks on where we are today, where Congress is going, more importantly where the SEC is going, and where the industry is going.

ANDREW DONOHUE: Thank you, and thank you for inviting me to speak at the *Fordham Journal of Corporate & Financial Law's* Third Annual Symposium on the Regulation of Investment Funds.

I look forward to a spirited discussion of the current regulatory proposals affecting hedge funds and other private funds.

I remind you that my views I express today are my own and not necessarily those of the Commission, the individual Commissioners, or my colleagues on the Commission staff.

Today I would like to discuss the regulation of private funds through their advisers and the persons selling private funds to investors. You will see that there are gaps in the regulation currently. I will also briefly cover international cooperation in the regulation of private fund managers.

The U.S. securities laws have not kept pace with the growth in market significance of hedge funds and other private funds, and as a result, the Commission has very limited oversight authority over these vehicles. Sponsors of private funds, typically investment advisers, are able to organize their affairs in such a way as to avoid registration under the federal securities laws. The Commission only has authority to conduct compliance examinations of those funds and advisers that are registered under one of the statutes the Commission administers.

Consequently, advisers to private funds can opt out of Commission oversight. This presents a significant regulatory gap in need of closing.

The Commission tried to close the gap in 2004, at least partially, by adopting a rule requiring all hedge fund advisers to register under the Investment Advisers Act of 1940. That rulemaking was overturned by an appellate court in the *Goldstein*[†] decision in 2006.

Legislative action is needed at this time to enhance regulation in this area. Advisers Act registration, coupled with existing law regulating persons selling funds, would, I believe, provide the Commission with needed tools to provide oversight of this important industry in order to protect investors and the securities markets, without impeding investment strategies of the funds.

Today I wish to discuss how registration of advisers to private funds under the Advisers Act would greatly enhance the Commission's ability to properly oversee the activities of private funds and their advisers.

I would also like to discuss the regulation of the people selling private funds, because this is an important element for ensuring that only the appropriate types of investors participate in these funds.

Although hedge funds, private equity funds, and venture capital funds reflect different approaches to investing, legally they are indistinguishable. They are all pools of investment capital organized to take advantage of various exemptions from registration.

Other than the Qualified Purchaser Exemption, all of these exemptions were designed to achieve some purpose other than permitting private funds and their advisers to avoid registration.

Private funds typically avoid registration of their securities under the Securities Act of 1933 by conducting private placements under Section 4(2) and Regulation D. As a consequence, these funds are sold primarily to accredited investors. The investors typically receive a private placement memorandum, rather than a statutory prospectus, and the funds do not file periodic reports with the Commission. In other words, they lack the same degree of transparency required of publicly

[1] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

offered issuers, on the theory that investors can fend for themselves.

Private funds seek to qualify for one of two exemptions from the regulation under the Investment Company Act of 1940: Either limit themselves to 100 total investors, as provided in Section 3(c)(1); or permit only qualified purchasers to invest, as provided in Section 3(c)(7).

As a result, the traditional safeguards designed to protect investors in the Investment Company Act are the subject of contractual arrangements in private funds. These safeguards include investor redemption rights, application of auditing standards, asset valuation, portfolio transparency, and fund governance. They are typically included in private fund partnership documents, but are not required, and vary significantly among funds.

The investment activities of private funds are directed by an investment adviser, which is typically the fund's general partner. Investment advisers to private funds often claim an exemption in the registration under Section 203(b)(3) of the Advisers Act, which is available to an adviser that has fewer than fifteen clients and does not hold itself out generally to the public as an investment adviser.

Section 203(b)(3) of the Advisers Act contains a *de minimis* provision that I believe originally was designed to cover advisers that were too small to warrant federal attention. The exemption now covers advisers with billions of dollars under management, because each adviser is permitted to count a single fund as a client. Interestingly, this exemption predates the rise of hedge, private equity, and venture capital funds.

The Commission recognized the incongruity of the purpose of the exemption with the Accounting Rule, and adopted a new Rule in 2004 that required hedge fund advisers to look through the funds to count the number of investors in the funds as clients for purposes of determining whether or not the adviser met the *de minimis* exemption. This was the Rule that was overturned by the appellate court in the *Goldstein* decision.

All advisers to private funds, whether registered or not, must comply with the antifraud provisions of the Investment Advisers Act, including an antifraud rule the Commission adopted in response to the *Goldstein* decision that prohibits advisers from defrauding investors in pooled investment vehicles. Registered advisers, however, are also subject to additional requirements as described below.

Ensuring that only appropriate sophisticated persons invest in private funds is fundamental to their unregistered status. Beyond the formal Investor Qualification Test embedded in funds' exemptions, broker-dealer regulation of intermediaries provides important protections to investors.

Under the Securities Act of 1934, "any person engaged in the business of effecting transactions in securities for the account of others" must generally register as a broker-dealer. As with advisers, registration of broker-dealers provides important investor protections.

Among other things, registered broker-dealers are subject to SRO regulation, suitability requirements, or the sales practices regulations. Although there are exceptions to the registration requirement, they are narrowly drawn, and as a practical matter the lawful receipt of compensation in connection with the purchase and sale of securities typically requires registration as or association with a registered broker-dealer.

I am concerned that some participants in the private fund industry may be inappropriately claiming to rely on exemptions or interpretative guidance to avoid broker-dealer registration. In so doing, these participants may be creating a *de facto* gap in broker-dealer regulation, in addition to the legislative gap in the Commission's authority with respect to adviser regulation. Persons who are not currently registered as or associated with a broker-dealer should carefully consider whether they should be.

Legislative proposals under consideration would address the legislative gap in adviser registration by eliminating the Section 203(b)(3) *de minimis* exemption from the Advisers Act. Investment adviser registration would be beneficial to investors and our markets in several important ways.

Registration of private fund advisers would provide the Commission with the ability to collect data from the advisers about their business operations and the private funds that they manage. The Commission would thereby, for the first time, have accurate, reliable, and complete information about the sizable and important private fund industry, which could be used to better protect investors and market integrity. Significantly, the information collected could include systemic risk data, which could then be shared with other regulators.

Advisers are fiduciaries to their clients. Advisers' fiduciary duties are enforceable under the antifraud provisions of the Advisers Act. They require, among other things, that advisers avoid conflicts of interest with their clients or fully disclose the conflicts to their clients.

Registration under the Advisers Act gives the Commission authority to conduct on-site examinations of advisers designed, among other things, to identify conflicts of interest and determine whether the adviser has properly disclosed them.

In the case of private funds, it gives a regulator an opportunity to determine facts that most investors in private funds cannot discern for themselves. For example, investors often cannot determine whether fund assets are subject to appropriate safekeeping or whether the performance represented to them in an account statement is accurate. In this way, registration may also have a deterrent effect, because it would increase an unscrupulous adviser's risk of being discovered.

Registration of private fund advisers under the Advisers Act would permit oversight of adviser trading activities to prevent market abuses, such as insider trading and market manipulation, including improper short selling.

Private fund advisers registered with the Commission are required to develop internal compliance programs administrated by a chief compliance officer. Chief compliance officers help advisers manage any conflict of interest the adviser has with or among its clients, including its private funds. Examination staff resources are limited and cannot be at every office of every adviser at all times. Compliance officers serve as the front-line watch for violations of securities laws and provide protection against conflicts of interest.

Registration with the Commission permits us to screen individuals associated with the adviser and to deny registration if they have been convicted of a felony or engaged in securities fraud.

In addition, many private fund advisers have small-to-medium-sized businesses. So it is important that any regulation take into account the resources available to those types of businesses. Fortunately, the Advisers Act has long been used to regulate both small and large businesses, so the existing rules and regulations already account for those considerations. In fact, roughly 69 percent of the investment advisers registered with the Commission have ten or fewer employees.

Under current law, an investment adviser with fifteen or more clients and at least $30 million in assets under management must register with the Commission, while an adviser providing the same advisory services to the same individuals through a limited partnership could avoid registering with the Commission. Investment adviser registration, in my view, is appropriate for any investment adviser, regardless of the form of its clients or the types of securities in which they invest.

While the legislation being discussed does close some gaps in regulation, in my opinion some of the provisions would, unfortunately, create new gaps. The various bills provide exemptions for advisers to private equity and venture capital funds, as well as private fund advisers with less than $150 million in assets under management. Those provisions do contemplate that the advisers would be subject to record-keeping and reporting requirements, which are important elements of adviser regulation. However, as unregistered advisers, they would avoid other provisions that are vital to investor protections afforded by the Advisers Act. For example, the Commission would not have the ability to keep convicted felons from associating with these advisers, and the advisers would not be subject to the Compliance Rule.

The Commission's 2004 rule-making was limited to hedge fund advisers. However, since that time, the lines which may once have separated hedge funds from private equity and venture capital funds have blurred and distinctions are often unclear. The same adviser often manages funds pursuing different strategies, and even individual private funds often defy precise categorization.

Moreover, I am concerned that, in order to escape Commission oversight, advisers may alter fund investment strategies or investment terms in ways that will create market inefficiencies. This happened following the Commission's 2004 rule-making, when advisers lengthened the lock-up imposed on investors in order to avoid registration.

In addition, Ponzi scheme operators are likely to gravitate to less-regulated spaces in the investment management industry. Those that have falsely claimed to be hedge funds until now could just as easily claim to be venture capital funds tomorrow, as they would have a much longer window before investors expected to see any cash.

Europe is also looking at the regulation of hedge funds and other private funds through new European legislation in the form of the proposed Alternative Investment Fund Managers Directive. A new Directive was first proposed by the European Commission in spring of 2009. Various possible changes are being discussed by the European Council and the European Parliament.

The main proposals that have been published in Europe so far resemble the U.S. legislative proposals in some respects. For example, they focus on regulating the manager or adviser to the hedge fund or other private fund instead of regulating the fund directly. Also, there is a debate about the scope of the Directive with respect to private equity and venture capital funds.

Not surprisingly, however, the European proposals differ in some ways from those in the United States. For example, the European proposals require alternative fund managers to maintain specified levels of capital and have risk management programs.

Another important distinction is how the U.S. and the EU regimes apply to advisers physically based outside of their territory. The Advisers Act registration requirements generally apply to non-U.S. advisers if they have U.S. clients. Under longstanding SEC staff interpretations, a non-U.S. SEC-registered adviser need only apply many Advisers Act requirements to its dealings with its U.S. clients. Under this position, a non-U.S. private fund adviser without direct U.S. clients, such as a foreign adviser to offshore funds with U.S. investors, may treat the fund as its clients for purposes of the Advisers Act, simplifying its compliance. Non-U.S. advisers wishing to manage money for U.S. persons may elect to subject themselves to these proportionate and tailored regulatory requirements, regardless of the requirements of the adviser's home regulator.

The application to non-EU managers, including U.S. managers, of the proposed EU Directive varies significantly among the published versions. However, various proposals appear to require that the adviser's home country regulator have a regulatory system that is deemed to be equivalent to Europe's or contain specified elements from the European proposal in order for the adviser to manage assets raised from European investors.

The proposals do not appear to contemplate that a non-EU manager could elect to register with an EU regulator. In effect, these proposals may impose requirements on the adviser's regulator instead of on the adviser itself. As a result, these proposals seem likely to exclude some non-EU managers, including potentially U.S. advisers, even if those managers are willing to follow the European requirements.

I believe countries should work together on a multilateral and cooperative basis to ensure consistently high standards. For example, the Commission staff has been working with the U.K. FSA and IOSCO to develop a template for the collection of consistent and comparable data from hedge fund managers. However, I do not believe this means that we must as regulators in all cases apply identical standards.

The registration and oversight of private fund advisers without exemptions based on strategy would provide transparency and enhance Commission oversight of the capital markets. It would give regulators, for the first time, reliable and complete data about the impact of private funds on others and on our securities markets. It would give the Commission access to information about the operation of hedge funds and other private funds through their advisers, and it would permit private funds, which play an important role in our capital markets, to retain the current flexibility in their investment strategies. Coupled with the application of existing requirements to those persons selling private funds, adviser registration would help ensure investor protection.

Internationally, all countries should achieve high-quality and similar outcomes in our regulatory and supervisory practices, but countries should not impose standards on one another if they are not identical.

JAMES JALIL: Thank you. There will be a lot of questions on that, I'm sure.

Paul?

HOLLAND WEST: Thank you, Jim.

Excuse me one minute. I have a little something I want to bring up here. I'm going to be talking about proposed legislation. There are two major bills.

One has been passed by the House. This is it. It's printed each on double sides, so it's 1279 pages. They say legislation is not easy to watch in the process. It's not easy to read either. This is a 249-page sponsors' amendment for technical corrections in this 1279-page volume here. By the way, many of these came from my staff.

Afterwards, I'm sure that Mr. Donohue would accept questions. All you have to do is refer to the page number and he'll know what to do.

ANDREW DONOHUE: This is entirely unfair, because I told Paul I was going to ask him about a particular page, and he just — he's the master. He just turned it around on me.

PAUL ROTH: So I'm going to focus mostly in H.R. 473, (1) because I have it with me, (2) because it has been passed by the House of Representatives, and (3) in many respects in which it impacts investment advisers it's not all that different than the proposed Dodd bill that we have before us — and I say "proposed Dodd bill" because nothing has been passed in the Senate, even by the committee that has it.

Today's *Wall Street Journal* indicates that Senator Dodd and a Republican senator are going off to visit someplace and that they're going to come back after this weekend and present a bill for the committee for next week. So we'll hope and see what happens.

Now, the House bill is called The Wall Street Reform and Consumer Protection Act. The part that deals with hedge funds is called Title 5, The Private Fund Investment Advisers Registration Act. That's kind of small. So why didn't I bring the whole bill? The reason is — we'll go over some of the provisions — the meat as it affects private investment advisers is in Title 5, but there is an awful lot in the rest of the bill, just scattered throughout, that also affects the way private investment advisers will be regulated in the future.

There are some basic policy issues that are faced by this kind of legislation, some of which Buddy has already indicated.

The first question is: Registration of advisers to hedge funds, should it be all hedge funds? Should it include other entities that take advantage of the exemptions and exceptions from the Investment Company Act, such as venture capital funds and private equity funds, including all flavors of those funds, such as oil and gas funds, energy funds, and real estate funds? We'll talk about the policy reasons for doing that one way or the other a little bit later in the program.

