A New Definition of Rich
An Interesting Proposal
The Hedge Fund Investment Company
Equal Choice, Equal Access, Equal Opportunity
South Africa, Miami, and Tulsa

By John Mauldin

I am in South Africa as this week's letter is being sent out; so it is with some irony that the letter is focused on a topic that generally concerns only US-based investors, although what the SEC does has an effect on regulatory bodies abroad. This is a letter you may want to forward to your friends and associates.

The Securities and Exchange Commission (SEC) has posted a new proposed rule that would raise the minimum net-worth requirement needed to invest in private funds from $1,000,000 total net worth to $2.5 million liquid net worth. This is a major change, and it means that some 7% of American households will no longer be able to invest in private offerings. In my opinion, it is likely to become law in the not too distant future unless there is significant public comment. This week we look at the proposed rule and some of its consequences, as well as a very interesting proposal by SEC commissioner Roel Campos.

Let's start with some background. The current definition of an accredited investor was adopted in 1982 and was set at $1,000,000 total net worth, including your home and other assets. At the time, according to the SEC, some 1.87% of all US households were qualified to invest in hedge funds and other private equity offerings. Due to inflation and the growth in all sorts of assets, including homes, today about 8.5% of US households are eligible. The original rule was proposed to keep supposedly unsophisticated investors from getting involved in investments like hedge funds, which were considered riskier than mutual funds.

If the original amount were adjusted for inflation, the net-worth requirement today would be $1.9 million. The SEC proposes to raise that limit to $2.5 million in investment assets, so your home or primary business real estate would not be included in the $2.5 million. This would reduce the number of investors eligible to invest in hedge funds by about 88%, or to just 1.29% of American households. Since they are proposing that the amount be adjusted for inflation every five years starting April 1, 2012, that would suggest to me they are considering adopting the proposal as early as April of this year, although there is no way to be certain, as comments could alter the proposals.

The SEC is asking for comments as to whether the proposed changes in the net-worth requirement are too much or too little, and more interesting, whether net worth alone should be considered. I will put a link to the proposed rule changes and explain how you can make comments if you should desire to do so, later in this column. But first, let's look at some of the practical and philosophical implications of the proposed rule, and why you should care about this no matter what your net worth is.

First, the SEC is being consistent with the mandate they have from Congress. Congress long ago established rules on private offerings, and among them is the requirement that private offerings such as hedge funds are only offered to sophisticated investors who are capable of understanding the risks and have the financial capacity to withstand potentially significant losses.

Since there is no test you can take to prove sophistication, a net-worth requirement was established under the presumption that someone with sufficient capital was either sophisticated or would have advisors who were capable of doing the proper due diligence on any such offering.

Given that $1,000,000 isn't what it used to be 25 years ago, if you agree that private offerings of unregistered funds should be subject to some level of investor sophistication, then it makes a certain level of sense to raise the bar.

It may surprise readers to know that on a practical level I agree with the thinking that it requires a certain level of sophistication to invest in unregistered private offerings. This is the field I work in, and I can confirm that hedge funds are not for unsophisticated investors. They can be quite complex and involve different sets of risks than other types of investments. There are many reasons for the following risk statement that accompanies nearly all hedge fund offerings:

"When considering alternative investments, including hedge funds, you should consider various risks including the fact that some products: often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager."

I also think it is philosophically wrong to limit the choices of investors based simply upon assets. The rich have advantage enough without limiting the choices of those with less assets. But before we get into that, let's look at some practical implications.

First, the rules are such that private offerings are limited to 99 investors with a net worth of $1,000,000 or more. If a fund agrees to only take investors with a net worth of $5,000,000, then they can have up to 499 investors.

But let's deal with a fund that can take investors with $1,000,000 net worth. Let's assume an investor has $2,000,000. Even if they were willing to invest $250,000, that would be a significant percentage of their assets in one fund. If an investor was worth $1,000,000 including his house, that would be a prohibitively high proportion of his net worth.

If a fund accepted 99 investors for just $250,000 apiece, that would mean the fund would only have $25,000,000, which quite frankly would be a small fund. And while some start-up funds may take smaller amounts, in the long run if the fund becomes successful, the minimum investment they require begins to increase beyond the practical ability (in terms of reasonable diversification) of investors with less than $2.5 million, in any event.

