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Lartease Tiffith

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# Hedge Fund Regulation: What the FSA Is Doing Right and Why the SEC Should Follow the FSA's Lead

*Lartease Tiffith\**

## I. INTRODUCTION

Recent news about hedge funds' successes<sup>1</sup> and failures, and in some cases outright fraud,<sup>2</sup> has increased the public's interest in a field that often prefers to cloak itself in a hidden veil. One can analogize hedge fund

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\* J.D.-M.B.A. Candidate, 2007, Northwestern University. I wish to thank Professor David Ruder for his invaluable advice and feedback on this and previous drafts. I also wish to thank my family and friends for their continued support and Professor Peter Swenson for being an excellent mentor over the years. Last but not least, I wish to thank the staff of the journal for their excellent editorial help. Without their help, this comment would not be possible. The errors are attributable solely to me.

<sup>1</sup> See Sandra Guy, *Lampert Leapfrogs to Top Income in Hedge Funds*, CHI. SUN-TIMES, May 30, 2005, at 53 (reporting that Edward Lampert, "the [hedge fund] manager who engineered Kmart's takeover of Sears, Roebuck and Co. won't be needing any blue-light specials" because he was the best paid hedge fund manager in 2004 with his reported salary of \$1.02 billion); Jenny Anderson & Riva D. Atlas, *Is This the New Emerald City, or the Road to the Next Crash?*, N.Y. TIMES, Mar. 27, 2005, at C1 (reporting the recent successes of hedge funds).

<sup>2</sup> See Gretchen Morgenson, *A Hedge Fund Falls Off the Face of the Earth*, N.Y. TIMES, Aug. 28, 2005, at C1 (reporting the recent announcement by federal and state regulators that regulators were investigating in the Bayou Group, a \$400 million hedge fund accused of investor fraud); David Sedore, *Hedge Funds Assets Frozen*, PALM BEACH POST (Florida), Mar. 4, 2005, at 1D (reporting the freezing of assets belonging to KL Group, an \$81 million hedge fund with 250 investors, after SEC investigators alleged that the principals of KL Group had defrauded their investors of more than \$70 million); Justin Hibbard & Adrienne Carter, *Another Fishy Hedge Fund; a Mysterious Money Manager, Nonstop Hype, Plunging Returns, Empty Offices, and Now an SEC Probe—The Intrigue at Wood River Deepens*, BUS. WK., Oct. 24, 2005, at 36 (reporting the SEC launch of an investigation into Wood River Capital Management, a multi-million dollar hedge fund); Ian McDonald & Valerie Bauerlein, *NFL Players Sue A Hedge Fund for Fraud, Theft*, WALL ST. J., Feb. 18, 2006, at B1 (reporting the lawsuit filed by current and former NFL players such as Terrell Davis and Steve Atwater against International Management Associates LLC, claiming that the hedge fund had failed to return more than \$15 million the players had invested in the hedge fund).

managers and the hedge fund industry to the nostalgic era of cowboys and the wild frontier. Hedge fund managers, like cowboys of the old days, do not want to be regulated. Just as the cowboys entering the frontier appreciated the lack of law or authority over their actions, today's hedge fund managers appreciate the lack of law or authority over their actions. And just as the frontier's significance to our nation grew requiring sheriffs and marshals to protect the new settlers from the wild cowboys, investors and the financial markets require protection from these modern day cowboys. Of course, just as the cowboys tried to fight the imposition of law and authority by arguing that they did not need policing because they are able to police themselves, hedge fund managers have advocated that regulation is unnecessary because they are able to self-police. In our modern frontier, while some hedge funds undoubtedly have helped make our financial markets more efficient, other hedge funds may have hurt investors and the financial markets through investor fraud, market manipulation, and additional market failure risk. The negative effects of hedge funds have persisted largely because hedge funds have remained lightly regulated. Investors and the financial markets need and desire some protection. More importantly, the recent rapid growth in the size and scope of hedge funds has made them the biggest players in the global financial markets. As a result of this rapid growth, unregulated hedge fund activity poses an ever-increasing threat to the very stability of the global financial markets.

This comment is organized into five sections. In Section II, I discuss what hedge funds are and why the public should care about them. In Section III, I discuss how the near collapse of Long-Term Capital Management ("LTCM") was the first major indication to the U.S. Securities and Exchange Commission ("SEC") and United Kingdom's Financial Services Authority ("FSA") that some type of regulation of hedge funds was needed. In Section IV, I provide an overview of the SEC's current and past stances on regulating hedge funds. In Section V, I discuss what the FSA has done and is proposing to do and why the SEC should follow its lead. In sum, I conclude that while the SEC has focused on preventing investor fraud and requiring hedge fund disclosure of certain operational and financial data to investors, the FSA has focused on more important concerns: market risk, liquidity risk, capital requirements, and excessive economic leverage.

## II. HEDGE FUNDS: WHAT ARE THEY AND WHY SHOULD WE CARE?

### A. Definition of a Hedge Fund

Despite all of the recent attention paid by both the SEC and FSA to the

hedge fund industry, neither regulator has attempted to provide a legal or statutory definition of a hedge fund. Instead, hedge funds are usually defined by several characteristics rather than by any particular legal structure. Of the lists of characteristics provided by the two regulators, the FSA's list is the more comprehensive. The FSA characterizes hedge funds by their investment management techniques and by their common structures.<sup>3</sup> Typical investment management techniques used include short selling,<sup>4</sup> derivatives,<sup>5</sup> and economic leverage.<sup>6</sup> Common structures include:

[Pursuing] absolute returns, rather than measuring their investment performance relative to a benchmark; charging performance-based fees in addition to a management fee; having broader mandates than traditional funds which give [hedge fund] managers more flexibility to shift strategy; high trading volumes/fund turnover; [and] frequently setting a very high minimum investment limit (e.g. US \$100,000 or higher for most funds).<sup>7</sup>

On the other hand, the SEC lists three characteristics that are typical of a hedge fund: (1) "an entity that holds a pool of securities" or other assets that "does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act;" (2) a "fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital

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<sup>3</sup> FINANCIAL SERVICES AUTHORITY, HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT 10–11 (June 2005), available at [http://www.fsa.gov.uk/pubs/discussion/dp05\\_04.pdf](http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf) (last visited Jan. 11, 2007) [hereinafter 2005 DP].

<sup>4</sup> According to Gordon De Brouwer,

Short-selling is the sale of an asset, such as a bond, stock or another asset that the [investor] does not own. The [investor] first borrows the bond, stock or other asset from another party [the lender], with the promise of repaying it back at some future time, and then [the investor] sells it. If the price of the stock, bond or other asset has fallen by the time the [investor] is due to repay it to the lender then he can buy it back in the market for less than he initially sold it. The profit is the selling price less the buying price and the cost of borrowing the asset.

GORDON DE BROUWER, HEDGE FUNDS IN EMERGING MARKETS 9 (2002).

<sup>5</sup> A derivative is a financial instrument, traded on or off an exchange, the price of which is directly dependent upon the value of one or more underlying securities, equity indices, debt instruments, commodities, other derivative instruments, or any agreed upon pricing index or arrangement. Derivatives involve the trading of rights or obligations based on the underlying product but do not directly transfer property. They are used to hedge risk or to exchange a floating rate of return for a fixed rate of return. Commodity Futures Trading Commission's Glossary Online, [http://www.cftc.gov/opa/glossary/opaglossary\\_d.htm](http://www.cftc.gov/opa/glossary/opaglossary_d.htm) (last visited Dec. 23, 2006).

<sup>6</sup> 2005 DP, *supra* note 3, at 10.

<sup>7</sup> *Id.*

appreciation;" and (3) the fund managers "often invest significant amounts of their own money into the hedge funds that they manage."<sup>8</sup>

### B. Organization of Hedge Funds

Hedge funds are usually organized into limited liability corporations or limited partnerships.<sup>9</sup> Hedge funds acquire investors through private placements.<sup>10</sup> The minimum investment required varies among hedge funds, with minimum amounts as low as \$100,000 for some hedge funds and as high as \$5,000,000 for other funds.<sup>11</sup> The investors are usually locked-in to the fund for a short period of time, usually less than one year, and must provide advance notice to the hedge fund when seeking to withdraw their money.<sup>12</sup> Hedge funds' managers charge management and performance incentives fees, typically two percent and twenty percent, respectively.<sup>13</sup> Most hedge funds are incorporated offshore, in exotic places such as Grand Cayman and Bermuda, to minimize taxes paid.<sup>14</sup>

### C. Hedge Funds Investment Strategies

Hedge funds use several different investment strategies. Generally, there are two broad types of investment strategies: macro investment strategy<sup>15</sup> and arbitrage investment strategy.<sup>16</sup> Some of the financial

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<sup>8</sup> SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS viii (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter SEC REPORT]. By virtue of its adoption of Rules 203(b)(3)-2 and 203(b)(3)-1, the SEC has all but eliminated this characteristic.

<sup>9</sup> See REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1, (Apr. 1999), available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf> [hereinafter PRESIDENT'S WORKING GROUP REPORT].

<sup>10</sup> See SEC REPORT, *supra* note 8, at ix. For a brief explanation of private placement in relation to hedge funds please see Section IV.A, *infra* (discussing the private offering exemption).

<sup>11</sup> SEC REPORT, *supra* note 8, at x.

<sup>12</sup> See DE BROUWER, *supra* note 4, at 11.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 12. According to the SEC Report, in addition to minimizing taxes there may be other reasons why hedge funds are organized in foreign jurisdictions. SEC REPORT, *supra* note 8, at ix.

<sup>15</sup> Hedge funds use a macro investment strategy to assess endogenous factors, such as a country's financial markets, macroeconomy, and political process, and exogenous factors, such as other countries' economic indicators, to determine whether there is a "fundamental imbalance" which would likely "result in substantial movement" in that country's "financial asset prices" such as its exchange rate, stock prices, bond yields, and short-term interest rates. DE BROUWER, *supra* note 4, at 21.

