THE LONG VIEW

MARC E. ELOVITZ
asks if US regulation is a new bubble or a 'new normal'?

"FOR THE FIRST TIME IN ITS HISTORY, THE SEC IS CHAIRED BY A LITIGATOR AND FORMER PROSECUTOR, SO WE CAN EXPECT [ITS] AGGRESSIVE EFFORTS TO CONTINUE"

Are we in a regulatory bubble? The hedge fund industry has been in a period of unprecedented regulation. New rules have come fast and furious, along with stepped-up examination and enforcement activity. Is this a bubble, which will burst like others before it, or a 'new normal' for the industry?

The SEC has completed much of its Dodd-Frank rulemaking. New short sale disclosure requirements are still due, which may impact fund managers. These disclosures could be as easy as aggregated reporting of short sale data by the exchanges to the SEC. Or they could be as potentially problematic as public reporting by managers of individual short sales and positions.

The SEC's new rules are not limited to Dodd-Frank. Just last month, it proposed an overhaul of the Regulation D private placement process. Under current rules, the filing of a Form D in connection with an offering is not a condition to the offering being an effective private placement. The SEC's new proposed rules would penalise a manager for failing to file a Form D by imposing a one-year 'time out' for new fund offerings under Regulation D. While the SEC made this proposal in connection with the JOBS Act, the 'time out' would apply to all offerings under Regulation D, not just those using general solicitation under the JOBS Act. SEC staff also recently questioned whether many hedge fund managers should be registered as broker-dealers based on marketing of funds by internal personnel of the manager.

The SEC is not the only US regulator focusing on hedge funds. The CFTC was slated for extinction by some as part of the Dodd-Frank legislative process. Instead, it has emerged with jurisdiction over a large chunk of the swaps market and the hedge fund managers that trade swaps for investment purposes – or even just for hedging purposes. The CFTC then eliminated the most commonly used exemption from registration for hedge fund managers.

Additional regulators wait in the wings. The US Treasury Department's Financial Crimes Enforcement Network is planning new anti-money laundering and suspicious activity reporting rules for hedge fund managers. On the global stage, the AIFMD and Emir add to the complexity.

What about the existing compliance burdens? The good news is that the start-up costs of getting registered with the SEC, or filing as an exempt reporting adviser, are behind most managers. The same is true for many of the new periodic filing requirements. Last year at this time, large managers were sweating their first Form PF filing. Now, filing has become a relatively routine cost of doing business.

Other regulatory burdens are increasing. Expectations of registered investment advisers are substantial. Hedge fund managers need to dig deeply into their major risk areas. Simply having a policy on conflicts of interest, for example, will be insufficient if a manager does not address its conflicts.

An SEC-registered adviser is required to conduct an 'annual review' to assess its compliance programme and that programme's efficacy. Managers should evaluate: (1) changes in legal requirements, (2) changes in the manager's business, (3) breaches of the firm's policies, and (4) the firm's compliance testing and training programmes.

A meaningful annual review process will also help managers should they come under examination or investigation. The SEC's examination programme has been reinvigorated, including new staff hired from the private sector with specific hedge fund industry expertise. The SEC's enforcement programme has been increasingly aggressive, including with respect to large hedge fund managers. For the first time in its history, the SEC is chaired by a litigator and former prosecutor, so we can expect these aggressive efforts to continue.

The depth and breadth of these regulatory changes look like more than a temporary phenomenon. The 'new normal' for hedge fund managers will be increased oversight by a range of regulators. ■

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