

# COMMUNITY OF SUPPORT: MOVING TOWARD INDIRECT REGULATION OF THE HEDGE FUND INDUSTRY

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## Abstract

The popularity of hedge funds has exponentially increased over the past decade due to the unparalleled gains that hedge funds present for investors. However, hedge funds remain largely unregulated in comparison to other financial instruments such as traditional stocks and derivatives. The emergence of the hedge fund as a component of the financial industry has brought with it questions pertaining to the optimal method of hedge fund regulation. The foremost concern in regulating hedge funds is to strike a balance between market stability and investor protection. In order to do so, an equilibrium must be found between leaving hedge funds unrestrained on the one hand, so that hedge funds can utilize innovative strategies and provide the unique benefits they offer to investors, and imposing regulation on hedge funds on the other hand, in order to protect investors and the economy against pertinent and systemic economic risks.

This Article argues for a more indirect system of regulation of hedge funds, rather than a more direct system of regulation. This Article proposes and argues for an architecture of law and policy that would seek to strike the necessary regulatory balance that the Article describes. In doing so, this Article critically analyzes, in light of the needs, benefits, and qualities of hedge funds, the historical impacts and regulatory merits of the Investment Advisors Act of 1940, the Investment Companies Act of 1940, *Goldstein v. U.S. Securities and Exchange Commission*, the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the regimes of registration and disclosure that are contemplated by such laws.

## I. Introduction

The landscape of the financial markets has significantly changed within the last ten years. One of the most prominent features of this change is the exponential growth of hedge funds.<sup>1</sup> Investors are increasingly investing in hedge funds, hoping

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1. See *infra* Section II.B.

to capitalize on the unparalleled gains hedge funds present.<sup>2</sup> Although hedge funds did not cause the recent crisis,<sup>3</sup> the government bailouts of 2008-2009, coupled with the liquidity crisis in major financial institutions, caused a consensus among regulators that hedge funds need stricter oversight.<sup>4</sup>

Focusing on Congress's past and present efforts to regulate hedge funds, this Article examines the various initiatives that affect hedge funds under the Investment Advisors Act of 1940 (the "IAA"),<sup>5</sup> the Investment Company Act of 1940 (the "ICA"),<sup>6</sup> and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank" or "Dodd-Frank Act").<sup>7</sup> Part II provides the historical development of hedge funds, discussing what a hedge fund is, how it operates, and the risks it poses to the economy. Part III addresses the IAA and ICA provisions for regulating hedge funds. Part IV details the implications of hedge fund regulations under the current requirements, including the Dodd-Frank Act, and explains how and why the regulations go too far. Part V recommends a more suitable approach to regulating the hedge fund industry, addressing hedge fund transparency and dealing with hedge funds in the current financial setting.

## II. Historical Background

### A. Characteristics of Hedge Funds

Taking on an "aura of mystery," the term "hedge fund" often indicates an exclusive group of sophisticated and wealthy investors who earn colossal returns on their investments.<sup>8</sup> There is no universally accepted regulatory or legal definition of "hedge fund" making it difficult to explain what they actually are.<sup>9</sup> However, the term has commonly been used to describe different types of investment vehicles that share common characteristics, including investor exclusivity, manager compensation, and legal and regulatory leniency.<sup>10</sup>

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2. See Melissa Antoszewski, *Las Vegas Style Investing: In the Absence of Regulation, Risky Hedge Fund Bets Can Win Big and Lose Even More*, 8 TENN. J. BUS. L. 381, 381 (2007) (stating that the growth of hedge funds is fueled by investors "who hope to receive high returns").

3. See *Hedge Funds and the Financial Market: Hearing Before the House Comm. on Oversight & Gov't Reform*, 112th Cong. 7 (2008) (written testimony of Houman B. Shadab, Professor of Law, New York Law School), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1302705](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1302705); see also TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'N, HEDGE FUNDS OVERSIGHT: CONSULTATION REPORT 31 (2009), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCO288.pdf>.

4. See *infra* Section II.C.

5. Investment Advisors Act of 1940, 15 U.S.C. § 80b (2000).

6. Investment Company Act of 1940, 15 U.S.C. § 80a (2000).

7. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C. 8301 et seq.) [hereinafter Dodd-Frank Act].

8. See Duff McDonald, *The Running of the Hedgehogs*, N.Y. MAG. (Sept. 4, 2007), <http://nymag.com/news/features/2007/hedgefunds/30341/>.

9. More than ten diverse definitions of the term "hedge fund" were offered during a SEC Roundtable. See DAVID A. VAUGHN, COMMENTS FOR THE U.S. SEC ROUNDTABLE ON HEDGE FUNDS (2003), available at <http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm>

10. See *id.* (a hedge fund is best described as a private investment fund that gathers capital from investors for purposes of having that collection invested by a manager or investment advisor).

## *Indirect Regulation of Hedge Fund Industry*

The first hedge fund was started in 1949 when Alfred Winslow Jones developed an investing practice that incorporated the use of leveraging and short selling in order to hedge the fund's exposure to the market.<sup>11</sup> Expanding on this idea, other creative hedge fund managers began utilizing various techniques to generate favorable returns, such as the use of futures and options.<sup>12</sup> Since 1949, and more noticeably within the past fifteen years, hedge funds increasingly grew in popularity.<sup>13</sup>

### B. Benefits to the Financial Marketplace

Playing a substantial part in the financial industry, hedge funds offer investors and financial markets numerous benefits that are more attractive than traditional investment vehicles. Hedge funds provide investors with the potential for substantial returns by serving as diversification tools in investment portfolios that minimize volatility and provide access to investment strategies, including short selling and leveraging, not otherwise available.<sup>14</sup> Moreover, hedge funds increase liquidity and enhance market efficiency through their willingness to make investments in all market conditions.<sup>15</sup> For example, many hedge funds invest in undervalued securities and assets, which assists in moving their actual prices closer to their true values.<sup>16</sup> Finally, hedge funds often include several types of derivatives, which diversify an investor's portfolio while allowing counterparties to reduce their own risks.<sup>17</sup>

Collectively, there are an estimated 10,000 hedge funds globally managing over \$2.01 trillion in assets.<sup>18</sup> Thus, hedge funds are noticeably significant in the financial arena. However, notwithstanding the general acceptance that the term "hedge" simply means managing risk, the SEC has been apprehensive toward allowing the market to regulate hedge funds.

### C. Current Risks to Investors and Economy

While the financial industry faced many difficulties over the past two decades, hedge funds have played a crucial role in the global financial system. Due to the flexible nature of hedge funds, hedge funds assist with establishing efficiency

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11. See James E. McWhinney, *A Brief History of the Hedge Fund*, INVESTOPEDIA (Nov. 15, 2009), <http://www.investopedia.com/articles/mutualfund/05/HedgeFundHist.asp>.

12. See SEC STAFF REPORT TO THE U.S. S.E.C., IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 37 (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter SEC STAFF REPORT].

13. See Alfred C. Tierney, *The SEC's Rule 206(4)-8: Two Steps Back and One Step Forward*, 44 CAL. W. L. REV. 589, 628 (2008).

14. See SEC STAFF REPORT, *supra* note 12, at viii.

15. See *id.*

16. See *id.* at 4.

17. See *Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 32 (2006) (prepared statement of Christopher Cox, Chairman, SEC), available at <http://www.gpo.gov/fdsys/pkg/CHRG-109shrg50245/pdf/CHRG-109shrg50245.pdf>.

18. See Press Release, Hedge Fund Research, Inc., Hedge Fund Investors Rotate into Macro, Arbitrage Strategies for 2012 (Jan. 19, 2012), available at [https://www.hedgefundresearch.com/pdf/pr\\_20120119.pdf](https://www.hedgefundresearch.com/pdf/pr_20120119.pdf).

in capital markets and absorbing financial risks.<sup>19</sup> Even though hedge funds did not cause the recent financial crisis, there is a growing sentiment among regulators that hedge funds need additional oversight.<sup>20</sup>

The first concern amongst regulators is that hedge funds may be a great source of systemic risk leading to chain reactions beyond the hedge fund industry.<sup>21</sup> Financial calamities have shown that markets are acutely intertwined.<sup>22</sup> Some commentators have suggested that the size, complexity, and continued growth of hedge funds may risk and ultimately provoke a chain of failures that could lead to an overwhelming financial catastrophe.<sup>23</sup> Not surprisingly, assessing the systemic risk of hedge funds is challenging for regulators who lack the necessary legal and regulatory tools to evaluate such risks.<sup>24</sup>

The second concern justifying hedge fund regulation is the need for greater transparency of these investment vehicles so that regulators can better guarantee an appropriate level of investor protection.<sup>25</sup> As previously discussed, hedge funds are often criticized for their unique attributes, so one of the SEC's main fears is hedge fund "retailization."<sup>26</sup> Retailization is suggested to occur when hedge funds become increasingly available to smaller investors who do not have the sophistication to properly assess hedge fund investing.<sup>27</sup> In other words, regulators worry that certain investors lack the sophistication to appropriately predict a hedge fund's valuation or adequately gauge investment risks.<sup>28</sup>

### **III. Hedge Funds and Financial Markets: An Overview of the U.S. Regulatory Framework of Hedge Funds**

Prior to the passing of the Dodd-Frank Act, hedge funds were regulated directly and indirectly through the securities regulatory framework. The Securities Act of 1933,<sup>29</sup> the Securities Exchange Act of 1934,<sup>30</sup> the IAA, and the ICA were part of the legislation that Congress enacted in direct response to the collapse of the

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19. SEC STAFF REPORT, *supra* note 12, at 4.