<sup>16</sup> Hedge funds use arbitrage investment strategy to take advantage of discrepancies in the price of two financial instruments. *Id.*

instruments used in both macro investment and arbitrage strategies include spots,<sup>17</sup> forwards,<sup>18</sup> swaps,<sup>19</sup> futures,<sup>20</sup> and complex derivatives<sup>21</sup> or options.<sup>22</sup>

#### D. The Use and Importance of Economic Leverage

Hedge funds typically make use of economic leverage.<sup>23</sup> Hedge funds can acquire assets, such as securities, either by using their own capital, usually that of their limited and general partners or by using borrowed funds, from entities such as banks. When hedge funds use debt to acquire assets, this is called leveraging.<sup>24</sup> For example, a typical hedge fund is able to borrow \$2 for every \$1 that it has in its capital reserves.<sup>25</sup> Thus, a hedge fund with a typical size of \$1 billion is able to borrow at least \$2 billion from creditors. LTCM, discussed in depth *infra* in Section III.A, was able to borrow \$125 billion from creditors based on the reputation of its principals and its capital reserve of \$5 billion, creating a whopping debt-to-equity ratio of 25 to 1.<sup>26</sup>

There are two types of leverage in the hedge fund context: on-balance sheet and off-balance sheet. Assets, capital, and debt are balance sheet

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<sup>17</sup> A spot or spot price of an asset is the price for immediate delivery of that asset. See RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 730 (McGraw-Hill Irwin 2006) (1981) [hereinafter BREALEY MYERS].

<sup>18</sup> A forward is a contract where one party promises to pay for a certain asset, commodity or cash in the future for a specific price and the other party commits to sell the asset at a specific price. *Id.* at 727–34.

<sup>19</sup> In a swap, an investor swaps risk extending from an underlying asset. For example in a default swap, one party will promise to pay a fixed sum each year to another party as long as a certain company does not default on its debts. If the company does default, then the party who received the fixed payment will then compensate the first party, but if the company never defaults then the original party never receives anything. This is analogous to the second party providing the first party with long-term insurance against default in return for an annual insurance premium. *Id.* at 735.

<sup>20</sup> Unlike a forward contract, a future contract is standardized and traded on an exchange. According to Brealey Myers, “When you buy or sell a futures contract, the price is fixed today but payment is not made until later. You will, however, be asked to put up a margin in the form of either cash or Treasury bills to demonstrate that you have the money to honor your side of the bargain. *Id.* at 729.

<sup>21</sup> A derivative is an “asset whose value derives from that of some other assets (e.g., a future or an option). *Id.* at 995.

<sup>22</sup> Generally, there are two kinds of options: a call option where the owner has the option to buy an asset at a specified exercise price on or before a specified exercise date and a put option where a seller has the option to sell an asset at a specified exercise price on or before a specified exercise date. See *id.* at 993, 1002.

<sup>23</sup> See PRESIDENT’S WORKING GROUP REPORT, *supra* note 9, at 4–5.

<sup>24</sup> See DE BROWER, *supra* note 4, at 10.

<sup>25</sup> See PRESIDENT’S WORKING GROUP REPORT, *supra* note 9, at A1.

<sup>26</sup> *Id.* at 12.

items, so hedge funds typically report them on the balance sheet. However, when hedge funds make use of short positions, repurchase agreements, and derivatives contracts, they typically do not report these on the balance sheet. This is justified in the case of shorted stock sales because there are no assets. The underlying asset is bought and then sold and therefore no "liability" attached to that borrowing is on the balance sheet although in actuality there is a liability.<sup>27</sup> This accounting treatment is justified because the liability is contingent, meaning that it is a future liability and not a current liability.<sup>28</sup> Most hedge funds have little to no on-balance sheet leverage but do have a large amount of economic leverage associated with these off-balance sheet positions.<sup>29</sup> Hedge funds often prefer to use off-balance sheet leverage because this enables them to boost their positions or exposures in financial markets.<sup>30</sup> Why invest only \$1 billion of your own capital if you could also invest \$5 billion of someone else's capital as well for little additional cost?

Hedge funds are able to get favorable lending terms from creditors based on their track record and collateral.<sup>31</sup> For a small hedge fund with no credit history with a bank, the collateral required could be for the full amount of the loan. In a situation such as this, the hedge fund would only be able to use its own capital to establish a market position, and therefore could not leverage its own capital.<sup>32</sup> For a hedge fund with an established history and reputation, the loan funds would be provided at a margin, with the percentage of required collateral ranging anywhere from a few percentages up to twenty percent of the borrowed amount.<sup>33</sup> In this situation, the hedge fund would be able to leverage its own capital. The amount of leverage would depend on its margin requirement. A small margin requirement would allow its leverage to be substantial. Banks require margins typically to enable them to cover daily mark-to-market<sup>34</sup> exposures associated with a hedge fund's position.<sup>35</sup> No collateral is required for a large hedge fund, such as a macro-focused hedge fund; thus, a large hedge fund can establish market position without using any of its own capital, allowing the hedge fund's capital to be substantially

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<sup>27</sup> DE BROUWER, *supra* note 4, at 10.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> PRESIDENT'S WORKING GROUP REPORT, *supra* note 9, at 4.

<sup>31</sup> DE BROUWER, *supra* note 4, at 25.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> According to the President's Working Group Report, mark-to-market practice is "the discipline of periodically valuing positions at current market prices. . . this discipline is useful for preventing the concealment of losses and for encouraging the timely resolution of problems." PRESIDENT'S WORKING GROUP REPORT, *supra* note 9, at 4.

<sup>35</sup> *Id.*

leveraged.<sup>36</sup> The large hedge fund's market positions would not be subjected to margin requirements unless they move into a loss.<sup>37</sup>

Only a few restraints exist on the amount of economic leverage a hedge fund may obtain. They are (1) the willingness of financial intermediaries, such as banks, to provide the credit that finances the off-balance sheet transactions; (2) the cost of leveraging to the hedge fund; and (3) the hedge fund's risk tolerance.<sup>38</sup> Currently, no source of comprehensive data on hedge funds' economic leverage exists; regulators in the United States and United Kingdom need to address this void.

#### E. The Benefits of Economic Leverage

Hedge funds, including their use of economic leverage, provide some very valuable benefits to the financial markets by making the financial markets more efficient. First, hedge funds, through their continual trading, provide liquidity to the markets.<sup>39</sup> According to Gordon De Brouwer, "liquidity in markets refers to the willingness of participants to enter the market and buy or sell. The more buyers and sellers willing to enter the market, the more liquid it is."<sup>40</sup> Liquidity is beneficial because it means that a given asset can be easily traded without causing a significant change in the asset's price. Next, hedge funds, through their constant search for mispricings of financial assets, reduce "the mispricing of financial assets that might occur across markets."<sup>41</sup> Hedge funds, in an effort to make a quick profit, seek out opportunities such as mispricings of financial assets across financial markets. The more hedge funds and hedge fund dollars seeking these opportunities, the less likely it is that a mispricing would exist for very long before the mispricing is corrected. Together these aspects of hedge fund activity help to make financial markets more efficient.<sup>42</sup>

#### F. The Disadvantages of Economic Leverage

In addition to providing these benefits, hedge funds substantially increase the risk of a systemic global financial meltdown, similar to what might have occurred had LTCM's collapse not been avoided by a last-minute bailout by its creditors.

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<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 10.

<sup>39</sup> *Id.* at 2.

<sup>40</sup> DE BROUWER, *supra* note 4, at 22.

<sup>41</sup> Roger Ferguson, Vice Chairman, Federal Reserve Board, Speech To the Banco de Mexico International Conference, *U.S. Fed. News* (Nov. 15, 2005), available at <http://www.federalreserve.gov/boardDocs/Speeches/2005/200511152/default.htm> (last visited Feb. 5, 2007).

<sup>42</sup> *Id.*



Although increases in economic leverage help to reduce market risk, increases in leverage also increase funding risk, which in turn increases liquidity risk.<sup>43</sup> In general, an increase in leverage increases market risk; however, in the case where the portfolio is actively managed, increased leverage will actually lead to lower levels of market risk.<sup>44</sup> Financial intermediaries frequently “manage the market risks they assume from their customers by taking offsetting market risk positions.”<sup>45</sup> According to the Counterparty Risk Management Policy Group, “[l]everage introduces third-party liabilities . . . which introduce funding risk. . . . [T]he satisfaction of such liabilities and conditions thereon may require early liquidation of positions comprising the portfolio, thereby introducing asset liquidity risk” to the hedge fund’s portfolio.<sup>46</sup> When a counterparty<sup>47</sup> increases its margin or collateral requirements, a hedge fund that lacks capital reserves must raise the needed funds either through investors or by liquidating its current portfolios to meet the margin or collateral requirements. In the case where a hedge fund is experiencing losses, having to liquidate its current portfolio might exacerbate its losses, which could lead to additional margin or collateral calls, which would of course lead to additional losses. Thus, the risk of having inadequate capital reserves could substantially amplify any losses suffered by the hedge funds. If hedge funds experience unanticipated shocks, which do tend to occur, which they are not capable of withstanding, a tidal wave of losses in the financial markets and a reduction in investor confidence could result. What happened during LTCM’s near collapse is a perfect example of this type of problem.

With the rapid increase in the size and activity of hedge funds, and with that a substantial increase in hedge funds’ influence on the global financial markets, the risk of a systemic meltdown of the global financial markets has increased substantially. According to the SEC, hedge funds have grown tremendously in size over the last five years.<sup>48</sup> Over the last five years total assets under management by hedge funds have grown 260 percent.<sup>49</sup> In 2004 alone, hedge fund managed assets grew thirty percent.<sup>50</sup>

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<sup>43</sup> See COUNTERPARTY RISK MANAGEMENT POLICY GROUP, IMPROVING COUNTERPARTY RISK MANAGEMENT PRACTICES at 17–18, (June 1999), [http://www.defaultrisk.com/pp\\_other\\_08.htm](http://www.defaultrisk.com/pp_other_08.htm) (last visited Jan. 26, 2007) [hereinafter CRMPG Report].

<sup>44</sup> *Id.* at 17.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 18.

<sup>47</sup> In the finance industry, parties to a contract are often referred to as counterparties.

<sup>48</sup> See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72054, 72056 (Dec. 10, 2004) [hereinafter SEC Final Rule].

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

Today, hedge funds manage an estimated \$1.1 trillion in assets.<sup>51</sup> More astonishing is what that amount means to the global financial markets. One commentator believes that \$1 trillion dollars in assets held and used by hedge funds has the equivalent affect of \$22 trillion because of leveraging and asset turnover.<sup>52</sup> A CS First Boston study estimated that hedge funds account for as much as fifty percent of trading done on the stock exchanges.<sup>53</sup> The hedge fund industry is a colossal beast and poses significant danger to the global financial markets if left unchecked.

