

# 1 Regulation on Hedge Fund Investment Advisers in the US and its 2 Implications for China

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## 6 **Abstract**

7 In recent years, with the innovation and adjustment of financial market, hedge funds grown  
8 rapidly and became the major actor in the world financial market. The main law on  
9 investment adviser is the Investment Advisers Act of 1940, and the US amended it in 2004. In  
10 2010, the Private Fund Investment Advisers Registration Act of 2010 made further  
11 amendment to the Investment Advisers Act of 1940. The continuously strengthened regulation  
12 on investment advisers in the US is of great significance for China.

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14 **Index terms**— Hedge funds, investment advisers, regulation, implications.

15 Since Alfred Winslow Jones created the first hedge fund in 1949, hedge funds came to the spot of the public.  
16 Through a prosperous development during the financial globalization in the 1990s, there are over 9,000 hedge  
17 funds in the world, managing assets worth more than two trillion US dollars, and the trading volume of hedge  
18 funds has accounted for 40-50 percent of total trading volumes in global main stock markets. In addition, hedge  
19 funds are used as major financing means by listed companies. Today, hedge funds have become an important  
20 participant in global financial market and a financial investment means significant to the market.

## 21 **1 I. Brief Introduction to Hedge Funds a) Concepts and Fea- 22 tures of Hedge Funds**

23 Though hedge funds have enjoyed a rapid development, there are many interpretations to and divergences over  
24 its concepts, and hence the definition of a hedge fund is still under discussion. Chinese scholar Li Xun defines  
25 hedge funds as "a portfolio formed through non-public offering to a few of rich individuals and sophisticated  
26 investors whereby fund managers as the major investor of the fund may take any investment strategies, use a  
27 vast range of techniques like short selling and leveraging to pursue absolute returns and receive performance-  
28 based remunerations." [1] Hedge funds are unique and far different from traditional funds in terms of objectives  
29 and strategies of investment. What hedge funds emphasize is absolute return while traditional funds relative  
30 return. Hedge funds usually make use of techniques such as credit Author : Zhang Lu, Science and Law,  
31 Baoding 071000, Hebei Province. Tianjin University of Finance and Economics School of Law. E-mail :  
32 tony@eastwestlaw.com expansion, short selling or leveraging, while in comparison, traditional funds employ  
33 less strategies and approaches.

34 In general, hedge funds have the following features: (1) mainly open for investment from sophisticated investors;  
35 (2) non-public offering; (3) use of flexible investment strategies, mainly through credit expansion, short selling and  
36 other hedging approaches; (4) adoption of an incentive commission structure and pursuit of absolute return; and  
37 (5) subject to few regulations. b) History of Hedge Funds "The traditional story about the origin of hedge funds is  
38 that they were invented in the late 1940s by Alfred Winslow Jones." "In 1949 he formed an investment partnership,  
39 A.W. Jones & Co., which lays claim to being the first hedge fund." [2] From then, hedge funds entered into a slow  
40 development period. In the 1970s under advocacy of financial liberalization, innovative financial products were  
41 launched in western countries. US government gradually relaxed financial regulation in the 1980s, providing a  
42 large stage for hedge funds. "In the 1990s, the number of hedge funds increased 12 times over and the size of asset  
43 under management was 37 times that of the past. Especially, hedge funds enjoyed a rapid development in terms