The second question is: How do you allocate the responsibility for investor protection between the states and the SEC? At present, there are somewhat more than 11,000 registrants as investment advisers with the SEC. That includes, if I recall correctly, something in the nature of 1,700 hedge fund advisers. So there will be more hedge fund advisers coming in. As I go through the statute, we'll see that there will be smaller advisers who presumably will be registered by a state.

A third question is: What should be the way in which these hedge fund managers or private investment fund managers, if it includes both private equity, venture capital, and other types of funds that are organized through this exemption from the Investment Company Act — how should they be systemically evaluated? What kind of information should be obtained from them for systemic risk purposes? I don't think anybody is arguing that no one should be forced to give information relating to systemic risk. The question becomes: How do you avoid the SEC becoming a document dump for information that isn't usable, and how will it be used, and who will they give it to, and who's going to be able to analyze it?

Should those small number of hedge funds — and I'll get to this in a little while — who are systemically relevant be subject to the same kinds of requirements that depositary institutions are subject to under the Bank Holding Company Act because they are systemically relevant?

Now, broadly speaking, what the legislation does is it does away with the private advisory exemption and focuses on if you advise people with a certain amount of assets under management, you are required to register. I think there is, at least among people that I represent in the hedge fund community and the Managed Funds Association, which is, I'd say, the representative of the hedge fund industry in Washington, general agreement that registration, done intelligently, is the correct thing to do at this stage.

Hedge funds are no longer a cottage industry. There's over $2 trillion of assets in the hedge fund industry. While that may sound small compared to the $40 trillion that Buddy regulates, for those of us who work in the industry, we think that's a lot of money.

Up till now, broadly speaking, the Advisers Act has focused, I would say, entirely on investor protection. What the amendments do is include systemic risk issues to the Advisers Act.

Now, let's just talk about what happens.

Under the House bill, it provides that there will be an exemption available for registration for fund managers who advise only private funds — and a private fund is defined as something which takes advantage of the exception from registration under the Investment Company Act pursuant to 3(c)(7) or 3(c)(1) of that Act — if they manage less than $150 million in assets. But there is a provision that says "the Commission shall take into account the size, governance, and investment strategy of the funds advised by such managers and, if it determines that they pose a systemic risk, it could subject them to regulation which is appropriate for the systemic risk posed." I would say that provision is likely to be definitionally nonoperative, because if you have less than $150 million under management, systemic risk is not likely to be the issue that they are related to. Investor protection for investors in the funds for managers who manage less than $150 million is apparently left entirely to the states.

Now, there are some complicated things that go on in this bill, because the bill seems to leave the threshold for registration with the SEC mandatory at $30 million and optional at $25 million. On the other hand, it creates a concept called "mid-sized investment advisers," and mid-sized investment advisers are those who manage between $25 million and $100 million. The SEC can expand those numbers, but that's the little universe of mid-sized investment advisers.

As I read it, it says that those mid-sized investment advisers must register with the state in which they maintain their principal office and place of business if that state has a registration provision and conducts examinations. If it doesn't have an examination regime, then they must register with the SEC.

I think there's a lot of room for what is the examination regime that the state creates, and there's a lot of confusion that may exist as this concept of federalism takes place if it continues in these bills.

Now, the Senate bill, or the Dodd proposal, simply raises the limit for registration, or the threshold for registration, with the SEC to $100 million. It says: "If you don't manage at least $100 million, you are going to go to the states, that's where you're going to be registered" — in a sense saying, "You're not systemically relevant," something with which I agree, "and the states are capable of handling investor protection for your clients," something which I wonder whether it's actually true.

I will tell you that, as a lawyer who is representing people who are starting funds, the concept of having to deal with the laws of the various states — on the one hand, I think, "Well, that's pretty good; that will give us the opportunity to hire more lawyers to figure out all these state things"; on the other hand, I think, "Oh my God, how are we going to advise people with respect to all of these different states?"

Now, the House bill says: "If you're subject to regulation by more than five states, you can come back and register with the SEC." So I'm thinking we're going to have to get clients and tell them, "You've got to be subject to registration by more than five states so we can go to the SEC, because at least we know what the SEC wants. When you get to the states, do we really know what they want? Not sure."

Only one state's books and records requirement can be imposed upon any particular adviser, and that's the state where you have your principal place of business. But, if you go through the Act, and if you've ever had a client who has gone through an examination by OSI, you know there is a lot more than books and records that is required with respect to regulation, and the idea of having to deal with that in the various fifty states if you've got up to $100 million in assets under management is, frankly, intimidating. And I don't get scared easily.

So that's one of the big questions.

A second big question that's raised by the legislation — and Buddy talked about it, and he put it in his exquisite language: he said that the way in which the SEC deals with registration of offshore advisers is "proportional and tailored." I'm surprised he didn't say "exquisite" as well.

ANDREW DONOHUE: I left that for you.

PAUL ROTH: Okay.

But one of the real questions that you have, and it's a policy question — both the House bill that has been passed and the Senate bill that is proposed talk about something called "foreign private investment advisers." As far as I can tell, they are pretty much irrelevant in terms of the concept, because they don't give relief to anybody who is a foreign adviser to hedge funds or to private equity or venture capital, should they be required to register.

Now, there are good public policy issues that really should be addressed with respect to this.

One is: You're managing money and you're a U.S. manager and you're registered with the SEC and you've got somebody who is in an emerging market and you've got a global investment program and you want this manager in the emerging market to manage, let's say, a couple hundred million because you've got billions of dollars in your fund. You go to the guy and you say, "We've done research on your record, you're terrific, and we really would like to give you a couple hundred million to manage in the Indonesian market." You do this with the interpreter because he doesn't speak English, but he's really good in the Indonesian market.

He says he's very happy to do it. You put down the requirements under which you will supervise him. Then you say, "And by the way, because you're a sub-adviser to us, you're going to have to register with the SEC."

The interpreter says, "You've got to register with the SEC."

He says, "What's that, and do they publish an Indonesian version of what the Investment Advisers Rules are?"

In a nutshell, that captures the problem. People who do not engage in business in the United States, should their talents as investment advisers be available to institutions who want global investment management exposure?

An argument on the other hand is: You don't have to take money from people who are residents of the United States. If you do, it comes with the requirement that you provide some information regarding your operations to the SEC because what you do will have impact upon people who are U.S. residents.

It's an interesting policy question, and I think that, hopefully, we will engage in conversation with the staff as to how to deal with this through rule-making if it's not more intelligently addressed in the legislation.

Now, the systemic risk issues are dealt with by requiring the SEC to collect information from the advisers regarding the funds that they advise. It says that "the records of a private fund maintained or filed by its registered investment adviser shall be deemed to be the records and reports of the investment adviser."

Matt may talk about whether this is really a pitfall. If you are not preparing the records but the records are being prepared by the fund that you advise, is that something that you should have responsibility regarding the truthfulness of when you file it or maintain those records?

Each investment adviser to a fund is required for each fund to file with the SEC some things which are easy and some things which I don't really understand.

• One is assets under management. That's easy.

• Second is the use of leverage. That's okay, it seems to me, if we understand what leverage is — and there are many, many different definitions of how you achieve leverage. Every derivative has leverage in it. If you buy an option to buy a security, that creates leverage in some people's definition. In other people's definition, leverage is if you borrow money. A third definition is what your exposure is with respect to a position.

So one of the big things we're going to have to go through here, which is part of rule-making generally, is: How do we create a set of common understandings of what people are going to be asked to file information about; or, if we can't create a set of common understandings, how people articulate in their filings how they are calculating what it is that they say is their leverage, for example.

Other things are:

• Counterparty credit risk exposure, which is clearly relevant, I suspect, for systemic risk;

• Trading and investment positions — that's easy to figure out;

• Trading practices — Buddy will tell us what we mean; and

• "Such other information in consultation with the other federal systemic risk regulators as the Commission determines is appropriate."

And then, there is a series of optional information provisions in the statute, which the SEC is asked to determine what other information shall be required.

So we move into this whole new area that the Commission has not been in before, which is collecting information relevant to systemic risk.

The provisions in the Act really do not change the amount of information dramatically that the SEC is asking for with respect to investor protection.

There is one curious provision — I say "curious" because I wonder what it really means — and that is that "the Commission can require managers to provide reports and other documents to investors, prospective investors, counterparties, and creditors." It's a pretty broadsided thing, and I'm not sure why it's there because I'm not sure what the Commission can't require under existing law. But this is an affirmative statement, that the Commission has the opportunity to do this, rather than the Commission, for example, relying on the antifraud provisions to require it.

"The Commission is also given the authority to classify people and functions based upon size, scope, business model, compensation scheme, and potential for creating systemic risk." This is an enhancement of a classification provision that exists under the current law, and I think, hopefully, will be one that makes a great deal of sense for Buddy's Division to exercise through rule-making, because it seems to me that there is a rather good argument for requiring registration for, let's say, anybody who is a private fund, but changing the reporting requirements to meet the needs of those private fund investors. Personally, I would much rather that this guy and his staff did it than that the people in Congress try to write these provisions.

Now, what will be the impact of these changes?

I don't think registration is going to be a great burden, as Buddy agreed — 1,700 registered investment advisers already exist with respect to hedge funds.

I think it's really important to understand that the hedge fund industry is a heavily concentrated industry and that when we're talking about systemic issues as it relates to hedge funds, while there may be 7,000 or 8,000 hedge fund advisers globally, maybe something like 5,000 in the United States, maybe 6,000 — I don't know.

ANDREW DONOHUE: Don't look at me. I don't have any data.

PAUL ROTH: Well, we only have our client list, and that stops at 5,000.

[Laughter]

But there are certainly fewer than 500 — and I'm tempted to say 350, but I haven't seen lists lately — that account for between 75 and 85 percent of the assets under management. So you've got a very, very highly concentrated industry, which, from my way of thinking about things, is one of the reasons why it makes a lot of sense for the SEC to differently approach the requirements for different advisers on the basis of their assets under management — on the basis of their strategy, on the basis of the riskiness, if you will, the interconnectedness for systemic purposes, of these advisers.

Now, Audra asked me whether this kind of legislation would have an impact on whether people would find it easier or more difficult to raise money on a going-forward basis. Intuitively, you'd say, "Well, if you're registered, that should help you raise money" — and it may.

But one of the interesting things that we've seen is the large institutional investors have not put that in the top five of their requirements as they look at investment managers in terms of what it is that they want to make sure these managers do. They are much more concerned with the valuation procedures that these managers have, the operational procedures. In fact, if registration was at the top of their list, all of the large managers would be registered, because these guys have the money.

Roughly, I would say, half of the top 100 in terms of assets under management are already registered. So we know that this is a scheme that can work.

Let me just, for one moment, talk about things other than those that are in the advisers bill and go to the other parts of the Wall Street Reform Act that are going to have an impact on hedge fund managers.

One, subjecting advisers to hedge funds at a $10 billion level of assets under management, whereas everybody else in the world is subjected to this at a $50 billion level of assets under management, assessments for the systemic dissolution fund. Now, this is kind of like, in my view, taxation without representation. I mean, at $10 billion you're not going to be systemically relevant, but we want you to pay in. At $50 billion you may be. Why? I have a hunch it's just because people think they don't like hedge funds. Why otherwise would hedge funds be forced to pay assessments at $10 billion while everybody else is at $50 billion?

Secondly, subjecting hedge funds which are determined to require heightened prudential standards because of their interconnectedness or their size to leverage concentration, liquidity, and risk management may be extremely relevant and important. People don't like it because they don't like being subject to those things, but it may be relevant and important. I'm not prepared to say that shouldn't happen.

However, it is an entirely different thing to say that if you are systemically relevant, and therefore subject to a regulator looking at you with respect to concentration, liquidity, and risk management, that you should also be subject to other requirements under the Bank Holding Company Act, such as restrictions on your activities and the requirement that you be forced to separate your financial activities and your nonfinancial activities. The Act doesn't do that. Frankly, it makes very little sense to me that if you're a non-depository institution you should be subject to those restrictions as well.

Third, we've all heard complaints about compensation on Wall Street. The hedge fund industry has not been known for being cheap when it comes to compensation. But I can tell you, even though I haven't done a survey, that not a lot of people are looking forward to Buddy and his colleagues determining whether or not "the incentive compensation structure of their funds is aligned with sound risk management structured to account for the time horizons of risks and meets such other criteria as federal regulators determine." In fact, buried within these 1279 pages it says that that's what the SEC working with other federal regulators can and should do if they are dealing with a covered institution; and a registered investment adviser is a covered institution.

Lastly, under the Consumer Protection Act, which is part of all of this, there is a new definition of fiduciary duty to make it applicable to brokers who are doing what supposedly is the same thing investment advisers would do. I have a great concern that since 1940 or before, in terms of common law, we have been developing a body of law as to what are the requirements in the fiduciary duty of an investment adviser. Why Congress feels it's necessary to throw that out and put in a new definition of what that fiduciary duty is, is beyond me. It seems to me, if they want to make brokers subject to that fiduciary duty, they simply should say, "When you're acting as an investment adviser, you should follow the requirements of the fiduciary duty under the Investment Advisers Act."

Lastly, two things.

One, there is a provision in there that is applicable to investment advisers. It changes the law with respect to aiding and abetting liability.

It says right now that you can be liable for aiding and abetting if you "knowingly participate" in a fraud; this says "if you are reckless." I don't know. I don't like that. I think it's in part because my wife sometimes says I'm reckless. I just don't — you know, it's a little hard to define what "recklessness" is.

The last thing is "the SEC is given enhanced authority regarding surveillance and risk assessment in the securities markets under the Advisers Act." I'm not sure I understand that. I think they have enough ways to poke their way under the tent to find out what's going on and that there is a different division which generally monitors what's going on in the markets. But it's very interesting because it says that "at any time, and from time to time, the Commission can with respect to registered investment advisers get such reasonable periodic, special, or other information as they deem to be necessary." Very, very broad provisions.

So I'll turn it over to Matt at this point.

MATTHEW SIANO: Thank you.

Good morning. As Professor Jalil mentioned, my name is Matthew Siano. I'm the General Counsel of Two Sigma Investments and Two Sigma Advisers to hedge fund managers that are registered with the SEC, and I'm also the Corporate Secretary of Two Sigma Securities, which is a FINRA-registered broker-dealer. So, as you probably have figured out, I'm at the crossroads of basically everything that's in that book that Paul put out on the table.

