From The Morning Call
February 25, 2007

Hedge fund limits draw investors' criticism

Government wants to raise net worth requirements for individuals.

By Tom Petruno Special to The Morning Call

A Securities and Exchange Commission proposal to sharply limit the number of Americans who can invest in hedge funds has triggered a public backlash — and the latest controversy over the booming private investment pools.

The agency has received hundreds of e-mails and letters since December, when it proposed raising the financial bar for hedge fund eligibility for the first time since 1982.

The vast majority of those writing have advised the SEC to back off. Some comments have an angry tone, unusual for matters of securities regulation.

"This has got to be unconstitutional if not communistic," wrote M. Joan Conrad, a Naples, Fla., resident who says she has had money in hedge funds for the past decade.

The commission proposed limiting participation in the largely secretive and unregulated investment vehicles to investors who have a minimum of $2.5 million in investable assets, excluding the value of their primary residence.

Currently, investors must have a minimum of $1 million in net worth, including real estate, or earn at least $200,000 a year.

The change would restrict hedge funds to 1.3 percent of U.S. households, down from 8.5 percent currently, according to the SEC's Office of Economic Analysis.

SEC Chairman Christopher Cox said the tighter standards would do a better job of limiting the funds to people who have the necessary "knowledge and sophistication" to be in the pools, which have mushroomed over the past five years.

On Thursday, the Bush administration and top financial regulators pledged increased vigilance over hedge funds but stopped short of proposing any new regulations to control the trillion-dollar industry.

Instead, the President's Working Group composed of administration officials and various market regulators put forward a set of guidelines they said would enhance information about the largely secretive investment pools.

There are more than 9,000 hedge funds holding a total of $1.4 trillion in assets, according to Hedge Fund Research Inc. in Chicago.

They have become popular with wealthy individuals as well as pension funds and other institutional investors looking to earn higher returns than on plain-vanilla investing, although there are no hard statistics on who these investors are.

The term "hedge" has become a catch-all label for private investment pools that can pursue any number of complex — and often high-risk — strategies in stocks, bonds, commodities, currencies and other assets.

The industry's rapid growth has fueled controversy over its effect on financial markets.

The SEC in 2004 voted to require hedge funds with $30 million or more in assets to register with the agency for oversight purposes. But a federal court last year voided the registration rule, saying the SEC had overstepped its authority.

By proposing new limits on hedge fund access, the SEC said it was acting under the mandate that Congress had given the agency to protect investors from undue risk.

The agency is allowing the public to comment until March 9, before it takes up the issue for final consideration.

So far, most of the comments posted on the SEC's Web site in response to the proposal are advising regulators to leave the eligibility standard where it is.

Some accuse regulators of being overly paternalistic.

''This proposed rule change is misguided and based on the false assumption that rational, self-interested adults are less capable of determining their financial well-being than a government committee,'' wrote Robert Durde of Glen Ellyn, Ill.

Many of those commenting said the $2.5 million asset hurdle would make hedge funds even more exclusive, denying millions of less-well-off Americans the chance to participate in what could be a lucrative investment.

The proposal ''unfairly discriminates against all but the most wealthy and reinforces the perception that the 'rich keep getting richer,''' wrote Dennis Shak of Saratoga, Calif.

Some investors said the SEC would be keeping people from adding greater diversification to their portfolios via hedge funds — diversification that could lower rather than raise risk levels and boost investment returns over time, they said.

''To close out millions of soon-to-be retirees from the benefits of hedge funds would be wrong,'' wrote Jack McCormick.

A common view expressed by those writing to the SEC was that the agency was confusing financial sophistication with wealth.

''In my extensive experience I have seen nothing to indicate that those of higher net worth are more capable of making better investment decisions than more actively involved smaller investors,'' wrote Brian Loescher, who identified himself as an analyst at a multi-billion dollar investment consulting company.

Kim Azizy of Aventura, Fla., said any hedge fund restriction ''should not discriminate between wealthy and not wealthy, but between sophisticated and not sophisticated. Maybe a questionnaire addressing an investor's understanding of capital markets would be more appropriate.''

The SEC's request for comments also demonstrated the split within the hedge fund industry over the agency's plan.

The Managed Funds Association, a trade group for hedge funds, is ''supportive'' of the SEC's goals with the proposed changes, John Gaine, the group's president, said in an interview.

He said the industry had to be careful "not to go down the food chain" to average investors who might not understand the risks involved.

But managers of some relatively small hedge funds said the proposal would make it difficult for them to grow, while favoring funds that have big-money clients.

"This rule mainly just punishes small managers like myself, increases barriers to entry … and benefits the elite in our society," wrote Rick Puglisi of Apprecia Capital Advisors in New York.

Tom Petruno is a reporter for the Los Angeles Times, a Tribune Publishing newspaper.

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