### III. THE NEAR COLLAPSE OF LONG-TERM CAPITAL MANAGEMENT: THE FIRST MAJOR SIGN OF TROUBLE AND NEED FOR REGULATION

#### A. LTCM's Near Collapse

In 1993, John Meriwether, a former vice-chairman of the prestigious finance firm Salomon Brothers, set out to create the greatest hedge fund ever.<sup>54</sup> Meriwether had assembled some of the greatest financial markets theorists and bond traders to join him.<sup>55</sup> One of the notables included Myron Scholes, a finance and economics professor at Stanford University, who was famous for co-inventing a formula to value options that Wall Street refers to as the Black-Scholes model,<sup>56</sup> and who would go on later to share a Nobel Prize in Economics. Another notable was Robert Merton, an economist at Harvard University famous for improving on the Black-Scholes model,<sup>57</sup> who would go on later to share in the Nobel Prize with Scholes and Fischer Black. Additionally, Meriwether was able to convince David W. Mullins, Vice-Chairman of the Federal Reserve under Alan Greenspan, to join his hedge fund. The hedge fund was named Long-Term Capital Management to signify the group's desire to have investors commit long-term to the fund to enable it to withstand short-term changes in the market without having to go back into the market for more capital.<sup>58</sup> The

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<sup>51</sup> Hunt Taylor, *The Prudent Man vs. the Sophisticated Investor, Round II*, HEDGEWORLD DAILY NEWS May 11, 2005.

<sup>52</sup> Hunt Taylor, *The Sophisticated Investor*, HEDGEWORLD DAILY NEWS, Oct. 31, 2005.

<sup>53</sup> 2005 DP, *supra* note 3, at 14.

<sup>54</sup> Leah Nathans Spiro, *John Meriwether's Brain Trust Made Billions at Salomon. Can They Do It On Their Own?*, BUS. WK, Aug. 29, 1994, at 50.

<sup>55</sup> *Id.*

<sup>56</sup> See *The Nobel Prize for Economics. The Right Option*, THE ECONOMIST, Oct. 18, 1997, at 75 (explaining the significance of Merton's, Scholes', and Black's work).

<sup>57</sup> See *Nobel Economists' Bittersweet News Late Partner Cited for Theory*, USA TODAY, Oct. 15, 1997, at 7B.

<sup>58</sup> ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 27–28 (2000).

hedge fund raised an initial \$1.25 billion from private and public foreign banks,<sup>59</sup> wealthy businessmen such as celebrity agent Michael Ovitz and Phil Knight, CEO of Nike, and pension funds such as the Black & Decker Corporation's pension fund.<sup>60</sup> The hedge fund's management team contributed \$125 million of its own money into the fund.<sup>61</sup>

LTCM's investment strategy was to exploit discrepancies in market pricing—a strategy that allowed LTCM to focus on making money over long periods of time and thus fit LTCM's goal of having a long-term investor lock up period so LTCM could withstand short-term market fluctuations.<sup>62</sup> According to Andre Perold: "LTCM generally sought to hedge the risk-exposure components of its positions that were not expected to add incremental value to portfolio performance and to increase the value-added component of its risk exposures by borrowing to increase the size of its positions."<sup>63</sup>

In the beginning, LTCM was extremely successful, so successful that it was able to raise an additional \$2 billion from investors.<sup>64</sup> At its peak, LTCM held \$6.7 billion in capital.<sup>65</sup> In 1997, LTCM decided to return \$2.7 billion of capital to outside investors after determining that it needed to bring the capital base of the fund in line with its risk and liquidity needs.<sup>66</sup> However, in August of 1998, LTCM suffered some of its worst losses, losing \$550 million in one day. Subsequent to these events, LTCM's leverage climbed from a debt-to-equity ratio of 19:1 to 42:1.<sup>67</sup> In the month of August alone, LTCM lost \$1.8 billion in equity, bringing it down to \$2.3 billion in capital.<sup>68</sup>

LTCM's problems started when Russia declared that it would devalue the ruble and place a 90-day moratorium on repaying most of its foreign debt.<sup>69</sup> As a result, investors rushed to investments that offered lower risk and provided liquidity. According to the Treasury Department's report on Hedge Funds, Leverage, and Lessons of Long-Term Capital Management:

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<sup>59</sup> *Id.* at 38.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> Andre F. Perold, Long-Term Capital Management, L.P. (A), (Harvard Bus. School Publ'g 1999).

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> Andre F. Perold, Long-Term Capital Management, L.P. (C), (Harvard Bus. School Publ'g 1999).

<sup>67</sup> *Id.* at 3.

<sup>68</sup> *Id.*

<sup>69</sup> Thomas Walkom, *Tumbling Ruble is No Penny-Ante Crisis Russian Woes Could Lead to Collapse of World's Economy*, TORONTO STAR, Aug. 23, 1998, at F1.

Russia's actions sparked a 'flight to quality' in which investors avoided risk and sought out liquidity. As a result, risk spreads and liquidity premiums rose sharply in markets around the world. The size, persistence, and pervasiveness of the widening of risk spreads confounded the risk management models employed by LTCM and other participants. Both LTCM and other market participants suffered losses in individual markets that greatly exceeded what conventional risk models, estimated during more stable periods, suggested were probable. Moreover, the simultaneous shocks to many markets confounded expectations of relatively low correlations between market prices and revealed that global trading portfolios like LTCM's were less well diversified than assumed. Finally, the 'flight to quality' resulted in a substantial reduction in the liquidity of many markets, which, contrary to the assumptions implicit in their models, made it difficult to reduce exposures quickly without incurring further losses.<sup>70</sup>

As the world braced for what might have been a worldwide systematic meltdown of financial markets, creditors such as those who supplied credit to LTCM began to tighten credit requirements, making it likely that LTCM would be forced to exit some of its positions at substantial losses.<sup>71</sup> Roger Lowenstein, in his book *When Genius Failed: The Rise & Fall of Long-Term Capital Management*, perfectly described LTCM's position:

In such a climate, there was no way [LTCM] could get out of its humongous trades without moving the markets even more. The partners had assumed that other arbitrageurs would recognize the values that they saw; their failure to step forward mystified them. Now, like generals who overcommit to a distant war, they found the road out blocked.<sup>72</sup>

Finally, faced with the possibility that LTCM would default on its loans, and thus cause many of them substantial losses, LTCM's counterparties began to look for an alternative solution to a default. A consortium of the most affected counterparties, aided by the Federal Reserve Bank, entered into a consortium to inject \$3.6 billion in new equity in LTCM's portfolio in exchange for a ninety percent stake in the portfolio plus operational control.<sup>73</sup> As a result, LTCM's investors and management team were left with only ten percent equity in the fund, thus sustaining a substantial loss.<sup>74</sup>

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<sup>70</sup> PRESIDENT'S WORKING GROUP REPORT, *supra* note 9, at 12.

<sup>71</sup> *See id.* at 12–13.

<sup>72</sup> LOWENSTEIN, *supra* note 58, at 148.

<sup>73</sup> PRESIDENT'S WORKING GROUP REPORT, *supra* note 9, at 14.

<sup>74</sup> *Id.*

### **B. Important Lessons Learned**

There were several important lessons to be learned from the LTCM disaster. First, LTCM provided regulators and market participants with a first-hand look at the effect substantial leverage can have on a hedge fund's ability to restructure its positions in the market. LTCM's high leverage and lack of readily available capital caused it to suffer more losses than it would have had it been more appropriately leveraged and held adequate capital reserves.

Second, LTCM's near collapse demonstrated that international financial markets are becoming more interdependent, so that events in Russia, Japan, or Mexico can have enormous effects on financial markets in the United States or United Kingdom.

Third, LTCM highlighted the possible effect that one participant in the global financial markets can have on the entire system. LTCM's near failure threatened not only its investors and principals but also the many counterparties who had loaned substantial sums to LTCM. If LTCM had collapsed completely, its counterparties would have suffered substantial losses and the global financial markets could have experienced greater disruption. LTCM illustrates the enormous effect a hedge fund's leverage can have on the financial markets including many of its counterparties. More importantly, it illustrates the potential for excessive leverage to cause a devastating multiplying effect on the global financial markets.

### **C. LTCM's Near Collapse was the First Indication of the Need for Greater Regulatory Supervision over Hedge Funds.**

LTCM's near collapse was the first indication of the need for greater regulatory supervision over hedge funds. Up to this point, the SEC merely has addressed the consumer fraud problems through disclosure and registration requirements. The SEC, like the FSA, needs to go beyond disclosure and registration requirements to include capital requirements, limits on leverage, and active monitoring. Both regulators and LTCM's counterparties failed to monitor LTCM sufficiently. According to the President's Working Group Report:

This insufficient monitoring arose, in part, because of LTCM's practice of disclosing only minimal information to these parties, information such as balance sheet and income statements that did not reveal meaningful details about the Fund's risk profile and concentration of exposures in certain markets. In LTCM's case, this minimal level of disclosure was tolerated because of the stature of its principals, its impressive track record, and the opportunity for the Fund's investors and counterparties to profit from a significant relationship with LTCM. LTCM's willingness to bear risk also made it an attractive counterparty for those firms seeking to hedge

their own exposures. Thus, the main limitation on the LTCM Fund's overall scale and leverage was that provided by its managers and principals.<sup>75</sup>

For highly leveraged hedge funds, regulatory restraints, such as capital requirements, could serve to constrain more effectively the degree of their leverage and the probability of a failure with systemic implications. A possible negative impact of increased regulation is that it would likely drive more hedge funds offshore, which would decrease the effectiveness of regulation.<sup>76</sup>

#### IV. AN OVERVIEW OF THE FINAL SEC RULE REGULATING HEDGE FUNDS

##### A. Preliminary Background on Four Important U.S. Laws

Four U.S. laws principally concern hedge funds operating in the United States: the Securities Act of 1933,<sup>77</sup> the Securities Exchange Act of 1934,<sup>78</sup> the Investment Company Act of 1940,<sup>79</sup> and the Investors Advisers Act of 1940.<sup>80</sup>

##### *1. Securities Act of 1933*

Generally, the Securities Act of 1933 ("Securities Act") requires full and fair disclosure in securities transactions.<sup>81</sup> The Securities Act requires that securities for public offering be registered with the SEC and that purchasers of such securities receive a prospectus containing particular categories of information about the offering and the issuer such as "a profit and loss statement for not more than three preceding fiscal years" and "a statement of the capitalization of the issuer," unless the offering satisfies an exemption from the registration requirements.<sup>82</sup>

Hedge funds, which often offer interests in a limited partnership, limited liability corporate partnership, or other legal entity, fall within the Securities Act's definition of securities and thus must register their offer and sale of these securities, unless they rely on an available exemption from

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<sup>75</sup> *Id.* at 15.

