

Overview: The US Approach to Regulation of Investment Companies

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Outline

- Philosophical Notes
- Regulated Investment Companies
- Hedge Funds

Two Preliminary Points: First

“The federal securities laws do not deprive a man of his God-given right to make a fool of himself. They merely prohibit others from making a fool of him.” — Louis Loss

“Thou Shalt Not Lie.”

Two Preliminary Points: Second

“No man can serve two masters.” —
Matthew 6:24

Regulated Investment Companies

Two Preliminary Points: Second, Restated

In 1935, the US Congress Mandated a Study of Investment Companies —

- Many Investment Companies Organized and Operated to Benefit the Interests of their Owners and Affiliates at the Expense of their Shareholders
- A Significant Problem in the Industry: Whether Consciously or Not, Advisers Favored Their Own Financial Interests

Specific Risks

- Management in the Interests of Managers or Certain Shareholders
- Dishonest or Incompetent Management
- Assets Improperly Valued
- Policies or Management Changed without Shareholder Approval
- Assets Not Properly Safeguarded
- Misleading or Inadequate Disclosures to Shareholders

The Result:

- The Investment Company Act of 1940
- The Investment Advisers Act of 1940

What Regulation Is Supposed to Do (1)

- Prevent Managers from Managing Companies to Their Benefit to the Detriment of Investors
- Prevent the Issuance of Securities Having Inequitable or Discriminatory Provisions
- Prevent Management by Irresponsible Persons
- Prevent the Use of Misleading Methods of Computing Earnings and Asset Value

What Regulation Is Supposed to Do (2)

- Prevent Changes in the Character of the Investment Company without Shareholder Consent
- Protect Assets
- Prevent Excessive Leveraging
- Require Full and Accurate Disclosure

Investment Company Act

- Any Issuer That Holds Itself Out to Be or Proposes to Be Engaged Primarily in the Business of Investing, Reinvesting, or Trading Securities
- Any Issuer that is, in fact, Engaged Primarily in the Business of Investing, Reinvesting, or Trading In Securities
- For example — a Mutual Fund Company

Mutual Funds

- The Most Popular Type of Investment Company — Open-End Investment Company
- Offers Shareholders the Right to Redeem Shares at their Net Asset Value at Any Time
- Invest Companies are Prohibited from Selling, Redeeming, or Repurchasing Fund Shares Except at Net Asset Value

Net Asset Value

- Total Value of the Fund's Holdings Divided by the Number of Outstanding Fund Shares
- Value of the Fund's Holdings:
 - Market Quotations
 - Fair Value as Determined in Good Faith by the Fund's Board of Directors

Closed-End Funds

- A Defined “Basket” of Securities
- Not Redeemable at their Net Asset Value
- Shares are Traded on the Market at Market Prices — Often Higher or Lower than Underlying Value

Investment Companies:

Firms Meeting the Definition Must Register with the SEC

- Subject to the Regulations Provided by the Investment Company Act
- Subject to Examinations by SEC Staff

But there are Exceptions . . .

Firms Excepted from Regulation

- Banks, Savings and Loans, Insurance Companies, Broker-Dealers, and Employee Stock Bonus, Pension or Profit-Sharing Trusts
- Private Investment Companies —
 - Securities Held by 100 Beneficial Owners or Less, or
 - Held Only by Qualified Purchasers
 - . . . Hedge Funds

Investment Company — Organization

- Typically Organized by the Persons Who Serve as Investment Advisers and Managers to the Investment Companies — Not by the Investors
- Investment Advisers Typically Get a Fee Calculated as a Percentage of Assets Under Management

Investment Advisers Act

- SEC Regulates Investment Advisers under the Investment Advisers Act
- The Act Imposes Obligations on Investment Advisers
 - Fiduciary Duty to Exercise the Utmost Good Faith on Behalf of their Clients
 - Duty to Provide Clients with Full and Fair Disclosure of All Material Facts

Preventing Managers from Managing Companies to Their Benefit to the Detriment of Investors (1) Independent Checks On Management

- The Crucial Role of the Directors
- Investment Adviser Compensation
- Semi-Annual Reports by Independent Auditors
- Books and Records

Preventing Managers from Managing Companies to Their Benefit to the Detriment of Investors (2)

- Prohibited Transactions
 - Self-Dealing
 - Transactions With Affiliates
- Transactions by Officers and Directors in the Same Securities Held by the Fund
- Prohibitions Against Interests in Broker-Dealers, Investment Advisers or Underwriters

Preventing the Issuance of Securities Having Inequitable or Discriminatory Provisions

- Fund Must Sell or Redeem Shares Only at Current Net Asset Value
- Shareholders May Not Negotiate Individual Discounts