PAUL ROTH: You want it?

MATTHEW SIANO: I have two copies.

I was invited to speak here this morning because Professor Jalil believes I can faithfully represent the perspectives and opinions of managers and their in-house counsel who are out there every day trying to assess and plan for the fallout of these various hedge fund and other financial services regulations being pushed on Capitol Hill.

Professor Jalil is hoping that I can cogently discuss whether the passage of, whether it be H.R. 4173 or Senate Bill 344 or any of their predecessors on both sides of the House — how they would put people like me and other in-house counsel in a professional position not dissimilar to where I sit on this panel, which is the government on one side, academics and practitioners on the other.

To fulfill my responsibilities to you and to him, I intend to use these opening remarks to briefly discuss which parts of these recent statutes or bills I think will cause internal counsels like myself the most concern, as well as which parts of the statutes I think are either beneficial, or certainly less problematic.

I should note that these formal remarks will be relatively short, because I tend to favor the Q&A portions and the dialogue portions of these presentations. So I'll try to be brief.

Before I begin, though, I would be remiss if I didn't thank all of you for coming. There's nothing worse than coming and speaking to an empty room. I also want to thank the *Corporate and Financial Law Journal*, Professor Jalil certainly, the Law School, and Dean Treanor. I want to thank my firm, Two Sigma Investments, and in particular my associates Dana Sckolnick and Amy Pollack for helping me put these remarks together, because without them, frankly, I wouldn't have anything to say.

Just like Mr. Donohue started with, I have to also start with a couple of disclaimers. While I think certainly Professor Jalil is happy to have me back and I'm happy to be a Fordham alum, I don't speak for the Law School, I don't speak for Two Sigma Investments, I certainly don't speak for the SEC or either of the law firms or academics that are here. I don't even speak for my wife and kids either. And while I certainly hope my opinions are based on information and beliefs that are accurate and informed, I can't guarantee that they will be accurate or informed. And nothing in here, obviously, is a solicitation for my firm or any of the funds that we manage, just to be clear.

JAMES JALIL: I like the last part there.

ANDREW DONOHUE: Well, you're registered. You can hold yourself out.

MATTHEW SIANO: And finally, the topic of these remarks you should all know is really subject to constant change. I mean, I think as all of us found, we were going to speak about certain bills, and then they changed, frankly, on us a couple weeks after we all met to talk about what we were going to talk about. So you really do have to keep track of where the legislative process is and where Congress is really sort of going.

So where do I begin? I think I wouldn't be doing my job this morning if I didn't state at the onset that not all of the parts of these bills are problematic.

I don't think that registration in and of itself is problematic for the industry. I think Paul's comment that the hedge fund industry is no longer a cottage industry is correct. Frankly, registration would take one of the easy targets that hedge fund managers generally have off their backs, which is that they are somehow secretive and outside the regulatory regime; and, frankly, for the funds that are already registered, it may act as a barrier to entry, speaking just from a competitive advantage perspective for a moment, for those of us who are registered, if it puts up barriers to having other managers come in — I don't have to compete as hard for those institutional dollars, so that's terrific. But I do think as a general matter for the markets, and certainly for the industry, I do think that registration is a positive thing and it's something that we shouldn't shy away from.

Moreover, good managers want stable markets. We want reduced systemic risks. Good managers want a collaborative relationship, not only with Capitol Hill, but also with the folks on F Street and with the press. We don't want to be misperceived, mischaracterized, or misunderstood.

Good managers also want the ability to pursue legitimate investment strategies and to be able to be seen as a value to the financial system, and not the sort of hidden root of the financial meltdown, which I don't think is correct.

Good managers also want clear rules that they can follow in confidence, and they want speedy enforcement against bad actors.

Statutes that focus on, or even enhance, these components of the regulatory landscape are welcome. That's why I'm going to focus on the parts of the House and Senate bills that I think represent the greatest concerns for managers as well as the parts of the recent bills that I think are sensible and welcome.

Let me be clear again that the general premise that investment managers should register with the SEC is not at the top of that list as being a problem.

What is at the top of the list for me?

Well, in my opinion, the most problematic of the concepts that I've seen in the recent bills are clearly the attempts to either register the funds themselves or to act in some way to prevent what the funds can do. While this is an important distinction, it's not actually drawn out very clearly in a lot of the press clippings that you read. You generally hear "registration of hedge funds," and what they're most of the time really referring to is registration of the managers of those funds.

It's bills that look to actually register the investment funds themselves that I think are more problematic. Take for example the previous Senate Bill 344, which attempted to register the funds themselves, albeit a "registration-lite" version. While they may appear innocuous on the surface, I think they're a slippery slope toward some of the potential things that Paul identified, which would be limitations of the types of strategies, limitations of the types of activities that the funds themselves can actually engage in, and I think it's those things that will have a detrimental impact on the capital markets generally, as well as for investors.

This is clearly the biggest concern among hedge fund managers because it has the potential to disrupt not only the profitability of the industry, which certainly is near and dear to all of our hearts, but it's also the innovation that I think has really defined the industry. The industry is an innovative industry. There's a reason that people leave well-established investment houses to go out on their own and be entrepreneurs and start new firms.

I don't think that it's hyperbole to say that these attempts to register funds and potentially subject them to the limitations — whether it be of the Investment Company Act or control over compensation or some of the parts that are laid out in the House bill — to say they belong in the same category as measures designed to outlaw short selling or other ideas to prevent the use of leverage or restrict trading frequency or institute trading taxes. They all seem to be attempts to actually curtail legitimate trading activities.

Nobody in the hedge fund space that is a legitimate actor is saying hedge funds should be allowed to engage in insider trading or market manipulation. What they are saying is, "we should be allowed to engage in investment strategies that are legitimate and do add to the capital markets."

Additionally, I see these types of statutes as a tacit abandonment of the basic premise that sophisticated investors, be they accredited investors or qualified clients or qualified purchasers, are able to act on their own and appraise their own risk-reward profiles for particular investments. I believe that any retreat towards a regime of regulators deciding what investment product strategies are appropriate for investors is not only fraught with peril but I don't actually think it's operable, to use the term that Paul used.

The second category of proposals that I believe are of grave concern to hedge fund managers are rules that require the disclosure of sensitive proprietary and valueable information about funds, their investors, and their activities. Such proposals present at least four interconnected problems:

- The type of information that's being demanded;
- The volume of the information that's being requested;
- With whom this information is going to be shared; and
- For what is this type of information going to be used.

On the type of information, several of the recent bills in both houses of the Capitol call for hedge fund managers, unlike managers of mutual funds in most cases and certainly managed accounts, to disclose among other things investor names, fund trading practices, investment positions, and leverage levels, all of which are in fact highly confidential and highly proprietary because they can be used to reverse-engineer the actual strategies that are being used by the managers.

While some of this information certainly would be relevant to the government's attempts to assess systemic risks that are the purported roots of many of these pieces of legislation, other pieces would not and would do little but impose burdensome and potentially fatal disclosure obligations on legitimate investment managers.

I think the panel has already drilled down on some of the problematic terms that we are talking about.

When you're talking about how much leverage an investment firm — let's say one based in SoHo — is using on behalf of its clients, that's a very difficult thing to define, whether it's because you're talking about explicit leverage, the actual borrowing of funds, whether it be from a brokerage house or a bank, or whether you're talking about using particular types of investment instruments that within them have tremendous amounts of "embedded leverage." I'm not sure, frankly, if I were asked to do that — I don't know how I would define it within my own firm, let alone if I were working at the Commission trying to tell other people how to do it.

On the volume prong, I don't believe there's a true appreciation for the amount of data that the government is going to be inundated with. I shouldn't necessarily speak for Mr. Donohue and his team, but I certainly can see from the Form SH, which was an attempt to collect short sale information, that we were producing tremendous amounts of data and sending it along, and I'm not sure how much of that was actually processible or usable.

While I certainly applaud the desire of the Commission and the Federal Reserve, as well as what other agencies the government elects to create, to understand basic information about our industry and how it has grown from its obscure beginnings into a more substantial market participant, I question how well this information can be digested and used.

I also don't believe that the Commission appreciates the time and cost of producing any of these reports. I shouldn't paint with such a broad brush. I'm sure there are certainly people who do appreciate it, but there is a tremendous amount of time and energy that goes into the production of these things.

If the process of producing Form SH is any indicator, managers will expend tremendous resources to transmit information to the SEC and/or its designees, regardless of the impact said reports may have on the bottom line.

On the audience prong — in other words, the people who are actually going to see this information — under congressional proposals, whether it's H.R. 3818, which is the predecessor bill, or Senate 344, not only would hedge fund managers have to disclose this kind of information to the government, but also to existing prospective investors, counterparties, and creditors, along with in one of those earlier bills "any other entity that the Commission identifies as having systemic risk responsibility." Well, does that include the exchanges? Does that include the brokerage houses that are regulated? I'm not sure where that was going to go.

I think the critical distinction to make is that some of the bills now are addressing the disclosure to the government, which I think is a legitimate exercise, and the disclosure to other participants in the marketplace, who may be able to use that information to actively work against the interests not only of my firm but of its clients.

To quote former Representative Richard Baker, the current CEO of the Managed Funds Association, which is the trade association that Paul referenced down in Washington representing the funds on the Hill: "Public disclosure of much of the information sought under these bills would be like asking Colonel Sanders to disclose the secret spices for his fried chicken." While it's certainly fair to tell, using the analogy of food, the Food and Drug Administration what's going in to make sure you're not poisoning the public, it's a very different thing to be sharing that with its competitors, or even the people who aren't necessarily consuming the product.

I believe that H.R. 4173 still has some of these problems, as Paul has already pointed out and I'm sure will be discussed by the other two speakers.

On the use front, I'm also concerned about the lack of limitation on the use of that information when it's disclosed to the government.

I'm also concerned about when government officials, frankly, leave public practice and head back into private practice. I don't think it's being paranoid for investment managers to be concerned about the information about their strategies, the way they manage money, for whom they manage money, to be worried about that information then being used when people leave the government to go into private practice.

While I'm encouraged by language in 4173 that provides for, among other things, explicit protection from FOIA requests and the deletion of certain information, I'm still concerned about some of the use limitations that I don't see.

The third, and probably the final, major concern I have when I read these statutes is the unclear rules that I see when I read through them. I trust that the SEC and Congress are aware, but maybe not, that unclear rules only compound the difficult jobs that CCOs and general counsels have in trying to carry out the objectives of these regulations.

While I certainly applaud statements like the need for anti-money-laundering processes and procedures, not defining those regulations or other items like them — like the definition of what a "client" is and the definition of "leverage" and some of the other things we've talked about — only leads us to scramble.

I certainly believe that CCOs and general counsels want to do the right thing. I certainly believe that, not only because they have personal liability, certainly in the case of the CCOs, but just because I don't believe personally that people get into the hedge fund industry to become a crook. The vast majority of people in the industry are actually entrepreneurs who are actually trying to do the right thing.

So what are some of the positives, after I've spent ten minutes railing against what's going on down in Washington?

Again, I think it's important to state that regulation takes the target off the hedge fund industry's back. Whether we talk about regulating all the hedge fund managers as well as all the private equity managers or all the venture capital managers, I think at the end of the day it's important to recognize that registration takes one of the easy criticisms that's leveled at the industry off the table. As to how we go about doing that, there's certainly room for debate, and we're certainly going to talk about that later today, but I think it's important to recognize that the idea that this is, potentially, a major win for what we do is not to be lost among all the discussion.

I also like the fact that there are clear custody requirements being built into some of these statutes. The fact that you have to actually maintain other people's money appropriately I think is something that we shouldn't lose sight of.

I like the fact that there are escalations of the definitional amounts that make you qualify as an accredited investor or a qualified client or a qualified purchaser. I find it interesting that in some statutes they fix one of them, but they don't fix the other two. However, I do think escalating all of these definitions — for example, the accredited investor one was set in 1982, I think was the last time it was raised, and back then $200,000 was a real salary. Now that amount is still real, but it is certainly capturing many more people than it did in the past.

I think the fact that they are trying to codify best practices is admirable. I certainly take Paul's point that if the funds' records are now my records as an investment adviser, that certainly puts a greater burden on me. However, I think what you'd find is that most of the investment managers out there, pick their administrator or pick their prime broker very carefully and are, frankly, relying on those records to produce audited financial statements and their performance numbers, and I think I'm, surprisingly, not as concerned about the extension of that responsibility to force accountability for what's in those records. There is certainly risk there, it's certainly not something that we would do lightly, but I do think it represents, frankly, what most of us are doing anyway.

Government accountability — I think this is one thing that I very much liked in the House bill. I liked the fact that Congress was going to look into how was this information being used and was actually going to circle back after a certain period of time to say: "Okay. You've been given all this information. What did you do with it?" I think that's helpful. I think that certainly lowers some of the concern that you hear in the industry about the government either is out of touch or they're not concerned about the cost that this is going to put on us. That actually goes a long way to being able to point to it and say: "Look, they put this in a piece of legislation; they clearly are thinking about that."

I also think synchronization among the regulators, whether it be domestic regulators or international regulators, is a good thing. The idea that it's clear that information sharing will happen between the Federal Reserve and the Commission under some of these bills, the CFTC under other bills, and, as Buddy introduced, the FSA component or the international component, that's certainly helpful. It would be helpful if the government were going to do that on a lot of different levels.

Last but not least, I think the House bill certainly does a good job of eliminating some of the sillier provisions that I think still sit in the Dodd bill:

• The distinction between a fund being formed in Delaware versus being formed in the Caymans — I think there shouldn't really be a distinction between those two things. I'm happy to see that come out.

• And again, the fact that it's codifying the idea that you need to keep records and that you can justify to senior management that expending resources to have good retention systems is important, because it's in the bill, actually goes a long way to making our lives easier.

Let me close by thanking Professor Jalil and the *Corporate and Financial Law Journal* again for the opportunity to offer my thoughts, and I certainly welcome the Q&A portion and the discussion portion of the panel.

JAMES JALIL: Thank you.
Professor?

J.W. VERRET: Thanks. I want to thank everyone for coming. Thanks to Audra for setting up this panel and doing a fantastic job with all the logistics.