<sup>76</sup> According to sources such as International Financial Services and the government of the Cayman Islands, 43% to 80% of hedge funds are located offshore. *See On New Ground*, LEGAL WK., Nov. 10, 2005.

<sup>77</sup> 15 U.S.C. §§ 77a–77aa (2000).

<sup>78</sup> *Id.* §§ 78a–78nn (1994).

<sup>79</sup> *Id.* §§ 80a-1–80a-64 (1994).

<sup>80</sup> *Id.* §§ 80b-1–80b-21 (1994).

<sup>81</sup> *Id.* §§ 77a–77aa.

<sup>82</sup> *Id.* §§ 77e, 77aa.

registration.<sup>83</sup> Hedge funds rely on the private offering exemption in section 4(2) of the Securities Act, or Rule 506 promulgated under that section, to avoid the registration and prospectus delivery requirements of Section 5.<sup>84</sup> Section 4(2) exempts “transactions by an issuer not involving a public offering.”<sup>85</sup> The private offering exemption is available only to issuers, so it does not exempt sales to any person who wishes to resell the securities nor does it exempt sales by any affiliates of the issuer. This uncertainty leads most hedge funds to tailor their security offerings to meet the criteria in Rule 506.<sup>86</sup> According to Rule 506, offers and sales of hedge fund securities cannot be made using any form of “general solicitation or general advertising.”<sup>87</sup> This means that hedge fund issuers and those acting on their behalf cannot solicit potential investors through media such as newspaper advertisements or articles, nor can issuers solicit investors through seminars to which the investors have been invited by general solicitation or advertising.

Thus, Rule 506 requires that hedge funds must exercise reasonable care to insure that their investors are not investing with the goal of later distributing their interests in the hedge fund to the public.<sup>88</sup> As long as hedge funds make a reasonable inquiry, they can continue to take advantage of this safe harbor even if investors later sell their interests to the public.

## *2. Securities Exchange Act of 1934*

The Securities Exchange Act of 1934 (“Exchange Act”) requires dealers in securities to register with the SEC.<sup>89</sup> Section 3(a)(5) defines a dealer as “any person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise.”<sup>90</sup> The Exchange Act contains registration and reporting provisions that may apply to hedge funds. Section 12 of the Exchange Act, and the rules promulgated thereunder, govern the registration of classes of equity securities that are (1) traded on an exchange, or (2) meet the holder of record and asset tests of Section 12(g) and related rules.<sup>91</sup> Section 12(g) requires that an issuer having 500 holders of record of a class of equity security (other than an exempted security) and assets in excess of \$1 million at the end of its most recently ended fiscal year register the equity security

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<sup>83</sup> *Id.* § 77d.

<sup>84</sup> *Id.* § 77d(2).

<sup>85</sup> *Id.*

<sup>86</sup> See 17 C.F.R. § 230.506 (2006).

<sup>87</sup> 17 C.F.R. § 230.506, 502(c).

<sup>88</sup> 17 C.F.R. § 230.506, 502.

<sup>89</sup> 15 U.S.C. §§ 78a–78nn (1994).

<sup>90</sup> *Id.* § 78c(a)(5)(A).

<sup>91</sup> *Id.* § 78l(a)–(l).

under the Exchange Act, unless the issuance meets one of the exemptions.<sup>92</sup> Domestic registrants of a class of equity securities are then subjected to the periodic reporting requirements of Section 13,<sup>93</sup> proxy requirements of Section 14,<sup>94</sup> and insider reporting and short swing profit provisions of Section 16 of the Exchange Act.<sup>95</sup> Although hedge fund interests fall within the definition of equity security under the Exchange Act, most hedge funds seek to avoid Exchange Act registration by having fewer than 500 holders of record (which in the case of hedge funds are also generally the investors).

Under the beneficial ownership rules in Sections 13(d) and 13(g) of the Exchange Act, any person who, after acquiring beneficial ownership of any equity securities registered under Section 12 of the Exchange Act, beneficially owns greater than five percent of the class of equity securities, must file a beneficial ownership statement containing the information required by Schedule 13D or Schedule 13G.<sup>96</sup> Rule 13d-3 under the Exchange Act provides the definition of beneficial ownership.<sup>97</sup> Within its broad definition are those with the power to vote or dispose of any equity securities or the power to direct the voting or disposition of those securities.<sup>98</sup> Hedge funds and hedge fund managers who exercise power over equity securities held by the fund may be deemed by the rule to own the equity securities owned by the hedge fund.<sup>99</sup> Under limited circumstances, hedge funds and their advisors may opt to file a short form, Schedule 13G, in lieu of filing the longer Schedule 13D.<sup>100</sup>

Schedule 13D also requires disclosure of certain other material information regarding the reporting person and the acquisition of the securities.<sup>101</sup> Upon being subjected to the reporting obligations of Section 13(d) or 13(g), any previously submitted beneficial ownership statements must be amended if certain information in statements changes.<sup>102</sup> Additionally, hedge fund advisers may be required to provide quarterly updates as required by Section 13(f) of the Act.<sup>103</sup> Section 13(f) applies to any “institutional investment manager” who exercises investment discretion with respect to accounts having an aggregate fair market value of at least

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<sup>92</sup> *Id.* § 78l(g).

<sup>93</sup> *Id.* § 78m.

<sup>94</sup> *Id.*

<sup>95</sup> 15 U.S.C. § 78o.

<sup>96</sup> *Id.* §§ 78m(d), (e).

<sup>97</sup> 17 C.F.R. § 240.13d-3 (2006).

<sup>98</sup> *See id.*

<sup>99</sup> *See id.*

<sup>100</sup> 17 C.F.R. § 240.13d-1(b)(1).

<sup>101</sup> 17 C.F.R. § 240.13d-5.

<sup>102</sup> *See id.* § 240.13d-2.

<sup>103</sup> *Id.* § 240.13f.



\$100 million in equity securities.<sup>104</sup> An “institutional investment manager” includes any person (other than a natural person) investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.<sup>105</sup> Section 16 applies to every person who is the beneficial owner of more than ten percent of any class of equity security registered under Section 12 of the Exchange Act and each officer and director of the issuer of the security (collectively, “reporting persons” or “insiders”).<sup>106</sup> Upon becoming a reporting person, a person is required by Section 16(a) to file an initial report with the SEC disclosing the amount of his or her beneficial ownership of all equity securities of the issuer.<sup>107</sup> Section 16(a) also requires reporting persons to keep this information current by reporting to the SEC changes in ownership of these equity securities, or the purchase or sale of security-based swap agreements involving these securities.<sup>108</sup> Hedge funds are also subject to the short swing profit provisions of Section 16(b) of the Exchange Act.<sup>109</sup>

### *3. Investment Company Act of 1940*

The Investment Company Act of 1940 (“Investment Company Act”) regulates investment companies’ activities and transactions and requires them to register with the SEC.<sup>110</sup> Hedge funds rely on one of two exclusions under the Investment Company Act to avoid having to be subjected to registration and regulation, Section 3(c)(1) and Section 3(c)(7).

Section 3(c)(1) excludes “[a]ny issuer whose outstanding securities (other than short-term paper) 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” from the definition of “investment company” under the act.<sup>111</sup> However, the exclusion places limitations on the hedge fund to purchase or acquire any security issued by any registered investment company and the sale of any security issued by any registered open-end investment company to any such issuer. Generally, corporate investors count as one investor when evaluating compliance with the 100-investor limitation. Section 3(c)(1) reflects Congress’s view that privately placed investment companies owned by a limited number of investors do not rise to the level of federal interest under the Investment Company Act.

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<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> 15 U.S.C. § 78p(a)(1) (1994).

<sup>107</sup> *Id.* § 78p(a).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* § 78p(b).

<sup>110</sup> *See generally* Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–80a-64 (1994).

<sup>111</sup> *Id.* § 80a-3(c)(1).

Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company “any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.”<sup>112</sup> Congress’s rationale for this exclusion was its belief that certain highly sophisticated investors do not need the protections of the Investment Company Act because those investors are in a position to appreciate the risks associated with pooled investment vehicles. Although a hedge fund relying on Section 3(c)(7) may accept an unlimited number of qualified purchasers for investment in the fund, as a practical matter, most funds have no more than 499 investors to avoid the registration and reporting requirements of the Exchange Act.

Unlike Section 3(c)(1), Section 3(c)(7) does not have a “look-through” provision in the event that a registered investment company or a private investment company owns ten percent or more of the Section 3(c)(7) fund’s outstanding voting securities. A hedge fund using the section 3(c)(7) exemption “is only required to look through any company (investment company or otherwise) that invests in its shares to determine whether that company’s investors are qualified purchasers if the company was ‘formed for the purpose’ of investing in the . . . fund.”<sup>113</sup>

#### *4. Investment Advisers Act of 1940*

Under the Investment Advisers Act of 1940 (“Investment Advisers Act”), investment advisers must register with the SEC and comply with the provisions of the Act, including any SEC rules.<sup>114</sup> Registered investment advisers are required (1) to keep a current Form ADV<sup>115</sup> on file with the

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<sup>112</sup> *Id.* § 80a-3(c)(7)(A).

<sup>113</sup> SEC REPORT, *supra* note 8, at 13.

<sup>114</sup> *See generally* Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–80b-21 (1994).

<sup>115</sup> The SEC’s website explains the Form ADV requirements.

Advisers use Form ADV to register as an investment adviser with the SEC. Generally, an investment adviser that manages \$25 million or more in client assets must register with the SEC. Advisers that manage less than \$25 million must register with the state securities regulator where the adviser’s principal place of business is located. Form ADV also is used for state registration. Form ADV has two parts. Part I contains information about the adviser’s education, business, and an adviser’s disciplinary history within the last ten years. Part I is filed electronically with the SEC. Part II includes information on an adviser’s services, fees, and investment strategies. The SEC does not require advisers to file Part II electronically.

