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Regulation on Hedge Fund Investment Advisers in the US and its Implications for China

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Abstract - In recent years, with the innovation and adjustment of financial market, hedge funds grown rapidly and became the major actor in the world financial market. The main law on investment adviser is the Investment Advisers Act of 1940, and the US amended it in 2004. In 2010, the Private Fund Investment Advisers Registration Act of 2010 made further amendment to the Investment Advisers Act of 1940. The continuously strengthened regulation on investment advisers in the US is of great significance for China.

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Regulation on Hedge Fund Investment Advisers in the US and its Implications for China

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Since Alfred Winslow Jones created the first hedge fund in 1949, hedge funds came to the spot of the public. Through a prosperous development during the financial globalization in the 1990s, there are over 9,000 hedge funds in the world, managing assets worth more than two trillion US dollars, and the trading volume of hedge funds has accounted for 40-50 percent of total trading volumes in global main stock markets. In addition, hedge funds are used as major financing means by listed companies. Today, hedge funds have become an important participant in global financial market and a financial investment means significant to the market.

I. Brief Introduction to Hedge Funds

a) Concepts and Features of Hedge Funds

Though hedge funds have enjoyed a rapid development, there are many interpretations[1] to and divergences over its concepts, and hence the definition of a hedge fund is still under discussion. Chinese scholar Li Xun defines hedge funds as "a portfolio formed through non-public offering to a few of rich individuals and sophisticated investors whereby fund managers as the major investor of the fund may take any investment strategies, use a vast range of techniques like short selling and leveraging to pursue absolute returns and receive performance-based remunerations." [1]

Hedge funds are unique and far different from traditional funds in terms of objectives and strategies of investment. What hedge funds emphasize is absolute return while traditional funds relative return. Hedge funds usually make use of techniques such as credit expansion, short selling or leveraging, while in comparison, traditional funds employ less strategies and approaches.

In general, hedge funds have the following features: (1) mainly open for investment from sophisticated investors; (2) non-public offering; (3) use of flexible investment strategies, mainly through credit expansion, short selling and other hedging approaches; (4) adoption of an incentive commission structure and pursuit of absolute return; and (5) subject to few regulations.

b) History of Hedge Funds

"The traditional story about the origin of hedge funds is that they were invented in the late 1940s by Alfred Winslow Jones." "In 1949 he formed an investment partnership, A.W. Jones & Co., which lays claim to being the first hedge fund." [2] From then, hedge funds entered into a slow development period. In the 1970s under advocacy of financial liberalization, innovative financial products were launched in western countries. US government gradually relaxed financial regulation in the 1980s, providing a large stage for hedge funds. "In the 1990s, the number of hedge funds increased 12 times over and the size of asset under management was 37 times that of the past. Especially, hedge funds enjoyed a rapid development in terms of number and size of assets after 2000. The size of assets under management by hedge funds reached about USD 265 million at the early 2008." [3] However, the bankruptcy of Lehman Brothers Holdings, liquidity unwinding and subprime crisis heavily hit hedge funds in 2008, resulting in poor performance of the overall industry in the year. Nevertheless, "there were more than 9,000 hedge funds globally, which managed assets worth USD 2.02 trillion in April 2011. The trading volume of hedge funds accounted for 40-50 percent of the total trading volumes in global major stock markets except China." [4]

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[1] Scholar Stefano Lavinio defines hedge funds in The Hedge Fund Handbook: A hedge fund may be defined as a tool of investment that makes use of such techniques as short selling, hedging, arbitrage, leveraging or synthetic positions and derivatives or their combination, and managers of the fund may earn incentive incomes from the structure of their tactices. According to the IMF, "Hedge funds are ...typically organized as private partnerships and ofthen located offshore for tax and regulatory reasons." The well-known US-based VHFA defines hedge funds as "limited partnerships or limited liability companies invested primarily in public securities or in financial derivatives".

c) New Issues Arising from Hedge Funds

Table 1 : History of Regulation on Hedge Funds.