20. *See, e.g.*, Louise Story, *Hedge Funds Step up Efforts to Avert Tougher Rules*, N.Y. TIMES (June 22, 2009), <http://www.nytimes.com/2009/06/23/business/23hedge.html?ref=business&r=0> (discussing that regulators favor an increase in the regulation of hedge funds).

21. *See* BASEL COMM. ON BANKING SUPERVISION, JOINT FORUM, BANK FOR INT'L SETTLEMENTS, REVIEW OF THE DIFFERENTIATED NATURE AND SCOPE OF FINANCIAL REGULATIONS 1 (Jan. 2010), *available at* [www.bis.org/publ/joint24.htm](http://www.bis.org/publ/joint24.htm).

22. *See, e.g.*, *Systemic Risk: Examining Regulators' Ability to Respond to Threats to the Financial System: Hearing Before the H. Comm. on Financial Services*, 112th Cong. 10-12 (2007) (statement of Steven L. Schwarcz, Professor of Law and Business, Duke University), *available at* <http://www.gpo.gov/fdsys/pkg/CHRG-110hhrg39903/pdf/CHRG-110hhrg39903.pdf>.

23. *See id.* at 3.

24. *See infra* Section IV.

25. *See* Louis Aguilar, Comm'r, SEC, Speech at the 2009 Hedgeworld Fund Services Conference: Hedge Fund Regulation on the Horizon—Don't Shoot the Messenger (June 18, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch061809laa.htm>.

26. *Investor Protection Implications of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. (2003) (statement of William H. Donaldson, Chairman, SEC), *available at* <http://edgar.sec.gov/news/testimony/041003tswhd.htm>.

27. *See id.*

28. *See* SEC STAFF REPORT, *supra* note 12, at 83.

financial industry in the 1920s and 1930s.<sup>31</sup> Regulatory influences including the Commodity Futures Trading Commission (the “CFTC”),<sup>32</sup> the Employee Retirement Income Security Act of 1974,<sup>33</sup> the Financial Industry Regulatory Authority,<sup>34</sup> and state securities regulations have more recently been involved in conducting indirect regulation of hedge funds. Hedge funds regularly seek to avoid these government regulations to preserve any proprietary information about their trading activities.<sup>35</sup> Their versatile structures, restricted investor groups, and inclinations toward private offerings have allowed most hedge funds and their advisors to avoid regulation under the respective federal securities laws through various exemptions.<sup>36</sup> This Article generally focuses on the IAA and ICA because these particular statutes contain various exemptions that hedge funds and their investment advisers generally rely upon to escape regulation in the financial system.

#### A. Hedge Fund Regulation under the Investment Advisers Act of 1940 Pre-Dodd-Frank Act

Generally, the IAA gives the SEC authority to regulate investment advisers by implementing registration, disclosure, and regulatory requirements for advisers that fall within the ambit of the Act.<sup>37</sup>

The IAA has specific language defining who is an investment adviser for purposes of the Act. Section 202(a)(11) defines an “investment advisor” as:

Any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.<sup>38</sup>

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29. 48 Stat. 74 (1933), as amended by 48 Stat. 905 (1934); 15 U.S.C. § 77 (1935).

30. 48 Stat. 889 (1934); 15 U.S.C. § 78i(e) (1958). The Securities Act of 1933 and the Securities Exchange Act of 1934, although important to the hedge fund industry, are outside the scope of this Article.

31. See James F. Koehler, *Impact of Dodd-Frank and Registration Acts of 2012 on Investment Advisers*, 13 DUQ. BUS. L.J. 29, 31 (2011).

32. See *About the CFTC*, U.S. COMMODITY FUTURES TRADING COMM’N, <http://www.cftc.gov/About/index.htm> (last visited Sept. 22, 2014) (the CFTC regulates commodity futures and options markets under the Commodities Exchange Act).

33. See 29 U.S.C. § 18 (2010) (requiring private employers to comply with minimum standards when creating pension plans for their employees).

34. See *About FINRA*, FIN. INDUSTRY REG. AUTH., <http://www.finra.org/AboutFINRA/> (last visited Oct. 5, 2014).

35. See John Poirier, *House Democrats Introduce Hedge Fund Bill*, RED ORBIT (June 9, 2006) (statement of Bruce McGuire, President, Connecticut Hedge Fund Association), available at [http://www.redorbit.com/news/politics/555333/house\\_democrats\\_introduce\\_hedge\\_fund\\_bill/index.html](http://www.redorbit.com/news/politics/555333/house_democrats_introduce_hedge_fund_bill/index.html).

36. See *infra* Sections III.A.1., III.B.

37. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. IA-2333, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) [hereinafter Hedge Fund Rule] (requiring advisers to register with the SEC).

38. 15 U.S.C. § 80b-2(a)(11) (2012).

Hedge fund advisers would normally qualify as “investment advisers” within the meaning of the IAA because they provide advice for a fee to investors about the value of securities. Nevertheless, meeting the definition of an “investment adviser” does not automatically require registering with the SEC.

*1. Safe Harbor Provisions: Exemptions to Registration Pre-Dodd-Frank Act*

Hedge funds have historically avoided registration requirements by relying on the “Private Advisor Exemption” of section 203(b),<sup>39</sup> an express provision within the IAA. Section 203(b)(3) of the Act enabled investment advisers to avoid registration if they were advisers “who during the course of the preceding twelve months . . . had *fewer than fifteen clients* and who neither [held themselves] out generally to the public as [] investment adviser[s] nor act[ed] [as] [] investment adviser[s] to any investment company registered under [the ICA].”<sup>40</sup> Additionally, SEC Rule 203(b)(3)-1 allows advisers to consider each hedge fund they manage as one client for the purposes of the “private adviser” exemption.<sup>41</sup> Accordingly, hedge fund advisers could “manage large amounts of client assets and, indirectly, have a large number of clients,” even though they were not registered with the SEC as investment advisers.<sup>42</sup>

In response to the increasing number of investment advisers, namely hedge fund advisers, who were structuring their funds to fall within the various IAA exemptions, the SEC published a 2003 Staff Report recommending that the SEC require hedge fund advisers to register under the IAA.<sup>43</sup> The Staff Report found that hedge fund advisers were habitually using the Private Advisor Exemption in a manner inconsistent with its intended purpose of exempting advisers whose business was so limited that federal attention was unnecessary.<sup>44</sup> The Report noted that changing the definition of “client” would force hedge fund adviser registration.<sup>45</sup> As a result, the following year the SEC adopted the “Hedge Fund Rule,” which defined each owner of a private fund as a “client” and required hedge fund advisers who did not meet the more restrictive client threshold to register with the SEC.<sup>46</sup> Shortly after the Hedge Fund Rule was adopted, a suit was filed against the SEC arguing that the “Commission lacked any power to regulate the hedge fund advisor industry and that only Congress may change the Advisers Act.”<sup>47</sup> Ultimately, in *Goldstein v. U.S. Securities and Exchange Commission*, the United

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39. *Id.* § 80b-2(b)(3).

40. *Id.* (emphasis added).

41. *Id.*

42. Hedge Fund Rule, *supra* note 37.

43. SEC STAFF REPORT, *supra* note 12, at 59.

44. *Id.* at 59, 62.

45. *Id.* at 59, 89.

46. Hedge Fund Rule, *supra* note 37, at 72,089.

47. See Thierry Olivier Desmet, *Understanding Hedge Fund Adviser Regulation*, 4 HASTINGS BUS. L.J. 1, 22 (2008) (citing Siobhan Hughes, *Court Sets Hearing on Suit over SEC Hedge Fund Rule*, DOW JONES NEWSWIREs, Oct. 4, 2005).