SEC and (2) to provide a disclosure statement to their clients.<sup>116</sup> The purpose of the disclosures is to provide both the SEC and the adviser's investors with current information about the adviser, such as the business practices. Registered advisers are required to maintain books and records and to submit to periodic examinations by the SEC staff.<sup>117</sup>

Most hedge fund advisers have avoided having to register with the SEC by relying on the de minimis exemption. Section 203(b) of the Investment Advisers Act excludes "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered. . . ."<sup>118</sup> Section 203(b) permits advisers to count a "legal organization," such as a hedge fund, as a single client.<sup>119</sup> Therefore, as long as they satisfy the "no holding out" condition, advisers may manage up to 14 funds before they are required to register with the Commission as an investment adviser.<sup>120</sup>

#### B. SEC's Staff Conducts Study of Hedge Funds

In June 2002, the SEC's staff undertook a study of the operations and practices of the hedge funds in large part due to the increase in hedge fund enforcement cases, the greater role of hedge funds in the financial markets, and the agency's lack of basic information on hedge funds.<sup>121</sup> At the same time that the SEC's staff members were conducting their study, they organized a roundtable on hedge funds with industry representatives and other interested persons, and requested comments from the public on issues dealing with hedge funds.<sup>122</sup> As a result of the staff's study, the roundtable, and the comments it received, the staff submitted a report to the SEC with preliminary findings and recommendations.<sup>123</sup>

The preliminary report outlined four major areas of concern for the SEC in regard to hedge fund activity. First, as hedge funds become more and more important participants in the financial markets and important investment vehicles for large institutions, the SEC is concerned that its lack of direct information on hedge funds and their activities hampers its ability to develop effective regulatory policy.<sup>124</sup> The SEC is concerned that its

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<sup>116</sup> 15 U.S.C. § 80b-3(c)(1).

<sup>117</sup> *Id.* § 80b-3(c).

<sup>118</sup> *Id.* § 80b-3(b)(3).

<sup>119</sup> 17 C.F.R. § 275.203(b)(3)-1(2)(i).

<sup>120</sup> 15 U.S.C. § 80b-3(b)(3).

<sup>121</sup> See SEC REPORT, *supra* note 8, at vii–viii.

<sup>122</sup> *Id.* at viii.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.* at x.

inability to examine hedge funds essentially places it in a position of having to wait and see if fraud or misconduct develops.<sup>125</sup> Only when third parties report such conduct is the SEC able to take action. Usually, by then, investors (or whatever the appropriate party is) have suffered substantial losses.

Second, the SEC is concerned that investors in a hedge fund “may not always receive useful information about the investment adviser and its management of the fund.”<sup>126</sup> The SEC also believes that disclosure to hedge fund investors could help “address conflicts of interests of hedge fund advisors.”<sup>127</sup> The SEC feels that there should be some regulatory measures that help ensure that investors receive material information that will help them make “fully informed investment decisions.”<sup>128</sup>

A third concern of the SEC is the way that hedge funds’ managers value their hedge funds’ assets. According to the SEC, this “broad discretion that [hedge fund] advisers have to value assets and the lack of independent review over that activity gives rise to questions about whether some hedge funds’ portfolio holdings are accurately valued.”<sup>129</sup> Finally, the SEC is concerned about the proliferation of hedge funds that essentially advertise their investment funds through the internet.<sup>130</sup>

#### C. The SEC Staff’s Recommendations

To address these concerns, the SEC’s staff made several recommendations to the Commission. The first was that the SEC should consider revising its rules under the Investment Advisers Act to require advisers of hedge funds to register as investment advisers.<sup>131</sup> According to the SEC staff, revising the rules would “require hedge fund advisers to ‘look through’ any hedge fund under their management and count each investor in each hedge fund as a separate client of the adviser.”<sup>132</sup> The effect of this would require most large hedge funds to register.<sup>133</sup> In addition, the SEC’s staff recommended that the SEC consider changing its rules “to require that registered hedge fund advisers file with the Commission, and deliver to investors, a disclosure statement specifically designed for hedge fund investors.”<sup>134</sup>

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<sup>125</sup> *Id.*

<sup>126</sup> *Id.* at xi.

<sup>127</sup> SEC REPORT, *supra* note 8, at xi.

<sup>128</sup> *Id.* at x.

<sup>129</sup> *Id.* at xi.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* at xi–xii.

<sup>132</sup> *Id.* at xi–xii.

<sup>133</sup> SEC REPORT, *supra* note 8, at xi–xii.

<sup>134</sup> *Id.*

The SEC's staff saw several benefits to requiring registration. First, "registered hedge fund advisers would become subject to the Commission's regular inspections and examinations program."<sup>135</sup> This would result in a more effective SEC oversight of the hedge funds and would likely lead to "earlier detection of actual and potential misconduct, help to deter fraud and encourage a culture of compliance and controls."<sup>136</sup> Second, the SEC would be authorized to "collect basic and meaningful information about the activities of hedge fund advisers and hedge funds, which are becoming increasingly influential participants in the U.S. financial markets."<sup>137</sup> Third, required registration would allow the SEC to require hedge fund advisers to disclose information important to investors.<sup>138</sup> Fourth, required registration would "effectively increase the minimum investment requirement for direct investments in certain hedge funds because registered advisers are generally prohibited from charging performance fees unless investors have \$750,000 invested with the adviser or have a net worth of \$1.5 million."<sup>139</sup>

According to the SEC staff, required registration would not adversely affect the way hedge fund advisers operate their hedge funds.<sup>140</sup> Required registration would not restrict hedge funds' ability "to trade securities, use leverage, sell securities short or enter into derivative transactions."<sup>141</sup> The proposed registration requirement would not require hedge fund advisors to disclose proprietary trading strategies or portfolio positions.<sup>142</sup> Registration also would not result in hedge funds having to identify their investors or inadvertently identifying their investors.<sup>143</sup>

The SEC staff also recommended that the Commission:

Consider requiring, through rulemaking, that all registered investment companies that invest their assets in hedge funds, including registered FOHFs,<sup>144</sup> have policies and procedures designed to ensure that funds and their boards value their interests in hedge funds in a manner consistent with the requirements of the Investment Company Act.<sup>145</sup>

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<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at xi.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> SEC REPORT, *supra* note 8, at xi.

<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> A Fund of Hedge Funds ("FOHF") is an investment fund that invests in multiple hedge funds rather than investing in individual securities.

<sup>145</sup> SEC REPORT, *supra* note 8, at xii.

Finally, the SEC's staff report recommended that the Commission consider eliminating the prohibition on hedge funds' general solicitation of advertising of their offerings because of the requirement that hedge funds' investors be sophisticated investors.<sup>146</sup> The SEC believed that allowing hedge funds, which already limit their investors to a higher standard of sophistication, to solicit, would not raise significant investor protection concerns and would help with capital formation for hedge funds and other pooled investment vehicles.<sup>147</sup>

#### D. The SEC's Adoption of the Final Rule

The SEC received over 160 comments from a range of interested parties, including hedge fund advisers, investors, trade associations, and law firms. Most commentators supported additional oversight by the SEC. Others were strongly opposed to additional oversight, including the two SEC commissioners who voted against the proposed rule, Commissioners Cynthia A. Glassman and Paul S. Atkins.<sup>148</sup>

An additional concern cited by the SEC's staff in the Final Rule was the recent increase in investment in hedge funds by public and private pension funds, college and university endowments, foundations, and other charitable organizations.<sup>149</sup> As these entities invest more of their assets in hedge funds, they are exposed to the risks of hedge fund investing. If they suffer losses from their hedge fund investments, it may significantly impact their ability to satisfy their obligation to their beneficiaries.<sup>150</sup> The rule and rule amendments were designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets.

Recent changes by the SEC have made avoiding regulation more difficult for hedge funds. The SEC Final Rule created Rule 203(b)-2 to

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<sup>146</sup> *Id.* at xii.

<sup>147</sup> *Id.*

<sup>148</sup> Commissioners Glassman and Atkins stated several reasons for their dissent. They view mandatory registration as an inappropriate response to the Commission's concerns related to hedge funds, including that: (1) the growth of hedge funds alone is not a reason alone to justify registration, (2) "registration is not likely to deter or lessen substantially the harm of fraudulent activities of the type cited by the majority," and (3) no evidence corroborates the majority's opinion that retailization of hedge funds is a problem and even more importantly that mandatory registration would be the appropriate remedy. SEC Final Rule, *supra* note 48, at 72089-98. Furthermore, Commissioners Glassman and Atkins believe neither that the stated reasons for requiring registration justify imposing substantial costs on hedge funds nor that these reasons justify diverting precious SEC resources to regulating hedge funds. *Id.* at 72098. Commissioners Glassman and Atkins also believe the majority "failed to draw legitimate distinctions between hedge funds and other types of private investment pools that would justify different regulatory schemes." *Id.*

<sup>149</sup> *Id.* at 72057-58.

<sup>150</sup> *Id.* at 72058.

“close the loophole” by which hedge funds could escape registering under the Investment Advisers Act. Rule 203(b)-2 “requires investment advisers to count each owner of a ‘private fund’ towards the threshold of fourteen clients for purposes of determining the availability of the private adviser exemption of section 203(b)(3) of the Act.”<sup>151</sup> Thus, an adviser to a private fund “can no longer rely on the private adviser exemption if the adviser, during the course of the preceding twelve months, has advised private funds that had more than fourteen investors.”<sup>152</sup> Furthermore, “an adviser that advises individual clients directly must count those clients together with the investors in any private fund it advises in determining its total number of clients for purposes of section 203(b)(3).”<sup>153</sup> “If the total number of individual clients and investors in private funds exceeds fourteen, the adviser is not eligible for the private adviser exemption and must register with [the SEC], assuming it meets [the SEC’s] minimum requirements for assets under management.”<sup>154</sup>

The SEC defines a “private fund” in regard to three characteristics that are “shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles such as private equity funds or venture capital funds.”<sup>155</sup> First, an investment company is a private fund if it would be subject to regulation under the Investment Company Act but for its use of one of two exceptions under sections 3(c)(1) and 3(c)(7).<sup>156</sup> Second, an investment company is a private fund if it permits investors to redeem their interests in the fund within two years of acquiring them.<sup>157</sup> Finally, an investment company is a private fund “only if interests in it are offered based on the investment advisory skills, ability or expertise of the investment adviser.”<sup>158</sup> The SEC amended Rule 203(b)(3)-1 to clarify further that “investment advisers may not count hedge funds as single clients under the safe harbor.”<sup>159</sup>

Since the adoption of the Final Rule requiring hedge funds to register with the agency, several hedge funds and hedge fund managers have sued the SEC over the SEC’s rule changes.<sup>160</sup> In addition, some hedge funds

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<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> SEC Final Rule, *supra* note 48, at 72070.