Year	Event
1969	The first fund of hedge funds (FOHF) --- Leveraged Capital Holdings --- was formed in Europe.
1971	The first FOHF in the US --- Grosvenor Capital Management --- was formed.
1992	The Quantum Fund managed by Soros defeated the Bank of England, devaluing the pound and causing the bank lose over USD 30 billion and Soros earn as much as USD 1.1 billion, which shock the economic world.
1997	The Asian financial crisis broke out. Currencies of southeast Asian countries were devalued under the hit by international hedge funds and former Malaysian Primer Mahathir Mohamad called Soros “a villain”.
Oct. 1997/Sep. 1998	In order to maintain the stability of the financial market, the government of Hong Kong SRA fought a fierce battle with international capital in the exchange, stock and futures markets in Hong Kong. Finally, Paul Jones, Soros’ assistant, acknowledged his participation and loss.
Sep. 1998	A US hedge fund --- Long-term Capital Management (LTCM) --- went bankruptcy and the financial products worth over one trillion US dollars affiliated with the assets under its management were exposed to systematic risks, which forced intervention of the Fed.
Sep. 2006	A US hedge fund --- Amaranth Advisers --- closed down due to its loss of as many as USD 6.6 billion in two weeks, which exceeded the value of assets under its management, much more than the loss of the LTCM. Such loss was resulted from purchase of substantial positions due to its false estimation on price tendency of natural gas.
Jun. 2007	The bankruptcy of two hedge funds under the umbrella of Bear Stearns ignited the subprime crisis and unveiled the global financial crisis. Bear Stearns was acquired by its competitor in Spring of 2008.
Nov. 2008	Madoff’s Ponzi Scheme was exposed, which involved over USD 50 billion, and brought loss to over 2,900 institutions in 25 countries, including large institutions. Swiss financial industry was expected to suffer a loss as much as five billion US dollars, among which, the loss to United Private Financial Co., a hedge fund, and Banco Santander, Spanish financial giant, was expected to reach one billion US dollars and three billion US dollars respectively.
Nov. 22, 2010	US FBI searched three hedge funds: Level Global Investor, Diamondback Capital Management and Loch Capital Management

Source : History of Regulation on Hedge Funds. [2]

From Table 1 it may be read that, firstly, hedge funds have expanded their source of financing since the birth of FOHF, through which, hedge funds may raise funds from large institutions including banks, insurance companies, investment banks and pension funds, hence reaching to a broader scope of investors and involving more potential risks. Secondly, the impact of hedge funds on economic stability has been increased, as bankruptcy of a large hedge fund might give a heavy strike on the financial market. Finally, regulation on hedge funds is far from sufficient, as revealed by the case of Madoff in 2008.

II. Regulation of us on Hedge Fund Investment Advisers

The focus of regulation on hedge funds may be regulation on hedge fund investment advisors, which is also told by the case of Madoff. From the Investment Advisers Act of 1940 (hereinafter referred to as the Investment Advisers Act) to its amendment in 2004 and Private Fund Investment Advisers Registration Act of 2010, we may see US government has strengthened regulation on investment advisers.

a) Relevant Provisions in the Investment Advisers Act of 1940

In the Investment Advisers Act, investment advisers are defined as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities…”

Section 203 (a) of the Investment Advisers Act provides that investment advisers need be registered with the SEC, but there are two exceptions. The first is small investment advisers. Section 203 (a) (1) provides an investment adviser may not be registered with the SEC if the assets he manages are less than USD 25 million or he is not an investment adviser of a hedge fund. The second is investment advisers with limited clients. Section 203 (b) (3) of the Investment Advisers

[2] History of Regulation on Hedge Funds: 2011.02.15, www.morefund.com

Act provides that any investment adviser who during the course of the preceding 12 months has had fewer than 15 clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any fund registered under the Investment Advisers Act may be exempted from registration.

b) Amendment to the Investment Advisers Act in 2004

"The SEC amended the Investment Advisers Act and adopted certain rules including Rule 203 (b) (3) on December 2, 2004. Those rules require all owners or beneficiaries of a private fund be counted as a single client for the purpose of application of the exception rule of limited clients, and any hedge fund adviser who has had 14 or more clients (i.e. investors) and managed assets worth USD 30 million during the course of the preceding 12 months shall be registered with the SEC before February 1, 2006." [5] Under Rule 203 (b) (3), hedge fund must deem every investor as a single client. In such way, most hedge funds have more than 15 clients and investment advisers therefore must be registered with the SEC.

