

U.S. REGULATION 101

GUIDE TO U.S. OVERSIGHT OF THE HEDGE FUND INDUSTRY

Updated June 2016

HEDGE*fundamentals.org*

U.S. Regulation 101

Overview

While the financial regulatory landscape in the U.S. is evolving due to recent legislative changes, including the Dodd-Frank Act, this guide provides a brief overview of the U.S. regulatory structure and how it relates to the hedge fund industry.

Fast Facts*

Hedge funds play a vital role in helping a wide range of institutions – from pensions to endowments to non-profits – meet their financial obligations. Nearly two-thirds of global hedge fund assets come from institutional investors.

Globally, the industry oversees approximately \$3 trillion in assets, more than 70 percent of that is managed by U.S. fund managers.

Hedge funds are subject to the same trading and reporting requirements as other investors in publicly traded securities in the U.S.

Funds are also subject to additional industry-specific regulations, including a limit on the type of investors that each fund may have.

Contents

| | |
|-----------------------------------------------------------|----|
| Expanded Oversight of the Hedge Fund Industry | 3 |
| A Brief Legislative History of U.S. Securities Regulation | 4 |
| Regulatory Institutions Impacting the Hedge Fund Industry | 6 |
| The SEC | 10 |
| The CFTC | 11 |
| Investor Restrictions | 12 |
| The Regulated Marketplace | 14 |

U.S. Regulation 101

Expanded Oversight of the Hedge Fund Industry In The United States

Federal regulation of the financial services industry in the U.S. has been shaped by a series of legislative and regulatory developments over the past century.

U.S. financial markets and investment advisers, such as hedge funds, are overseen and regulated by a group of government regulators.

Together, and collectively, these entities are tasked with maintaining fair and orderly markets and enforcing the rules to protect all investors.



A Brief Legislative History of U.S. Securities Regulation

Securities Act of
1933

The 1933 Act includes a number of provisions to strengthen investor protections and the integrity of securities markets. The Act requires the registration of publicly offered securities, providing limited exemptions for certain offerings, including: private offerings to a limited number of sophisticated persons or institutions; offerings of limited size; intrastate offerings; and, securities of municipal, state, and federal governments.

Securities Exchange
Act of 1934

The 1934 Act created the SEC, providing it with broad authority to register and regulate the securities industry. The Act also defines and outlaws certain types of market behavior and provides the SEC with the power to discipline regulated entities and other persons who trade in the securities markets. The Act also regulates the secondary trading of securities, as well as the physical exchanges where securities are traded.

Investment Company
Act of 1940

The ICA defines what constitutes an investment company under U.S. law. The ICA establishes guidelines to regulate and organize companies engaged in investing, reinvesting and trading in securities. Provisions in the ICA impose strict disclosure requirements, place limits on the investment strategies and holdings of registered investment companies (RICs), and rules regarding the structure of RICs. Hedge funds are not generally subject to regulation under the ICA as they are excluded from the definition of “investment company” in the ICA.

Investment Advisers
Act of 1940

The Advisers Act generally requires persons and firms receiving compensation for providing advice about securities to register with the SEC, including hedge fund managers with at least \$150 million in assets under management. Advisers must register using Form ADV, which includes pertinent background information on the individual adviser as well as the type of investment advice to be offered. Form ADV must be updated at least annually with the SEC.

A Brief Legislative History of U.S. Securities Regulation

Commodity Futures
Trading Commission
Act of 1974

The 1974 Act amended the Commodity Exchange Act to create the Commodity Futures Trading Commission (CFTC) to serve as an independent federal agency that regulates futures and option markets and some aspects of derivatives trading.

Dodd-Frank Act
(2010)

Congress and the Obama Administration worked to enact the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in response to the 2008 financial crisis. The Dodd-Frank Act set forth significant changes to the regulatory structure for many financial services firms, including new registration requirements for investment advisers, hedge funds, and others. The Dodd-Frank Act also ushered in several market reforms including changes to the derivatives marketplace, central clearing, segregation of collateral and others. The Dodd-Frank Act also created the Financial Stability Oversight Council (FSOC), which monitors systemic risk in order to prevent future economic crises.

JOBS Act (2012)

Section 201 of the Jumpstart Our Business Startups (JOBS) Act amends an existing rule under Regulation D to remove the ban on general solicitation and advertising by companies conducting private offerings, including hedge funds, provided that securities are only sold to sophisticated investors. Removing the ban on general solicitation will allow alternative investment fund managers to better communicate information about their businesses to policy makers, regulators, investors, potential investors and the broader public, providing greater transparency about the industry.



U.S. Regulation 101

In response to the financial crisis, the U.S. developed a new framework for financial supervision. Under this framework, various regulators coordinate to monitor the financial services industry, provide investor protections, promote effective capital markets, and address issues that could pose a “systemic risk” to the financial system and the economy.

An outline of this new framework is below and a brief description of each regulators’ role is included on subsequent slides.

Federal & Executive Branch Agencies

U.S. Department of Treasury

Financial Stability Oversight Council

Board of Governors of the Federal Reserve System

Independent Regulatory Agencies

Commodities Futures Trading Commission

Securities and Exchange Commission

State Regulatory Agencies

Attorneys General, State Financial Regulatory Agencies, Regulatory oversight covering hedge funds with less than \$150 million in AUM

Self Regulatory Organizations

National Futures Association

Financial Industry Regulatory Authority

U.S. Regulation 101

Regulatory Institutions Impacting the Hedge Fund Industry



The **U.S. Treasury Department** is the executive agency responsible for promoting economic prosperity and ensuring the financial security of the United States. The Department advises the President on economic and financial issues that encourage sustainable economic growth and foster improved governance in financial institutions and markets.



