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Hedge funds may gain new fans

By Jeff Benjamin

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DETROIT - Last week's decision by the Securities and Exchange Commission to require the majority of hedge fund managers to register as investment advisers could have the unintended consequence of creating a seal of approval for the $870 billion hedge fund industry.

For financial advisers who had previously shied away from hedge funds because of a general lack of transparency and regulatory oversight, the idea of SEC registration changes everything.

"To me, hedge funds have always been an unclear area, but by having more information available, I would take the time to learn more about them," said Amy Jensen Wolff, an adviser who runs AJW Financial Inc. in Minneapolis. "I would feel more comfortable with hedge funds knowing that they are registered and being monitored at some level by the SEC."

The SEC voted 3-2 in support of requiring those hedge fund managers with 15 or more clients and at least $25 million under management to register as investment advisers by February 2006.

According to the SEC's calculations, the new rule would affect between 830 and 1,260 hedge fund managers.

The SEC estimated that there are between 2,300 and 3,500 hedge fund managers in the United States, overseeing an estimated 7,000 hedge funds.

Of the total universe of hedge fund managers, the SEC estimates that registration will be required for about 60%, and 40% of those are already registered.

While the outcome of the vote wasn't a surprise to most, it still inspired plenty of vocal opposition across the hedge fund industry.

"I'm going to do everything that is legally and morally possible to avoid registering," said

Phillip Goldstein, who manages the $73 million hedge fund Opportunity Partners LP in Pleasantville, N.Y.

"I think basically that the rule is illegal," he added. "The SEC shouldn't be in the business of passing laws."

Mr. Goldstein might represent the extreme end of the opposition to the new rule, but his general perspective is shared by much of the industry, including several business groups and associations.

Michael Tannenbaum, a partner at the New York law firm Tannenbaum Helpern Syracuse & Hirschtritt LLP and president of the Hedge Fund Association of in Aventura, Fla., challenged the rule's legality. But he also charged that the SEC isn't prepared for this new regulatory responsibility.

And that, Mr. Tannenbaum added, isn't going to be good for the investing community.

"There is the issue of whether or not the commission even has sufficient people power to oversee all these new registrants," he said.

Opposition to the rule, which split the SEC down the middle when the idea was first introduced two years ago, runs the gamut from how it might constrain the free-wheeling hedge fund industry to whether it is even legal for the commission to reinterpret a 1985 Supreme Court ruling regarding the definition of a hedge fund client.

The Supreme Court decision defined a hedge fund as a single client. The SEC vote gives the commission "look-through" privileges that enable it to count the individual investors toward the "15 or more investors" rule.

Ultimately, it boils down to the SEC's role as a watchdog for the financial markets and whether hedge fund registration will help protect investors.

"The commission took pains to make sure [registration] wasn't seen as a seal of approval for hedge funds," Mr. Tannenbaum said.

But that horse may already have left the barn.

"It does make me feel more comfortable knowing that the hedge fund managers will be registered," said Titus Song, senior vice president at Wayzata, Minn.-based Wealth Enhancement Group Inc.

"I think it's a benefit to investors, but I'm a little skeptical as to SEC's effectiveness in this area," he added. "This kind of transparency has been available for mutual funds forever, and the SEC hasn't shown a great deal of success in regulating that."

Charles Gradante, managing principal at Hennessee Hedge Fund Advisory Group LLC in New York, said one benefit of registration is that the industry will become more institutionalized.

"On the negative side, people will start to get a false sense of security with regard to hedge funds, and managers may start to use registration as a marketing tool," he said.

In his statement at last week's meeting, Paul Roye, director of the SEC's division of investment management, cited "deterrence of fraud" among the benefits of hedge fund manager registration.

He also noted that the hedge fund industry has grown by 260% over the past five years, including 30% last year. The rapid pace of growth, Mr. Roye added, has also brought "troubling growth" in terms of SEC enforcement cases.

"In the last five years, the commission has brought 51 cases involving hedge fund fraud, resulting in losses of more than $1.1 billion," he said. "You can slice and dice these cases in a number of ways, but they signal to us that this is an area where we should have concerns."

For hedge fund managers, registration represents a costly nuisance that some say could have a negative ripple effect on the industry.

"I think it's an unfortunate waste of resources and time that will be costly for the industry and will not protect investors," said James R. Hedges IV, president of LJH Global Investments LLC in Naples, Fla. "The SEC doesn't have the resources to properly police the number of hedge funds out there, and it will be very hard for them to come up to speed as far as fully understanding the industry."

As a hedge fund advisory firm, LJH is already registered with the SEC as an investment adviser.

Mr. Hedges said that in addition to the "business disruption" associated with maintaining an updated SEC registration and audits, the SEC's estimated annual cost per hedge fund manager of $25,000 for registration and related expenses is low.

"The SEC has dramatically underestimated the cost of all of this," he added.

There are theories that because registration raises the bar for entry into the industry, some hedge fund managers may simply move offshore, which would restrict access by U.S. investors.

"I think it's a double-edged sword," said Douglas Ehrman, chief executive of AlphAmerica Asset Management LLC in Chicago.

"Registration will give legitimacy to hedge funds, but you'll also kill some proprietary models [by requiring the managers to report their trading strategies]," he added. "You're also going to see cost going up significantly at the smaller shops. And who knows? This could lead to the SEC requiring daily [net asset value] reporting."

Ultimately, Mr. Ehrman added, "some hedge fund managers may just say, 'Screw it,' and move offshore."