There are some exceptions. As an example, commodity funds, because they are regulated by the CFTC and NFA, can have an unlimited number of accredited investors. There are some hedge funds that will take a limited number of smaller investors, but frankly not many. So, for all practical purposes, raising the limit does not have that much of an affect on the opportunities for most investors, as there are sadly not enough opportunities available under the current rules.

(As an aside, under the proposed rules, it is not clear whether the SEC intends for this rule to apply to commodity funds. While commodity funds are offered as private funds, there are differences in the rules they follow. This is a topic that should be specifically addressed in the final rules.)

I should note that in England there are no real net-worth requirements for investing in hedge funds. Investment advisors are required to determine the sophistication and suitability of potential investors regardless of net worth. And Europe is slowly moving to open up hedge funds to investors within a regulatory framework.

Also, the SEC proposal specifically exempts private equity funds, as they provide a great deal of the funding for new business in the US. I would also note that, in my opinion, equity funds are in general more volatile and harder to understand than most hedge funds. But the commission is right that private equity funds are important for American business.

An Interesting Proposal

Now let's look at an interesting proposal from Roel Campos, one of the Democratic commissioners on the SEC. (I met commissioner Campos a few years ago, and found him to be thoughtful and very straightforward.) Let me quote from *The Wall Street Journal:*

"Roel Campos, a Democratic commissioner, said there was a need for 'very moderate oversight' of the hedge-fund industry to see the full picture of risk to investors and the market. He suggested a carrot-and-stick approach: easing marketing restrictions for hedge fund advisers that register with the SEC and submit themselves to a degree of regulatory oversight. A previous attempt by the SEC to require many hedge-fund advisors to register was struck down by an appeals court."

I think this is an excellent proposal and similar to one I made in Congressional testimony in May of 2003. But I would go farther. I think that Congress should open up the opportunity of investing in hedge funds to all investors. Quoting (with some edits) from my testimony to Congress:

It is my contention that the positive values that hedge funds offer to rich investors should also be offered to everyone, within a proper regulatory structure. The current two-class structure (rich or not rich) limits the investment choices of average Americans and makes the pursuit of affordable retirement more difficult than it should be. The rich have a considerable advantage in growing assets for retirement, in that they simply have more assets to begin with. They should not also have an advantage in better investment choices.

Why should 95% (or maybe soon to be 99%!) of Americans, simply because they have less than $1,000,000 (or $2,500,000?), be precluded from the same choices available to the rich? Why do we assume those with less than $1,000,000 to be sophisticated enough to understand the risks in stocks (which have lost trillions of investor dollars), stock options (the vast majority of which expire worthless), futures (where 95 % of retail investors lose money), mutual funds (80% of which underperform the market), and a whole host of very high-risk investments, yet deem them to be incapable of understanding the risks in hedge funds?

The Hedge Fund Investment Company

Let me suggest the following: the creation of a new type of investment company vehicle. Simply modifying the current mutual fund rules might work, but it is not direct enough, in my opinion. Let's call this new vehicle a Hedge Fund Investment Company or HFIC. Let me describe it first and then outline some of the advantages.

A hedge fund would be allowed to register with the SEC (or CFTC if there is a commodity focus) as an HFIC. They would be required to have an annual independent audit, at least quarterly independent valuations of their assets, and independent administrators, plus they would be subject to SEC or CFTC advertising rules. Nearly all of the rules which apply to mutual funds should apply to an HFIC. There would be few, if any, limits on the strategy the fund could employ, and they could charge a management fee and an incentive fee. They would have to fully disclose not only the relevant risks, but also their strategies, fees, personnel, and management experience.

As with mutual funds, there would be no limits on the number of investors. They would be allowed to advertise within current regulatory guidelines. With certain restrictions outlined later, they would be able to take non-accredited, or average, investors.

As noted above, hedge funds pose a set of different and unfamiliar risks than do stocks, bonds, or mutual funds, not to mention futures, options, and real estate, all of which are available to the average investor today. I would suggest that for a certain period of time, say 7-10 years, an HFIC be limited to investors who could demonstrate a required level of investment sophistication or to investors who used an investment advisor or broker who had passed an appropriate exam demonstrating competency in hedge funds (such as the Chartered Alternative Investment Analyst program sponsored by the Alternative Investment Management Association) or who had a sufficient number of years in the industry.