States Court of Appeals for the District of Columbia held that the rule was arbitrary and unreasonable, and decided that the SEC failed to justify its implementation.<sup>48</sup>

The defeat in *Goldstein* led the SEC to question whether it had authority to enforce the antifraud provisions of the IAA against hedge fund advisers who were defrauding investors.<sup>49</sup> In particular, the language in the *Goldstein* opinion established that a fund itself is the “client” of an investment adviser.<sup>50</sup> Instead of challenging the ruling or altering the rule, in 2007 the SEC adopted a new antifraud rule under Section 206(4) of the IAA.<sup>51</sup> The new rule provides the SEC with the authority to bring enforcement actions against hedge fund advisers by “prohibit[ing registered and unregistered] advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles.”<sup>52</sup> The Hedge Fund Rule essentially applied a “look-through” to hedge funds whereby, rather than consider a fund as the client, or a legal entity investor as one single client, each individual investor would be considered an individual client.<sup>53</sup> Because the *Goldstein* court did not accept the justification for altering the plain meaning of “client,” the SEC created a new term, “pooled investment vehicle,” when it adopted Rule 206(4)-8.<sup>54</sup> A “pooled investment vehicle” is “any investment company defined in section 3(a) of the Investment Company Act and any privately offered pooled investment vehicle that is excluded from the definition of investment company by reason of either section 3(c)(1) or 3(c)(7) of the [Act].”<sup>55</sup> Consequently, using the term “pooled investment vehicle” broadens Rule 206(4)-8 to encompass funds relying on IAA and ICA exemptions, including hedge funds.

## *2. Dodd-Frank Act Needlessly Intensifies Requirements for Hedge Fund Regulation*

On July 21, 2010, President Barack Obama signed the Dodd-Frank Act into law, which is arguably the most sweeping financial regulatory overhaul since the Great Depression.<sup>56</sup> Intending to close the regulatory gap for hedge funds, Title IV of the Dodd-Frank Act, wholly dedicated to private fund advisers, amends the IAA by requiring hedge fund advisers to register with the SEC.<sup>57</sup> To accomplish this

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48. *Goldstein v. U.S. Sec. & Exch. Comm'n*, 451 F.3d 873, 880-84 (D.C. Cir. 2006).

49. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. IA-2628, 72 Fed. Reg. 44,756, 44,756 (Aug. 9, 2007) [hereinafter Antifraud Rule].

50. *Goldstein*, 451 F.3d at 880.

51. Antifraud Rule, *supra* note 49, at 44,758.

52. *Id.*

53. See David Schneider, *If at First You Don't Succeed: Why the SEC Should Try and Try Again to Regulate Hedge Fund Advisers*, 9 J. BUS. & SEC. L. 261, 281 (2009).

54. Antifraud Rule, *supra* note 49, at 44,758.

55. *Id.*; see also 15 U.S.C. § 80a-3a (defining investment company as a “security issued by or any interest or participation in any pooled income fund, collective trust fund, collective investment fund, or similar fund that is excluded from the definition of an investment company under section 80a-3(c)(10)(B) of this title”).

56. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

57. *Id.* at 1570.

goal, Dodd-Frank defined legal language encompassing hedge funds and created reporting and registration requirements for hedge fund advisers.

First, section 402 of the Dodd-Frank Act amended the IAA by adding a definition for the term “private fund.”<sup>58</sup> Specifically, the term “private fund” means “an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 . . . but for section 3(c)(1) and 3(c)(7) of that Act.”<sup>59</sup> Prior to enacting Dodd-Frank, there was no accepted definition of “hedge fund” in the federal securities laws, but this amendment brings hedge funds within the governing landscape. Second, section 403 of the Dodd-Frank Act further amended the IAA by requiring hedge fund advisers who have “fewer than fifteen clients” to register with the SEC.<sup>60</sup> Ultimately, since most hedge fund advisers will be advisers of “private funds,” Dodd-Frank completely eliminates the IAA exemption relied on by hedge funds to circumvent registration requirements, discussed *infra*.

Although eliminating the private adviser exemption will effectively require most hedge fund advisers to register under the IAA, the registration requirement also subjects hedge funds to an “assets under management” (“AUM”) threshold.<sup>61</sup> Dodd-Frank jurisdictionally reallocates the responsibility for oversight of investment advisers by requiring private fund advisers who meet the client threshold and are responsible for assets between \$25 million and \$100 million of AUM to register with the state.<sup>62</sup> Private fund advisers responsible for assets above \$100 million of AUM are required to register with the SEC.<sup>63</sup> Furthermore, advisers overseeing assets reaching \$150 million are required to register regardless of the number of clients they have.<sup>64</sup>

The SEC has adopted rules that implement the Dodd-Frank amendments to the IAA. Most notably, the implemented amendments include those which facilitate registration of advisers to hedge funds, necessitate recordkeeping by certain advisers exempt from SEC registration, and clarify exemptions to adviser registration.<sup>65</sup> As a result of Dodd-Frank, the SEC staff estimates that 750 private advisers, including many that are hedge fund advisers, will have to register with the SEC.<sup>66</sup>

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58. *Id.* § 402.

59. *Id.*

60. *Id.* § 403.

61. *See id.* (indicating a new threshold for the market value of assets that an investment company manages on behalf of investors).

62. *See id.*

63. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1572 (2010).

64. *Id.* at 1575.

65. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3221, 76 Fed. Reg. 42950 (June 22, 2011).

66. *Id.*



B. Regulation of Hedge Funds under the Investment Company Act of 1940 Pre-Dodd-Frank

The ICA regulates, *inter alia*, investment companies' transactions by requiring them to register with the SEC and establishing limitations on the types of transactions registered companies may perform.<sup>67</sup> Regulation under the ICA is triggered when an entity satisfies one of the Act's definitions of "investment company."<sup>68</sup> Two of these definitions are applicable to most hedge funds. First, hedge funds are required to register as investment companies if they are or hold themselves out as being engaged "primarily, or propos[ing] to engage primarily, in the business of investing, reinvesting, or trading in securities."<sup>69</sup> Second, hedge funds are required to register as investment companies if they are engaged or propose to be engaged "in the business of investing, reinvesting, owning, holding, or trading in securities, and own[] or propose[] to acquire investment securities having a value exceeding forty percent of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."<sup>70</sup>

While hedge funds qualify as investment companies per the ICA definition, hedge funds have been able to avoid the ICA altogether by relying on one of two key exemptions within the ICA: Section 3(c)(1) and Section 3(c)(7).

*1. Section 3(c)(1): Ninety-Nine Investors or Less*

Section 3(c)(1) of the ICA states that none of the following persons is an investment company within the meaning of the ICA:

Any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities . . . .<sup>71</sup>

Therefore, under this exemption an issuer who does not make a public offering of its securities and who sells its securities to not more than 100 persons is not an investment company.<sup>72</sup> Hedge funds have historically limited their number of investors to a maximum of ninety-nine or less per fund to avoid registering with the SEC.<sup>73</sup> They are able to do this because corporate investors, including limited partnerships and limited liability partnerships, count as one investor under the ICA.<sup>74</sup> As a result, hedge funds are not considered investment companies and do not have to register with the SEC.

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67. 15 U.S.C. § 80a-1-64 (2006).

68. *Id.* § 80a-3(a).

69. *Id.* § 80a-3(a)(1)(A).

70. *Id.* § 80a-3(a)(1)(C).

71. *Id.* § 80a-3(c)(1).

72. *Id.*

73. See Matthew F. Gately, *Much Ado about Nothing: An Analysis of the "Accredited Natural Person" Standard*, 2008 COLUM. BUS. L. REV. 760, 782 (2008).

74. William A. Roach, *Hedge Fund Regulation: "What Side of the Hedges Are You On?"* 40 U. MEM. L. REV. 165, 183 (2009).

2. Section 3(c)(7): Qualified Purchasers

Similarly, the exemption under section 3(c)(7) allows hedge funds to avoid the definition of investment company.<sup>75</sup> Section 3(c)(7) specifically excludes from the definition “investment companies that do not make a public offering and whose securities are owned exclusively by qualified purchasers.”<sup>76</sup> The ICA defines a “qualified purchaser” as any person who owns not less than \$5 million in investments.<sup>77</sup> These requirements are higher than those demanded by other investor definitions under the ICA.<sup>78</sup> More importantly, the level of sophistication required for the “qualified purchasers” exemption makes these investors less susceptible to fraud and misrepresentation.<sup>79</sup> Allowing hedge funds to sell securities to “qualified purchasers” evidences Congress’s belief that sophisticated, wealthy investors reasonably understand the risks that hedge funds pose and therefore do not need to be protected.

