

MEMORANDUM

September 9, 1968

TO: Chairman Cohen  
Division of Trading and Markets  
Division of Corporate Regulation

SUBJECT: Hedge Funds

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*Hedge Funds*  
*DD Steady*  
*Copies to*  
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This is in response to your memorandum of August 30, 1968. As the Chairman is aware, the staff has been looking into the activities of hedge funds. In so doing we have attempted to gather information as to the activities of such funds both on an industry wide basis and as to operations of A.W. Jones & Company and A.W. Jones Associates, two of the largest unregistered hedge funds. This has been a most difficult undertaking and has presented numerous problems.

In regard to the activities of the A.W. Jones funds, the New York Regional Office has made a detailed study of the operations of those funds, with particular emphasis on who their limited partners are and how they are obtained. The regional office has recently completed its investigation and has recommended that no enforcement action be taken against the two Jones funds. They concluded there was no public offering of partnership interests, that less than 100 persons were involved in each fund and that treating the two funds as one would be an extremely difficult position to sustain.

We have carefully considered this report and concluded that while establishing a public offering may be difficult, we would like to thoroughly review the matter before commenting upon the recommendation of the New York Office. At the same time, we recognize that establishing a public offering would be difficult because of the wealth and sophistication of the great majority of the investors in these funds and the fact that these investments are apparently unsolicited.

On an industry wide basis, staff members of the Division of Trading and Markets have visited some seven hedge fund managers and obtained information as to how such funds were organized, their investment objectives, their investment techniques, the number of participants and the total amount of money invested. In addition, copies of documents were also obtained including partnership agreements, periodic letters sent to fund participants, names and identity of fund participants and the names of other persons receiving information on the funds' trading.

Copies of the ledger accounts for each of the funds for the period January 1 through June 31, 1966 were obtained from the principal brokers for each of the funds and the transactions recorded therein were transferred to punch cards and analyzed by the computer in a number of different ways. The results of these runs were then carefully reviewed. They showed no trading patterns which appeared, on their face, to be manipulative or otherwise in violation of the securities laws.

Nevertheless, we are proceeding with the inquiry and attempting to explore more fully the above aspects, as well as other aspects, of hedge fund operations. In this regard, we have been reviewing the activities of such funds to determine if these funds and/or their operators should be required to register under the Securities Act, the Exchange Act, the Investment Company Act, or the Investment Advisers Act. In addition to presently pending matters, we also plan further inquiry to determine the extent to which hedge funds may be trading on inside information.

Our inquiry will also include a review of the following: (1) The amount of give-ups directed by hedge funds and the true reasons therefor; (2) The borrowing activities and credit arrangements of such funds; (3) The general market impact of trading by such funds with emphasis on its impact on the short side of the market.

While we will be concentrating our efforts on the unregistered hedge funds, we also plan to examine several registered hedge funds to determine whether the registered funds engage in the same activities and, if so, whether registration appears to have resulted in any lessening of the problems presented by the unregistered hedge funds.

In order to accomplish these objectives we are employing the following techniques: (1) Circulation of a comprehensive questionnaire to both registered and unregistered hedge funds; (2) Scheduling of inspections of both registered and unregistered hedge funds with a view toward ascertaining the reasons for, and methods by which, portfolio transactions are effected; (3) Analysis of approximately 50 situations in which it appears that there may have been trading on inside information, to ascertain the extent to which trading by hedge funds may have been involved; (4) The subpoenaing of records and taking of testimony in situations which appear to indicate the need for corrective measures.

It is our view that any corrective action should await the results of our inquiry. To date it has been most difficult to isolate problems which seem to be peculiar to hedge funds. As clearly demonstrated by information available to us, there is no question that these entities effect transactions on the basis of inside information. Of course, as we all know, this practice is not the private preserve of hedge funds. While generally registration under the Securities Act, Investment Company Act and Investment Adviser Act would place certain restrictions on the nature and extent of their activities, the fact remains that a good many of them would still be able to operate on a smaller scale. 1/ Registration as broker-dealers would permit us to impose on hedge funds reporting requirements patterned after those imposed upon investment companies and it is for this reason that very active consideration is currently being given to this facet of the problem.

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1/ We have been requiring registration as Investment Advisers in those situations coming to our attention where the facts appear to warrant it.

On the basis of our inquiry to date, a major problem area that seems to be raised by certain practices of hedge funds is the substantial sums of pooled monies that they represent. Concentrated use of such funds with respect to securities with small floating supplies can, and we believe have, caused sharp market swings. Once again, this practice is not exclusively a hedge fund problem, but is engaged in extensively by the "new breed" of broker-dealers which have been soliciting and servicing large numbers of discretionary accounts. Because of the subtlety of these problems and their pervasiveness, it may well be difficult to deal with them satisfactorily under existing regulations. The further study which we are making may result in recommendations for new regulations and perhaps statutory changes. It is against this background that we suggest the making of any recommendations await the outcome of further study.

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