Professor Jalil and this notable panel — I think this crew has probably forgotten more about hedge funds than I've ever known, so I won't purport to tell you anything about the hedge fund industry. But I will offer a bit more of an academic perspective, which to me that word means the most important thing, contrary to probably conventional wisdom on that, and also a perspective of someone who works for a think-tank that operates in D.C., which we should all be aware of, the Mercatus Center. *Mercatus* is Latin for markets, free markets. We take a free-market advocacy perspective in engaging with regulators and with members of Congress. It's a tough row to hoe these days. It's a tough, kind of a hard sell, but that's the perspective that I'm going to offer today.

One of my favorite quotes from Ronald Reagan is: "The problem with Washington, the problem with the culture of Washington, is this: it's the idea that if it moves we should tax, and if it keeps moving then we should regulate, and if it stops moving then we should subsidize it."

I think one of the problems with what we are seeing and one of the problems with what we are going to see in regulation of the hedge fund industry, both by the SEC, and by other financial regulators, is the way we're going to tax hedge funds — and they're going to tax you, don't worry; if you keep moving they're going to tax you — is I think all three of these problems: it's regulation, it's taxation, and regulatory subsidy as well.

Now, just to throw out the general critiques of hedge fund regulation, what happens if we get the cost-benefit analysis wrong and we over-regulate? Generally, I think that the general criticisms include that:

• We'll see more offshore flight; we'll see firms try to find some other jurisdiction where they can get a better deal, although that might be a little bit harder these days than it was in 2003 and 2004;

• We'll see costs to liquidity and to the price-discovery function of the capital markets; and

• We'll see some false bonding as well, we'll see the notion that "Look, we're registered, so we're safe." We've seen, I think, to some extent that might not necessarily be always the best inference, but sometimes markets take that inference from the bonding effects of registration and regulation.

Proponents of hedge fund registration and regulation assert a couple of things. I think we've seen quite a great deal of confusion about the objective of these changes in the law.

Is it about Madoff or is it about Bear Stearns? — That's the issue. Is it systemic risk or is it fraud prevention?

The SEC has a history of statutory mandate and some technical expertise for dealing with fraud after the fact. The SEC has some ability with preventing fraud, some ability with it, but a mixed record, I think, with fraud prevention.

With systemic risk, the SEC has no expertise whatsoever. The SEC has some expertise with dealing with issues of credit between a regulated party and the folks that loan money to them, making sure that that credit risk is appropriate for the profile of the investors in that institution. However, in terms of systemic risk, in terms of the domino effect on parties that deal with the parties that deal with the parties, many of whom aren't necessarily SEC-regulated, the SEC doesn't have any expertise. That is the province of the macroeconomists. One of the problems with the SEC is there aren't enough macroeconomists at the SEC; there are too many darn lawyers.

So I think we have to consider the real objective of all of this.

Now, to the extent the objective is fraud prevention, the reason I'm here is I'm an advocate of self-regulation in the financial services sector. I think it generally tends to be a good way to go. I think we have a mixed history of self-regulation in the financial services sector.

Now, critics of self-regulation will tell you that it fails. To use the phrase that Roosevelt used when he picked, coincidentally, Joe Kennedy to be the first chair of the SEC, it's the fox guarding the henhouse. And it's even worse, they'll say, in self-regulation because it's subject to regulatory capture; firms take it over and use it to keep smaller firms out, and they won't really regulate at all; self-regulation isn't real regulation, it's toothless.

Well, I think sometimes that happens just because the self-regulatory organization or the self-regulatory strategy is designed to fail from the very beginning. That's how I would describe, for instance, the consolidated supervised entity program at the SEC to oversee investment banks. I wouldn't really call that self-regulation. I think that was designed to fail from the very beginning, but I think if you design it right, self-regulation can work, and it can work for two reasons.

First of all, with respect to internal competition for capital between funds, I think you can develop what the economists call a sort of Prisoner's Dilemma situation, Nash equilibrium. Anybody who has seen *NYPD Blue* or one of the cop shows knows about the Prisoner's Dilemma. You put two suspects that are co-conspirators in a crime in different rooms and you tell each of them, "Look, if you confess you'll get some time, but not as much as the person that doesn't confess." If they could only collude, if they could only both agree not to talk, they could both walk. But because they want to get the slightly better deal, one of them talks, they both go to jail — the Prisoner's Dilemma. If you set up the dynamics of the self-regulatory organization right, you get the same sort of Prisoner's Dilemma in the types of regulation that you see the SRO promulgating.

Now, with respect to external competition for capital, I think everybody's on the same page. The hedge fund sector wants to get money from people that might otherwise invest in other asset classes, so they want to promote the integrity of the hedge fund sector as a sector more generally. So I think a much easier sort of incentive is set up there.

Alternatively, you could have the SEC do it, but there will be some problems with it.

• First of all, there is a problem, frankly, of knowledge of what's going on the ground — I think the SRO is going to have more expertise.

• There's a problem of the Administrative Procedures Act. If you want to act quickly to stop something that you see on the horizon, the APA delays your ability to rule-make — and there are reasons why it tries to slow things down, but it does slow things down, where the SRO can potentially act a little bit more quickly.

• There are also, of course, public choice constraints on regulators acting. We see a lot of different incentives faced by bureaucrats in making regulation, and it doesn't necessarily always relate to the public interest. There's some element of careerism; there's some element of "We're regulators, we should regulate; and if we want our budget to grow over time, we should regulate more; and if there has been a crisis, we should say, 'Well, the only reason why we didn't stop the crisis is because we couldn't regulate more. Just let us regulate more stuff and everything will be okay.'"

So if I were to design a self-regulatory organization for the hedge fund sector, what would I do? Now, I think this is in some ways sort of academic, but academic ideas can have real power in securities laws. If you like, the Private Securities Litigation Reform Act (PSLRA) was the result of Professor Weiss, who just wrote an article. If I were to change private regulation, here are five ideas of what I would do. Congress cut and pasted from his article and put it into legislation and now we have the PSLRA.

Now, I don't have anything of nearly that force or power, but I offer something in the same respect, and I think going forward, as we see the SEC continue to grow in its regulation of hedge funds, potentially — God forbid — a Company Act-type legislation or just growth of Investment Advisers legislation, I think we'll see the pendulum also swing in the other direction, as it always does in securities regulation. Maybe, hopefully, the next chairman will be more of a deregulatory chairman, appointed by maybe a different president, and we'll start thinking about exemptive relief.

I think we can talk about exemptive relief along something like these lines:

• First of all, I would make sure that the SRO has term limits for the members that govern the SRO and set rules for the SRO.

• I think the SEC should have an important role in vetting nominees to the SRO, making sure, for instance, to vet the nominees for diversity of fund strategy and for size. You don't want a couple of large funds to use the SRO as a vehicle to maintain their dominance of the industry, and you don't want to create rules that promote one asset strategy over another, so you want to make sure there's some diversity in terms of company size and asset strategy in terms of the sort of companies that get to have a role in the SRO.

• You'd want an independent budget.

• You'd want some sort of independent enforcement.

• The one thing I think we really need in terms of SROs more generally is a standard of review when the SEC reviews rules made by the SRO, some sort of an abuse-of-discretion standard of review, such that the SEC cannot dominate the SRO rule-making process, I think the way it does now. So I think some sort of a statutory limitation on the SEC's ability to overturn rules or to mandate that the SRO promulgate certain types of rules.

We've seen some bit of promulgation of best practices. Of course, the President's Working Group on Financial Markets convened investors and convened a group of hedge fund advisers to put together some best practices. I think that's a beginning for what we could see the SRO do.

The United Kingdom started with a bit of a stronger, I think, self-regulatory approach, and is still sort of thinking how it wants hedge fund regulation to work. But the Hedge Fund Standards Board has promulgated a lot of rules in the United Kingdom, and I think the United Kingdom, at least, is taking a milder approach than Europe, the European Directive. The House of Lords was very critical of the European Directive on hedge fund regulation because they're concerned about competitive issues.

I think to that extent we might have an opportunity here. If the United Kingdom ends up going in the direction of Europe, I think we might have a competitive opportunity to make sure maybe we become the lighter regulatory regime and we continue to be the great international competitive forum for these types of, I think, very important funds and assets.

Now, with respect to systemic risk, again I don't think the SEC has the expertise to engage, and to the extent that it becomes a source of information for other regulators directly focused on systemic risk, I think that the mission of the SEC will, frankly, be threatened. They don't have the toolkit to do it, so why should we expect them to take the lead on information-gathering for systemic risk issues?

With respect to the Dodd bill, I've been privileged to work with Senator Corker's staff on this bill. Depending on your point of view, he's either the Republican defector or the Republican voice of compromise. I think we can have faith with him to keep Senator Dodd honest on this and be helpful. I think this compromise will eventually minimize some of the damage of some of the burdensome regulations included.

But I would want to build on, I think, Matt's comment and Paul's comment about information and the proprietary trading concerns about information gathering.

One of the exemptions in the Senate bill, in the Dodd version at least — I don't know if it's in the House version or not — is an exemption for Congress from confidentiality requirements. So anything in the SEC, Congress can get their hands on.

Now, you might call me a conspiracy theorist, but one thing we have definitely seen in the securities litigation context is private plaintiffs say: "Oh no, we can't get access to this information through the discovery process because of some evidentiary limitations, some procedural limitations. Here's what we can do: Congress is not subject to these limitations. Let's donate and develop a dialogue with members on House oversight and Senate oversight, and let's get them to do an investigation into some firm, let's get them to get the evidence we need, and then, because it's now part of the public record, we can use it to prosecute our private plaintiff litigation."

I think in the same vein, if I was a clever hedge fund, I'd make friends with some people on House oversight and Senate oversight. I'd get them to get the information from the SEC and I'd get access to it ahead of time and trade on it. Or I would just get it out in the open to destroy a competitor. There is nothing whatsoever illegal about that. Trading based on knowledge you get from members of Congress is not subject to the insider trading rules.

Now, there's a law that has been proposed in the House, the so-called STOCK Act, Stop Trading on Congressional Knowledge Act, that I actually testified against for different reasons, that would limit your ability to trade on information you gain from Congress. But that law, I think, is probably going to go nowhere. I don't think the STOCK Act is going to pass. I think it's one of those sort of "milker bills" that you just put forward with knowledge that you're going to take it back later in exchange for donations. But that's another thing.

So I think you can definitely use the congressional exception to some effect. I think that's maybe just one example of the threat that Matt was mentioning.

So that's hedge fund registration and regulation. I know that's the topic of this panel. Let me just take a minute and a half to go off the reservation and tell you a little bit about what else is coming that's going to affect — it's maybe not hedge fund regulation, but regulation affecting hedge funds.

• Short sales restrictions. You probably know a lot about that. That's likely to come down the pipeline, I would imagine. I don't know quite what form it will take, the uptick rule, or the so-called "circuit breaker" and then uptick or alternative uptick, modified uptick, but in some fashion we'll see restrictions on short sales. The world seems to blame, in part, the financial crisis on short sellers for some reason, I think. My own personal view is I think short sales are great, they help price discovery, and I think sometimes they pop asset bubbles. Long bias in the securities markets and long bias in regulation of the securities markets is not something that helps any of us. In other words — maybe it's a bold statement — I think that a company that can't survive a bear raid doesn't deserve to survive. But to that extent limitations and restrictions on your ability to short sell are going to limit your ability to hedge. To the extent that hedge funds really do hedging anymore — I don't know how big that is in your industry — but if you can't hedge, then you don't take the long position either, so that limits again liquidity and price discovery.

• Taxation. Well, President Obama's budget released early this month includes a provision to tax carried interest as income rather than as capital gains, tax your performance fees as income. Obviously, that's not going to be very much fun. I don't think that's going to go anywhere this year because Senator Baucus is very adamant that he thinks this is going to stifle growth and he doesn't want to stifle growth during a recession, which I think is probably wise. But as the recession fades but the deficit remains, I think we have a very real threat of this change in carried interest taxation going forward. Now, the good news is they're probably going to raise capital gains taxes anyway, so it might not make much difference to you. But that's likely.

There's also a transaction tax in the works, tax every single trade in the securities market, the so-called Make Wall Street Pay for Wall Street's Bailout Act. I don't know how likely it is, but I know the Chamber of Commerce is worried about it and lobbying heavily against it. So to the ordinary mom-and-pop investor it might not be a big deal, it would be a very small percentage, but to the high-volume investor obviously the transaction tax would be a really big deal.

• I also think that there will be some changes in proxy access that will be very important for those of you that engage in activist hedge fund strategies — sort of buy shares and rattle the saber for changes in publicly traded companies. My understanding right now from discussions with the folks on the Hill and staff and lobbyists on this issue is that unions were obviously big proponents of proxy access. Proxy access is still being redesigned by the folks at Corporate Finance and might or might not be part of the Dodd bill, depending, I think, on the outcome of negotiations between Corker and Dodd this weekend. But one of the concerns that has developed within the union side is that they're concerned about hedge funds using proxy access. God forbid hedge funds should put nominees on the board that would downsize and that would put assets at more productive uses elsewhere. So I think we might see some changes in the holding period restrictions and in the percentage ownership minimums to try to edge hedge funds out. I don't know quite how they'll try to do it. I don't know how you can empower union shareholders but not hedge funds. But rest assured the union lobby is looking for a way at this point, so I think we might see some changes in proxy access that reflect that.

So if it moves they're going to tax it, if it keeps moving they're going to regulate it, and at some point if it stops moving maybe they'll try to subsidize it.

I hope that has all been useful. Again, I appreciate the opportunity to talk to all of you today.

JAMES JALIL: Thank you.
Holland?

HOLLAND WEST: Thank you.

That was great. There is a reason why they made me sit to the left of Professor Verret. I did enjoy your comments.

I've made a career off the private fund and derivatives business, and I'm a big proponent of the business, but I'm not an apologist for the industry. I honestly believe that some intelligent, meaningful, disciplined transparency and oversight is needed in this business, and that has been the case since the mid-1990s.

To me it's critical to rebuild the trust in the financial services business. The business simply can't be ignored. It's too big and important to price discovery, liquidity, and capital flows. It's in no one's interest to bring the financial system to its knees again or to put systemic participants at risk. That's just my personal view on this whole thing. At the same time, I do believe it needs to be intelligent and meaningful and that it works fairly for all participants as well as the regulators.

What I'd like to do in finishing up, because much of what I could cover here has been touched upon, but I'd like to just fill in the gaps on some of the things that have not received as much attention.

The Administration's proposal included no significant exemption from investment adviser registration, except for very limited ones for small investment advisers with limited assets under management and number of clients — basically, a *de minimis* exemption.

