



All that's hot in the mutual fund industry

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Hedge Reg U-Turn Renews Competition Concerns

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Renewed discussions on regulating hedge funds have sparked a debate on the competitiveness of '40 Act funds.

The debate has some industry watchers saying the current lack of regulations of hedge funds gives the products an unfair advantage over mutual funds. The advantage exists because hedge funds aren't burdened by the maze of regulations that are currently imposed upon mutual fund shops.

Other observers, however, say mutual funds and hedge funds pursue assets from different types of investors rather than competing against each other. At the same time, at least one industry researcher maintains that the high regulatory standards imposed upon mutual funds actually add to the appeal of the products.

SEC chairman Christopher Cox, in recent testimony before the Senate Banking Committee, said he wants the commission to implement a series of emergency regulations on hedge funds. The call for action comes as the D.C. circuit court is finalizing its June 23 decision to strike down an SEC rule that would require hedge fund advisors to register with the SEC. The court's final mandate is expected to be released in the middle of August.

In his testimony, Cox said he will recommend that the SEC promulgate a new anti-fraud rule based on the Investment Advisers Act of 1940. The rule will describe hedge funds' fiduciary duties to investors. Cox said he has also requested that SEC staffers evaluate changing the current definition of "accredited investor."

Hedge funds that fall under the accredited investor rule can accept assets only from investors that have at least \$1 million in net worth or \$200,000 in annual income. Cox is proposing to increase that minimum to \$1.5 million for any hedge fund that charges a fee tied to investment performance. Cox says he has also instructed SEC staffers to continue performing examinations of hedge advisors that have registered with the SEC. He added that registrations by hedge fund advisors have actually increased since the June 23 court decision was released.

The final fate of the SEC's efforts to regulate hedge funds will be significant for the fund industry, says Niels Holch, executive director of the Coalition of Mutual Fund Investors. Requiring hedge fund advisors to register with the SEC and subjecting the firms to examinations would help level the playing field for mutual fund firms, he maintains.

The impact of regulations on the fund industry, of course, has always been a heated issue. Some industry observers say regulations increase fund firms' operating expenses. Those extra expenses are then passed on to shareholders in the form of higher fund fees. In addition, resources devoted to complying with regulations could better be allocated to managing portfolios, they say.

Holch says that at one time, hedge funds were targeted primarily to a small portion of the U.S. population that could qualify as accredited investors. That meant that the funds didn't compete on a wide scale with mutual funds. Over the years, however, inflation has pushed many Americans into the accredited investor category, making them ripe candidates for hedge fund marketers.

"The \$200,000 income requirement is a mid-level-management corporate position," he says. "We aren't talking about multimillionaires."

He maintains that investors that currently qualify to invest in hedge funds are also being sought by fund shops. That means the regulatory differences in the two types of products are significant, he adds.

The ICI, for its part, believes that hedge funds do in fact compete with mutual funds, says Chris Wloszczyna, a spokesman for the organization.

"They definitely compete for assets from wealthy individuals," he maintains. "And there are quite a few wealthy individuals that invest in funds."

Hedge funds also compete with mutual funds for institutional investor assets, he adds.

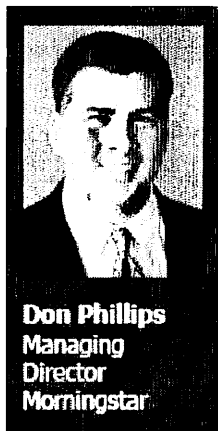
Other observers have added that regulatory oversight (and resulting costs to investors) is only one factor that advisors consider when constructing portfolios. They add, for example, that advisors typically create target asset allocations for their clients and then decide what type of fund structure, such as an open-end fund, closed-end fund or hedge fund, is the best way to gain exposure to individual asset classes.

"As an individual's net worth increases and investments increase, they tend to use mutual funds as part of their investments and supplement mutual funds with other investments such as hedge funds," adds Marco Adelfio, a partner with **Morrison & Foerster**.



Thus the regulatory structure of mutual funds and hedge funds doesn't come into play when advisors are selecting investments for clients. Rather, it's the asset class that each fund focuses on that's the important factor.

Yet, some hedge fund marketers are likely to try to get an ever larger portion of investors' assets, adds Don Phillips, a managing director with **Morningstar**. In doing so, they convince investors to allocate an excessive portion of their assets to their funds.



Hedge funds currently do that by claiming that they can outperform actively managed funds, he says.

"You always have to be suspicious when one party [hedge funds] is trying to build a case by criticizing another party [mutual funds]," he maintains.

He adds that the current regulations covering mutual funds are actually an advantage to the '40 Act fund industry. Financial advisors have previously said they prefer using mutual funds because they know that fund shops are held to high regulatory standards. The same can't be said for hedge funds, he says.

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