## 4 II. REGULATION OF ON HEDGE FUND INVESTMENT ADVISERS

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44 of number and size of assets after 2000. The size of assets under management by hedge funds reached about USD  
45 265 million at the early 2008.” [3] However, the bankruptcy of Lehman Brothers Holdings, liquidity unwinding  
46 and subprime crisis heavily hit hedge funds in 2008, resulting in poor performance of the overall industry in the  
47 year. Nevertheless, “there were more than 9,000 hedge funds globally, which managed assets worth USD 2.02  
48 trillion in April 2011. The trading volume of hedge funds accounted for 40-50 percent of the total trading volumes  
49 in global major stock markets except China.” [4] 1 Scholar Stefano Lavinio defines hedge funds in The Hedge  
50 Fund Handbook: A hedge fund may be defined as a tool of investment that makes use of such techniques as short  
51 selling, hedging, arbitrage, leveraging or synthetic positions and derivatives or their combination, and managers  
52 of the fund may earn incentive incomes from the structure of their tactics. According to the IMF, “Hedge funds  
53 are ...typically organized as private partnerships and often located offshore for tax and regulatory reasons.” The  
54 wellknown US-based VHFA defines hedge funds as “limited partnerships or limited liability companies invested  
55 primarily in public securities or in financial derivatives”. c) New Issues Arising from Hedge Funds ??971 The  
56 first FOHF in the US —Grosvenor Capital Management —was formed. 1992

57 The Quantum Fund managed by Soros defeated the Bank of England, devaluing the pound and causing the  
58 bank lose over USD 30 billion and Soros earn as much as USD 1.1 billion, which shock the economic world. 1997

59 The Asian financial crisis broke out. Currencies of southeast Asian countries were devalued under the hit by  
60 international hedge funds and former Malaysian Primer Mahathir Mohamad called Soros “a villain”. Oct. 1997/  
61 ??Sep. 1998 In order to maintain the stability of the financial market, the government of Hong Kong SRA fought  
62 a fierce battle with international capital in the exchange, stock and futures markets in Hong Kong. Finally, Paul  
63 Jones, Soros’ assistant, acknowledged his participation and loss. Sep. 1998

64 A US hedge fund —Long-term Capital Management (LTCM) —went bankruptcy and the financial products  
65 worth over one trillion US dollars affiliated with the assets under its management were exposed to systematic  
66 risks, which forced intervention of the Fed.

### 67 2 Sep. 2006

68 A US hedge fund —Amaranth Advisers —closed down due to its loss of as many as USD 6.6 billion in two weeks,  
69 which exceeded the value of assets under its management, much more than the loss of the LTCM. Such loss was  
70 resulted from purchase of substantial positions due to its false estimation on price tendency of natural gas.

### 71 3 Jun. 2007

72 The bankruptcy of two hedge funds under the umbrella of Bear Stearns ignited the subprime crisis and unveiled  
73 the global financial crisis. Source : History of Regulation on Hedge Funds.

74 From Table 1 it may be read that, firstly, hedge funds have expanded their source of financing since the birth of  
75 FOHF, through which, hedge funds may raise funds from large institutions including banks, insurance companies,  
76 investment banks and pension funds, hence reaching to a broader scope of investors and involving more potential  
77 risks. Secondly, the impact of hedge funds on economic stability has been increased, as bankruptcy of a large  
78 hedge fund might give a heavy strike on the financial market. Finally, regulation on hedge funds is far from  
79 sufficient, as revealed by the case of Madoff in 2008.

## 80 4 II. Regulation of on Hedge Fund Investment Advisers

81 The focus of regulation on hedge funds may be regulation on hedge fund investment advisors, which is also told  
82 by the case of Madoff. From the Investment Advisers Act of 1940 (hereinafter referred to as the Investment  
83 Advisers Act) to its amendment in 2004 and Private Fund Investment Advisers Registration Act of 2010, we may  
84 see US government has strengthened regulation on investment advisers. a) Relevant Provisions in the Investment  
85 Advisers Act of 1940

