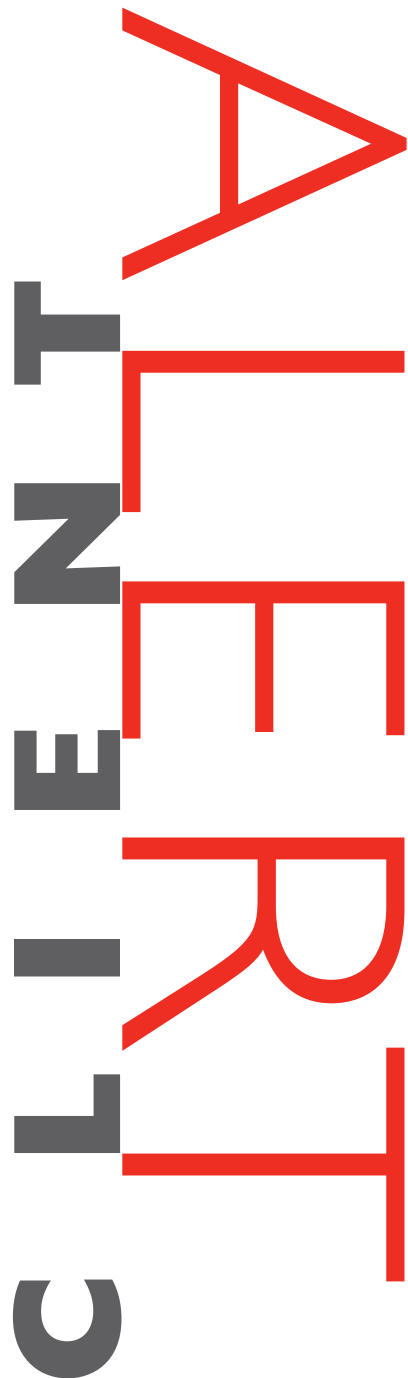

HEDGE FUNDS UNDER INCREASING SCRUTINY:

A SQUEEZE ON BOTH SIDES OF THE ATLANTIC

. . .

As it stands today, the levels of regulation in the United States and the United Kingdom for hedge funds are quite different, but the long-term trend in both is for more supervision - and any gap between the two locations is closing.

In the wake of the Amaranth Advisors collapse, politicians and regulatory chiefs are talking tougher as the pattern of recent public statements indicates. The practical implications of this changing environment in both locations can be shown sharply in the context of side letter arrangements, a common feature of hedge funds, which are subject to growing scrutiny.

THE UNITED STATES

PRE-FEBRUARY 2006: A LIGHT TOUCH

Prior to February 2006, most hedge fund managers were not regulated by the SEC. To avoid registration, they were able to rely upon the "private adviser exemption" in the Investment Advisers Act of 1940 (the "Advisers Act").

The exemption was available to anyone who did not hold themselves out as an investment adviser and that had fewer than 15 "clients" in the preceding 12 months; until February 2006, the SEC defined the collective hedge fund vehicle as one "client" rather than counting each individual investor in a fund as a separate client.

FEBRUARY 2006: INTRODUCTION OF "HEDGE FUND RULE"

In February 2006, the SEC adopted the so-called "hedge fund rule" that required advisers to look through a fund and count each individual investor as a separate client, unless investors in the fund were prohibited from redeeming their interest for at least two years. As a result, most hedge fund managers were required to register with the SEC. With registration under the Advisers Act came required compliance with the SEC's examination process.

JUNE 2006 - HEDGE FUND RULE RULED UNLAWFUL

The "hedge fund rule" was effectively overturned by the decision of the US Court of Appeals for the District of Columbia on June 23, 2006 in the case of *Goldstein v. SEC* ("Goldstein"). The court vacated the hedge fund rule as an unlawful exercise of the SEC's authority and thereby restored the traditional definition of "client," leaving the SEC to regulate the activities of hedge fund managers managing 15 or more separate investment entities.