"Nevertheless, the SEC still kept two safe harbors for hedge funds. Firstly, the new Rule 203 (b) (3) does not involve the general rule that an investment adviser who manages assets less than USD 25 million may not be registered with the SEC, and thus small and emerging hedge funds may still not be subject to regulation by the SEC. Secondly, the SEC amended Rule 203 (b) (3)-1, providing only private fund may not be applied to private adviser exception. A private fund refers to a company that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests. In other words, if the manager of a hedge fund requires an over two year lock-up period, he may still share the private adviser exception. It means hedge fund managers still need not to "look through" hedge funds to count the number of investors if there is a provision on lock-up period of two years or more in the hedge funds.[3]" However, this new rule was overthrown by Goldstein v. SEC case.

c) US's Financial Regulatory Reform Bill

US President Obama signed the financial regulatory reform bill on July 21, 2010, turning on a new page of financial regulation in the US. Title V of the act is the Private Fund Investment Advisers Registration Act of 2010 (hereinafter referred to as the Registration Act). It makes amendments to the Investment Advisers Act, "raising the assets threshold of investment advisers subject to registration from USD 30 million to USD 100 million and eliminating the limited client exemption relied upon by most private fund investment advisers today". [6] The amendments are mainly made in the following aspects:

[3] Wang Wen, http://blog.sina.com.cn/wangwen1973，2011.08.

i. *Registration and Exemption*

a. Elimination of Private Adviser Exemption

The amendment to Section 203 (b) (3)-1 eliminates the "private adviser exemption", which once provided that any investment adviser who during the course of the preceding 12 months had fewer than 15 clients and who neither held himself out generally to the public as an investment adviser nor acted as an investment adviser to any fund registered under the Investment Advisers Act might be exempted from registration.

b. Limited Exemption for Foreign Private Advisers

There is an exemption for foreign private advisers who meet certain conditions. It provides that a foreign private adviser (1) who has no place of business in the US; (2) the assets of US clients or investors under whose management are less than USD 25 million or more as prescribed by the SEC; (3) whose clients or investors in the private fund in the US are less than 15; and (4) who does not hold himself out to the public of the US as an investment adviser, may be exempted from registration. When counting the number of clients or investors, the foreign private adviser shall include US investors in offshore funds. Consequently, compared with exemptions for foreign fund managers provided by existing laws, the extent of exemption offered by the new rules is narrower.

c. Exemption of Venture Capital Fund Advisers

Section 203 of the Investment Advisers Act is amended by adding at the end the exemption of venture capital fund advisers. According to the new rule, no investment adviser shall be subject to the registration requirements with respect to the provision of investment advice relating to one or more venture capital funds.

d. State and Federal Responsibilities

According to the new rule, a medium-scale investment adviser shall be registered with the SEC rather than state authorities. An adviser may not be registered with the SEC if he (1) is required to be registered with the state authorities in the State in which it maintains its principal office; (2) is subject to examination of the state authorities after registration; and (3) manages assets between USD 25 million and USD 100 million, unless he has to register in more than 15 states. In any case, if the investment adviser is an adviser of an investment company registered under the Investment Company Act or of a business development company, he shall be registered with the SEC.

ii. *Private Fund Records, Reporting and Examination*

The Act contains substantial recordkeeping, reporting and examination requirements specifically for registered private fund advisers, including:

Private Fund Records and Reports. For each private fund, the adviser must maintain certain records and reports which will be subject to SEC inspection. The required information will include information such as the amount and types of assets under management, use of leverage (including off-balance sheet leverage), side letter arrangements, and valuation policies. Several of these areas reflect longstanding SEC concerns particular to hedge funds. The Act authorizes the SEC, in consultation with the Financial Stability Oversight Council (the "Council") to require additional information and reports beyond what is specified in the Act as necessary and appropriate in the public interest for investor protection or assessment of systemic risk. Additional reporting requirements may be established for different classes of fund advisers, based on the type of private fund (e.g., hedge fund or private equity fund) or size of private fund being advised. The Act directs the SEC to issue rules concerning the required reports to be filed by private fund advisers.

SEC Examination of Private Fund Records. All records and reports of any private fund advised by a registered adviser, not only specific SEC required reports, will be considered the records and reports of the registered adviser, subject to SEC examination. The SEC is required to conduct periodic examinations of private fund records, and may also conduct additional special or other examinations.