86 In the Investment Advisers Act, investment advisers are defined as “any person who, for compensation, engages  
87 in the business of advising others, either directly or through publications or writings, as to the value of securities  
88 or as to the advisability of investing in, purchasing, or selling securities?” Section 203 (a) of the Investment  
89 Advisers Act provides that investment advisers need be registered with the SEC, but there are two exceptions.  
90 The first is small investment advisers. Section 203 (a) (1) provides an investment adviser may not be registered  
91 with the SEC if the assets he manages are less than USD 25 million or he is not an investment adviser of a hedge  
92 fund. The second is investment advisers with limited clients. Section Act provides that any investment adviser  
93 who during the course of the preceding 12 months has had fewer than 15 clients and who neither holds himself out  
94 generally to the public as an investment adviser nor acts as an investment adviser to any fund registered under  
95 the Investment Advisers Act may be exempted from registration. b) Amendment to the Investment Advisers Act  
96 in 2004 ”The SEC amended the Investment Advisers Act and adopted certain rules including Rule 203 (b) (3) on  
97 December 2, 2004. Those rules require all owners or beneficiaries of a private fund be counted as a single client  
98 for the purpose of application of the exception rule of limited clients, and any hedge fund adviser who has had 14  
99 or more clients (i.e. investors) and managed assets worth USD 30 million during the course of the preceding 12  
100 months shall be registered with the SEC before February 1, 2006.” [5] Under Rule 203 (b) (3), hedge fund must  
101 deem every investor as a single client. In such way, most hedge funds have more than 15 clients and investment  
102 advisers therefore must be registered with the SEC.

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103       "Nevertheless, the SEC still kept two safe harbors for hedge funds. Firstly, the new Rule 203 (b) (3) does  
104       not involve the general rule that an investment adviser who manages assets less than USD 25 million may not  
105       be registered with the SEC, and thus small and emerging hedge funds may still not be subject to regulation by  
106       the SEC. Secondly, the SEC amended Rule 203 (b) (3)-1, providing only private fund may not be applied to  
107       private adviser exception. A private fund refers to a company that permits its owners to redeem any portion of  
108       their ownership interests within two years of the purchase of such interests. In other words, if the manager of a  
109       hedge fund requires an over two year lock-up period, he may still share the private adviser exception. It means  
110       hedge fund managers still need not to "look through" hedge funds to count the number of investors if there is a  
111       provision on lock-up period of two years or more in the hedge funds. " However, this new rule was overthrown  
112       by Goldstein v. SEC case.

## 113       **5 c) US's Financial Regulatory Reform Bill**

114       US President Obama signed the financial regulatory reform bill on July 21, 2010, turning on a new page of  
115       financial regulation in the US. Title V of the act is the Private Fund Investment Advisers Registration Act of  
116       2010 (hereinafter referred to as the Registration Act). It makes amendments to the Investment Advisers Act,  
117       "raising the assets threshold of investment advisers subject to registration from USD 30 million to USD 100 million  
118       and eliminating the limited client exemption relied upon by most private fund investment advisers today". [6]  
119       The amendments are mainly made in the following aspects:

## 120       **6 i. Registration and Exemption**

121       The amendment to Section 203 (b) (3)-1 eliminates the "private adviser exemption", which once provided that  
122       any investment adviser who during the course of the preceding 12 months had fewer than 15 clients and who  
123       neither held himself out generally to the public as an investment adviser nor acted as an investment adviser to  
124       any fund registered under the Investment Advisers Act might be exempted from registration.

## 125       **7 b. Limited Exemption for Foreign Private Advisers**

126       There is an exemption for foreign private advisers who meet certain conditions. It provides that a foreign  
127       private adviser (1) who has no place of business in the US; (2) the assets of US clients or investors under whose  
128       management are less than USD 25 million or more as prescribed by the SEC; (3) whose clients or investors in  
129       the private fund in the US are less than 15; and (4) who does not hold himself out to the public of the US as an  
130       investment adviser, may be exempted from registration. When counting the number of clients or investors, the  
131       foreign private adviser shall include US investors in offshore funds. Consequently, compared with exemptions for  
132       foreign fund managers provided by existing laws, the extent of exemption offered by the new rules is narrower.