The **Financial Stability Oversight Council (FSOC)** is a council of regulators established by the Dodd-Frank Act. The Council has authority to: identify and monitor systemic risks to the U.S. financial system; eliminate expectations that any American financial firm is "too big to fail;" coordinate regulatory reporting and rulemaking; and, respond to emerging threats to U.S. financial stability. The Treasury Secretary chairs FSOC.



The **Federal Reserve System**, also known as the "Fed," serves as the central banking system for the U.S. The Fed oversees monetary policy and regulates the U.S. banking system, while also monitoring systemic risk in the financial marketplace. The Board of Governors of the Fed is the regulator tasked with enforcing the enhanced regulatory framework governing systemically important financial institutions (SIFIs).

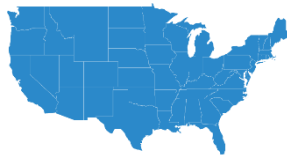
Regulatory Institutions Impacting the Hedge Fund Industry



The **Commodity Futures Trading Commission (CFTC)** is an independent federal agency that regulates, together with the SEC, many aspects of the derivatives market. Its stated mission is to protect market users and the public from fraud, manipulation, and abusive practices in the sale of commodity and financial futures and options, and to foster open, competitive option markets.



The **Securities and Exchange Commission (SEC)** is an independent federal agency that holds primary responsibility for enforcing federal securities laws; regulating the securities industry; and, overseeing the nation's stock and options exchanges and other electronic securities markets in the U.S. The SEC enforces the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Sarbanes-Oxley Act of 2002, the Dodd-Frank Act and other statutes.



Each state in the U.S. has defined financial services regulators who regulate financial services markets and participants, to the extent not preempted by Federal law. Additionally, many state Attorneys General have some oversight authority, including general antifraud authority. Hedge fund managers with less than \$150 million in assets under management (AUM) are regulated by the state in which their headquarters are located.

Regulatory Institutions Impacting the Hedge Fund Industry



The **National Futures Association (NFA)** is a self-regulatory organization (SRO) which regulates the managed futures industry. Membership in NFA is mandatory for the more than 4,200 firms and 55,000 individuals trading in the marketplace.



The **Financial Industry Regulatory Authority (FINRA)** is an SRO for broker-dealers and certain stock exchanges. It performs financial regulation of brokerage firms and registered securities representatives.

Hedge Fund Regulation: The SEC

Hedge fund managers are subject to a number of SEC regulations, including:

- Mandatory registration with the SEC
 - All hedge fund managers with more than \$150 million in assets under management (AUM) are required to register with the SEC.
- Form PF
 - For larger managers, this form must be filed on a quarterly basis.
- Form ADV
 - Filed at least annually, providing regulators with information, including:
 - Organizational and operational information about the manager and its fund(s).
 - Information about the size of the manager and its fund(s).
 - Information about the ownership of the manager and its fund(s).
 - General data about the manager and its fund(s).
 - Identification of parties performing services for the manager and its fund(s), like prime brokers, auditors, custodians, administrators and marketers.



Hedge Fund Regulation: The CFTC

Certain hedge fund managers are subject to a number of registration and disclosure requirements with the CFTC.

- As a result of recent CFTC rulemaking, many commodity pool operators (CPOs) and commodity trading advisors (CTAs) to private funds that are commodity pools register with the CFTC.
- CPOs and CTAs registered with the SEC and the CFTC use Form PF to provide relevant information on the size and activity of the manager and its funds.
- Under this process, CPOs and CTAs registered with both the CFTC and SEC are also required to file one of two proposed forms:
 - Form CPO-PQR, for CPOs.
 - Form CTA-PR, for CTAs.

And, registered advisers operating commodity pools not satisfying the definition of “private fund” under Dodd-Frank would also have to complete these forms.



Hedge Fund Regulation: Investor Restrictions

Hedge funds are also restricted in the nature of their sales or offerings.

In order to comply with the private offering requirements set forth in the Securities Act of 1933, hedge funds generally must restrict their selling to entities or individuals the SEC defines as an “accredited investor.”

Accredited investors include:



Groups such as charities, organizations, corporations, etc. with total assets in excess of \$5 million



Banks, insurance companies and investments firms



Employee benefit plans like corporate pension plans with assets in excess of \$5 million



An individual whose net worth, or joint net worth with their spouse, exceeds \$1 million – excluding their primary residence – at the time of the purchase



Individuals with a yearly income of \$200,000 or more for the last two years or a joint income with their spouse exceeding \$300,000 for those years, as well as a reasonable expectation of the same income level for the current year

Hedge Fund Regulation: Investor Restrictions:

Certain hedge funds also must restrict their selling to what the Investment Company Act of 1940 defines as a “qualified purchaser.”

Qualified purchasers include:

- i. Any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) with that person’s qualified purchaser spouse) who owns not less than \$5,000,000 in investments, as defined by the Commission
- ii. Any company that owns not less than \$5,000,000 in investments and that is owned directly or indirectly by 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct linear descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons
- iii. Any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv)
- iv. Any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25,000,000 in investments.

The Regulated Marketplace

Hedge funds and their advisers, such as Commodity Trading Advisors (CTAs) and Commodity Pool Operators (CPOs), operate in regulated markets and are subject to the same trading rules and restrictions as other market participants.

For example, individuals trading in the futures marketplace are regulated by the CFTC and the National Futures Association (NFA), an SRO that oversees the managed futures industry.

The CFTC and NFA regulate industry participants through a variety of methods, including:

- Registration
- Annual reporting and disclosure
- Monitoring for market manipulation and systemic risk
- Enforcement mechanisms to address potential manipulation