**IV. Concerns about Further Hedge Fund Regulation: Unnecessary Reform Does Not Offer Greater Market Discipline**

The foremost concern in implementing a regulatory structure for hedge funds is finding the right balance between leaving hedge funds unrestrained, thus allowing them to provide the numerous benefits they offer, while at the same time suppressing systemic risk that could result from a market depression. Notable proposals for the most appropriate form of hedge fund regulation include: changing the standard for investing in hedge funds,<sup>80</sup> increasing transparency,<sup>81</sup> creating a self-regulatory organization,<sup>82</sup> regulating hedge fund creditors,<sup>83</sup> and regulating hedge funds through their investors.<sup>84</sup> The future of hedge fund adviser regulation should, generally, unfold along three facets: (1) amend hedge fund adviser registration requirements under the Dodd-Frank Act; (2) continue to exempt hedge funds from registering under the ICA; and (3) regulate hedge fund counterparties while implementing a best practices guide for the hedge fund industry to promote transparency. The following reforms are unnecessary, and will likely not support the right balance.

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75. 15 U.S.C. § 80a-3(c)(7)(A) (2006).

76. *Id.*

77. *Id.* § 80a-2(a)(51)(A).

78. SEC STAFF REPORT, *supra* note 12, at 226.

79. S. Rep. No. 104-293, at 10 (1996).

80. See Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 ANN. REV. BANKING & FIN. L. 581, 627-28 (2009).

81. See Schneider, *supra* note 53, at 309-10.

82. See J.W. Verret, *Dr. Jones and the Raiders of Lost Capital, Hedge Fund Regulation Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 817-18 (2007).

83. See Evan M. Gilbert, *Unnecessary Reform: The Fallacies With and Alternatives to SEC Regulation of Hedge Funds*, 2 J. BUS. ENTREPRENEURSHIP & L. 319, 345-46 (2009).

84. See Paul M. Jonna, *In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation*, 45 SAN DIEGO L. REV. 989, 1016-17 (2008).

A. Requiring Hedge Fund Adviser Registration Is Excessive Overreaching

The Dodd-Frank Act was lauded as a law that could further regulate hedge funds. “The mission of the [SEC] is to protect investors, maintain . . . efficient markets, and facilitate capital formation.”<sup>85</sup> To satisfy these mandates, the SEC’s central regulatory tool is disclosure.<sup>86</sup> Through disclosure, and other various mechanisms, the extensive reforms promulgated under Dodd-Frank represent Congress’s effort to promote secure markets and to protect investors. Notwithstanding Dodd-Frank’s broad implications, congressional representatives supported the legislation by maintaining that the lack of regulation was the basis for the 2008 financial crisis.<sup>87</sup> Conversely, numerous representatives opposed to the legislation argued that hedge funds served no negative function in the financial crisis because hedge funds do not create systemic risk.<sup>88</sup>

Although hedge funds are often depicted as unregulated investment vehicles,<sup>89</sup> hedge funds have never been completely unregulated since the anti-fraud provisions of the Securities Act of 1933, Exchange Act of 1934, and IAA apply with full force, as do state laws against investor fraud.<sup>90</sup> Therefore, Dodd-Frank merely augments an adequately existing framework by subjecting hedge funds to increased levels of examination and disclosure. Specifically, Dodd-Frank extends the scope of the IAA<sup>91</sup> but fails to properly amend the principal philosophy, *caveat emptor*, under which the SEC has historically regulated hedge funds.<sup>92</sup>

In 1998, the implosion and near failure of Long-Term Capital Management (“LTCM”), a \$4.4 billion hedge fund, invoked the idea of systemic risk within the industry.<sup>93</sup> At the time, LTCM held a balance-sheet leverage ratio of more than 25-to-1, making the fund’s total portfolio value only \$5 billion from investors while the remaining \$120 billion was borrowed to enhance returns on equity.<sup>94</sup> Numerous factors threatened the collapse of LTCM including, most significantly, Russia’s devaluation of the ruble and threats to withhold payment of credit obligations.<sup>95</sup> This threat caused liquidity premiums to rise sharply throughout financial markets worldwide, and consequently LTCM lost hundreds of millions of dollars on junk

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85. *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM., <http://www.sec.gov/about/whatwedo.shtml> (last visited Sept. 22, 2014).

86. *See id.* (“To achieve [the agency’s mission], the SEC requires public companies to disclose meaningful financial and other information to the public.”); *see also* Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 128 n.295 (1989) (“Disclosure is, of course, the SEC’s main regulatory tool.”).

87. 156 Cong. Rec. H5196, H14413 (daily ed. June 29, 2010) (statement of Rep. Barney Frank); *see also* 156 Cong. Rec. H5196, H14418 (daily ed. June 29, 2010) (statement of Rep. Henry Waxman).

88. *See* 156 Cong. Rec. S5876 (daily ed. July 15, 2010) (statement of Sen. Richard Shelby).

89. *See supra* Section III.

90. *See* Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 7 (2006).

91. *See supra* Section III.A.2.

92. *See* U.S. Sec. & Exch. Comm’n v. Cap. Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

93. Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, REGULATION, Spring 2007, at 39.

94. PRESIDENT’S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 11–12 (1999), *available at* <http://www.treasury.gov/resource-center/finmkt/ Documents/hedfund.pdf>.

95. *See id.*

bond exposure and mortgage pools.<sup>96</sup> As a result, LTCM's ability to repay investors and creditors was compromised, and the Federal Reserve had to broker a deal with investment banks to rescue the fund and prevent a financial catastrophe.<sup>97</sup> Ultimately, LTCM was an anomaly<sup>98</sup> that held an extraordinarily high leverage ratio. In a report to congressional requestors, the Government Accounting Office responded to LTCM's bailout by highlighting three specific changes that occurred because of the LTCM incident: first, "[t]he number of banks and securities and futures firms doing business with hedge funds has decreased;" second, "[t]hese firms have focused on their risk management activities, including obtaining more complete information through required data reports and on-site visits; tightening credit terms and increasing margin requirements; and improving risk models and recognizing the risks of unanticipated market events;" and third, "hedge funds have become more forthcoming with meaningful data and information ensuring greater transparency to their activities."<sup>99</sup>

Amaranth Advisors ("Amaranth") is the only other hedge fund to significantly collapse within the past ten years. However, like LTCM, Amaranth's impact on the financial industry was negligible.<sup>100</sup> Less than ten years after LTCM's failure, Amaranth was unable to liquidate its positions in energy futures (an area of heavy investment for the firm) fast enough, causing Amaranth to lose more than \$6 billion in two weeks.<sup>101</sup> This collapse, however, did not threaten the economy at large because of the various changes implemented after the LTCM incident.<sup>102</sup>

The events that unfolded for both LTCM and Amaranth portray the potential impact that hedge funds have on the financial economy. Yet, neither example provides strong support for hedge fund regulation because neither potential threat came to fruition. Instead, the market was able to self-regulate poorly managed hedge funds, further demonstrating that additional hedge fund regulation is unnecessary.

Even assuming that hedge funds potentially present systemic risk issues, these issues and the Dodd-Frank regulations overlap within the financial industry—meaning that the benefit sought by the SEC will unnecessarily require the involvement of various jurisdictions and agencies. Dodd-Frank attempted to address this concern with the creation of the Financial Stability Oversight Council

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96. *See id.* at 11-13.

97. *See* Diana B. Henriques & Joseph Kahn, *Back from the Brink: Lessons of a Long, Hot Summer*, N.Y. TIMES (Dec. 6, 1998), <http://www.nytimes.com/1998/12/06/business/back-from-the-brink-lessons-of-a-long-hot-summer.html?pagewanted=all&src=pm>.

98. *See* Annette L. Nazareth, Comm'r, SEC, Remarks Before the PLI Hedge Fund Conference (June 6, 2007), *available at* <http://edgar.sec.gov/news/speech/2007/spch060607aln.htm> ("In September 2006, the hedge fund Amaranth lost over \$6 billion. Despite the astounding size and speed of the losses to Amaranth and its unfortunate investors, there were no significant effects on the markets from a systemic risk point of view.").

99. U.S. GOV'T ACCOUNTING OFFICE, GAO/GGD-00-3, REPORT TO CONGRESSIONAL REQUESTERS, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK 14 (1999), *available at* <http://www.gao.gov/assets/230/228446.pdf>.

100. *See* Nazareth, *supra* note 98.

101. *See* Kathy Burton & Jenny Strasburg, *Amaranth's \$6.6 Billion Slide Began With Trader's Bid to Quit*, BLOOMBERG (Dec. 6, 2006), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aRJS57CQQbeE>.

102. *See* Nazareth, *supra* note 98.

(“FSOC”),<sup>103</sup> which is charged with, *inter alia*, consolidating financial regulation across the federal government.<sup>104</sup> While Dodd-Frank, through the FSOC, demands greater oversight and more transparency, its ability to achieve that result is questionable.