## 133       **8 c. Exemption of Venture Capital Fund Advisers**

134       Section 203 of the Investment Advisers Act is amended by adding at the end the exemption of venture capital  
135       fund advisers. According to the new rule, no investment adviser shall be subject to the registration requirements  
136       with respect to the provision of investment advice relating to one or more venture capital funds.

## 137       **9 d. State and Federal Responsibilities**

138       According to the new rule, a medium-scale investment adviser shall be registered with the SEC rather than state  
139       authorities. An adviser may not be registered with the SEC if he ( ??) is required to be registered with the  
140       state authorities in the State in which it maintains its principal office; (2) is subject to examination of the state  
141       authorities after registration; and (3) manages assets between USD 25 million and USD 100 million, unless he has  
142       to register in more than 15 states. In any case, if the investment adviser is an adviser of an investment company  
143       registered under the Investment Company Act or of a business development company, he shall be registered with  
144       the SEC.

## 145       **10 ii. Private Fund Records, Reporting and Examination**

146       The Act contains substantial recordkeeping, reporting and examination requirements specifically for registered  
147       private fund advisers, including:

148       Private Fund Records and Reports. For each private fund, the adviser must maintain certain records( D D D  
149       D ) C Year a.

150       Elimination of Private Adviser Exemption 3 required information will include information such as the amount  
151       and types of assets under management, use of leverage (including off-balance sheet leverage), side letter  
152       arrangements, and valuation policies. Several of these areas reflect longstanding SEC concerns particular to  
153       hedge funds. The Act authorizes the SEC, in consultation with the Financial Stability Oversight Council (the  
154       "Council") to require additional information and reports beyond what is specified in the Act as necessary and  
155       appropriate in the public interest for investor protection or assessment of systemic risk. Additional reporting  
156       requirements may be established for different classes of fund advisers, based on the type of private fund (e.g.,

### 13 III. IMPLICATIONS FOR CHINA

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157 hedge fund or private equity fund) or size of private fund being advised. The Act directs the SEC to issue rules  
158 concerning the required reports to be filed by private fund advisers.

159 SEC Examination of Private Fund Records. All records and reports of any private fund advised by a registered  
160 adviser, not only specific SEC required reports, will be considered the records and reports of the registered adviser,  
161 subject to SEC examination. The SEC is required to conduct periodic examinations of private fund records, and  
162 may also conduct additional special or other examinations.

163 Information Sharing and Confidentiality. The SEC will share any information filed with or provided to it  
164 by an adviser with the Council for an assessment of the systemic risk posed by a private fund. The SEC, the  
165 Council and other departments, agencies and self regulatory organizations receiving this information from the  
166 SEC must keep such information confidential with certain exceptions. Information provided to the SEC or shared  
167 by the SEC is not subject to disclosure under the Freedom of Information Act. There is additional protection of  
168 proprietary information concerning the adviser that is contained in any report filed with the SEC. SEC Report.  
169 The SEC is to report annually to Congress on how it has used the data collected from advisers for purposes of  
170 investor protection and market integrity.

171 Disclosure of Client Identity. The SEC may now require disclosure of the identity, investments and affairs  
172 of a client for purposes of assessment of potential systemic risk in addition to its prior powers to compel this  
173 disclosure.

#### 174 11 iii. De Minimis Exemption

175 A Banking Entity may invest in the hedge and private equity funds that it organizes and offers. Such investments  
176 may not exceed: (i) 3% of the total ownership interests of the fund not later than one year after the fund's  
177 establishment (subject to a two year extension as determined by the Federal Reserve), and (ii) an amount that  
178 is "immaterial" to the Banking Entity (to be defined by the regulators), in no event exceeding in the aggregate  
179 3% of the Banking Entity's Tier 1 capital.

