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Looking Ahead

Changes and challenges for hedge funds in 2009.

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Like my mother says, what doesn't kill us makes us stronger. Hedge funds were affected on some level by almost all of the calamities of the past year, including the public persecution of the securities industry. But now, the hedge fund industry is marshaling what's left of its resources, tapping its creativity and fighting to survive in a bombed-out landscape. And the landscape is likely to include more regulation, and tougher examinations, of portfolio trading strategies, hedge fund managers and to some extent, hedge funds themselves.

To understand where we are headed, it's important to remember where we have been. The past 12 months have been a whirlwind of legal, regulatory and enforcement activity. And, similar to past financial downturns, it was the enforcement side that led the way, as falling markets exposed Ponzi schemes and other fraudulent activity. The SEC came under fire, and Congressional leaders and administration officials openly debated the structure of the U.S. system of securities regulation. The U.S. Treasury issued a "blueprint" proposal to create a "systemic" regulator. Lawmakers openly debated whether to merge the SEC into the CFTC or FINRA. Against this backdrop, Senators Grassley and Levin introduced the Hedge Fund Transparency Act of 2009 (S. 344), which would amend the Investment Company Act of 1940 to require all private investment funds with $50 million or more in assets under management to register with the SEC.

When the Madoff fraud exposed weaknesses in SEC oversight, the agency finally sprung into action. The SEC proposed to: clarify how it deals with whistleblower complaints; strengthen its oversight of credit rating agencies; create an Office of Risk Assessment (staffed with non-lawyer securities industry veterans); and revive the "uptick" rule for short sales and rules for related circuit breakers. The SEC approved several central counterparties to facilitate clearinghouse trading of credit default swaps (CDS) and most recently, the Treasury outlined a proposal that would require certain types of swaps and derivatives to trade through central clearinghouses instead of over the counter.

The SEC brought the first insider trading action relating to CDS just this month. Similarly, SEC enforcement continues with insider trading cases being brought at a pace not seen since the late 80s. Most recently, the enforcement division has filed actions against placement agents receiving "pay-to-play" payments from hedge funds and advisers seeking business from public pension plans.

Even without the Hedge Fund Transparency Act, the SEC is

empowered by current law to examine both registered and unregistered advisers, and the agency has announced its intention to do this more aggressively than in the past. The SEC and FINRA have publicly announced a particular focus on custody and valuation issues, which is not unexpected after the events of 2008. Finally, hedge funds have been targeted by the SEC's new enforcement chief for vigorous enforcement activity.

Based on the Treasury Department blueprint, it is likely that a "systemic" regulator will be created this year, and larger hedge funds should expect to provide certain position information to that body and to face limits on portfolio leverage.

Going forward, OTC swaps and derivatives (at least those that are in some kind of "standard" form) are likely to be traded via one or more clearinghouses.

It is almost a foregone conclusion that Congress will empower the SEC to require hedge fund adviser registration, with Rep. Barney Frank publicly promising financial services reform by the end of 2009.

Beyond the heightened regulatory requirements, hedge fund managers and funds will need to respond to the challenges to their products and fees now being demanded by investors, prospects, intermediaries and their consultants and other representatives. It is perhaps these changes which will have the quickest and most profound effect. And they have already begun. Investors conducting due diligence on hedge funds and their managers demand more information before investing. Besides investment performance and attribution, due diligence now includes a review of the manager's service providers (such as administrators and auditors) and infrastructure (including operations, risk management and compliance). Large prospects, especially public retirement plans, have begun negotiating with managers for lower and/or different fee structures, including the use of benchmarks and other hurdles. Funds now commonly use multiple prime brokers to minimize counterparty risk.

The business condition and public profile of the manager have also become factors for investors to gauge the headline risk of an investment.

With the sting of "gates" still fresh in their minds, large hedge fund investors are now demanding that managers set up separate accounts for their investments instead of pooling with smaller players. Investors large and small are seeking more transparency into their portfolios and requiring more detailed and frequent updates from managers. Some managers will consider eliminating "gates" at redemption, replacing them with the more predictable rolling lockup periods.

Continuing scrutiny of the hedge fund industry in the financial and popular press will intensify the pressure on the industry to reinvent itself, but that's not necessarily a bad thing. With increased regulation comes the opportunity for the industry to publicly demonstrate its value and legitimacy.