<sup>155</sup> *Id.* at 72073.

<sup>156</sup> *Id.* at 72068.

<sup>157</sup> *Id.* at 72074.

<sup>158</sup> *Id.* at 72075.

<sup>159</sup> *Id.*

<sup>160</sup> On December 21, 2004, Phillip Goldstein, President of Kimball & Winthrop, a hedge fund advisory company, and other interested parties sued the SEC in federal court, arguing that by adopting the hedge fund rule requiring “advisers to private investment entities known as hedge funds to register under the Advisers Act,” the SEC seeks to do “what Congress has

have sought to avoid registering under the new rule by changing their lock-up period, so that the amount of time investors' investments are locked into the fund exceeds the two year period after which the SEC considers an investment fund to be a hedge fund.<sup>161</sup>

The SEC's recent change to the Investment Advisers Act is a step in the right direction. However, the SEC needs to go further to include capital requirements and limits on leverage.

## V. AN OVERVIEW OF THE FINANCIAL SERVICES AUTHORITY'S REGULATION OF HEDGE FUNDS IN THE UNITED KINGDOM

In August 2002, the FSA issued a discussion paper ("2002 DP") detailing the British regulator's regulatory approach to hedge funds and hedge fund managers.<sup>162</sup> The FSA sought comment on its existing regulatory approach to selling and marketing of hedge funds in the United Kingdom.<sup>163</sup> The FSA also sought comment on its regulation of U.K.-based fund managers who manage offshore hedge funds and its approach to monitoring the effects of hedge funds on U.K. markets from parties

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precluded the Commission from doing—regulate private investment entities and advisers that Congress has expressly exempted from regulation under the Investment Company Act and the Advisers Act." Opening Brief for Petitioners, *Goldstein v. SEC*, No. 04-1434, 2005 WL 1666937, at \*8 (D.C. Cir. June 23, 2005). The plaintiffs asked the court to vacate the Hedge Fund Rule "because it is contrary to the clearly expressed intentions of Congress." *Id.* at \*2. In response, the SEC argued that the plaintiffs' challenges to the Final Rule and rule amendments "have no merit." Brief of the SEC, *Goldstein v. SEC*, No. 04-1434, 2005 WL 1636146, at \*5 (D.C. Cir. June 23, 2005). According to the SEC, the plaintiffs "erroneously rely . . . on unwarranted inferences drawn from the exemptive provisions of a different statute, the Investment Company Act, and on a Supreme Court case, *Lowe v. SEC*, 472 U.S. 181 (1985), which involved a different provision of the Advisers Act not at issue here." *Id.* at \*5-6. The SEC argues that "under well-settled principles of statutory construction and administrative law" it has "the authority to interpret an ambiguous statutory provision," and its "reasonable interpretation of this provision is entitled to deference." *Id.* at \*6. The D.C. Circuit recently issued a decision in the case. The court found that the hedge fund rule requiring investors in a hedge fund to be counted as clients of the fund for the purpose of determining whether the fund meets the fewer-than-fifteen clients exemption to conflict with the purpose of the underlying statute, and that the rule was arbitrary. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). Although the courts have overruled the SEC, this setback may be only temporary: the SEC may now either (1) revise its registration requirements to meet the court's opinion or (2) ask Congress to empower it to impose the Hedge Fund rule. Nevertheless, the D.C. Circuit's decision does not impact the aim of this comment, which is that the most important issue that the SEC should focus on is not investor protection but the risk associated with hedge fund activities to the global financial markets.

<sup>161</sup> See, e.g., *Locked Up: Hedge Funds Tie Up Investor Money for Longer*, AFX NEWS LIMITED (London), Aug. 17, 2005.

<sup>162</sup> See generally FINANCIAL SERVICES AUTHORITY, HEDGE FUNDS AND THE FSA (Aug. 2002), available at <http://www.fsa.gov.uk/pubs/discussion/dp16.pdf> [hereinafter 2002 DP].

<sup>163</sup> See *id.* at 3-5.



connected to the hedge fund industry.<sup>164</sup> At that time, the FSA was considering relaxing its rules against the marketing and selling of hedge funds to the general U.K. public to make hedge fund investment products more readily accessible to the U.K. general public.<sup>165</sup>

The FSA considered the “small scale of operations of most hedge fund managers, and the lack of impact on retail consumers,” to mean that most hedge funds had a low impact on the financial markets and thus did not jeopardize the FSA’s ability to meet its regulatory objectives.<sup>166</sup> In addition, the FSA felt that offshore hedge funds that use U.K.-authorized hedge fund managers did not fall within the Financial Services and Markets Act, which provides FSA with its regulatory authority, and therefore the FSA had no authority over the hedge funds themselves.<sup>167</sup> Furthermore, because most hedge funds with U.K. hedge fund managers are located offshore, the FSA indicated that it did not use any of its resources to maintain an active supervision over most hedge fund managers.<sup>168</sup>

In the 2002 DP, the FSA stated that it did not formally prohibit the marketing of hedge fund products to consumers as long as hedge funds abided by certain regulations.<sup>169</sup> The FSA indicated that only regulated investment funds sold by “authorised persons” are allowed to be marketed to the general U.K. public.<sup>170</sup> To market to the general public in the United Kingdom, hedge funds have to follow the “collective investment scheme” requirements; important requirements of the scheme include (1) that the funds are authorized by the FSA and (2) that authorized funds report “particulars” of their investment scheme,<sup>171</sup> something that most hedge funds are opposed to doing for fear of giving away proprietary strategies. Thus, most hedge funds have not sought authorization.<sup>172</sup>

Besides seeking authorization from the FSA directly, there are a few other ways that a U.K. investor can invest in hedge funds. One is for the U.K. investor to deal directly with an offshore hedge fund.<sup>173</sup> In this case, the investor has to seek out hedge fund investments on his or her own accord. By investing in the offshore hedge fund, the investor loses any

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<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.* at 4.

<sup>167</sup> *Id.*

<sup>168</sup> 2002 DP, *supra* note 162, at 4.

<sup>169</sup> *Id.* at 12.

<sup>170</sup> *Id.* at 13.

<sup>171</sup> *See id.* at 26–27.

<sup>172</sup> Under the current U.K. regulations, “hedge fund managers typically require authorisation under the Financial Services and Markets Act (FSMA) because they carry on the activities that are specified by article 37 (Managing Investments) or article 53 (Advising on Investments) of the Regulated Activities Order.” 2005 DP, *supra* note 3, at 16.

<sup>173</sup> 2002 DP, *supra* note 162, at 14.

protection available under U.K. laws governing financial products. Another option available would be for the investor to invest through an intermediary.<sup>174</sup> A regulated firm could “opt up” an investor as long as the regulated firm takes reasonable care to determine that the investor client has “enough expertise and understanding” to be considered an intermediate customer.<sup>175</sup> This is similar to the requirement in the United States which allows hedge funds to be sold to “qualified investors.”<sup>176</sup> U.K. regulations require that the intermediary also “give a written warning to the customers of the protections forgone by the opt-up, such as access to U.K. compensation arrangements,” and “either get the investor’s written consent or be otherwise able to show that informed consent” was given by the investor.<sup>177</sup> The FSA also makes it possible for an intermediary to provide advice on hedge funds to a potential investor if the customer approaches the intermediary and asks about investing specifically in hedge funds or if the regulated firm/intermediary takes reasonable steps to make sure that the particular hedge fund is appropriate for the investor.<sup>178</sup> A third option for a U.K. investor is to invest in a FOHF.<sup>179</sup>

Following the release of the 2002 DP, the FSA requested responses from hedge funds and other interested parties on a series of questions, such as whether (1) there was a strong case for the FSA to change its regulatory approach to hedge fund marketing and selling to sophisticated investors, (2) hedge funds are suitable financial products that should be marketed and sold to retail investors, and (3) the FSA should change its regulatory approach to hedge fund managers.<sup>180</sup> In March 2003, the FSA published those responses and announced its decision not to change its current regulatory approach to hedge funds.<sup>181</sup>

The recent rise in hedge fund activity on a global scale and hedge fund fraud in the United States has prompted the FSA once again to examine its approach to regulating hedge funds. According to the FSA, investors, market participants, commentators, and regulators have indicated that hedge funds are becoming more important to the FSA.<sup>182</sup> Furthermore, the recent growth of hedge funds has significantly increased hedge funds’ role in providing market liquidity.<sup>183</sup>

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<sup>174</sup> *Id.* at 14.

<sup>175</sup> *Id.*

<sup>176</sup> 15 U.S.C. § 78c(a)(54) (1994).

<sup>177</sup> 2002 DP, *supra* note 162, at 14.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 15.

<sup>180</sup> *Id.* at 23.

<sup>181</sup> FINANCIAL SERVICES AUTHORITY, HEDGE FUNDS AND THE FSA: FEEDBACK STATEMENT ON DP16 (Mar. 2003), available at <http://www.fsa.gov.uk/pubs/discussion/fs16.pdf>.

<sup>182</sup> 2005 DP, *supra* note 3, at 3.

<sup>183</sup> *Id.*

Responding to those concerns, the FSA published its 2005 Discussion Paper ("2005 DP"). The FSA's overarching goals for publishing its 2005 DP are to clarify the FSA's current assessment of the risks posed by hedge funds to the regulator's objectives and to seek input from hedge funds, investors, and other important stakeholders on whether the FSA should change its current approach to regulating hedge funds.<sup>184</sup> Specifically, the FSA wanted feedback on whether it should distinguish hedge fund managers from other investment managers because hedge fund managers have significantly more risk associated with their activities than other investment managers.<sup>185</sup>

If the FSA distinguishes hedge fund managers from other investment managers, it proposes that any distinction be made based on the investment technique of hedge funds rather than the legal structure.<sup>186</sup> The FSA prefers to focus on the distinction in risk and discourage hedge funds from seeking ways to evade any distinctions that are made based on a particular legal structure.<sup>187</sup> Thus, it would appear that under such a proposal hedge fund managers who use investment techniques as defined by the FSA could be subject to FSA oversight, regardless of whether they operate within a legal structure that is entirely located within the United Kingdom, or a legal structure that involves the use of U.K.-based advisers where the majority of the hedge funds activities are located offshore.

