



Which is the Developing Market - Brazil vs. United States?

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Summary Points

- **Among all the ideas for regulatory reform being discussed today there seem to be no simple suggestions to improve public transparency of either hedge fund private partnerships or mutual funds.**
- **Brazil's regulatory structure sees hedge funds as regulated investment companies, just like mutual funds, that have comprehensive reporting and disclosure requirements.**
- **The greatest surprises and disappointments that many investors faced in the liquidity crisis after the Lehman bankruptcy were from hedge funds that had invested in esoteric and highly illiquid assets and derivatives. A Brazilian-type of disclosure would have allowed investors greater access to position information and fund flows. This in turn would have let them better decide whether their hedge funds were investing consistently with their needs and desires.**
- **Brazilian managers have learned to operate in a more transparent world without apparent damage to their investors. Perhaps it is time for the United States to recognize that U.S. investors deserve comparable transparency.**

Press reports on Washington's efforts to reform the financial services sector are increasing rapidly as several Congressional committees work through draft legislation. It is still premature to speculate on the shape of the final law, but the broad objective is to institute enough investment and banking reform to minimize the chance of a repeat of the most recent financial crisis.

There are targets everywhere: over-the-counter derivatives, proprietary trading desks, disclosure reports for consumer loans, etc. Universal hedge fund registration seems to be a certainty. Whether or not one can actually link a specific activity to the extreme events of 2007-2008, Congress seems to be using the crisis as a reason to reshape many facets of our financial system.

The goal here is not to discuss the myriad of proposals currently under debate. Instead, its purpose is to ask whether there aren't some basic reforms in the narrow area of fund investments that would improve the lot of institutional and individual investors alike.

This Commentary was prompted, in part, by a recent trip by some Offit Capital partners to Brazil, where they met with many fund managers pursuing different investment programs. Time and again, questions that we ask U.S. managers were answered, "That's not how it is done in Brazil." Slowly, a picture of fundamentally different regulation emerged, prompting suggestive comparisons.

When one looks at U.S. managers, there is a wide gulf between publicly available registered funds and private partnerships. This split dates back to the Investment Company Act of 1940, which for the first time defined what constituted a mutual fund. A by-product of the Act was the definition of what was *not* going to be a regulated investment company. The seeds of the modern American hedge fund were sown.

The world was broken into “sophisticated” investors and everyone else. For more than 70 years it has been assumed that if one is sophisticated (i.e., sufficiently wealthy) one should be able to deal with managers of private placements with minimal protections other than from basic fraud. Hedge funds, exempt commodity trading advisors (CTAs), private equity, venture capital and real estate partnerships all have operated under this framework for decades.

Before hedge funds became prevalent in Brazil, the Brazilian securities regulator, CVM, created clear definitions of investment fund types, along with reporting and disclosure rules. There are seven categories of funds, ranging from short-term funds (like money market funds in the U.S), to stock funds, to a final category called multi-market funds. Most U.S. hedge funds would fall into this latter group. In addition to the categories of marketable funds, there is a broad range of truly illiquid private partnerships identified as well.

The biggest distinction between the two countries is how hedge funds are treated. Since there is effectively no legal category of private hedge funds in Brazil, these fund managers must follow reporting and disclosure rules that are similar to those followed by long stock, bond and cash managers. For example, all positions, long and short, are disclosed to the regulator monthly, which then releases the information to the public with a 30-day lag. Additionally, managers must report inflows and outflows on a daily basis, which is also disclosed to the public. These disclosures are even more complete and timely than the quarterly filings by U.S. mutual funds.

If one asks most U.S. hedge fund managers their opinion of such disclosure rules, they universally respond that comparable laws would put them at a severe disadvantage in the market. Specifically, they say they sometimes buy positions that they don't want “the Street” to know about because if they had to offset the position, dealers and other traders would exploit them.

That seems to be a logical response, as anonymity in a market is usually an advantage. Yet Brazilian managers seemingly have learned to deal with their rules by being very aware of their position sizes and the underlying liquidity of each asset.

Perhaps the biggest disappointments from the crisis of 2008 and early 2009 were hedge fund managers who erected gates and liquidating trusts because of the often esoteric and illiquid nature of substantial parts of their portfolios. Anonymity did not help the managers find bids in the depths of the crisis. These illiquid positions did, however, cause surprise and dismay among their limited partners who discovered that they could not have their money when they asked for it.

If Brazilian style disclosure had been in place in the United States, would hedge fund managers have been so eager to build their portfolios with odd and illiquid investments? Many of these investments do not fit well in a liquid trading vehicle and more rightly belong in true illiquid partnerships. The hedge funds that put up gates and liquidating trusts in many cases blurred the lines between the two types of funds. They reached for extra returns by adding illiquid securities, while they simultaneously promised fund liquidity. Such an approach works well in a bull market, but the flaws are revealed at times of crisis. Investors here generally lack enough position detail to assess the risk beforehand.

Not all hedge funds behaved this way. Most of the U.S. managers who avoided liquidity problems in 2008 maintained portfolios that were fundamentally highly liquid. They did so not to conform to regulation, but because they believed it consistent with sound business practice. Today those managers enjoy higher regard among their investors because of their ability and willingness to perform as advertised.

Another feature of the Brazilian regulatory landscape is that the regulator acts as a clearing house for marketing material for all funds. Every piece of promotional material is filed with the CVM, collected in the regulator's data base, and freely accessible to anyone interested. The regulator not only monitors sales materials, but attempts to assure their free and accurate distribution.

In all of the current U.S. discussions of financial regulatory reform and customer protection, nothing remotely like the CVM approach is being proposed to address the issue of accurate customer communications. Investors always have the ultimate responsibility for the evaluation and oversight of their investments, but the CVM has proactively provided a wealth of information for investors that the SEC apparently never has considered organizing.

Brazil is a very different country than it was 15 years ago. All political parties there have seemingly rejected inflationary policies. Real growth rates and interest rates are the envy of the Western hemisphere. But perhaps just as important is their embrace of transparent, competitive capital markets with an investor-focused regulatory structure that is not too burdensome to managers.

There should be no misunderstanding about what the CVM regulation can and cannot do. It cannot prevent market losses. Many Brazilian hedge funds suffered equally severe losses as their American counterparts in 2008. But examples of unexpected gates and side pockets in Brazil are rare. Portfolio disappointments will always be part of investing. What the CVM has done is minimize the chance of surprises by demanding much more disclosure than the SEC has ever considered for hedge funds or mutual funds. It seems fair and reasonable then for the U.S. investor to ask, "Which is the developing market, and when might we expect to catch up?"

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