

# Alternative investment vehicles still safe at any speed?

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By Thomas Mason

While the specter of hedge fund regulation might appear to have been gaining momentum of late with the SEC proposing two new rules at the end of 2006 and no less an authority than Federal Reserve Chairman Ben Bernanke recently weighing in on the issue, a number of observers believe that, for now at least, hedge fund managers might not have too much to worry about.

The hedge fund arena has traditionally been adept at avoiding regulatory scrutiny, with the argument that its relatively sophisticated client base can sufficiently surmise the risks inherent in their funds' investment strategies. But the SEC appeared to target that very assumption in December 2006 with two new proposals. One would make it a fraudulent act for an investment adviser of a pooled asset vehicle to make false or misleading statements, while the other would redefine the term "accredited investor" to include only those individuals with at least \$2.5 million in investments.

The spotlight seemed to further shine on hedge funds the following February, when the President's Working Group revived its inquiry into the industry — having concluded its investigation of the Long Term Capital Management "fiasco" in 1999 — by issuing a set of principles on "private pools of capital." The House Financial Services Committee held a hearing the next month to discuss systemic risk issues associated with hedge funds, following two previous Senate sessions.

On April 11, Bernanke also commented on the regulation of hedge funds in a speech before the New York University Law School, remarking that "the growing market share of hedge funds has raised concerns about possible systemic risk." As he went on to say, however, market discipline can be a powerful tool for controlling leverage and risk-taking,

and imposing more intrusive regulation on the industry after the LTCM episode would have been costly and technically difficult.

"Private investors must be sophisticated enough to understand and monitor the financial condition of the firm and be persuaded that they will experience significant losses in the event of a failure. When these conditions are met, market discipline is a powerful and proven tool for constraining excessive risk-taking," Bernanke said in his concluding remarks.

As a number of observers told SNL Financial, the Fed chief's remarks appear largely consistent with the President's Working Group — of which the Federal Reserve is a party — and, as Bernanke indicated, the onus seems to now be on the ones investing in hedge funds to police their own risk-taking.

"Warren Buffett has the right theory. If you don't understand the investment, don't buy the stock," Thomas Westle, a partner with law firm Blank Rome, told SNL. Large institutional owners like investment banks and pension plans should perform the necessary due diligence to ensure the vehicles are safe, since even registered investment advisers are susceptible to violating market rules or blowups, he said. "I don't think that the abuses that we saw in the mutual fund industry, and the activities that were borderline criminal, would have ever been stopped just because of more regulation."

Investment banks can also help to prevent systemic risk issues through their roles as counterparties to hedge funds, according to Paul Roth, a partner with Schulte Roth & Zabel LLP. "Everybody is concerned that they don't want to have a repeat of Long Term Capital Management. The problem is, the only people who are in a position to monitor their own risk are the counterparties," he told SNL, adding, "The government is not going to be able to monitor that."

As far as a greater clampdown from Capitol Hill, observers say the fact that hedge funds are a large contributor to campaigns could stymie any possible moves in that direction. "[Hedge funds] may be able to persuade the administration that there is not a need for additional regulation," Amy Lynch, president of FrontLine Compliance LLC, said in an interview with SNL. However, a party switch in the next presidential election could change things, she added. "If we have a Democratic president, it may shift more to a pro-regulatory environment again, and you may see some additional regulations come out on hedge funds."

But while some of these issues might not be likely to produce additional rules or legislation anytime soon, regulators across the globe have been making strides in the valuation of securities, according to Lynch. "That's a huge area of concern for regulators. It affects how the funds are priced, and therefore how they are documenting their performance," she said. Both the International Organization of Securities Commissions and the Alternative Investment Management Association have introduced best practice guidelines on valuation issues for hedge funds, which Lynch believes global hedge funds will follow in order to attract investors.

The issue for regulatory agencies is that some smaller domestic funds may choose to flout the rules. "The concern is that funds that don't have the pressure of the global regulators ... can more or less do what they want here in the U.S. regarding how they may want to value their securities, and that's where they can get into trouble," Lynch said.

Indeed, the Financial Accounting Standards Board has already extended its reach in the area of securities valuation with its recent FAS 157 rule, which applies to entities that produce financial statements, including hedge funds. In an effort to increase the transparency

of how funds determine "fair value," FAS 157 now calls for a three-level hierarchy of valuation techniques. "My read into this pronouncement from the FASB is that 'not all fair value is created equal,'" Michael Patanella, an assurance senior manager with Grant Thornton, said in an interview with SNL.

The first level would track quote prices in active markets for identical as-

sets, the second would be for significant other observable units and the third for significant unobservable inputs. "When you pick up a financial statement now and you see fair value now ... you can honestly say that the level three investments are something I need to pay attention to," Patanella said.

Depending on the portfolio, the fund could be required to detail its investments

by such criteria as the country, industry and percentage owned, which compares with anything the SEC or Washington might dish out. "As we can see from this FASB rule, accounting standards disclosures will cause additional transparency, which may get us to the same point as regulation," he said. *i*