As a result, nearly all hedge funds who registered with the SEC as a result of the hedge fund rule and who remain registered with the SEC are doing so voluntarily.

Significantly, the Court also held in Goldstein that, for the purposes of the fiduciary duty under the Advisers Act, a hedge fund manager "owes fiduciary duties only to the fund, not to the fund's investors."

POST JUNE 2006: A LESS ONEROUS FIDUCIARY OBLIGATION?

Prior to Goldstein, it had been the view that a fund manager's fiduciary duty owed to each investor to act in the best interests of the fund as a whole required full disclosure of material conflicts of interest (such as those which may arise as a result of certain side letter arrangements).

Susan Ferris Wyderko, former Acting Director of the SEC's Division of Investment Management, during the course of testimony to the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs on May 16, 2006 (a month before Goldstein), endorsed this.

In her testimony, she said that, as hedge fund managers, were "investment advisers" under the Advisers Act, they owed the fund and its investors a fiduciary duty that required the manager to place the interests of the hedge fund and its investors first, or at least to fully disclose any material conflict of interest the manager may have with the fund and its investors.

She went on to say that hedge fund managers have this fiduciary obligation as a matter of law regardless of whether they are registered with the SEC and added that a number of enforcement cases have been brought during the recent past against hedge fund managers who have violated their fiduciary obligations to their hedge funds and investors.

However, following the Goldstein ruling that, under the Advisers Act, no fiduciary duty is owed by hedge fund managers to investors, it would seem that, as the law currently stands, the SEC will no longer be able to argue that inadequate disclosure of side letters by managers to investors constitutes a breach of the former's fiduciary duties under the Advisers Act.

THE UNITED KINGDOM

The situation is rather more straightforward in the United Kingdom as all UK-based hedge fund managers must be registered with the Financial Services Authority ("the FSA") and are thus regulated by it.

SIDE LETTERS: A USEFUL CASE IN POINT

The issue of secret "side letters" by hedge fund managers is coming under increasing regulatory scrutiny on both sides of the Atlantic. Hedge fund managers often give special terms to large, loyal or early investors set out in side letters. Sometimes these allow chosen investors to redeem their investment more quickly than others, putting ignorant investors at a potentially devastating disadvantage in the event of a collapse of the hedge fund.

With the current disparity in the regulatory background between the US and the UK, side letters receive markedly differing treatment in the two locations.

SIDE LETTERS IN THE US: UNCERTAIN TIMES

During the brief period of the "hedge fund rule," side letter arrangements were subject to SEC examination. However, following Goldstein, in the absence of any other duty to disclose the existence of such a side letter (e.g. arising out of State law or as a matter of contract), managers may have very little motivation to disclose the existence or subject matter of any side letter agreements into which they may enter.

The regulatory position in the US is becoming less clear and recent statements add to the uncertainty as to what new SEC regulations may be in the pipeline.

SEC Chairman Christopher Cox has said, within the last few weeks, that the SEC is currently considering a new anti-fraud rule under the Advisers Act that would have the effect of "looking through" a hedge fund to its investors, thus reversing the side effect that Goldstein referred to above.

Whilst nothing specific has been announced, the potential is increasing for a radical change to the current "leave alone approach" under which hedge funds have prospered in the US.

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SIDE LETTERS IN THE UK: AN IMPORTANT CHANGE THIS MONTH

In the FSA's Feedback document of March 2006 (in response to a Discussion Paper on hedge fund regulation that it had published in June of the previous year), the FSA commented that side letter agreements with individual investors:

"May be to the detriment of other investors in the same share class in the hedge fund who should be aware that side letters can affect the risk profile of their hedge fund investment. A lack of transparency and disclosure about side letters deprives these other investors of access to comprehensive information."

The FSA went on to say that it believed that:

"Failure by UK-based hedge fund managers to disclose the existence of these side letters is, amongst other potential breaches, in breach of Principle 1 of [the FSA's] Principles for Business ("a firm must conduct itself with integrity"). If needs be, [the FSA] will take action against firms for breaches of the Principles on that basis. The Principles are a statement of firms' fundamental obligations. They apply to all firms and this includes hedge fund managers.