At best, allowing the FSOC to enforce registration and disclosure requirements on hedge fund advisers may improve transparency and make hedge fund advisers more accountable to investors. Conversely, transparency may limit the ability of hedge funds to achieve high returns because disclosure requirements will publically expose investment strategies. Likely accepting the latter argument, the two Commissioners who opposed the Hedge Fund Rule noted that greater transparency would not have prevented the downfall of LTCM.<sup>105</sup> The LTCM matter illustrates the risks associated with hedge funds that are highly leveraged, but LTCM’s investment strategies were extremely profitable, and the fund unexpectedly declined only because financial conditions perfectly aligned to impair the risk-based investments.<sup>106</sup> As the Hedge Fund Rule dissenters and the President’s Working Group identified, additional disclosures regarding LTCM’s financial status would not have deterred many, if any, investors.<sup>107</sup>

Notwithstanding the limited effect disclosure requirements may have on hedge fund stability, consideration must be given to the influence further regulations will have on the financial industry. Former Federal Reserve Board Chairman Alan Greenspan commented that “[a]ny direct U.S. regulations restricting [the hedge funds’] flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. . . . If the funds move abroad, our oversight will diminish.”<sup>108</sup> Once hedge funds move beyond the jurisdiction of the United States, investment opportunities will weaken and investors will not be afforded any protection under the federal securities laws.<sup>109</sup> Implementing a regulatory system that provides superfluous protection to mainly sophisticated investors does not justify burdening such investors with additional fees and diminished returns paid through registration costs or with less protection brought

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103. The creation of the Financial Stability Oversight Council as a post-crisis regulatory institution is not a novel concept because it is similar to the pre-crisis arrangement of the President’s Working Group on Financial Markets.

Much like the new-born FSOC, the PWG was a multi-agency council, which brought together the heads of the Federal Reserve, SEC, and CFTC, under the chairmanship of the Secretary of the Treasury. Although its official charge did not explicitly include systemic risk management, the goals behind the creation of PWG were enhancing the integrity, efficiency, orderliness, and competitiveness of our Nation’s financial markets and maintaining investor confidence.

Saule T. Omarova, *The Dodd-Frank Act: A New Deal for A New Age?*, 15 N.C. BANKING INST. 83, 89 (2011) (internal quotations and citations omitted).

104. Dodd-Frank Act, Pub. L. No. 111-203, §§ 111-12, 124 Stat. 1376 (2010).

105. Hedge Fund Rule, *supra* note 37, at 72,090.

106. See PRESIDENT’S WORKING GRP. ON FIN. MKTS., *supra* note 94, at 10-19.

107. Hedge Fund Rule, *supra* note 37, at 72,090; PRESIDENT’S WORKING GRP. ON FIN. MKTS., *supra* note 94, at 31.

108. *Hedge Fund Operations: Hearing Before the House Committee on Banking and Financial Services*, 105th Cong. 160-61 (1998) (statement of Alan Greenspan, Chairman, Federal Reserve System Board of Governors), available at <http://www.federalreserve.gov/boarddocs/testimony/1998/19981001.htm>.

109. See *id.*

on by investing in offshore hedge funds.<sup>110</sup> Moreover, hedge funds must employ new investment strategies in order to increase the fund's AUM, but further direct regulation obviates a hedge fund's drive for strategic innovation because disclosure requirements will allow rival funds to discover and imitate successful trading strategies.<sup>111</sup> Therefore, promoting indirect, rather than direct, regulatory transparency presents an ideal compromise between protecting investors and protecting the proprietary investment strategies of hedge funds.

## B. Applying Provisions of the ICA to Hedge Funds Would Be Unnecessary and Unwarranted

Expanding the ICA to cover hedge funds is unnecessary because registration could reduce market participation, and the SEC lacks adequate resources to govern increased registration requirements. Requiring hedge funds to register under the ICA would significantly reduce the profitability of these intricate trading techniques because hedge funds would not be able to maintain their unique investment characteristics. The ICA prohibits or limits certain activities, including the use of leverage, short selling, and secrecy which are known hedge fund strategies.<sup>112</sup> Restricting leverage and short selling options would prohibit hedge funds from magnifying their exposure to investments. At the same time, not allowing investment advisers to charge performance fees and requiring disclosure of investment strategies would lead to decreased market liquidity.<sup>113</sup> Since hedge funds engage in complex trading strategies and utilize ICA exemptions to meet this purpose, requiring ICA registration has many potential negative implications that would lead to reducing hedge fund market participation.

Before Dodd-Frank was introduced, the financial markets were coming under increasing public scrutiny following troublesome leverage cases, allegations of fraud in the subprime mortgage market, and substantial problems in real estate markets.<sup>114</sup> In an effort to provide stability to the financial markets, Congress and the regulatory agencies decided to reintroduce the prospect of regulating hedge fund advisers, including regulation requirements that had previously been struck down by the courts.<sup>115</sup> Ultimately, Dodd-Frank was passed, but the competing Hedge Fund Transparency Act of 2009 (the "Hedge Fund Transparency Act"),<sup>116</sup> was circulating at the time to impose government oversight of hedge funds. Under this bill, hedge funds would be required to register with the SEC and to disclose their

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110. See PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 94, at B-1.

111. RICHARD BOOKSTABER, *A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION* 195 (2008).

112. See, e.g., 15 U.S.C. § 80a-18.

113. See Oesterle, *supra* note 90, at 28-30.

114. See *supra* Section IV.A.

115. Robert P. Bramnik, *Coping With the Post-Dodd-Frank Environment: New Concerns For Counsel to Investment Managers, Advisors, and Their Investment Fund Clients*, in *RECENT DEVELOPMENTS IN SECURITIES LAW* (2011).

116. See Hedge Fund Transparency Act, S. 344, 111th Congress (2009).

assets.<sup>117</sup> Eventually, certain provisions of the Hedge Fund Transparency Act made it into the Dodd-Frank legislation, including the requirement that all hedge funds that utilize ICA sections 3(c)(1), 3(c)(7), or have assets equal to or greater than \$50 million register and file reports detailing their trading positions.<sup>118</sup>

Notwithstanding the several limitations the ICA would negatively place on hedge fund investing, the ICA's purpose of protecting unsophisticated investors is inconsistent with the proposed purpose of hedge fund regulation. Along with the other depression-era securities laws,<sup>119</sup> the ICA focuses on the large percentage of retail consumers who are the most susceptible to the abuses of investment companies.<sup>120</sup> Whereas other investment vehicles are more commonly traded in the retail market, hedge funds are generally limited to wealthy, sophisticated investors who do not require additional protections.<sup>121</sup> Therefore, the ICA *should* continue to successfully regulate the mutual fund industry. However, the ICA should retain exemptions for hedge funds as it has historically done for more discrete segments of the financial industry. Failure to retain such hedge fund exemptions could cause negative consequences to the hedge fund industry and financial market as a whole.

A second reason the SEC should not regulate hedge funds under the ICA is that the agency does not have the resources to effectively do so. In a 2011 report by the Government Accountability Office, it has been expressed that the SEC will need greater resources to provide effective oversight for any future regulation pertaining to the hedge fund industry.<sup>122</sup> Accordingly, hedge funds should continue reviewing their investment model under the ICA requirements to determine whether, and to what extent, their funds meet exempt relief status. When necessary, hedge funds can solicit advice and guidance from the SEC regarding their status under the ICA, which would be more efficient than relying on an overextended agency and still afford the appropriate protections to investors.

## V. Indirect Regulatory Transparency: An Alternative Approach to Regulating the Hedge Fund Industry

Regulating hedge funds creates an enthralling equilibrium: the SEC's mission should be to protect investors, yet not over-regulate an industry that helps to ensure a well-functioning financial market. Prior to the recent financial meltdown, a renowned French economist accurately reviewed this symmetry.<sup>123</sup> Christian de Boissieu compared the pressure between financial innovation and

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117. *See id.*

118. Dodd-Frank Act, Pub. L. No. 111-203, §§ 111-12, 124 Stat. 1376 (2010).

119. *See supra* Section III.

120. *See* Douglas Hoffer, *A Square Peg In a Round Hole: Why the Investment Company Act Is a Poor Regulatory Fit For Hedge Funds*, 4 PIABA L.J. 403, 412 (2009).

121. *See id.* at 422.

122. Aguilar, *supra* note 25; *see generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-623, PRIVATE FUND ADVISERS: ALTHOUGH A SELF-REGULATORY ORGANIZATION COULD SUPPLEMENT SEC, IT WOULD PRESENT CHALLENGES AND TRADE-OFFS 3 (2011), *available at* <http://www.gao.gov/new.items/d11623.pdf>.

123. *See* Anne C. Rivière, *The Future of Hedge Fund Regulation: A Comparative Approach: United States, United Kingdom, France, Italy, and Germany*, 10 RICH. J. GLOBAL L. & BUS. 263, 321 (2011).

regulation to a “hide and seek game,” explaining that further regulation of hedge funds would fail because the controlled instrument—the hedge fund—would reappear under a new guise with a new name and form.<sup>124</sup> As such, imposing further regulatory limitations on hedge funds is counterproductive. Instead, indirectly promoting regulatory transparency would protect unsophisticated investors while also securing hedge funds’ proprietary information. Indirect regulatory transparency can occur, most appropriately, along two lines: regulating hedge funds’ counterparties and implementing a best practices guide within the hedge fund industry to provide appropriate protection for investors.