Some of the risks and concerns considered by the FSA include market disruption and erosion of investor confidence, liquidity disruption leading to disorderly markets, insufficient information to inform regulatory action, control issues, operation risk, risk management, valuation weaknesses, market abuse, fraud, money laundering, conflicts of interest, and insufficient information for investors to make informed comparisons between hedge funds.<sup>188</sup> The FSA has also taken the immediate step of establishing a center of hedge fund expertise within its Wholesale Markets Business to strengthen its oversight over the "high impact" hedge funds.<sup>189</sup> Additionally, the FSA sought feedback from interested parties on whether it should consider distinguishing prime brokers, including new prime brokers who might not follow standard risk management procedures in order to gain market share, and whether it should collect additional data from hedge fund managers to support its "enhanced supervisory oversight of high impact firms and the accurate targeting of thematic review."<sup>190</sup>

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<sup>184</sup> *Id.*

<sup>185</sup> *Id.* at 4.

<sup>186</sup> *Id.* at 39–40.

<sup>187</sup> *Id.*

<sup>188</sup> 2005 DP, *supra* note 3, at 6–7.

<sup>189</sup> *Id.* at 41.

<sup>190</sup> *Id.* at 9.

I will focus my discussion going forward on the FSA's concerns about market disruption and erosion of investor confidence, liquidity disruption leading to disorderly markets, insufficient information to inform regulatory action, risk management, and some industry participants' comment letters.

#### A. Market Disruption and Erosion of Investor Confidence

The FSA feels, and I agree, that the significant risk of massive financial instability to the overall market might occur—risk that hedge funds do not internalize when making their investment decisions or are more willing to accept than they should be willing to accept.<sup>191</sup> For example, if a few large hedge funds or collection of medium hedge funds were to suffer extraordinary distress, their distress would likely affect not only those funds<sup>192</sup> but also the global financial markets through the hedge funds' effect on their counterparties and investor confidence in the markets, and therefore the markets themselves. Although it is less likely that a single hedge fund will have the same effect that LTCM had on the global financial markets now or in the future, it is possible that a group of large hedge funds, all pursuing the same investment strategies because of the dearth of investment opportunities, might have an even greater effect on the global financial markets if they were forced by some unanticipated event to sell their positions or all suffered massive losses from the exposure to the same positions. The recent increase in investments in FOHFs exacerbates the problem because most of these funds are leveraged and they are investing in funds that are also leveraged. Thus, instead of lowering risk they magnify it. For example, the failure of one hedge fund may impact the FOHF's leverage position and may force it to sell and accept massive losses. It is impossible to estimate the extent of risk from hedge funds, FOHF market positions and leverage because most of the information is not available.

#### B. Insufficient Information to Inform Regulatory Action

The FSA is considering enhancing its data collection from hedge funds in order to identify "significant changes to a firm's impact over time."<sup>193</sup> The FSA believes increasing its awareness of major trends in the hedge fund field will allow it to respond more effectively to any crisis.<sup>194</sup> Unlike the SEC, the FSA is not as focused on requiring hedge funds to disclose certain financial or operational data to investors. The FSA correctly feels that its role as regulator is neither to facilitate "zero failure" of hedge funds

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<sup>191</sup> *See id.* at 18–22.

<sup>192</sup> It is assumed that investors accept the risk of losing of their investment but the risk placed on the market by hedge funds are not included in the hedge fund's assessment of its activity.

<sup>193</sup> 2005 DP, *supra* note 3, at 44.

<sup>194</sup> *Id.*

nor to “guarantee the financial soundness or profitability” of hedge funds.<sup>195</sup> The onus is on the investors to make sure that they received whatever information they deem necessary in monitoring their investment. If investors are unhappy with the hedge fund’s performance or levels of fund exposure, they can withdraw their capital.

The FSA has also created a “center of hedge fund” expertise to enhance supervision over the fifteen to twenty five hedge fund managers who have the largest market impact.<sup>196</sup> The center is responsible for “relationship management of high-impact hedge fund managers, driving relevant thematic work and supporting authorization, enforcement and policy initiatives that [can] benefit from such expertise.”<sup>197</sup> Hedge fund managers that pose little risk to the FSA’s objectives would not face significant additional supervision.

### C. Liquidity Disruption Leading to Disorderly Markets

The FSA is concerned that liquidity disruptions could cause disorder in the financial markets. One trend cited by the FSA is the search by hedge funds for investment opportunities with higher returns which has led some to move into “complex assets where liquidity may not be as great as that found in more traditional markets.”<sup>198</sup> This is a problem because the potential for liquidity disruption is increased as hedge funds move into more illiquid investments. An additional concern was that hedge funds concentrations into similar markets may exacerbate liquidity problems if all hedge funds attempt to exit positions or markets at the same time.<sup>199</sup>

The FSA is also alarmed by hedge funds’ leverage and its effect on liquidity risk. According to the FSA, “any hedge fund that is leveraged faces the risk of an increase in financing costs/margin payments or the cutting of credit lines.”<sup>200</sup> This effect of leverage on liquidity risks may rise with the introduction of more risky debt products, such as cross margining.<sup>201</sup> Additionally, the FSA is concerned about liquidity mismatches between hedge fund investments and their investors. The FSA believes that “substantial redemptions may make [hedge funds] become forced sellers.”<sup>202</sup> Liquidity risk from investors’ early redemptions may be growing as hedge funds rely more on large institutional investors.

The FSA received several comment letters from interested parties,

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<sup>195</sup> *Id.* at 46.

<sup>196</sup> *Id.* at 41.

<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at 30.

<sup>199</sup> 2005 DP, *supra* note 3, at 30.

<sup>200</sup> *Id.*

<sup>201</sup> *Id.* at 31.

<sup>202</sup> *Id.*

including the Managed Fund Association (“MFA”),<sup>203</sup> the Investment Management Association (“IMA”),<sup>204</sup> and the Alternative Investment Management Association (“AIMA”).<sup>205</sup>

#### D. MFA’s Comment Letter

The MFA agrees that, given the rapid growth and profile of hedge funds and their anticipated growth, the FSA should review its regulatory approach to hedge funds and reassess the risks associated with hedge fund activity. But the MFA believes that the growth and profile of hedge funds does not in itself justify any change.<sup>206</sup> The MFA argues that “the current level and method of regulation is appropriate.”<sup>207</sup> The MFA also agrees that the FSA should avoid encouraging more of the hedge fund industry to move offshore or seek “regulatory arbitrage.”<sup>208</sup> The FSA argues that although the risks identified by the FSA are “broadly correct,” the risks identified are not “specific to the hedge fund industry, but rather to financial services as a whole.”<sup>209</sup> The MFA is another proponent of “industry-led initiatives,” or self-policing, to deal with the FSA’s and the public’s concerns about hedge funds.<sup>210</sup> The MFA believes that “industry-led initiatives are the best way to achieve high standards in the industry,” citing its own work in the area of promoting sound business practices within the hedge fund industry as an example of such an industry-led initiative.<sup>211</sup>

Responding to the FSA proposal to distinguish hedge fund managers from other investment managers, the MFA contends that treating hedge

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<sup>203</sup> The MFA has over 1,000 members in the alternative investment industry, including hedge funds and FOHFs. A significant portion of the hedge fund industry is a part of MFA. See Managed Fund Association Comment Letter (Oct. 28, 2005), *available at* <http://www.mfainfo.org/images/PDF/MFAFSALetter.10.28.05.pdf> [hereinafter MFA Comment].

<sup>204</sup> The IMA represents the U.K.-based investment management industry. Its members include “independent fund managers, the asset management arms of retail banks, life insurers and investment banks.” Many of its members offer hedge fund products. See Investment Management Association Comment Letter (Oct. 28, 2005), *available at* <http://www.investmentuk.org/news/research/2005/recipient/fsa/fsa-1005.pdf> [hereinafter IMA Comment].

<sup>205</sup> The AIMA represents professionals who are involved in all aspects of the alternative investment management industry, including hedge fund manager. See Alternative Investment Management Association Comment Letter (Oct. 28, 2005), *available at* <http://www.aima.org/uploads/AIMAResponsetoDP05.4-27Oct.pdf> [hereinafter AIMA Comment].

<sup>206</sup> MFA Comment, *supra* note 203, at 2.

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*

<sup>209</sup> *Id.* at 3.

<sup>210</sup> *Id.*

<sup>211</sup> *Id.* at 3–4.

funds as a general class is difficult because of variations in strategy, size, and organizational structures.<sup>212</sup> It argues that “one size does not fit all” with regard to hedge funds, and that this makes it hard to develop a statutory definition to distinguish hedge funds from other investment funds.<sup>213</sup> The MFA is encouraging the FSA to use “guiding principles” to distinguish hedge funds managers’ funds from those of other investment managers.<sup>214</sup> Some of the guiding principles include distinguishing hedge funds on (1) “the net worth [and] sophisticated nature of investors,” (2) “‘absolute return’ strategies that are not tied to a benchmark such as the . . . S&P 500,” and (3) “active management, rather than traditional ‘buy and hold,’ strategies that utilize a range of investment products.”<sup>215</sup> The MFA believes that “a rigid definition” may allow hedge funds to circumvent the definition by restructuring to evade it.<sup>216</sup>

The MFA agrees with the FSA that “the probability of an event significantly affecting the financial stability of the United Kingdom is relatively low.”<sup>217</sup> The MFA also agrees that “robust risk management is essential within the hedge fund sector.”<sup>218</sup> However, the MFA believes that the onus should be on hedge fund managers to mitigate the potential risk of “liquidity mismatches” by employing strong “risk control” and “liquidity management.”<sup>219</sup> To manage market risk, credit risk, and liquidity risk, the MFA recommends that hedge fund managers establish a “risk monitoring function, which may be a hedge fund employee or a team of employees that is responsible for measuring and tracking the risk assumed” by the hedge fund.<sup>220</sup> The MFA believes that the hedge fund industry has made strides in managing market risk, which the MFA feels provides evidence that an “industry-led initiative” is the “best way to achieve high standards in a global industry.”<sup>221</sup>

The MFA made several additional recommendations to address liquidity risk, such as managers’ “evaluat[ing] their cash and borrowing capacity under the worst historical draw down and stressed market conditions, and taking into account potential investor redemptions and contractual arrangements that affect liquidity.”<sup>222</sup>

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<sup>212</sup> MFA Comment, *supra* note 203, at 5–6.