"As a minimum we would expect acceptable market practice to be for managers to ensure that all investors are informed when a side letter is granted and any conflicts that arise are adequately managed."

In addition, the Alternative Investment Management Association ("AIMA"), the hedge fund trade body that represents 1,100 hedge funds, has recently set out guidance on this issue, following consultation with the FSA, in an industry guidance note. The guidance does not have the force of law, and it is not FSA Guidance. Rather it applies directly only to AIMA members. However, it has the blessing of the FSA, and the FSA will expect hedge funds which it regulates to abide by the new regime.

Under the new guidance, firms will be required from October 31, 2006 to disclose to investors and potential investors the existence of side letters which contain "material" terms regarding the relationship between the hedge fund firm and the investor client. By October 31, 2006, firms will also be required to disclose to investors any side letters already in existence which contain material terms.

This does not only apply to a single hedge fund business. It also applies to a hedge fund investment manager, which is a party to the side letters of an affiliated marketing or other firm.

Common examples of terms that are likely to be considered "material" would include preferential redemption rights, key man provisions, redemption gate waivers and portfolio transparency rights.

In the light of the new AIMA guidance, a UK hedge fund manager should exercise extreme caution when considering side letter agreements, and we would recommend disclosure to investors in all cases. The extent of that disclosure will depend on the nature of the particular side letter, in particular the extent to which it contains "material" terms. At the very least, from October 31, 2006, all such side letters conferring preferential rights such as those referred to above will need to be disclosed.

STRONG WORDS: THE PUSH FOR GREATER TRANSPARENCY WITH MORE COMPLIANCE HEADACHES ON BOTH SIDES OF THE ATLANTIC

IN THE US... In the middle of October, Senate Finance Chairman Grassley wrote to the heads of the US Treasury, the US Department of Labor, the Securities and Exchange Commission and the Commodity Futures Trading Commission, amongst others, requesting that they report on the need for more transparency amongst hedge funds.

Following the recent collapse of Amaranth Advisors, political concern generally is on the rise, especially given that pension funds are now investing in hedge funds. Furthermore, the SEC Chairman has stated that the number of hedge funds being investigated for insider trading has risen and in October of this year the Loans Syndication and Trading Association - whose members include hedge funds, amongst others - issued guidelines designed to avoid abuses of information.

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In September of this year the US House of Representatives approved a bill which, if enacted into law, would require the President's Working Group on Financial Markets to analyze the sector and to recommend disclosure requirements.

IN THE UK... In an already more regulated environment for hedge funds than in the US, hedge funds are increasingly coming under the spotlight. As part of an address given in the middle of October by Margaret Cole, the FSA's Director of Enforcement, to US regulators, she said "some hedge funds may be testing the boundaries of acceptable practice with respect to insider trading and market manipulation." More criminal prosecutions are, apparently, being promised as a result.

Sir John Gieve, Deputy Governor of the Bank of England, has criticized hedge funds for "aggressive risk-taking." In addition, Edgar Meister, Chairman of the Supervisory Committee of the European System of Central Banks has referred to hedge funds operating in a "supervisory no-man's land" and wants more transparency. This sentiment is echoed by the Chairman of the Basel Committee on Banking Supervision, Jaime Caruana, who was reported recently as having stated to Reuters that greater transparency was needed given the exposure that banks have to hedge funds.

It is rumored that the UK Treasury may be about to conduct a fresh review of hedge fund regulation. This suspected move is raising concerns that this may drive hedge fund managers out of the UK.

VIGILANCE NOW... Given the distinct possibility of increased regulation in this area and with regulators now focusing with their existing powers on hedge funds, it is sensible for hedge funds to have a heightened awareness of possible compliance issues and ensure their house is in order before the promised increases in regulation materialize.

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