Preventing Management by Irresponsible Persons

- Persons Convicted of Crimes Involving the US Securities Laws are Barred from Working for an Investment Company
- Persons Enjoined from Violating the US Securities Laws are also Barred from Working for an Investment Company
- The Commission May Bar a Person from Working for an Investment Company

Preventing the Use of Misleading Methods of Computing Earnings and Asset Value

- Fund Must Sell or Redeem Shares Only at the Current Net Asset Value, Computed Daily, at a Specified Time
- Fund Must Value Assets at the Current Market Price
- If Market Quotations Are Not Available, at Fair Value as Determined by Fund's Directors

Preventing Changes in the Character of the Investment Company

- Investment Companies Must State Their Form, Purpose, and Policies
 - Open or closed end?
 - Diversified or undiversified?
 - Strategies

- Fundamental Changes Must be Approved by a Majority of Shareholders

Protecting Assets

- Limiting Sales Loads

- Restricting the Use of Fund Assets to Promote Distribution

- Custody Rules

Preventing Excessive Leverage

Mutual Funds Are Generally Prohibited from Issuing Debt Securities or Preferred Shares —

Redemptions Could Remove the Assets that Support Debt or Preferred Shares

Requiring Full and Accurate Disclosure

- Purchasers Must be Given a Prospectus Filed With the SEC
- Prospectus Must Make Full and Fair Disclosure of All Material Facts Regarding the Fund
 - Fund's Investment Objectives
 - Investment Strategies
 - Risks
 - Expenses
- Investment Companies Must Also Make Semi-annual Reports to the Shareholders and the SEC
- Principal Executive Officer and Principal Financial Officer Must Certify that Reports are Accurate and Not Misleading

Hedge Funds

Hedge Funds: What Are They?

- Unregulated Collective Investment Schemes
- Use Leverage and Shorting Techniques
- Restrictions on Investors' Ability to Redeem
- Managers Charge Fees Based on Performance
- Managers Participate in the Fund

Regulatory Concerns

- Financial Stability: the Ghost of LTCM
- Investor Protection
- Potential for Market Abuse

Financial Stability Concerns (1)

- Long Term Capital Management:
(Nearly) The End of the World as We
Knew It
- The President's Working Group, 1999
- The President's Working Group, 2007

Financial Stability Concerns (2)

“Sophisticated financial firms have both the direct financial incentives and expertise to provide for effective market discipline. By ensuring credit terms are appropriate given the risk posed, these institutions limit not only their own potential exposure to losses from default, but also help to constrain overall borrowing, thereby decreasing the potential for systemic risk.

Financial Stability Concerns (3)

“We believe that the collective decisions of self-interested and informed counterparties, reviewed by regulators, provide the very best protection against systemic risk.”

— Robert K. Steel
Undersecretary for
Domestic Finance
United States Treasury

Investor Protection (1)

F. Scott Fitzgerald: "The Rich are Not like Us."

Ernest Hemingway: "Yes. They Have More Money."

Investor Protection (2)

Solution: the Accredited Investor

- Premise: Hedge Funds Offer Securities Only to Accredited Investors
- Currently, an "accredited investor" is a person with a net worth of \$1 million or an annual income of \$200,000
- Proposed Revision: a person who meets this definition *and* owns at least \$2.5 million in investments

Investor Protection (3)

But some wonder what the accredited investor standard is getting at:

- A proxy for “sophistication”?
- A measure of the ability to withstand loss?

Investor Protection (4)

One other concern: Do Hedge Funds
Make Adequate Disclosures to
Investors?

Investor Protection (5)

“The guidance being given to [hedge fund investors] is that a lack of information should affect your investment decisions. If you are not obtaining the type of information you seek, you should act accordingly.”

— Treasury Undersecretary Robert Steel

Potential for Market Abuse (1)

What has been will be again,
what has been done will be done
again;
there is nothing new under the sun.

— Eccl. 1:9-14

Potential for Market Abuse (2)

“Rather than speaking ominously of a supposedly growing trend of hedge fund fraud . . . let us sort through the cases to distinguish garden variety fraudsters. . . .

Potential for Market Abuse (3)

“If we simply lump all the cases together, we might conclude incorrectly that regulations aimed at legitimate hedge fund advisors will stop every day thievery.”

— Paul Atkins
SEC Commissioner

Potential for Market Abuse (4)

- Insider Trading
- Front Running
- Fraud
- Theft

- New bit: Hedge Funds that Have Their Own Broker-Dealers

Potential for Market Abuse (5)

But Advisers — whether registered or not — are still subject to anti-fraud statutes.