Secondly, certain foreign investment advisers that Paul talked about with limited U.S. business and contacts. Accordingly, investment advisers to many different kinds of private pools of capital are going to be required to be registered and regulated under the various acts. That would include advisers to hedge funds, commodity pools, venture capital funds, private equity funds, buyout funds, real estate funds, funds of funds, and then, lastly, CDOs and other structured finance and securitization vehicles.

There is a heightened stridency in Washington and elsewhere on anything remotely perceived as a loophole. There is a lot of noise being made, a lot of lobbying going on. We're going to see how things sort out over time, but the bills that we've been talking about, the House bill and the Dodd proposal or discussion draft, are likewise broad, but you do see some exemptions working their way into the process at this point.

What I'd like to do is focus really on some of the non-hedge-fund-related investment advisers and what this all means to them, as well as the foreign advisers who are not getting a lot of attention due to just our parochial view of this here in the United States. And again, some of this has been touched upon, so I'm not going to go into all of the detail.

First, small managers — "small- and mid-sized managers" I think is the term. Both the House bill and the Dodd bill — and I'll refer to it as "the Dodd bill"; it's a discussion draft, not a bill — as Paul pointed out, substantially increase the amount of assets under management necessary for federal registration.

The House bill, again as Paul said, provides an exemption for an adviser to a private fund if each of the private funds under management has less than $150 million. Now, accordingly, a fund manager could have much more than $150 million under management, so long as each private fund has less than $150 million.

The Dodd bill raises the level to $100 million, and that's without reference to private funds at all. Now, those small advisers would be subject to federal recordkeeping and reporting requirements and would be — I thought Paul did a great job talking about the issues about state registration — subject to state registration.

In light of the fact that this increase has come up in these bills, it's highly likely that final legislation is going to raise the minimum requirement, or rather the minimum amount of assets under management, for federal registration.

Now, the same for so-called mid-sized fund managers. The House bill provides that in prescribing regulations the SEC is supposed to take into account size, governance, and investment strategy. Honestly, I think it's going to be very difficult — and Paul said this as well — for the SEC to adopt any sort of meaningful guidance and rules in that regard as to what that means.

Secondly, let me address family offices. I don't think that has been mentioned today. There are a lot of family offices — single-family offices, multiple-family offices — that operate where they invest in the alternative industry. By their very terms, under the Obama proposal they would have been required to register. The Dodd bill would completely exempt family offices from registration and reporting requirements. What the bill does not do, however, is define what a "family office" is, leaving it to the SEC to define that term. It remains to be seen how that will be defined and what attributes family office has.

Now let me get to some of the more controversial and actually, honestly, more important people in the industry, the venture capital and private equity folks.

Commentators and fund industry lobbyists have argued that these vehicles pose far less systemic risk than hedge funds, and therefore they needn't be registered.

Curiously enough, in January 2009 the Group of Thirty, financial regulators and bankers, issued a report where they called for subjecting the managers of private pools of capital that employ significant leverage to regulation and registration. The Group of Thirty report also exempted out venture capital funds — and venture capital funds were the only ones named — presumably on the notion that they were less reliant on leverage.

Both the House bill and the Dodd bill completely exempt managers of venture capital funds from registration, but they do require the venture capital managers to be subject to recordkeeping and reporting as the SEC will determine. So in that regard the SEC has to determine what those requirements are and, secondly, to define what a "venture capital fund" is. I'm going to get to that in a minute. So it remains to be seen how limited or how expansive any such definition would be.

This segues into private equity. The Dodd bill, unlike the House bill, exempts registration of an adviser to a private equity fund, again leaving the SEC the task of defining what a "private equity fund" is. Those advisers would be subject to recordkeeping and reporting requirements, again as the SEC would deem to be necessary and advisable to protect investors in the market.

Now, there are a couple of things here.

• One is, what is a "private equity fund" and what are the attributes? There have been some commentators that have said, "A private equity fund can be defined as an entity having a two-plus-year lockup. Simply that." There are probably some other attributes that should be introduced into this analysis as well.

Likewise, if the SEC, both for venture capital funds and private equity funds, gets to the point of defining what are those recordkeeping and reporting requirements. Assuming — and that's a big assumption — that actually there will be an exemption for these folks at the end of the day, there could be very rigorous reporting requirements, and therefore these people who enjoy an exemption from registration could still be subject to a bit of regulation.

Now, let me focus on an area that also hasn't been touched upon today, and that's real estate advisers. Those are advisers giving real-estate-focused advice in funds. The reason that's important here is, clearly, there are certain assets, such as real estate assets, that don't constitute securities under the securities laws. However, if part of the business of a manager is advising with respect to securities of a real estate fund, they are going to be swept into this whole regime.

For example, if an adviser is advising a real estate fund on cash flow from investor subscriptions and proceeds prior to payment of expenses and distribution and withdrawals — if there are withdrawals, but mostly distribution — it's likely that they might be investing in securities.

Secondly, if a fund's program involves lending of any sort of debt acquisition, such as direct lending or mezzanine debt or requiring participation interest in loans, that could be deemed to be securities as well. There are definitional issues here.

If a fund acquires limited partnership interest or any sort of interest in a real estate asset or certain real estate assets, if they acquire securities in a REIT, or if they acquire mortgage-backed securities, that constitutes giving advice with respect to securities.

Now, in these registration requirements there is no primary business exception, or *de minimis* exception, as to how many securities you would have to give advice with regard to would be swept under the regime.

So what's a real estate manager to hope for? A couple of things:

• One is there could be a lobbying effort to get real estate managers their own exemption from registration. There's no indication of that, but it's certainly something that people have thought about.

• Probably the most likely hope for the real estate managers, if any, and even if one is desired or deemed necessary, is that they could fall under some exemption that the private equity fund managers would fall under, if in fact there is one.

Real estate funds are very much like private equity funds. They have similarities in attributes like an initial offering and no continuous offering, accepting capital on a capital commitment basis and investing that capital, a limited investment period where investments are made and commitments are drawn down, multiple-year terms, and no liquidity events, no voluntary redemptions. I would submit that some of those attributes, as opposed to a single lockup period, is a better way to approach it, if there is an exemption to be had, on what attributes of venture capital and private equity funds and real estate funds should be looked at in that regard.

Regarding non-U.S. investment advisers, there has not been a lot of focus on this. It was mentioned earlier, but both proposals have a very broad extraterritorial effect. Fund managers, even if based overseas and with limited U.S. investing, are required to register if the fund assets attributable to U.S. clients exceed a particular threshold.

Now, there is the exemption that Paul described, and I'm going to give you a few details on this because it is important to a lot of people, including U.S. advisers with affiliates, but then many, many offshore advisers as well.

The exemption is for a "foreign private adviser." Now, that is defined as such an adviser has no place of business in the United States, doesn't hold itself out generally to the public in the United States as an investment adviser, and has fewer than 15 clients in the United States, and — and it's an "and," conjunctive — assets under management attributable to U.S. clients of less than $25 million, or a higher amount if the SEC were to determine to raise that amount. A couple of curious things on this:

It's unclear what "client" means. We haven't gotten into that precisely. We've alluded to it today. But that has always been an issue that has been debated, as to whether a client is the fund itself or the investors in a fund. There's a specific rule that treats a fund as one client, but that has been up for debate all through the 2000s.

The House bill specifically prohibits the SEC from defining "client" as investors in a fund. The Dodd bill does not include that.

As to how that's going to work its way into legislation, if at all, or into regulation remains to be seen, but we think that there probably, with everything that has happened, there probably is a high likelihood that clients are going to be defined in a much more expansive way.

Two things. The proposed legislation requires that a foreign private adviser have no place of business in the United States, whereas prior SEC guidance has allowed for a registration exemption for an adviser having a principal place of business outside the United States and fewer than 15 clients.

Secondly, assuming a look-through to fund investors when counting clients, which I think is a reasonably predictable feature of the final legislation and the SEC rule-making, a non-U.S. investment adviser with a relatively limited scope of U.S. relationships is going to be subject to registration and regulation.

One troubling aspect of this for the foreign advisers is that because it doesn't appear; it does disqualify a non-U.S. investment adviser from the exemption if it has either 15 or more clients or $25 million or more in U.S. client investments. Now, the practical application of that is a U.S. institutional investor with $25 million, one investor with $25 million, is going to require the registration of that adviser.

Now, let me just switch gears really quickly. The last area I want to cover is custody. We have alluded to that, and that's a very important area.

For some time, custody has been under discussion for upgraded requirements and expanded application. Primarily due to the Madoff and other frauds and other misconduct in recent years, there has been a renewed focus and some significant traction in this area. So what I would like to do is just quickly focus on the significant changes in the custody world, which I think were a long time coming, and how it affects the private investment funds. There are lots of details here.

The Dodd bill provides specifically that "the SEC shall prescribe rules for all registered investment advisers to use independent custodians." Likewise, the House Financial Services Committee passed the Investor Protection Act in November that also required that the SEC adopt a rule with regard to custody.

On December 30th, the SEC published Final Rules establishing custody rules, and likewise establishing an implementation schedule throughout the course of 2010 primarily for these rules to come into effect. The SEC did not prohibit an adviser from maintaining custody of client assets, despite everything you've heard and despite some of the high-profile problems that have occurred, but by way of these rules it certainly encourages custodians to be independent of the adviser.

Now, what's important is that the custody requirements only apply to registered advisers, not unregistered advisers. That said, if a universal registration regime comes into effect, it's going to sweep many, many more advisers into this regime.

First, what is "custody?" There are existing SEC rules that define custody as "an adviser maintaining physical custody of client assets" (that's funds and securities) or "acting in a capacity that gives it legal ownership to the securities," such as a general partner of a limited partnership or a managing member of an LLC or likewise, depending on the type of juridical entity we're talking about. And then, the third attribute that can be deemed to be custody is if the adviser "has authority to obtain client assets by way of deducting advisory fees or writing checks or withdrawing funds."

So in the custody rules, the definition of "custody" has been expanded beyond what I just mentioned, in the sense that if client assets are held directly or indirectly by a related person in connection with the advisory services, that likewise is deemed to be custody and subject to the rules.

The key attributes of the new rules — well, actually, I'm not going to go through them all, just the ones that really are important to the fund industry:

• An annual surprise examination requirement — that's to verify the client assets — and everybody can visualize Madoff and other situations coming to the fore here, that none of this really was in place — "to verify the client assets are held by a qualified custodian, either in a separate account in the name of the client or in an omnibus account held for the benefit of all the clients in the name of the adviser as agent or trustee."

Now, the elements of a surprise examination — and this would be an annual examination — is to confirm with both the qualified custodian and with the client where the assets are, that the assets are being held appropriately, and to reconcile cash flows in and out and the various confirmations.

Now, there are exceptions to the surprise examination requirement. Under the originally proposed amendments, all registered advisers with custody would be subject to an annual surprise examination. But the final rules include several exceptions that are important:

• One is an adviser deemed to have custody of assets, because of its authority to deduct fees from the accounts, will not be subject to the surprise exam requirement.

• Secondly, an adviser that is deemed to have custody solely because a related person is the custodian is not subject to that surprise examination requirement if the custodian is "operationally independent." There are definitions and guidance on what that means. You can think of that in terms of the big banks, the big brokerage houses, whether they're going to meet that requirement, although there are requirements for internal account controls certified by auditors.

• And then lastly — and this exemption has been around for a while but it has now been enhanced a bit — is an adviser to a pooled investment vehicle, like a hedge fund, is deemed to satisfy the examination requirement if the pool is subject to an annual financial statement audit by a PCAOB-registered accountant and that those financial statements prepared in accordance with GAAP are distributed to investors.

Another important area in connection with the custody rules are requirements for compliance policies and procedures. Advisers are required to adopt written policies and procedures reasonably designed to prevent violation of the Advisers Act anyway and the custody requirements. Some of these are common sense that you would think people would do, but they refer to background checks, authorization of more than one person to make withdrawals, segregating duties of advisory personnel from custodial personnel, and for the compliance staff of the adviser to identify, rectify, and report in a prompt manner any sort of problems or violations that occur so that they can be taken care of on somewhat of a real-time basis.

So last point: What's the impact on funds of the custody in broad,

broad strokes?

One is an adviser to a pooled investment vehicle would either have to obtain an annual financial statement audit, as I mentioned before, and distribute those financial statements to beneficial owners, or undergo the new surprise examination requirement. If they are subject to the surprise examination requirement, there is also a requirement for account statements, which I haven't touched upon. It's a detail.

For a firm not using a PCAOB-registered accountant — and that would be the case for some foreign advisers, foreign pools, and foreign accounting firms that actually don't have the registration — those advisers are going to have to transition to properly registered accountants or otherwise they're going to be subject to the surprise examination requirement and the account statement delivery.

For firms that have self-custody of pooled assets, because the firm or related person serves as the custodian, those firms will need to obtain the new internal control reports from a properly registered accountant.

I think that's all I wanted to cover.

JAMES JALIL: Thank you, Holland.

I was wondering how long we'd get before that man's name would be mentioned, Madoff. We got down to three people before somebody mentioned the name.

We'll take a small break, about ten minutes, and then we'll come back for a panel discussion and questions.

[Break: 11:05–11:26 a.m.]

JAMES JALIL: Welcome back.

For the second part of our Symposium today, I'd like to begin our discussion. But I want to invite the audience to participate in the discussion — questions, comments, directed as you will.

I'm going to start things off by asking this question, throw it out to whoever may want to answer: It seems to me that a good part of the rationale for legislation is tied up with the events of 2008 and 2009 and tied up with systemic risk and risk to the infrastructure of the capital markets posed by large pools of money — which, by the way, was one of the impetuses of the 1940 Act in the first place. So if a rationale for legislation is dealing with systemic risk, does registration of advisers even affect that? Does this bill even address it? Is it efficacious in dealing with systemic risk? And, on top of that, is the SEC in a position to deal with systemic risk — that is to say the risk to the capital markets from large pools of money and the way they are managed?

Anyone want to start that? Paul?