After the 7-10 year period, when investors had come to an understanding of what an HFIC is, and the funds themselves had developed sufficient track records, the funds would then be available on an equal basis with mutual funds, stocks, bonds, futures, real estate, options, and the host of other risky investments currently available to the average investor. This time period would also allow for a support industry and independent analysis firms to develop.

The simple fact is that most institutional funds hire outside analysts to evaluate and recommend hedge funds. They also hire consultants and outside managers to recommend stocks and bonds. The actual individuals sitting on institutional and pension boards do not make the initial investment decisions, although the final authority is in their hands. I would suggest for your consideration that many of the people on these boards are not accredited investors. Yet they are considered capable of evaluating the appropriateness of whether to invest in hedge funds. The evidence is that increasingly large numbers of them are doing so.

They are no different than the individual smaller investor. If you create a situation where they can access appropriate sophisticated advisors, they will do so. Indeed, they do so now. There are tens of thousands of advisors and brokers who offer investment services to the public. They simply do not have hedge funds as a choice.

Would hedge funds willingly register? Because of my involvement in the hedge fund industry, my belief is that they will. To say that there are thousands of funds who are seeking money is not an exaggeration. The problem today is that they must do so privately and only to high-net-worth investors and institutions.

If they could approach a new class of investor, I believe many of them would do so. The current rules do not allow them to do so, and so they do not. It is not the desire of the industry to be secretive, it is the requirements of the law. Most hedge fund managers would have no personal bias against small investors. The reason hedge funds avoid small investors is primarily legal. The large majority of managers simply want an appropriate amount of money to manage. If the rules allowed for appropriate and knowledgeable investing by smaller investors, they would adjust their programs to accept them.

A few comments on what might happen in the real world if an investment vehicle like the suggested HIFC came about.

The likelihood is that a large majority of the initial HFIC funds would be existing funds of hedge funds. Many of these have long-established track records and are well diversified. The process of taking numerous smaller investors would be no more problematic for a fund of funds than for a mutual fund. Certainly those funds of hedge funds that are registering under the currently available system anticipate taking many investors.

Secondly, I think this approach is likely to drive down fees over time. Just as the outrageously high fees of commodity funds came down in the ’90s as more funds became available, and many mutual funds are available with quite low fees, I think you would see an investor-friendly fee structure develop, especially for funds which are similar in nature.

The advantage of developing a new fund structure is that it does not displace the current status quo. If a fund wishes to remain private, it can do so. If it wishes to jump through the hoops of registering, that avenue would be available.

The reality is that the disclosures I suggest above are no more than what hedge funds already do today. High-net-worth investors today typically ask for and get the information mentioned in order to evaluate a manager. Thus, as time went on, managers with good programs and steady risk-adjusted returns would realize that an HFIC required no more than their current high-net-worth clients required on a private basis today. The HFIC would simply be seen as another way of raising funds.

This new industry would grow slowly, as did mutual funds when they were first offered. Over several decades, I would suggest that HFICs would become standard fare for investors. They would not replace mutual funds or other investments; they would simply be one more choice, just as they are now for the rich.

In summary, let me say that we should evaluate the decision whether to allow smaller investors the same rights as larger investors in the light of three questions:

1. **Is it appropriate?**

The premise of Modern Portfolio Theory is that you can smooth out the returns and decrease the risk of an investment portfolio by adding noncorrelated investment asset classes, even if those individual classes are individually highly volatile. Many hedge funds’ styles, by any reasonable assessment, are highly uncorrelated with the stock and bond markets. High-net-worth individuals and institutions are taking advantage of this fact by diversifying a part of their portfolios into hedge funds. This reasonable diversification should be made available to smaller investors as well.

No one would suggest that all or even a significant proportion of an investor’s portfolio should be in hedge funds. But a reasonable diversification is appropriate.

There is no real reason to believe that smaller investors cannot understand hedge fund strategies, if properly explained. If investors can be assumed to understand the risks involved with individual US stocks, foreign stocks, commodity futures, currencies, options, mutual funds, and real estate, not to mention a host of Reg D limited partnerships, then how can anyone suggest that hedge fund strategies are beyond the ken of investors?