Information Sharing and Confidentiality. The SEC will share any information filed with or provided to it by an adviser with the Council for an assessment of the systemic risk posed by a private fund. The SEC, the Council and other departments, agencies and self regulatory organizations receiving this information from the SEC must keep such information confidential with certain exceptions. Information provided to the SEC or shared by the SEC is not subject to disclosure under the Freedom of Information Act. There is additional protection of proprietary information concerning the adviser that is contained in any report filed with the SEC.

SEC Report. The SEC is to report annually to Congress on how it has used the data collected from advisers for purposes of investor protection and market integrity.

Disclosure of Client Identity. The SEC may now require disclosure of the identity, investments and affairs of a client for purposes of assessment of potential systemic risk in addition to its prior powers to compel this disclosure.

iii. *De Minimis Exemption*

A Banking Entity may invest in the hedge and private equity funds that it organizes and offers. Such investments may not exceed: (i) 3% of the total ownership interests of the fund not later than one year after the fund's establishment (subject to a two year extension as determined by the Federal Reserve), and (ii) an amount that is "immaterial" to the Banking Entity (to be defined by the regulators), in no event exceeding in the aggregate 3% of the Banking Entity's Tier 1 capital.

iv. *Fiduciary Duty*

The SEC is provided discretionary rulemaking authority to require investment advisers in providing personalized investment advice to retail customers to act in the best interest of the customer without regard to the financial or other interest of the investment adviser providing the advice. This standard (fiduciary one) must be no less stringent than the standard provided by section 206(1) and (2) of the Investment Advisers Act. The U.S. Supreme Court has interpreted these provisions as imposing on all investment advisers, regardless of whether the adviser is registered with the SEC, the fiduciary duties of loyalty and care to their clients. In light of their status as fiduciaries, the SEC has stated that investment advisers owe their clients, among other things, a duty of "undivided loyalty."

III. Implications for China

The exchange rate reform, opening of capital accounts and financial globalization create a positive environment for emergence of hedge funds in China. "The first hedge fund in China --- "Junxiang Lianghua" --- was formed by Guotai Jun'an Securities Assets Management Co. on March 7, 2011, which initiated an investment path in the capital market in China." [7] However, Chinese securities market is immature and short of regulation and legislation on hedge funds; therefore, it is urgent to make more efforts in this regard. In the US, the launch of the financial reform act indicated adjustment and reconsideration of regulation by the US government on the financial industry after the financial crisis. It furthers the reform of existing financial regulation and is of considerate value of reference for China.

Firstly, legislation on hedge funds may be improved to establish the legitimate status of such funds. Hedge funds do not exist in Chinese laws but is not explicitly prohibited. "If securities traders and private and public funds engage in hedge funds, they may form a large team, bringing unpredictable impacts on the market. Additionally, without laws concerned, regulators may be in an awkward situation. To change such negative conditions, regulators shall quicken the pace in legislation to remedy legal defects. I believe that special regulations may be launched to guide market behaviors and administrate different types of hedge funds based on their asset size. Some QFII hedge funds that meet certain conditions may be allowed to conduct limited hedging business after obtaining license. Regulators may impose corresponding requirements on them in respects of information disclosure, internal risk management, qualification of fund managers and investor protection, carry out real-time monitoring of capital flow and limit the frequency of capital inflow when there is great fluctuation." [8]

Secondly, more attentions may be given to hedge funds and professional ethnics may be enhanced. Since hedge funds just emerge in China, investors have limited knowledge about them. Therefore, it is necessary for regulators and investors attach attention to and understand hedge funds. "Education may be offered at moral, legal and ethnical levels with cases to enable those who engage in hedge funds understand the consequences of irregular practice. Regulations and rules may be improved to prevent and control moral risks and departments may be set up to conduct mutual check and restraint." [9]

Thirdly, specific regulatory measures and systems shall be strengthened. For instance, micro-restriction measures may be adopted and legal systems regarding professional ethnics may be reinforced. Especially, the measures of the above-mentioned de minimis exemption and systematical fiduciary regimes should be adopted in China.

Finally, international cooperation may be enhanced. Due to international capital flow and negative impacts of speculative hedge funds on global financial industry, countries may strengthen international cooperation and monitor abnormal flow of hedge funds to avoid adverse affect of hedge funds on global financial industry.

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Global Journal of Human Social Science (C) Volume XII Issue XI Version I Year 2012

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