PAUL ROTH: Yes. I think if you go back to 2004, the SEC passed a registration rule with respect to advisers to hedge funds, and that was before you had the systemic risk issue pop up. I think it is based largely — although Buddy seems very capable speaking for himself — upon the fact that the size of the industry indicates that basic information regarding how that industry is operating and how the managers are operating just made sense. I mean this is an industry, after all, that got its growth because the SEC proposed Section 3(c)(7) be added to the Investment Company Act. Before 3(c)(7), you had maybe $500 million in assets, or actually less in 1995, and the growth of the industry has far outpaced the growth of the mutual fund industry in the period 1995 to 2008–2009.

So I think that there was a movement — certainly a regulatory impetus — to find out more about hedge funds prior to the time that you had the systemic risk crash.

ANDREW DONOHUE: I'd jump in a little bit. The Administration in its proposal was dealing with the issue from worrying about systemic risk. Certainly, if there is going to be collection of data and sharing of data, the least obtrusive or intrusive manner of getting that data seemed to us, and I believe to the Administration, to use the existing mechanism inside the SEC to collect that data, to collect it from the advisers as opposed to trying to make the funds have that information, and to make it as simple as we can do that.

We are working closely with our foreign counterparts so that information that we might develop is consistent with the data that foreign regulators may develop.

By way of background, I don't know what the actual number is, but it's certainly north of 80 percent of all hedge fund assets and private fund assets are resident either in the United Kingdom or in the United States. So if we don't capture the information in the proper manner, we're going to have duplications, we're going to have the inability to be able to reconcile data. So there's a big effort that we are doing — and not just with the United Kingdom, but also with IOSCO, such that there is template-type information, so that there is standardization of the information so that it's useful, and so that we actually can share it with each other and eliminate overreaching or double-counting and things of that nature.

I would point out that while the Administration had that view toward systemic risk, there has been no determination of who a systemic risk regulator might be. You know, alternatively, they have talked about Treasury doing it. They have talked about the Fed doing it. They have talked about a council of regulators doing it. I do think that developing the information in the right format over time and making it available will help that effort.

From my perspective, we have had the growth of an industry where they are managing other people's money. That's precisely what the Advisers Act is supposed to take care of. The arguments that "we're not systemically important" — you're still managing other people's money, and if you're managing other people's money in the securities markets, you should be subject to a degree of regulation.

The "fourteen or fewer clients" has been pushed to a limit. It's not widely known to people that aren't in the industry, but I'll pass on a little bit of an insight. There are people who are managing hedge funds in the United States that have an office in London and are fully registered with the FSA, share all their information with the FSA about what's going on in the United States, and don't talk to me. And yet, the vast majority of their assets are actually located in the United States.

PAUL ROTH: Do you take that personally?

ANDREW DONOHUE: I don't, no. But I just think that that's a gap in our regulatory regime. As you look at that, I do think that those gaps shouldn't exist. I think that is something that if you were designing your regulatory regime today you would not put in "fourteen or fewer clients" as a way.

Now, you might decide that there may be certain asset classes for which you might make a determination that maybe the Advisers Act isn't the way it should be regulated, but you wouldn't have done it based on number of clients. You might have done it based on assets, you might have done it on any number of things, but I doubt anybody would say that, that is the right way to make that kind of judgment.

JAMES JALIL: But if you come in with an adviser registration scenario or structure, to take your point that whether you're managing money in a hedge fund, a venture capital fund, or a private equity fund, that you're still managing people's money — that's just your position —

but yet the Act and the policy seem to treat those asset classes differently. There is more systemic risk, for example, on a hedge fund pool because there's a long-short fund, or whatever, that may affect the market more than, say, a venture capital play.

ANDREW DONOHUE: There's a couple of things going on at the same time.

One is, you know, registering as an adviser in the United States has got to be the simplest thing. You fill out a form, you file it with us, and you wind up being registered. If you're overseas and want to be registered as an investment adviser, they have to decide that you are a fit and proper person. They want to know how much capital you're going to commit, they want to know who's going to do this for you, you can only use certain approved counterparties, a whole range — they really are very much into all the things you're doing. Our regime is, for better or worse, a much lighter regime in that respect, so we don't get into that.

What I would envision, if we wound up with a regime where we are supposed to collect data, the data you would collect from venture capital funds would be significantly different from what you would do if you had a $10 billion hedge fund, which would be significantly different from if you had a $500 million hedge fund. In other words, I think that the acts contemplate that the amount of information and the types of information we get would differ based on a number of different scenarios.

And by the way, if we don't build it that way, we are setting ourselves up to fail. You talk to anybody who manages money, they have what I call filters, that there's only certain information they look at, they can't look at everything all the time, so you decide what you think is important and that's what you look at.

That's some of the dialogue that we have going on with some foreign regulators. The FSA has already done voluntary data gathering, and so we have had dialogues with them about what they got, what they didn't get, and how they'd like to modify that, so we have a sense of what kind of data we should be getting and in what format, and then how do you build this.

I suspect that the new division inside the SEC, which we call Risk Fin, will have a lot to do with what type of data would be very helpful.

JAMES JALIL: Matt, for someone who has to put this data together, how would you respond to that? Would you say, "Well, just tell me what you need and I'll give it to you"? Is that just the end of it?

MATTHEW SIANO: No. I think, like I said in the formal comments, we've had some of these examples already. I generally agree — again, I want to make sure I'm very clear on this — I agree that this is a pretty light exercise. In terms of the ADV, in terms of the process to get started, that part I agree is pretty light. Frankly, if the idea is just to be able to get the government's arms around sort of who's out there, that's perfectly fine.

I do think as you drill down on the specifics of what it is that you want — not you — but when you're saying, "Mr. Regulator, you want something; what is it that you want and how do we go about doing that?" — I agree with you, it's fraught with not only difficulty in terms of manpower, but also, even if I wanted to comply to the absolute best of my ability, I'm going to be worried about things like what kind of disclaimers do I have to put on it, how do I define each of these terms, what do you want in, what do you want out. That's the part that I think has to —

JAMES JALIL: In the end, liability that you've never had. All of a sudden, here's a form. An analogy is I think that the industry suffered a little bit on the short sale forms; it was a little bit of a nightmare.

MATTHEW SIANO: Absolutely, absolutely.

ANDREW DONOHUE: My Division didn't do those.

MATTHEW SIANO: Absolutely not. But you're absolutely right.

JAMES JALIL: Okay. Then that was a terrible nightmare.

MATTHEW SIANO: We hired someone on a temporary basis just to address Form SH.

ANDREW DONOHUE: I mean I would say if we do this we need to do it right. People are going to be relying on us getting the right information, getting it in a format that people can manipulate and do what needs to be done, and not get so much data that in fact we can't use it.

I'll tell you that there is concern at the SEC that the more data we have, we have to use it. If you look at just the potential for the SEC as an agency to have a lot of data and not to use it appropriately, it is potentially a huge risk for the agency. So I think there will be a desire to make sure we get the right data, that we don't get too much data.

MATTHEW SIANO: It's interesting. I think the regulator and the industry suffer almost from the same problem, which is this misperception both in dealing with the press and dealing with one another. I think a lot of the angst and a lot of the palaver you hear from people about the registration would go away if that statement that you made was more widely disseminated, that there's at least an understanding, there's a recognition, that this is not something that we are going to do in a scattershot fashion or in a willy-nilly fashion, and we're going to really work to make sure that the data is right. I think that would drain a lot of the strain out of people.

ANDREW DONOHUE: In any organization there's some people that want everything they can ever get, and there's people like myself who look at this and say, "No. I want to be able to focus on what I think is the important information, stuff that is informative, that helps me make some judgments, as opposed to trying to get everything." Then, in a sense, it's like somebody putting you inside the New York Public Library and saying, "Everything is here, go look at it. By the way, there is no catalogue system for you."

PAUL ROTH: Just for a moment, Buddy, the registration process, I would agree with you that it's not that difficult to register. But the consequences of registering are what you're not addressing. The consequence of registering is the examination process, and that is something that I think it's fair to say a number of people find to be extremely difficult.

We've had clients where examiners have set up shop for nine months. You get a feeling that they're not leaving until they find something that they can report and give a demerit on the report card.

So if your approach with respect to the kinds of information that you would like to see, that it be tailored, could be carried over to the examination process, and that is more tailored to control issues and making sure that fraud is what they are looking for rather than violations, I think that there would be a much greater sympathy in the hedge fund world, in the investment advisers world, in the regulated world, to say, "Yes, we are on the same page."

ANDREW DONOHUE: And, Paul, I would point out I spent 30 years of my life on the other side, so I have an appreciation for what it's like. I was always at a big firm, so I used to see the examiners once a year, minimum. So I do appreciate that concern.

I would say that I think the Office of Compliance Inspections and Examinations has probably the most difficult job inside the Commission. I don't mean to criticize them or anything, but it is a difficult position that they have. There is a new head for that who has recently started. I think it will be interesting to see how he reshapes that program.

You know, one of the criticisms — and I'm not saying that this is valid or not — is that they are not focusing on big stuff; they're focusing on little things, and if you focus on the big things you're going to be in and out of firms a lot faster, and in fact you can then cover more of the industry, which has been one of the criticisms, that we don't cover enough of the industry.

JAMES JALIL: Professor, I think you might have a different take on this. What would you say if someone made the suggestion that this is a slippery slope; that we start with this benign registration of investment advisers, a simple ADV form, from which they want to collect certain information? Is this now the thread that pulls out the entire string and you get into ultimately regulation of hedge funds, which has not been the case in the past?

J.W. VERRET: Yes. I would point to the '33 and the '34 Acts, disclosure rules that are now affirmative prescriptive rules. The gun-jumping rules I think were the sort of thing that Congress did not have in mind in 1933 and 1934. So I think yes, that is evidence of a natural tendency for regulation to grow.

But I go back to the original purpose of what's the SEC doing. Is it systemic risk? Is it protection of investors from fraud? If it is investor protection from fraud, remember these are very sophisticated investors in this world. I suspect — I'm sure Paul has read thousands of these operative documents, the underlying business entities of these funds — but I suspect they probably tend to take advantage of the right under state corporate law and under LLC and LLP law to opt out of fiduciary duties. I suspect there is probably some significant fiduciary opt-out in some of those operative documents, and I suspect they probably represent an affirmative decision by the investors that maybe the cost of fiduciary duty suits isn't worth it and that market discipline is good enough. So why would we want to interfere with that decision?

And if it's about systemic risk, I still have yet to hear an accurate and complete definition of systemic risk. In fact, what I hear is a term sort of thrown around to justify action without any sort of really descriptive power and force.

I think systemic risk is something that initially developed in the context of banking panics. I think depositor insurance and the Treasury standing behind the FDIC largely protects us from systemic risk issues. If we define it as some large banks or some large institutions fail, billions of dollars are lost, but the rest of the system eventually comes back in a couple of years, that's part of the natural creative destruction of capitalism to me. I think that's a natural process of capitalism. Why would we want to interfere with that?

So I still don't think we are working from a good working definition of systemic risk, if that's our primary motivation.

PAUL ROTH: If I may just respond to your question, I think (1) from a legal standpoint, from a regulatory standpoint, a fraud standpoint let's say, state law and federal law, I don't believe you can contract yourself out of fiduciary duty.

J.W. VERRET: In LLCs absolutely.

PAUL ROTH: Well, no. What you see is a discussion with sophisticated investors as to whether or not you are held to a negligence or a gross negligence standard. It's an interesting question as to whether being a fiduciary is consistent with a negligence standard or consistent with a gross negligence standard. But that is a matter of contract that does get dealt with, I agree with you.

However, I'm reminded of what Alan Greenspan said, because he might echo some of the things that you have said here today, except that there's one thing that he has commented on with respect to the credit crisis and the crisis in the markets in 2007 and 2008, and that was the underlying premise of self-regulation is that institutions will not destroy themselves, that they will regulate themselves inherently without destroying themselves, that there is an inhibitor in terms of conduct that prevents them from killing themselves.

It turned out that inhibitor didn't work. I think that's why many of us are seeing the pendulum perhaps swing further than we'd like it to swing. But it's a natural part of the nature of regulation. It had gotten to the point where we were relying on institutions, boards of directors, management, to make sure that they did not destroy themselves, then suddenly we found out that they did such basic things as invest for the long term and borrow on the short term. You don't need to be an economic genius to know that long term is not a sustainable model. But the major corporations in this world did it.

In the absence of there being an exercise of self-restraint, I think you see a regulatory sort of compulsion to jump in and fill the vacuum. Will it go too far and do the bills go too far in some respects? I don't think there's any argument that they will and they do, and it will be carved back over time.

But, living through what we have lived through, to argue that self-restraint works, one might say the history of the last two years indicated it didn't.

J.W. VERRET: I would just respond to that by, first, just differentiating between self-restraint and self-regulation. By self-regulation I mean something much more formal than simple self-restraint. But even more than that, I think the overwhelming use of the words "systemic risk" as the bogeyman for regulation and for subsidy and for bailout is part of the reason why we didn't see enough self-restraint. So I think as we information-gather, as we say "here's a systemic risk issue," I think we'll see that information being used to promote further bailouts on the Federal Reserve side, and I think we'll continue to see that limiting the exercise of self-restraint in the long term.

ANDREW DONOHUE: The concerns that you have I would say are way above my pay grade.

J.W. VERRET: Above mine too, probably.

ANDREW DONOHUE: I do agree, I haven't seen a great definition of what systemic risk is. What you hear from some people is, "We know it when we see it," yet I'm not sure that's true either.

But as I think of it — you talk about what is the role of the SEC. The SEC's role is primarily as really the investor advocate and protecting investors, but we also have primary responsibility for fair and orderly markets and capital formation. So there are other things that we are responsible for.

To go back to why I think that some of the proposals with respect to registration of investment advisers make sense for hedge funds, it goes to filling gaps that I don't think make sense to be there. It's a mechanism; if one wants to get the data with respect to hedge funds in that area, that is the least intrusive way to get that. I thought that was a moderate means of trying to wind up getting that information in a format that people could wind up using it. So as I've thought about different approaches one could take, it seemed like that was the least intrusive means of getting that information.

There was a comment before, that the bills said that the documents and information we're requiring with respect to the funds is owned by the adviser. The reason is that we have to make sure we have access to that information. We don't have access if somebody says to us, "Well, it's not me. I'm just the general partner. It belongs to the limited partnership and you can't have it because you have no jurisdiction." So there were some aspects that we then had to deal with in order to make sure that if in fact that was the approach that was taken, that there wasn't the possibility that people could use roadblocks to what we needed to achieve.

So as I think of it, we were just in many ways trying to do what I thought was a sensible approach. Is there always the possibility that you wind up being much more intrusive? Yes.