#### A. De Facto Regulation Through Hedge Fund Counterparties Provides Sufficient Means for Regulating the Hedge Fund Industry

To effectively deal with its dilemma, the SEC should re-focus its efforts on providing transparency within the hedge fund industry by using the government’s regulatory authority over entities that already interact with hedge funds. Hedge funds live and die on their counterparties (prime brokers). Therefore, indirect regulation requires focusing on hedge fund creditors—namely large commercial and investment banks that enable hedge funds to maintain high degrees of leverage.<sup>125</sup> As creditors, counterparties have an economic incentive to impose restrictions on hedge funds’ risk-taking (i.e., to limit leveraging) and to protect themselves from large losses should one of their hedge-fund customers fail.<sup>126</sup> In order to ensure that hedge funds are not participating in excessively risky practices, “regulators expect financial firms to balance the demands of their fund clients against potential misuse by the funds of complex structured transactions and inadequately monitored day-to-day trading practices.”<sup>127</sup> A joint report by the Department of Treasury, the Board of Governors of the Federal Reserve, and the SEC, discussed *infra* Section IV.A., further indicates that the most effective way to contain excess leveraging and limit systemic risk is not by directly regulating hedge funds, but through the discipline of hedge fund counterparties.<sup>128</sup>

##### *1. Counterparty Risk Management Policy Group’s Guide to Effective Counterparty Regulation of Hedge Funds*

Following the events that led to LTCM’s collapse, and the exposure that financial firms as well as investors faced in their relations with hedge funds, regulators established the Counterparty Risk Management Policy Group

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124. *See id.*

125. *See* Eddy Wymeersch, *The Regulation of Private Equity, Hedge Funds and State Funds* 10 (Fin. Law Inst., Working Paper No. 2010-06, 2010), available at <http://www.law.ugent.be/fli/wps/pdf/WP2010-06.pdf>.

126. *See* Isaac Lustgarten, *De Facto Regulation of Hedge Funds Through the Financial Services Industry and Protection Against Systemic Risk Posed by Hedge Funds*, 26 BANKING & FIN. SERVICES POL’Y REP. 1, 11 (2007).

127. *Id.* at 6.

128. *See* PRESIDENT’S WORKING GRP. ON FIN. MKTS., *supra* note 94, at 34.



(“CRMPG”); CRMPG consisted of representatives from twelve major international commercial and investment banks.<sup>129</sup> CRMPG published three reports addressing numerous aspects of systemic risk prevention in the financial industry and advancing various risk management recommendations for financial institutions.

In 1999, CRMPG initially proposed a framework for enhancing counterparty credit risk management aimed at improving banks’ policies and procedures with hedge funds and other highly leveraged institutions.<sup>130</sup> The first CRMPG report details treatment of practical aspects of credit and market risk management issues and makes comprehensive recommendations in four areas: (1) transparency and counterparty risk assessment; (2) internal risk measurement, management, and reporting; (3) market practices and conventions; and (4) regulatory reporting.<sup>131</sup> In 2005, the CRMPG issued a second report (“CRMPG II”) suggesting that banks and broker-dealers seek greater transparency from hedge funds by conducting counterparty credit assessments and monitoring prime brokerage relationships, including greater measurement and reporting by hedge funds.<sup>132</sup> CRMPG II further recommends that, through due diligence, financial firms should attempt to minimize exposure to hedge funds by focusing on, *inter alia*, value-at-risk systems to measure and manage overall risk exposures; firm-wide risk management guidelines, and regulatory compliance programs.<sup>133</sup> In response to the credit market crisis of 2007-2008, CRMPG published its final report (“CRMPG III”) endorsing a “form of private initiative that will complement official oversight in encouraging industry-wide practices that will help mitigate systemic risk.”<sup>134</sup> CRMPG III identifies four “common denominators” in financial contagion: credit concentrations, maturity mismatches, and excessive leverage on balance sheets or embedded in individual classes of financial instruments, and the illusion of market liquidity.<sup>135</sup>

Given that hedge funds tend to not disclose their investment positions and strategies, financial firms often find it difficult to determine the extent of their risk exposure when engaging in transactions with hedge funds. In general, each of the CRMPG reports highlight that when a hedge fund is not registered with the SEC, a financial firm should request the necessary information that the fund would be required to disclose if the fund was registered. Most notably, the CRMPG reports make no definitive recommendation for oversight by any regulatory agency; instead, they suggest that financial institutions have done a “credible job in managing their exposures to hedge funds,”<sup>136</sup> thus indicating that hedge funds do not pose a substantial risk that requires further regulation.

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129. *See generally* COUNTERPARTY RISK MGMT. POLICY GRP., IMPROVING COUNTERPARTY RISK MANAGEMENT PRACTICES (1999), *available at* <http://www.isda.org/educat/pdf/CRMPG-Report6-99.pdf> (last visited July 7, 2013).

130. *See generally id.*

131. *Id.* executive summary, at 2-3.

132. *See generally* COUNTERPARTY RISK MGMT. POLICY GRP. II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (2005), *available at* <http://www.crmppolicygroup.org/crmppg2/docs/CRMPG-II.pdf>.

133. *See id.* at 41-68.

134. *See* COUNTERPARTY RISK MGMT. POLICY GRP., CONTAINING SYSTEMIC RISK: THE ROAD TO REFORM 7 (2008), *available at* <http://www.crmppolicygroup.org/docs/CRMPG-III.pdf>.

135. *Id.* at 6, 12.

136. *Id.* at 135.

*2. Framework for Indirect Regulation Through Hedge Fund Counterparties*

As Federal Reserve Chairman Ben Bernanke summarized, regulating hedge funds primarily involves focusing on hedge fund counterparties:

The principal counterparties of most hedge funds are large commercial and investment banks, which provide the funds with credit and a range of other services. As creditors, counterparties have a clear economic incentive to monitor and perhaps impose limits on hedge funds' risk-taking, as well as an incentive to protect themselves from large losses should one or more of their hedge-fund customers fail. Counterparties seek to protect themselves against large losses through risk management and risk mitigation. Risk management includes the use of stress tests to estimate potential exposure under adverse market conditions; risk-mitigation techniques include collateral agreements under which hedge funds must daily mark to market and fully collateralize their current exposures.<sup>137</sup>

Accordingly, indirect regulation of hedge funds comes from market discipline provided by hedge fund counterparties—the entities that enable hedge funds to maintain their high levels of leverage.<sup>138</sup>

Hedge funds generally perform trades with several dealers and then consolidate the settlement of their trades at one financial firm, known as the “prime broker.”<sup>139</sup> These financial trading and investment firms offer various services including financing, customer support, and research to provide prime brokerage that achieves the necessary levels of leverage for hedge funds.<sup>140</sup> The size and continued growth of hedge funds has made prime brokerage a significant source of revenue for investment banks and other service providers.<sup>141</sup> Therefore, generating business relationships with members of the hedge fund industry is a primary factor in loosening credit standards.<sup>142</sup>

Financial institutions dealing directly with hedge funds should understand the conditions that govern transactions from a credit and risk perspective.<sup>143</sup> When hedge funds take substantial risks, their counterparties will then be able to respond by increasing interest rates, reducing the availability of credit, or more closely monitoring the developments of the hedge funds' investments.<sup>144</sup> While market discipline comes through counterparties' self-initiatives, counterparties themselves

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137. Ben Bernanke, Chairman, Fed. Reserve Sys., Remarks on Financial Regulation and the Invisible Hand Before the New York University Law School, New York, New York (Apr. 11, 2007), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20070411a.htm>.

138. PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 94, at 25 (“The primary mechanism that regulates risk-taking by firms in a market economy is the market discipline provided by creditors, counterparties, and investors.”).

139. *See* Nicola Cetorelli et al., *Trends in Financial Market Concentration and Their Implications For Market Stability*, FED. RES. BANK OF N.Y. ECON. POL'Y REV. 40-41 (2007), *available at* <http://www.newyorkfed.org/research/epr/07v13n1/0703hirt.pdf>.

140. *See id.* at 41.

141. *See id.*

142. *See* Jonna, *supra* note 84, at 1026.