I would suggest that investors can understand quite readily the logic and value of hedging the interest-rate directional risk from a bond fund, or pairing undervalued and overvalued stocks, or hedging a convertible bond. While management competence is the real issue investors should focus on, how difficult is it to understand the concept behind buying undervalued assets in a distressed debt fund?

A hedge fund is a business, generally with a straightforward premise. It is no more, and often far less, difficult to understand than the business risks and plans of typical US-based company (to say nothing of a bio-tech or high-tech firm or international company) than the risks and concepts of a typical hedge fund.

2. Is it the right thing to do?

Most hedge funds have an offshore version with lower minimums. The reality is that investors from Botswana have more and better investment choices than do average US citizens from Boston, Massachusetts.

If you ask the brokers and investment advisors on the front lines of serving the public whether they wish they had access to hedge funds on behalf of their clients during the difficult stock markets of 2000-2002, the answer would be a resounding yes. If you ask investors whether they should be able to make their own decisions – to have the same choices as the rich – the answer would also be yes.

The only people who benefit from limiting investor choice are those who have a vested interest in not facing the competition from hedge funds. As they seek to protect their turf, they have lost sight of the interests of those they should be serving.

Those who oppose allowing average investors to have the same choices as the rich should tell us why lower-net-worth investors are less intelligent or are deserving of fewer options than the rich. They should show why average investors should only be allowed funds which are one-way bets on an uncertain future.

I believe that investors would tell you that not allowing them the same choices as the rich is the type of government protection they do not need.

3. Is it fair and just?

With all the proper regulatory scrutiny being devoted to hedge funds, with the concern of hedge funds that such activities could restrict their investment options and business, it would behoove us to remember the small investor, who is not even allowed a hedge fund crumb from the rich man's table. The focus of future regulation should be to make sure there is an honest game on an even playing field, not to exclude certain classes of citizens.

Equal Choice, Equal Access, Equal Opportunity

If you were to tell investors that they would be discriminated against because of their gender or race or sexual preference, there would be an outcry. To put it simply: it is a matter of Choice. It is a matter of Equal Access. It is a matter of Equal Opportunity. Congress should change the rules and allow all investors to be truly equal, at least as to opportunity.

I believe it is time to change a system where 95% (and maybe soon to be almost 99%) of Americans are relegated to second-class status based solely on their income and wealth and not on their abilities. It is simply wrong to deny a person equal opportunity and access to what many feel are the best managers in the world, based upon old rules designed for a different time and different purpose. I hope that someday Congress will see to it that small investors are invited to sit at the table as equals with the rich.

Write the SEC

I know that there will be many who disagree with me, and suggest the risks in hedge funds justify the limits. I acknowledge the risks, but for me it is more of a philosophical issue.

The SEC has asked for comments. You can go to their website or send an email to the address below. This is the best place to make your views known. Should they raise the minimum requirements or keep them the same? If there is enough response, maybe it will encourage the House or Senate to hold hearings. Of course, if you disagree you should make that opinion known as well.

You can read the new proposed rules at http://www.sec.gov/rules/proposed/2006/33-8766.pdf. The rules changes I am referring to start on page 14.

Comments may be made by:

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1. Use the Commission's Internet Comment Form at: http://www.sec.gov/cgi-bin/ruling-comments?ruling=s72506&rule_path=/comments/s7-25-06&file_num=S7-25-06&action=Show_Form

2. Send an email to rule-comments@sec.gov . Be sure and include File Number S7-25-06 in the subject line.

South Africa, Miami, and Tulsa

I am writing the letter early this week, as I will be in South Africa trying to recover from jet lag when you get this. Two weeks of non-stop fun in what partner Prieur du Plessis tells me is a major heat wave. And I have to wear a suit and tie. Seems South Africa is a tad more formal than my office. But I am excited to be there. When I get back it will be a quick trip to Miami to speak at a private conference and then on to Tulsa to watch my daughter Amanda cheer in her last varsity game as captain of the cheerleaders at ORU. She will graduate in May, and her twin sister Abigail graduates next December. It was only a few years ago that they were still in diapers, wasn't it? Where did the time go?

Next week's letter is almost finished as well. It will be my speech at the Raging Bull Awards on some of the challenges that face the investment world.

Have a great week.

Your waiting to the last minute to pack as usual analyst,

John Mauldin