I think the one thing about the SEC that keeps us from being overly aggressive at times is our own structure, which at the Commission level — you know, we are an independent agency, so we have two Republicans, two Democrats, and a Chairman. You can't get anything done unless you can get at least three people to vote for it. That is a restraint on us. It doesn't mean the pendulum won't swing, but it is a governor on the pendulum maybe not swinging too far, and it does lead to some consensus decision-making, and I think that's a good process.

JAMES JALIL: I think we have a question here.

QUESTION: It has been very interesting hearing what you gentlemen have been talking about, the regulation as it is written today. I'd ask, even in the broadest strokes, if you could talk about the current theme that many of you brought up, which is: What is intelligent regulation; what should it look like; should it include fraud; should it include systemic risk; should it be geared toward the investors? I'd like to hear your viewpoints as to if you had your druthers what should this look like, besides just the simple KISS principle of being able to read it without going through 2,000 pages of documents. Thank you.

JAMES JALIL: Well, I think 2,000 pages of documents is very good for lawyers.

I'll start that off, but I want almost everyone to comment on that. It's a great question and very insightful.

I think it's fair to say that the Investment Company Act of 1940, which is the starting point for all of this, really had two primary goals in mind: (1) the protection of the investor against fraud and (2) the protection against systemic risk from the capital markets.

This is not a new concept. If you look at the history of the stock market in 1929 and the congressional hearings in the early 1930s, one of the reasons for the instability of the market were these capital pools, which were highly leveraged and so forth.

If you look at the 1940 Act, when it deals with registered mutual funds, there are a lot of inherent systemic risk inhibitors right there. So this is nothing we just thought up in 2009.

So what is the proper regulation? I'll go down the panel. I think it's a great question.

What do you think, Buddy?

ANDREW DONOHUE: I start off if you look at the Advisers Act, you can't do fraud. You have to make sure that people out there are dealing honestly and fairly with their clients — first and foremost protection of that.

And I think you go to the integrity of the markets. What has made America great in terms of a securities market is the integrity of our markets. That goes to a whole range of issues that go to how the exchanges operate, how the over-the-counter market operates, making sure that, in fact, that is fair.

I think you almost always wind up starting off with the investor, but I also think that you have to always bear in mind that our markets aren't going to work well if in fact they don't help facilitate capital formation. Part of that is an active secondary market.

So as I think of securities regulation, to the extent that we affect any one of those things that I've just said, I think we have to be very careful, because it is going to have some consequences.

But I do think that investor confidence is incredibly important. Keeping people from committing fraud is paramount.

MATTHEW SIANO: I'd say, use the analogy that you need healthy animals in an environment and you need a healthy environment. So all the things that you're talking about — you need the players to be healthy, you need the places where they play to be healthy, and you need prosecution.

I think the part that keeps people in line — I guess this is the fundamental disagreement I have with the Professor — I think enforcement is the only thing that really ultimately keeps people in line. Putting a seventy-three-year-old man in jail for 150 years isn't really what gets people to actually behave. What gets people to behave is if you put someone who's my age in jail for forty years. That's the fundamental issue that I think is really important here.

ANDREW DONOHUE: I would point out that somebody who is going to engage in that kind of theft is not going to care what my regulations are.

MATTHEW SIANO: I agree that if you're a sociopath that doesn't change anything.

ANDREW DONOHUE: No, no, because he's going to jail. I mean the criminal law is going to get him. The fact that I can kick him out of the advisory business is not going to.

MATTHEW SIANO: But I think the important point is that I would argue that the individual that we keep talking about, this Madoff individual, who sort of floats over everything we talk about, is not the classic way that fraud really starts out, in the sense that it's little decisions. People make little bad decisions — "How do I value an illiquid investment?" You know, we talk about valuation, why it's difficult. If it's just a publicly traded U.S. equity, that's one thing — you just go and get your Bloomberg number, it is what it is. But there are a lot of little decisions that people start to make. They start to convince themselves that this is okay. The next thing you know, you're on to the next thing, on to the next thing, on to the next thing.

To me the only thing that effectively gets people who come to that sort of fork in the road — the CCO who's trying to do that, the GC who's trying to do that — "No, no, no, wait a minute. What did we tell investors about how we're going to do this? Are we a fiduciary first?" Unless I have the ability to point to and say, and somebody else is going to come and back me up and tell me, "Yes, this is right," it's very difficult on the ground to be able to get people to do those things.

J.W. VERRET: If I could just come in real quick, I would define good regulation as regulation subject to sincere cost-benefit analysis. So I would say one of the challenges I think, and I fashion myself a critic of the Commission — it's like a movie critic; you love movies, you love to watch them, you love to learn about them, but at the same time you try to keep them honest.

One of the challenges I see as I read these proposed rules is you get to the cost section and, frankly, it's something of a joke. It makes some lowball estimate of compliance costs. It says nothing about opportunity costs. It says nothing about cost to liquidity, capital formation. It says nothing about the cost of trades not undertaken, the deadweight losses — the harbinger triangles in the economic-speak — of efficient trades broadly defined, not just trades of securities, but trades not taken that would be taken otherwise but for the regulation. You see no sincere estimate of that.

Internalization of cost is, I think, the advantage to the properly designed self-regulatory organization, more internalization of cost than you see at the Commission side.

ANDREW DONOHUE: I can't let that go without a little counterpoint on that.

Cost-benefit analysis is a challenge, and it's a big challenge in securities regulation.

I would first point out that typically when one engages in cost-benefit, the costs and the benefits are to the same parties. In securities regulation they are not. So you have to be careful.

Now, we have to do cost-benefit analysis for many of the rules that we do. I'm not saying that we shouldn't have to, but I think there should be a recognition that if I'm protecting somebody from robbing money from my mother, the fact that it might cost $100 to keep them from stealing $99 from my mother doesn't mean that I shouldn't spend the $100 to keep them from stealing the money from my mother. That's kind of lost in the debate about cost-benefit analysis.

The other thing about cost-benefit analysis is frequently you don't know what the behavior is then going to be. So it's very much behavioral-type economics in terms of if you do this what are all the different things.

When we come out with proposals, one of the things that we ask everybody to help us with is to give us the information on it, and nobody does. Then the criticism is, "You guys didn't do a very good cost-benefit analysis."

Frequently, we don't know how the industry is going to react to something — what changes they might make, what solutions they may have to the problems that we've pointed out. But if the industry and the critics aren't helpful in terms of coming forward with data for us or approaches that we could take on doing a better cost-benefit analysis, then I think we all lose. That's my theme.

I'm not saying we can't do a better job on cost-benefit analysis. I will tell you if you look at any of our releases, what's referred to as the "back end," which is all the cost-benefit analysis, I will tell you it takes up half the release. I will tell you that in the current Commission we have a whole new division, that is Risk Fin, and it's essentially all non-lawyers. The goal is to have people in that have the background, that have the experience, that can help us do a better job on that.

I'm not saying we get it right all the time, but I am saying that there are real challenges. I think it's really important to do.

But I also think that you need to recognize the limitations on a cost-benefit-type analysis. Clearly, we could eradicate fraud. We'd probably kill all the markets. So there is kind of an optimization of things.

JAMES JALIL: It's funny. I remember that when cost-benefit analysis started, it was meant to streamline things and make the Commission think about cost-benefit analysis. I think it's ironic that — and I know this to be the case — half the release is on the cost-benefit analysis. So you wonder, what is the cost-benefit to cost-benefit.

ANDREW DONOHUE: And by the way, when anybody doesn't like what we are doing, they say, "Well, obviously you didn't do a cost-benefit analysis, so we'll take you to court."

JAMES JALIL: I think there's a question over here.

QUESTION: I'm the CCO of a hedge fund here in New York City.

We are not registered, although we do operate as if we were registered, we have the same policies and procedures, which I think is the case for most non-registered funds that manage any substantial amount of money.

It seems that every time we start talking about hedge fund registration we go back to Madoff. Aside from systemic risk being the driver for hedge fund registration, we talk about fraud, and then when we talk about fraud we talk about Madoff. However, Madoff was not a hedge fund and Madoff was a registered entity.

So my concern is: How is this new registration of hedge funds going to protect the investor from fraud if it follows the same precedent that was set by the current registration that is in place for registered investment advisers? It didn't work in the case of Madoff, so why will it work in terms of the hedge funds?

JAMES JALIL: That's great, and I'll ask everybody to answer that question.

But I just would point out for the record that Long-Term Capital out of Greenwich was not a fraud, and that had a serious deleterious effect on the market. There was no fraud there at all. But your point is well taken.

Buddy?

ANDREW DONOHUE: I don't think you've heard me mention the need for registration as being driven by Madoff. To me there's a regulatory gap that I think, with respect to registration of people managing other people's money, is one that I think needs filling.

I'm not up here to try and defend the fact that the Commission didn't catch Madoff. Madoff was both a broker-dealer and an adviser. He only was a registered adviser at the very end of his tenure. He basically was probably lying about everything he did. Some people at the Commission kid — I don't mean actually kidding — that he could have been running a cleaner. He was just taking people's money and telling them he was doing things with it. So I separate that.

I think we certainly need to do a better job on things like Madoff. I had the distinct pleasure, or displeasure, depending on how you look at it, of having to go and testify before Congress about that. That testimony wasn't me speaking; it was people speaking to me, sometimes on volume.

I think we need to do a better job there. People should rely on us being able to do that.

JAMES JALIL: There's another question here.

QUESTION: Matthew Siano, I really share your philosophy on the credible threat. My firm deals with pre-launch hedge funds and we set up the policies and procedures and investor relations regime. I constantly am using the antifraud provisions as a reason why they should be taking actions, and it's really very, very useful.

My question really revolves around a couple of things. I see the SEC in my role especially useful as a credible threat. I have been an auditor in the past of financial institutions. The auditors will all tell you that they cannot detect fraud. Their sampling process cannot. So I feel like the SEC's reputation has been blemished by the perception that they could detect fraud and the inability to do it, but yet you're still using a filtering process.

My first question is: How is your filtering process of sampling data better than the auditor's? — and in some cases it's not hard to be better than the auditors in the Madoff case and in the Bayou case.

And then, secondly, my worry is that I have never seen an environment where investors are more diligent than in their approach to picking hedge funds. So the administrative choices and the auditing — the investors really know. They've gotten the message right now. If we move to registration, will they take a false sense of confidence, and what will be the SEC's messaging around making sure — "Oh, now this under-the-radar, unregulated hedge fund industry is now registered. So we can put our guard down" — Is there anything that you are doing to help with that?

ANDREW DONOHUE: I'll start off and then Paul can probably say where I'm wrong on things.

One of the approaches that the Chairman has challenged all of us to cinsider is, what can we do to get as many sets of eyes as we can so that things are discovered, things are reported, and we catch things early.

What kind of techniques can we use? One of the things is the custody rule that was spoken about before. Part of that is we want to make sure not just that there are eyes on it, but that the eyes are from people that have a sufficient degree of stature, being PCAOB-registered and inspected entities. That was not something that, by way of example, existed with Madoff. So on custody, how do we find that out?

We also look at some techniques in terms of — in one case, maybe you could say, "Okay, for certain types of funds who are the auditors?" So if you had a problem with a particular fund who used a particular auditor and you have that database, you would then know who the auditors were. You might want to go check other similar kinds. You might have a higher degree of comfort based on who some of the service providers were.

You might look at particular return characteristics that might exist inside certain types of pooled vehicles and say, "What is the likelihood that this return characteristic could be delivered over the period of time that people said?" It used to be the outliers were the ones that were performing extraordinarily well. Madoff was one that was performing extraordinarily consistently.

I think we are all trying to come up with the right techniques to take the data and sort through it. We're not going to be really good, we're not going to catch all those, but we are bringing in people with different types of expertises. One of the criticisms before was we were all lawyers. One of the things that the Chairman has made a real effort at is to get people in who do have the industry experience, people who are not lawyers, people who are economists, people who are risk people, and bring them in and use that expertise to help us do this better.

But we're not going to catch everything, and we recognize that. The thing is: How can we catch things earlier?

The Chairman has been quite vocal about the fact we really would like the opportunity to reward people who come in and turn in others, kind of like the approach that has been taken and that has been successful with the IRS, so that there is an incentive for people to, in effect, turn in organizations that aren't doing the things that they should do.

JAMES JALIL: Just to answer that, I want to add — not to defend the SEC, but it's curious to me that the investors and the press who criticized the Madoff situation — "How could you not have caught it?" — to pick up on a point you made about due diligence being done today, if you look back and look at the red flags, it looked like May Day in Moscow. There were more red flags you could see floating in the air.

QUESTIONER: I have to disagree. You know, $12 billion of very sophisticated investors didn't find it. It's easier now because it's easier to find something with hindsight.

PARTICIPANT: I would question whether they were really sophisticated, because a lot of people got burned in that. I would qualify them as not being very sophisticated because they were getting burned. I have an issue with how you define that.

PAUL ROTH: I think in some ways the three of you are asking the same question in different ways. One can argue you don't need a law to tell people that they're not supposed to take a gun and rob a bank. The fact that you do have a law that tells people you're not supposed to take a gun and rob a bank doesn't stop some people from taking a gun and robbing a bank.

When you talk about how regulation works, regulation will never dissuade certain people from antisocial behavior or self-enrichment behavior, or however they see it.

The one thing I remember from criminal class in law school — and that was a long time ago — was a professor saying, "Don't ever make the mistake of thinking that you understand the way a criminal thinks. The mere fact that you are not breaking the law indicates you do not understand how that person thinks."

[Laughter]

ANDREW DONOHUE: And you raised your hand and said, "No, I do understand," and then became a lawyer.

[Laughter]

PAUL ROTH: Now you see what a regulator says.

So I think what we are all trying to do is to recognize that bad actors will be bad actors probably no matter what we do. But they are on the outer fringe. Thankfully, there is an outer fringe of those people.

Now what we are dealing with is: How do we structure regulation so that it encourages best practices, it doesn't overly impact markets in ways that markets shouldn't be impacted and let markets operate in ways that markets should be allowed to operate?

There are very good questions about sophisticated investors. For example, one position I have is: does it make really any sense to have Form ADV that you use for a retail investor be the same Form ADV and the same information that you are giving to people who are investing in hedge funds, who have much more sophistication, and who have what we call DDQs, due diligence questionnaires that are this thick that they give to the investment manager to fill out prior to the time in which they invest?