143. COUNTERPARTY RISK MGMT. POLICY GRP. II, *supra* note 132, at 63.

144. *See* PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 94, at 5.

are subject to regulation requirements that affect their risk exposure when lending to hedge funds. For example, a broker-dealer who extends credit to a hedge fund must adhere to the margin requirements in the Federal Reserve's Regulations.<sup>145</sup> Also, FDIC insured banks that loan money to hedge funds must comply with general limits under federal treasury regulations, such as limiting their loans and extensions of credit to fifteen percent of the bank's surplus and capital for any one borrower.<sup>146</sup> Moreover, banks cannot exceed minimum capital limits determined by the risk of their assets, which includes transactions with hedge funds.<sup>147</sup> Additionally, self-regulatory organizations, such as the NASDAQ and New York Stock Exchange, impose their own "maintenance margin" requirements.<sup>148</sup>

Indirectly regulating hedge funds through the direct regulation of financial institutions that deal with the funds is complex and comprehensive.<sup>149</sup> Hedge fund failures are not novel issues;<sup>150</sup> therefore, financial firms transacting with hedge funds must remain cognizant of deal terms in order to not jeopardize their solvency. Nevertheless, following LTCM's collapse, margin requirements and capital adequacy limits for counterparties that deal with hedge funds were created and designed to guard against systemic failures within the financial industry by protecting hedge fund counterparties from credit risk.

## B. Sound Practices Will Foster More Effective Means for Regulating the Hedge Fund Industry

Apart from counterparty regulation, the greatest protection for investors is through self-regulation within the hedge fund industry. The best way to accomplish this is for hedge funds to voluntarily adhere to a defined set of industry standards such as the President's Working Group on Financial Market's ("PWG") Best Practices for Investors and the Hedge Fund Industry ("Best Practices"),<sup>151</sup> or the

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145. 15 U.S.C. § 78g (2012) (requiring a value margin of the securities involved in the transaction to be deposited within a specified period after execution); *see also* *Stonehill v. Sec. Nat'l Bank*, 68 F.R.D. 24, 31 (S.D.N.Y. 1975) ("The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry.").

146. *Id.* § 32.3(a) (the bank may exceed the fifteen percent by "an additional 10 percent of the bank's capital and surplus, if the amount that exceeds the bank's 15 percent general limit is fully secured by readily marketable collateral").

147. *See Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back*, FED. DEPOSIT INS. CORP. (Jan. 14, 2003), <http://www.fdic.gov/bank/analytical/fyi/2003/011403fyi.html>.

148. *See, e.g.*, NASDAQ, Inc., NASD Rule 2520 (c)-(d) (2006); NYSE, Inc., NYSE Rule 431(c)-(d) (2006).

149. *See also* John Kambhu, Til Schuermann, & Kevin J. Stiroh, *Hedge Funds, Financial Intermediation, and Systemic Risk*, FRBNY ECON. POL'Y REV. 1-2 (2007), *available at* <http://www.newyorkfed.org/research/epr/07v13n3/0712kamb.pdf> (noting that banks are in a unique position to limit their counterparty credit exposure); James Rowe, *De Rato Voices Hedge Fund Concerns*, IMF SURVEY (May 16, 2007), <http://www.imf.org/external/pubs/ft/survey/so/2007/NEW059A.htm> (averring that counterparty risk management will enhance market efficiency through risk spreading).

150. *See* discussion *supra* Section IV.A.

151. *See* BEST PRACTICES FOR THE HEDGE FUND INDUSTRY: REPORT OF THE ASSET MANAGERS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (Apr. 15, 2008); *see also* BEST PRACTICES FOR HEDGE FUND INVESTORS: REPORT OF THE INVESTORS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (Apr. 15, 2008).

Managed Fund Association's ("MFA") Sound Practices for Hedge Fund Managers Guide ("Sound Practices").<sup>152</sup> These recommendations are prime examples of how hedge funds can effectively structure themselves to increase the amount and type of information disclosed publically, thus providing further protection for investors.

*1. Another Governmental Response: The President's Working Group on Financial Markets*

The PWG, comprised of the chairs of the Secretary of the Treasury, Federal Reserve Board, the SEC, and the Commodity Futures Trading Commission,<sup>153</sup> performed a vital role in recommending policy changes for the hedge fund industry. In 1988, the group was formed to "[enhance] the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets and [to maintain] investor confidence."<sup>154</sup> In 2007, the PWG tasked two private sector committees with building upon these principles and developing guidelines for their respective stakeholder groups.<sup>155</sup> Comprised of representatives from ten leading U.S. hedge funds, the Asset Managers' Committee was charged with developing best practices for hedge funds. The Investors' Committee was made up of representatives from pension funds, endowments, labor organizations, and hedge fund consultants charged with developing best practices for those making hedge fund investments.<sup>156</sup>

In 2008, the Investors' Committee and the Asset Managers' Committee completed their studies and issued separate reports on hedge fund regulation.<sup>157</sup> Both reports make recommendations specific to their respective stakeholder groups, and encourage collective use of the reports as a means to increase the accountability between groups.<sup>158</sup> The urging of such collective use may be either for due diligence or interactive reasons. The Investors' Committee Report makes recommendations for prospective or existing hedge fund investors.<sup>159</sup> The report is divided into a Fiduciary's Guide and an Investor's Guide outlining the process for the evaluation, engagement, monitoring, and disposition of hedge fund investments.<sup>160</sup>

The Fiduciary's Guide, which is designed for plan trustees, pension funds, banks, and financial consultants with portfolio oversight responsibilities, "provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio."<sup>161</sup> Fiduciaries are directed to "exercise proper care in assessing whether a hedge fund program is appropriate

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152. See generally MANAGED FUNDS ASS'N, SOUND PRACTICES FOR HEDGE FUND MANAGERS (2009), available at [https://www.managedfunds.org/wp-content/uploads/2011/06/Final\\_2009\\_complete.pdf](https://www.managedfunds.org/wp-content/uploads/2011/06/Final_2009_complete.pdf).

153. See PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 94, at 1.

154. See Exec. Order No. 12,631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

155. PRINCIPLES AND BEST PRACTICES FOR HEDGE FUND INVESTORS, REPORT OF THE INVESTORS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS 6 (2009), available at <http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/principlespractices.pdf> [hereinafter REPORT OF THE INVESTORS' COMM.].

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.* at 1.

160. See *id.* at 4-5.

161. *Id.* at 3.

and whether they employ or can engage investment professionals with sufficient skill and resources to initiate, monitor, and manage such a program successfully.”<sup>162</sup> Fiduciaries must also pay close attention to the uniqueness and constant undertakings of hedge funds, performance fee structures, management oversight, and diversification among hedge fund, as well as portfolio, investments.<sup>163</sup>

The Investor’s Guide describes best practices and guidelines for investment professionals charged with “executing and administering a hedge fund program once a . . . hedge fund [has been added] to the investment portfolio.”<sup>164</sup> This section of the report provides recommendations that “focus on how investors can apply appropriate due diligence standards to verify that hedge fund managers are following best practices and identify independent controls and processes to further safeguard their assets.”<sup>165</sup> The guide primarily recommends that these investment professionals conduct proper due diligence on all hedge funds—including the hedge fund’s personnel, management, investment record, and plan implementation.<sup>166</sup> Furthermore, the guide suggests establishing a risk management process “including, where appropriate, comprehensive and professional internal and/or external risk management, measurement and compliance functions” and “compare that against the hedge fund manager’s risk management program . . . including in respect of the risks associated with investments, liquidity, leverage, compliance problems, prime brokers and other counterparties, operational and business risks, fraud and other crime and information technology.”<sup>167</sup> Also, investors should understand the legal and regulatory issues involved in a hedge fund investment, including the terms of investment, valuation policies, performance measures, and the fund’s overall governance structure.<sup>168</sup>

The Asset Managers’ Committee Report for the hedge fund industry establishes standards for hedge funds to reduce risk and promote investor protection.<sup>169</sup> Similar to the Investors Committee Report, the Asset Managers’ Committee Report makes recommendations in five areas: disclosure; valuation; risk management; trading and business operations; and compliance, conflicts, and business practices.<sup>170</sup> For each area, the report details an overarching framework to guide the implementation of specific best practices. The framework sets forth the basic principles applicable to each area, recommending the establishment of fundamental policies and procedures that managers must address to provide

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162. *Id.* at 6; *see also* Memorandum from Sullivan & Cromwell LLP on Best Practices For Hedge Fund Managers and Investors 4 (Jan. 22, 2009) [hereinafter Sullivan & Cromwell LLP Memorandum] (noting that the guide underlines the responsibility and care those fiduciaries must take in assessing the hedge fund, but also “in assessing whether they have or can engage investment professionals with sufficient skill and resources to initiate, monitor and manage a hedge fund program successfully”).

163. *See* REPORT OF THE INVESTORS’ COMM., *supra* note 155.

164. *Id.* at 3.

165. *Id.* at 17.

