

The disclosure debate

The US Securities and Exchange Commission implemented new hedge fund registration rules in February. Some investors are already calling for greater disclosure, but the voluntary introduction of independent valuations might be more effective, argues Penny Cagan

New disclosure regulations for hedge funds that went into effect in the US in February (*Risk* March 2006, page 64) are a good start in terms of ferreting out fraud within the sector, but they are perhaps not as targeted as they need to be. This may be the time for the hedge fund industry itself to take the initiative ahead of what may be inevitable tougher regulations.

Any solution should address a central theme of many hedge fund misdeeds: fraudulent valuations. The present set of disclosure regulations does not require independent valuation of portfolios, as is best practice in Europe.

One way to test if the adoption of the current so-called light regulation regime is adequate is to look at real-life hedge fund frauds and determine if the new disclosure requirements would have been effective in preventing the misdeeds. The hedge fund frauds uncovered in 2005 were noteworthy not just for their numbers and the amount of investor funds compromised, but also for the complexity of the perpetrated misdeeds. Valuation issues play a central role in many of these frauds.

One such hedge fund blow-up involved Connecticut-based Bayou Management last year (*Risk* October 2005, page 16), which was so complicated that initially it was unclear who the fraudsters were. Bayou attracted investors by marketing reliable and steady returns, rather than registering spectacular growth that was 'too good to be true'. Investors must have been comforted by their ability to withdraw their funds at any time, rather than being subject to lock-up agreements.

The Securities and Exchange Commission (SEC) disclosure regulations came into effect about six months after the Bayou fraud was uncovered. Not all funds are required to register and some of the largest have not. Only advisers with \$30 million in assets under management or at least 15 individual investors have to register. Exemptions include hedge funds that have investor money locked up for over two years.

Would the SEC disclosure requirements have discovered the fraud at Bayou? The fund had been in trouble in the past with the State of Connecticut's Department of Banking for failing to maintain proper records of its

securities business. In response to the investigation, Bayou agreed to improve its record-keeping procedures and to pay a minor \$7,500 administrative fine.

If the fund had filed Form ADV under the SEC rules, item 11 under disclosure information would have presumably picked this up. But would it have been significant enough to alert investors? Certainly, it is not unreasonable to assume that a firm that sent falsified statements to investors might falsify such a filing. Alternatively, the fund could have circumvented the requirements entirely by extending its investor lock-up period to more than two years.

There have already been calls for regulators to increase the level of disclosure, but hedge funds have argued that disclosure filings are tantamount to revealing trade secrets. Although the public filings do not currently include asset allocation, risk exposure and investment diversification, increased disclosure of these items would bring an associated risk that is unique to hedge funds – the last thing a hedge fund wants are regulations that would allow other funds to shadow their trades. This would also create inherent risk in the system, because during times of market dislocation it would be difficult for any one fund to move in and out of positions.

As such, the answer might not be increased regulation, but an industry-led initiative that would include certification of independent valuation. Among the red flags investors ignored in the Bayou case were the lack of independent oversight of the fund and absence of independent valuations. Some funds are already offering proof to investors that their portfolios have been independently valued. This practice could eventually be adopted by more funds and come from the industry itself.

Investors also need to start demanding such valuations before they turn over their funds. The sad truth is that some hedge funds are deceptive, and fraudulent valuations are often at their heart. Perhaps what is needed is an industry initiative that addresses this directly and takes an active role in shaping future regulations before they find themselves coping with more stringent requirements that might not be effective in their ultimate mission to prevent fraud and protect investors. ■

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