On the other hand, there are ways to encourage best practices. The law can do that and maybe should be doing that.

I think one of the ways to do that is you need to have a certain amount of information as to what's going on in order to be able to operate intelligently. I think that is what the registration provisions as it relates to hedge funds are trying to do. I think there are gaps right now, and I think Buddy is correct that we would like to fill those gaps — or he'd like to fill them. If I have any clients here listening, they might shoot me for saying we'd like to fill them.

ANDREW DONOHUE: You told me all your clients were registered.

PAUL ROTH: I never said that.

What I did say is that today you've got 1,700 fund managers who are registered. It definitely shows you that it can be done, that you can live side by side.

The issue is: Where do you draw the lines? They are difficult issues. As long as you conduct the conversation intelligently with each other, saying, "Look, this causes me a problem because if you put this rule in I've got to have X number of people working like I did on Form SH over the weekend. Unless it gives you an enormous amount of information that is incredibly important to the regulation of the markets, you shouldn't be making me do this. In addition to which, while I can afford to do it, you're inhibiting other people from coming into the space because the cost of this regulation is in fact an inhibitor to new competition coming into the market because people who are coming into the market can't afford it."

I think that's basically what we are trying to do. We are trying to find a balance. Anytime you are trying to find a balance, it's kind of like getting on a scale and trying to weigh yourself — you're never exactly happy as to where you are, but you're constantly striving to get to where you want to be.

JAMES JALIL: I'm never happy.

Holland, let me ask you.

HOLLAND WEST: I agree with everything that Paul said. I also agree that many of these questions really have a common theme.

I brought up Madoff, I think, in the context of custody. As Paul says — and I don't want to repeat everything because I have a couple of other points I want to make — fraud has not been a big thing in this business, it really hasn't. As you pointed out, Madoff was not a hedge fund, Madoff was an investment adviser, but this was basically — we talked about this last night — a broker-dealer fraud, a custody fraud. Yes, they were investment advisers.

Now, I don't want to argue about those differentiations, but at the end of the day people were receiving brokerage statements and listing their assets and the broker-dealer was the putative custodian. People said Enron was a hedge fund.

What I want to get to, is trying to answer the question. Although I said I wasn't an apologist for the business, the hedge fund business — and we're focused on that today, and, believe me, there are far bigger issues that need to be dealt with in financial services reform than the registration of investment advisers. In fact, I think it's probably one of the least controversial things.

The industry is painted unfairly in the press and throughout, and I think that's unfortunate. Everything becomes a hedge fund issue, everything becomes a hedge fund fraud, and that's just unfair.

What I would say is that the sensible regulation — which was your point, what is intelligent regulation — is, as Paul just said, gathering information and trying to instill best practices based on that kind of information and the way the markets work and to come up with a balance that is fair and reasonable to the people having to do this but also is not detrimental to innovation and growth of the markets.

If you look at this business — and this is my other point about the hedge fund business — on a relative basis, or even on an absolute basis, this industry did very well during this last couple of years. (1) There was no expectation of a safety net by the government; and (2) there was voluntary and some nonvoluntary deleveraging and private solutions, many of which were controversial, which are now the subject of best practices on how hedge fund private solutions will be dealt with going forward.

But what I would say — and this goes back to your point about systemic risk — is I don't know what systemic risk is. I've read plenty about the German banking crises and the Herstatt risk and those sorts of things. In 1998 people were throwing around the term "systemic risk" when Long-Term Capital — which had $4 billion, which is very small.

Of course, it was leveraged twenty-five times. But nevertheless, I don't know what systemic risk is.

But what I do know, and what we have witnessed, is the interconnectedness of the markets in today's world and the financial participants. It is a scary thing to get so close to the precipice when people are not restraining themselves and there is not the discipline in place.

So to me I don't think we are necessarily — I don't agree with everything that is in these bills or in any other proposals, but I think we are going in the right direction on gathering information and trying to enforce a discipline that will hopefully mean that this industry, which is very important, will adopt best practices and will keep doing what it needs to do.

JAMES JALIL: I would like to pick up on a point which was touched on before, which is barrier to entry, and whether the unintended consequence of further regulation — though I take the point that ADV is not difficult to fill out; I appreciate that — but as the perception is that you will be visited by the SEC, you will have to have a compliance manual, you will have to have lawyers, and you will have to have certain accountants who have to be of a certain registration before they can even be your accountant — when an entrepreneur looks at all that, does he say, "I'd rather open up a hot dog stand or go do something else because there's too high a barrier of entry"? And will the unintended consequence of further registration and regulation be a consolidation of the industry and a disincentive to the young man or woman with a dollar and a dream to open up a fund?

ANDREW DONOHUE: There are a couple of ways I would answer that.

One of the things I had mentioned before is that 69 percent of the advisers that are registered with us have ten or fewer employees. So I do not think the current state of affairs would indicate that it has been a barrier to entry. And there are 14,000 advisers that are registered with the states that do not even meet the criteria of having $25 million of assets under management. So I think in terms of barriers to entry there are no capital requirements, there are no bonding requirements, there are no licensing rule requirements, except with respect to some state licensing.

So I think, if anything, there are maybe too little barriers to entry into the business of managing other people's money. I think as you compare our regime versus regimes that exist elsewhere in the world — you know, others look at our regime and say, "My God, how can you have a regime that operates like this?" I point out to them that we have $40 trillion that operates under this and does quite well.

But I'm mindful of that point. I am just saying I don't think we are there yet. I don't think it has reached that point. I don't think we ask that much.

J.W. VERRET: Is it because it is voluntary now? Right now if a fund does not like how things might change going forward, they can maybe get out. But as registration becomes mandatory, then they are sort of stuck, right, if somebody replaces you who is not as well considered as you are?

ANDREW DONOHUE: I mean historically, when I was talking about the adviser regime — and forget about whether you are managing a hedge fund or you are just managing clients' money. You know, 69 percent have ten or fewer employees and function quite well in our regime.

So whether you are managing a pool of money or you are managing individual clients' money, it has not seemed to be a barrier to entry at this point for people getting into the business. We have not heard that it is a barrier to entry in that regard.

You know, clearly, if we imposed significantly different requirements, at some point it does become a barrier to entry. But it is almost like opening up a Kool-Aid stand at times, because there are no educational requirements, there are no licensing requirements, there are no minimum capital requirements. You have to file an ADV with us and you have to make sure you aren't a convicted felon.

PAUL ROTH: You don't have a chief compliance officer at a Kool-Aid stand, do you? Maybe you go to one that does. I don't know.

Look, I think in broad strokes you are right.

ANDREW DONOHUE: So it's really to have somebody who is actually responsible for making sure that the firm is complying with all the federal securities laws.

PAUL ROTH: It sounds like motherhood and apple pie. It is just not as easy as that. That's all I'm saying. You make it sound that way, only you were driven back into the government from doing that.

I think your statistics about 69 percent of advisers have ten or fewer employees are impressive. On the other hand, the rules are changing. By and large, I think the market takes care of itself because for most hedge fund advisers, long-short equity people — that's the largest group of hedge fund managers, long-short equity — valuation for those people is not a terribly complex problem because you can look at the last trade on a consolidated table for that day and you get a valuation.

If you are going to be doing more exotic strategies, you need to have an infrastructure that you have to build. What we are seeing right now is that funds that are starting with the desire to build these different strategies, which are generally in the fixed-income area — well, when they could start with $1 billion, they could afford the infrastructure that was necessary to meet all of the requirements. The realities of today's market are they cannot start with $1 billion, so they are starting with a couple hundred million or they are starting with 30 — I mean I talked to the prime brokers the other day and they are saying: "With the same strategy, same pedigree of a manager, that five years ago I could raise $1 billion, $2 billion, $3 billion to start; today is starting with $30 million — if we can get it, maybe $50 million." There is where their barriers to entry are coming, because they cannot afford it. That's a tough question.

ANDREW DONOHUE: That is not regulation. That is the market that is regulation.

PAUL ROTH: That is the market, but it is the market combined with the regulatory environment.

My own view is: You know what? If you haven't got enough capital to build the infrastructure that you need to build to run the business the way you should run the business, you can't be in that business. That is probably not regulatory, although people look at it as regulatory. It is operational.

What most investors are looking at as the key, number one point is: Do you have the operational structure to run your business?

As I said earlier, they do not look at whether you are registered or not as the most important issue. They want to know whether — my view is the way you run your business starts at the top, and if the person at the top has a view that you are going to run your business in the right way, whether you are registered or not, you are probably going to run your business very close to the same way this gentleman spoke about it.

That does not mean that we should not have any regulation because the fact that we do have regulation informs the way those people who care about things do run their businesses, and you can't get away from it.

ANDREW DONOHUE: Paul, do you think of it differently in the 3(c)(1) context from the 3(c)(7) context? You know, if it is 100 or fewer investors, they do not have to be widely sophisticated investors that have bargaining power to get things that they may want to get. Do you think the market disciplines are different and the dynamics are different in those two markets?

PAUL ROTH: Yes, I do.

You know, it's interesting. Holland talked earlier about whether venture capital funds and private equity funds should be required to register. My own belief is they face many of the same conflict-of-interest issues and they act as fiduciaries as hedge fund managers do. There is much more in the way of side letters, let's say. Side letters came into the hedge fund world from the venture capital and the private equity worlds. The purpose of those side letters was for investors to get a benefit that was not being offered to other investors, whether it be that they were allowed to co-invest along with the fund, did they get preferential co-investment opportunities.

So I think valuation issues are clearly very, very important with respect to these kinds of funds. My own personal view is toward a registration process where the information is there and they are subject to certain rules, but should not be following all the rules necessarily or filing all the same things that a market-oriented company is.

That is why I like the fact that there is a lot of emphasis in the House bill upon the Commission's ability to classify and differentiate among registrants and to get different information from those registrants. That has not been what they have done in the past. I hope that path will be one that they follow on a going-forward basis because I think that is better registration. It is more intelligent registration and it is more cost-effective registration.

JAMES JALIL: Given that, and given some of the remarks that you had earlier, Buddy, sort of an odd re-thinking, does it make any sense to have the bifurcation anymore between state regulation and SEC regulation? Has that train left the station? If it is true that 67 percent are ten or less, and if it is true — I don't mean if it is true, but assuming it is true — that the barrier to entry is not high, and if it is true that it is only really the compliance officers who want to do it in the first place, then why have this bifurcated system? What benefit does it have? And, if it is true that you want to centralize the information to make some cogent analysis of it, why should it all be centrally located? Why continue this bifurcation?

ANDREW DONOHUE: I am not here to defend the decisions that were made in ISMA to cut back. I do think that was a compromise that was reached for any number of reasons. Depending on your perspective when you are looking at it, you can have different outcomes from that.

The sense of moving the threshold from the $25 million or $30 million up to $100 million — by the way, the SEC could do that today if we decided to; ISMA gave us the ability to do that — the reluctance from my perspective of doing that related to whether or not I would be taking a problem and just moving it, as opposed to just saying, "We don't have the resources to take care of this. Let's give it to the states." The states themselves are strapped. That probably is 4,000 of our 11,000 — that's a guess on my part — that would then wind up moving to the state regime.

You know, this is not about me wanting to have more registrants, or whatever. The question is: What is the best solution for this?

If we just wanted to focus on where most of the money was, like hedge funds are very concentrated, advisers are very concentrated. If you decided, "We will only take advisers that have $1 billion or more of assets," we would have very few advisers but we would have almost all the assets. Our job would become much easier, but I am not sure that the American public would be better off.

J.W. VERRET: Can I speak to just the federalism issue a little bit, because most of my time and expertise is in the Delaware corporate law issue and the chartering competition question. In that respect, I think federalism only works, or works best at least, when there is some competition and when the regulation relates to the chartering or the state competes with other states to get charters, and so regulation internalizes cost in that way. I think that dynamic is probably one we don't really see here, because you regulate the firms located in your state or do business in your state or even get extraterritorial regulation.

Then if you want to go broader, you get the whole Spitzer issue of the attorneys general getting involved as well. So I think I would probably agree that states do not have the benefits they would in the corporate context.

PAUL ROTH: I think that this is a legacy of federalism. I am not prepared to argue against federalism.

What I would prefer, though, because I think that there is something in what J.W. is talking about in terms of different regimes providing competition and experimentation — my own concern is that the way the bills read presently, they are requiring people to register with the states unless they meet a certain assets-under-management threshold. I would not necessarily — well, if I could have one, I probably wouldn't do away with state regulation, because I think that there are some people who believe very, very strongly that the closer to home the regulator is, the better it is.

But I would like to see people who wish to be regulated by the SEC have the choice, rather than have to go through the states, because of the way in which the congressional bills appear to be focusing right now. I think, again, there is a huge body of law and a lot of learning on what it means to be registered with the SEC, and in some states there is not, and if you are in multiple states it can be a problem, whereas if you are registered with the SEC, except for antifraud violations, for which any state can go after you, they do not have substantive regulation over you.

So to my way of looking at it, you could keep the federalist approach but you should give the person who is registering the opportunity to choose which regime they want to go under.

ANDREW DONOHUE: I would point out something that is a complicating factor. We are talking here in the context of private funds and the legislative approach of having the advisers register and all that. There is another dynamic that is out there in the adviser space which does affect the state vs. federal, which is that there still is an open item that in my area and in the broker-dealer area we need to address, which is referred to as the IABD problem, which comes out of the FPA decision, which is the intersection of the broker-dealer community and the adviser community as it deals with retail clients. To the extent that one might move more advisers to the states, it may hinder potential solutions to that dynamic, which is whether or not broker-dealers and advisers have somewhat of a level playing field or whether we are kind of pushing the business one way or the other, and whether or not, particularly for retail clients, the remedies that are available to them, the duties that are owed to them, may differ significantly.

So when I think about adviser registration and issues moving numbers around, in the back of my mind, or sometimes in the front of my mind, is that we also need to solve this other problem, which is hugely important for retail investors. That is part of what I think when people say, "Okay, $100 million winds up going all to the states." That is all retail.

JAMES JALIL: Well, I think we could go on forever, but it's 12:30 and I know that we promised we would wrap up.

I would like to thank the panelists. They have done a wonderful job.

[Applause]

We are having lunch on the 12th floor at Lowenstein.

[Adjournment: 12:34 p.m.]