166. *Id.*

167. Sullivan & Cromwell LLP Memorandum, *supra* note 162, at 5.

168. *See id.*

169. REPORT OF THE INVESTORS’ COMM., *supra* note 155, at 3.

170. *See id.*

additional security for investors.<sup>171</sup> Additionally, the structure provides a process for reviewing and updating the adopted practices, as well as recommending the assurance of resources required to implement the framework.<sup>172</sup>

Importantly, neither of these reports offers governmental regulatory solutions to avoid or monitor future catastrophes that hedge funds could create. Instead, following the suggestions of the PWG, the reports provide a roadmap for self-regulation within the hedge fund industry that includes governmental oversight over hedge fund counterparties.<sup>173</sup> The PWG principles suggest that hedge funds “should have information, valuation, and risk management systems that meet sound industry practices and enable them to provide accurate information to creditors, counterparties, and investors with appropriate frequency, breadth, and detail.”<sup>174</sup> The Best Practices Report provides guidelines by which hedge funds might meet these conditions, and an April 2008 press release noting “separate yet complimentary sets of best practices” heralded “the most comprehensive public-private effort to increase accountability for participants in th[e] industry.”<sup>175</sup>

## *2. The Industry Response: Managed Fund Association’s Sound Practices*

MFA, a leading hedge fund trade group, prepared Sound Practices to provide advice for enhancing the ability of funds to “manage operations, satisfy responsibilities to investors, comply with applicable regulations, and address unexpected market events.”<sup>176</sup> Sound Practices is a specific set of recommendations that provides hedge funds “with a framework of internal policies, practices, and controls from a peer-to-peer perspective.”<sup>177</sup> Most importantly, the recommendations propose that hedge funds “disclose material information to investors” so that “investors are able to: (1) make informed decisions regarding investments in a Hedge Fund; and (2) appropriately monitor or manage the risks associated with exposure to the Fund.”<sup>178</sup>

First and foremost, “investors should have the tools to understand and evaluate for themselves the risks associated with” investing in a hedge fund and should be provided “with adequate information to enhance the investors’ ability to

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171. See Sullivan & Cromwell LLP Memorandum, *supra* note 162, at 5.

172. See *id.*

173. See Harvey Westbrook, Jr., *Hedge Fund Industry Structure and Regulatory Alternatives* (Sept. 8, 2003), available at <http://74.115.228.67/wp-content/uploads/2014/01/Westbrook.pdf>.

174. PRESIDENT’S WORKING GRP. ON FIN. MKTS., *supra* note 94, at 5.

175. Press Release, U.S. Dep’t of the Treasury, PWG Private-Sector Committees Release Best Practices For Hedge Fund Participants (Apr. 15, 2008), available at <http://www.treasury.gov/press/releases/hp927.htm>. Again in January 2009, the Asset Managers’ Committee and the Investors’ Committee issued separate reports for self-regulation concerning best practices for hedge fund managers and investors “so that market participants may enhance investor protection and systemic risk safeguard consistent with PWG principles and guidelines.” BEST PRACTICES FOR THE HEDGE FUND INDUSTRY, REPORT OF THE ASSET MANAGERS’ COMMITTEE TO THE PRESIDENT’S WORKING GROUP (2009), available at <http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf> [hereinafter REPORT OF THE ASSET MANAGERS’ COMM.].

176. MANAGED FUNDS ASS’N, SOUND PRACTICES FOR HEDGE FUND MANAGERS, *supra* note 152, intro., at 1.

177. *Id.*

178. *Id.* intro., at 5.

understand and evaluate their investment.”<sup>179</sup> Hedge fund managers should act in the best interests of the fund and the fund’s investors, and the managers “must also act in accordance with its investment management agreement with the Hedge Fund, the offering documents of the Hedge Fund, and applicable law.”<sup>180</sup> In order to assist prospective and current investors with understanding and evaluating their investments, hedge funds should disclose, to the extent necessary, the fund’s investment strategies, risk factors, relevant performance data, and the material terms of an investment in the hedge fund.<sup>181</sup> Also, hedge funds “should engage qualified independent auditors to audit the annual financial statements of any Hedge Fund with investors not affiliated with the Hedge Fund Manager” in order to recognize that investors “may both subscribe to and redeem interests in a Hedge Fund in reliance on the values derived from such policies and procedures.”<sup>182</sup>

The Sound Practices also recommends the issuance of a “Model Due Diligence Questionnaire for Hedge Fund Investors,” which is “designed to identify the kinds of questions that a potential investor may wish to consider before investing in a Hedge Fund,” such as matters concerning the “fund[']s incentive compensation structure, [u]se of leverage and margins and the valuation of assets, including illiquid investments.”<sup>183</sup> Providing investors with “[i]nformative disclosure regarding the material terms of an investment in a Hedge Fund (e.g., applicable charges, expenses, withdrawal or redemption rights and restrictions, reporting, use of ‘side pockets’, etc.) and the Hedge Fund’s investment objectives and strategies enhance[s] the ability of investors to form proper expectations as to the Hedge Fund’s performance.”<sup>184</sup> Without providing proprietary information to non-current investors, hedge funds should prepare and publish disclosure statements on a regular basis so that investors can better understand the funds’ foundations.<sup>185</sup> The questionnaire and voluntary disclosure statements should assist investors with asking or learning about the characteristics of their investments, as well as the investment practices of the hedge fund.<sup>186</sup> If everyone within the hedge fund industry follows this set of standards, the SEC should not need to require further disclosure and could maintain its notion that “[t]he use of best practices can be an effective means of addressing issues that arise in the hedge fund industry.”<sup>187</sup>

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179. *Id.* § 2, at 1.

180. *Id.* § 2.1, at 2.

181. *Id.* § 2.2, at 2.

182. *Id.* § 2.9, at 7.

183. Stephanie Baum, *Hedge Fund Industry Group Tightens Guidelines*, FIN. NEWS (Nov. 8, 2007), <http://www.efinancialnews.com/assetmanagement/index/content/2449136156>.

184. MANAGED FUNDS ASS’N, SOUND PRACTICES FOR HEDGE FUND MANAGERS, *supra* note 152, § 2.2, at 3.

185. *Id.*

186. *See* Baum, *supra* note 183.

187. SEC STAFF REPORT, *supra* note 12, at 9.

*3. Exercising Market Discipline Through Combining Indirect Regulation and Best Practices*

The framework outlined by the CRMPG reports, Sound Practices, and Best Practices is a perfect example of how indirect regulation and industry-wide guidelines can effectively regulate the hedge fund industry. These recommendations, if adopted, would resolve most disclosure issues and maintain market integrity by increasing the amount of information investors receive before investing. This form of regulation is self-imposing because it operates through counterparties and investors. For example, when investors request or require that funds adhere to these recommendations, hedge funds that do not adopt the recommendations would be disadvantaged.<sup>188</sup> “Sophisticated institutional investors and wealthy individuals that invest in hedge funds have sufficient sophistication and market power to demand and obtain the initial and periodic information that they require” which enables them to induce hedge funds to follow the recommendations and verify the accuracy of their disclosures.<sup>189</sup> Market power is a proven control, as evidenced by the fact that many hedge funds register with the SEC not because they are required by law to do so, but rather because influential investors condition their investment upon such registration.<sup>190</sup>

Moreover, the Model Due Diligence Questionnaire would further assist investors with understanding their overall investments, including the strategies used and the risks involved. Implementing sweeping business practices would provide the platform for stability, growth, and the ability to carry out investment activities more effectively. Counterparty monitoring of these model recommendations would instill confidence in the hedge fund industry and provide appropriate protection to investors.

## VI. Conclusion

The hedge fund industry is best served when it is allowed to remain free flowing and unencumbered by burdensome rules and regulations. This requires sustaining the fine balance between market stability and investor safety by allowing hedge funds the ability to employ innovative strategies and to operate with a degree of anonymity. History proves that registration and disclosure requirements have helped the SEC to uncover fraudulent wrongdoing and make investment vehicles more accountable to investors. However, as it pertains directly to hedge funds, further regulation will undermine the ability of funds to engage in market efficiency.

Within the spectrum of allowing transparency for accountability and keeping investment strategies private and unencumbered, there is room for improved, albeit

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188. Kathleen E. Lange, *The New Antifraud Rule: Is SEC Enforcement the Most Effective Way to Protect Investors From Hedge Fund Fraud?*, 77 *FORDHAM L. REV.* 851, 914 (2008).

189. Letter from John G. Gaine, President, Managed Funds, to The Honorable William H. Donaldson, Chairman, SEC (Nov. 21, 2003), *available at* <http://www.sec.gov/rules/proposed/s73004/s73004-34.pdf>.

190. *See* Lange, *supra* note 188.



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less burdensome, oversight over hedge funds. Unfortunately, the Dodd-Frank Act falls short, for it may prove useful in overcoming a reoccurrence in the subprime market, but it will not prevent future debt crises through its application to hedge funds. Investors, creditors, and counterparties impose adequate market discipline on hedge funds; therefore, indirect promotion of regulatory transparency through the use of hedge funds' counterparties will best support future financial growth and alleviate systemic risk fears for regulators and investors.