#### 180 12 iv. Fiduciary Duty

181 The SEC is provided discretionary rulemaking authority to require investment advisers in providing personalized  
182 investment advice to retail customers to act in the best interest of the customer without regard to the financial  
183 or other interest of the investment adviser providing the advice. This standard (fiduciary one) must be no less  
184 stringent than the standard provided by section 206(1) and ( ??) of the Investment Advisers Act. The U.S.  
185 Supreme Court has interpreted these provisions as imposing on all investment advisers, regardless of whether  
186 the adviser is registered with the SEC, the fiduciary duties of loyalty and care to their clients. In light of their  
187 status as fiduciaries, the SEC has stated that investment advisers owe their clients, among other things, a duty  
188 of "undivided loyalty."

### 189 13 III. Implications for China

190 The exchange rate reform, opening of capital accounts and financial globalization create a positive environment  
191 for emergence of hedge funds in China. "The first hedge fund in China —"Junxiang Lianghua" —was formed  
192 by Guotai Jun'an Securities Assets Management Co. on March 7, 2011, which initiated an investment path in  
193 the capital market in China." [7] However, Chinese securities market is immature and short of regulation and  
194 legislation on hedge funds; therefore, it is urgent to make more efforts in this regard. In the US, the launch  
195 of the financial reform act indicated adjustment and reconsideration of regulation by the US government on  
196 the financial industry after the financial crisis. It furthers the reform of existing financial regulation and is of  
197 considerate value of reference for China.

198 Firstly, legislation on hedge funds may be improved to establish the legitimate status of such funds. Hedge  
199 funds do not exist in Chinese laws but is not explicitly prohibited. "If securities traders and private and public  
200 funds engage in hedge funds, they may form a large team, bringing unpredictable impacts on the market.  
201 Additionally, without laws concerned, regulators may be in an awkward situation. To change such negative  
202 conditions, regulators shall quicken the pace in legislation to remedy legal defects. I believe that special regulations  
203 may be launched to guide market behaviors and administrate different types of hedge funds based on their asset  
204 size. Some QFII hedge funds that meet certain conditions may be allowed to conduct limited hedging business  
205 after obtaining license. Regulators may impose corresponding requirements on them in respects of information  
206 disclosure, internal risk management, qualification of fund managers and investor protection, carry out real-time  
207 monitoring of and reports which will be subject to SEC inspection. The capital flow and limit the frequency of  
208 capital inflow when there is great fluctuation." [8] Secondly, more attentions may be given to hedge funds and  
209 professional ethnics may be enhanced. Since hedge funds just emerge in China, investors have limited knowledge  
210 about them. Therefore, it is necessary for regulators and investors attach attention to and understand hedge  
211 funds. "Education may be offered at moral, legal and ethical levels with cases to enable those who engage  
212 in hedge funds understand the consequences of irregular practice. Regulations and rules may be improved to  
213 prevent and control moral risks and departments may be set up to conduct mutual check and restraint." [9]  
214 Thirdly, specific regulatory measures and systems shall be strengthened. For instance, microrestriction measures

215 may be adopted and legal systems regarding professional ethnics may be reinforced. Especially, the measures of  
216 the above-mentioned de minimis exemption and systematical fiduciary regimes should be adopted in China.

217 Finally, international cooperation may be enhanced. Due to international capital flow and negative impacts  
218 of speculative hedge funds on global financial industry, countries may strengthen international cooperation and  
monitor abnormal flow of hedge funds to avoid adverse affect of hedge funds on global financial industry.<sup>1 2 3</sup>



Figure 1:

1

Year	Event
1969	The first fund of hedge funds (FOHF) —Leveraged Capital Holdings —was formed in Europe.

Figure 2: Table 1 :

219 4 5 6 7 8  
220

<sup>1</sup>© 2012 Global Journals Inc. (US)

<sup>2</sup>© 2012 Global Journals Inc. (US)

<sup>3</sup>History of Regulation on Hedge Funds: 2011.02.15, [www.morefund.com](http://www.morefund.com)

<sup>4</sup>© 2012 Global Journals Inc. (US)

<sup>5</sup>Wang Wen, <http://blog.sina.com.cn/wangwen1973?2011.08>.

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