<sup>213</sup> *Id.* at 5.

<sup>214</sup> *Id.* at 6.

<sup>215</sup> *Id.*

<sup>216</sup> *Id.* at 7.

<sup>217</sup> *Id.*

<sup>218</sup> MFA Comment, *supra* note 203, at 7.

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* at 9.

<sup>222</sup> *Id.*

The MFA finds “problematic” the FSA’s consideration of imposing additional data requirements on hedge funds.<sup>223</sup> According to the MFA, there is no single process by which hedge funds process data internally, and even if there were an easy way to download the data to the FSA, “there would be no consistency in [the] method of preparation or presentation” such that “any meaningful analysis could be carried out.”<sup>224</sup> The MFA feels strongly that requiring hedge fund managers to prepare additional reports will add “a significant compliance burden” without necessarily adding value to hedge fund supervision.<sup>225</sup>

#### E. IMA’s Comment Letter

In its comment letter, the IMA commends the FSA on its “thorough job” identifying the main areas of concern regarding the impact of hedge funds on global financial markets.<sup>226</sup> The IMA agrees that a “further, targeted regulatory involvement in monitoring hedge fund impact on markets may be beneficial” and also agrees with the “FSA’s assessment of the risk posed to markets.”<sup>227</sup> However, the IMA does not agree that the FSA should “pull hedge fund managers further into the regulatory net” because this would not bring actual hedge funds within the FSA’s jurisdiction.<sup>228</sup> Instead, the IMA feels that the FSA should enhance its supervision of prime brokers because they are within the FSA’s jurisdiction.<sup>229</sup> But before further regulating prime brokers<sup>230</sup> or any other market participant, the IMA feels that the FSA should do an “economic analysis of the case for regulation.”<sup>231</sup> The IMA advocates that the FSA “establish better the real impact of the risks [the FSA] has identified, and whether these could be considered systemic.”<sup>232</sup> The IMA believes the FSA should take into consideration “the extent to which the market offers its own correcti[on].”<sup>233</sup>

The IMA believes prime brokers would be the best group for the FSA to target for regulatory reform because prime brokers are (1) within the

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<sup>223</sup> *Id.* at 13.

<sup>224</sup> MFA Comment, *supra* note 203, at 13.

<sup>225</sup> *Id.*

<sup>226</sup> IMA Comment, *supra* note 204, at 1.

<sup>227</sup> *Id.*

<sup>228</sup> *Id.*

<sup>229</sup> *Id.* at 2.

<sup>230</sup> Prime brokers help facilitate the clearance and settlement of securities trades and provide other services to large retail and institutional clients such as hedge funds. See SEC REPORT, *supra* note 8, at 5355 (describing prime brokers and the services they offer to hedge funds).

<sup>231</sup> IMA Comment, *supra* note 204, at 2.

<sup>232</sup> *Id.*

<sup>233</sup> *Id.*



FSA's regulatory reach and (2) "the single most important link to the markets for the [hedge] funds . . . ." <sup>234</sup> According to the IMA, without prime brokers, hedge funds cannot function. <sup>235</sup> The IMA does not believe that the FSA should target reform through hedge fund managers because the FSA has clear jurisdiction over those funds located within the United Kingdom, but not those located outside of United Kingdom. <sup>236</sup> The IMA argues that with regard to these latter funds, the FSA "has no jurisdiction to inquire into the fund" and more specifically, the FSA cannot "investigate whether the fund is doing what it says its doing and whether its governance is robust." <sup>237</sup> Although the hedge fund's managers manage the fund's assets, the IMA argues that the management of the fund's assets does not legally give the hedge fund managers control over the governance of the fund. <sup>238</sup> According to the IMA, usually the "fund's governance operates through several channels in addition to the [hedge fund manager], such as through its Board of trustees and through its administrator and custodian." <sup>239</sup> The IMA argues that the FSA would need to have "oversight of all these functions to be able to ensure that the fund was operating as it should." <sup>240</sup> Finally, the IMA says that "regulating the [hedge fund] manager in his relationship with the fund does not offer a feasible substitute for oversight of the fund's operations." <sup>241</sup>

The IMA similarly does not believe that the risks identified by the FSA are unique to hedge funds. <sup>242</sup> The IMA believes the only identified risk that warrants additional regulatory oversight is the "identification of (potential) systemic risk in the markets that cannot be mitigated by market users." <sup>243</sup> The IMA argues that "systemic risk" is likely to emerge from prime brokers' activities to the extent that the risk that primer brokers face is "so catastrophic that it impairs their ability to do business elsewhere and thus squeezes available liquidity in the market. The risk, in other words, is of over concentration of intermediary liquidity in a particular market. . . ." <sup>244</sup> Furthermore, the IMA argues that the FSA is "best able to protect markets through enforcing standards of behaviour on market operators and on intermediaries." <sup>245</sup> The IMA believes the same does not

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<sup>234</sup> *Id.*

<sup>235</sup> *Id.*

<sup>236</sup> *Id.* at 3.

<sup>237</sup> IMA Comment, *supra* note 204, at 3.

<sup>238</sup> *Id.*

<sup>239</sup> *Id.*

<sup>240</sup> *Id.*

<sup>241</sup> *Id.*

<sup>242</sup> *Id.* at 4.

<sup>243</sup> IMA Comment, *supra* note 204, at 4.

<sup>244</sup> *Id.*

<sup>245</sup> *Id.*

hold true for market users. In its words, “the best guard against systemic failure, and against adverse market impact, is to ensure that the intermediary firms are thorough in their dealings with hedge funds, and that all aspects of the relationship are managed and tested.”<sup>246</sup>

#### F. AIMA’s Comment Letter

The AIMA states that the FSA has offered “no evidence to suggest that hedge fund managers are likely to cause any more disruption to the market than other players.”<sup>247</sup> The AIMA argues that other than the LTCM’s near collapse in 1998, “in other times where hedge funds suffered losses, major redemptions and even closure . . . there was no substantial disruption to the market and very limited investor ‘pain,’ which was absorbed by the market without regulator intervention.”<sup>248</sup> The AIMA states that although recently hedge funds have closed due to poor performance, “in a free market, this is not a sign of ill-health in the market as a whole.”<sup>249</sup>

The AIMA believes that the distinction between hedge fund managers and other investment managers is “blurring.”<sup>250</sup> According to the AIMA, many hedge funds are now “running long-only funds.”<sup>251</sup> This calls into question whether the FSA should attempt to distinguish hedge fund managers from other investment managers. The AIMA is very troubled that the decision to distinguish certain hedge funds based on particular investment strategies would allow managers who do not fit any established criteria, but who propose equal or greater risks, to escape scrutiny.<sup>252</sup>

The AIMA also advocates that “any initiative to raise standards should be regulator—rather than industry—led.”<sup>253</sup> On the issue of whether the FSA should make hedge fund managers seek permission before engaging in hedge fund type activity, the AIMA believes that notification “is more in balance with the FSA’s intentions and would be more manageable for managers.”<sup>254</sup> The AIMA supports the idea of a new “Center of Expertise” as long as the center is appropriately staffed with qualified personnel and sufficient resources.<sup>255</sup>

The AIMA is not convinced that the FSA will be able to distinguish between hedge fund managers and the hedge funds themselves and be

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<sup>246</sup> *Id.* at 45.

<sup>247</sup> AIMA Comment, *supra* note 205, at 3.

<sup>248</sup> *Id.* at 4.

<sup>249</sup> *Id.*

<sup>250</sup> *Id.*

<sup>251</sup> *Id.*

<sup>252</sup> *Id.* at 9.

<sup>253</sup> AIMA Comment, *supra* note 205, at 5.

<sup>254</sup> *Id.*

<sup>255</sup> *Id.* at 6.

within its regulatory authority.<sup>256</sup> The AIMA does not believe the “liquidity disruption” or liquidity risks are as significant as the FSA thinks.<sup>257</sup> According to the AIMA, most hedge funds are taking advantage of protections available to them to help manage liquidity risk, such as increasing lock-up periods, “imposition of gates on redemptions, [and] notice periods for redemptions” which give hedge funds considerable protections “in the event of a liquidity mismatch. This means that in such extreme conditions the hedge fund investors will be compelled to remain fully or partially invested for longer than they might prefer in favour of achieving an orderly realisation of positions for redemptions from the hedge fund.”<sup>258</sup>

Not surprisingly, the members of AIMA who are prime brokers are against prime brokers’ being singled out by the FSA.<sup>259</sup> Also unsurprising is that members of AIMA who are hedge fund managers advocate that the FSA should focus on prime brokers rather than hedge fund managers.<sup>260</sup> The hedge fund managers argue that prime brokers pose a risk equal to or greater than hedge fund managers do “given the nature of [prime brokers’] activities and the variety of the services which they provide.”<sup>261</sup> According to hedge fund managers, prime brokers are “central to providing liquidity to hedge funds . . . [prime brokers] are the first in line when a credit event occurs and the positions that they hold and how they deal with them can determine whether a default escalates out of hand.”<sup>262</sup> Interestingly, hedge fund managers do admit that “introducing new rules for new [prime brokers] will tend to favor existing [prime brokers] since such a step is likely to raise barriers to entry.”<sup>263</sup>

## VI. CONCLUSION

Hedge funds’ impact on the global financial market has grown substantially in the last decade and is expected to continue to grow. When hedge funds first emerged as an alternative investment vehicle for sophisticated investors, it made sense that regulators such as the FSA and the SEC provided limited regulation to allow them to flourish. During the initial years, hedge funds had little meaningful affect on the financial markets and thus were small players. But given hedge funds’ impact on the financial markets today, the SEC and the FSA are correct to change their

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<sup>256</sup> *Id.* at 8.

<sup>257</sup> *Id.* at 8–9.

<sup>258</sup> *Id.* at 9.

<sup>259</sup> AIMA Comment, *supra* note 205, at 17.

<sup>260</sup> *Id.*

<sup>261</sup> *Id.*

<sup>262</sup> *Id.*

<sup>263</sup> *Id.*

regulatory approaches toward hedge funds. However, the SEC needs to go beyond just the problem of investor fraud. Investor fraud is only part of the potential problem with the growth of the hedge fund industry, and registration and disclosure requirements are only part of the solution. The SEC is overlooking more important concerns: market risk, liquidity risk, the lack of capital requirements, and excessive economic leverage. The FSA has yet to determine what changes, in addition to its establishment of a center on hedge funds, it will make to its regulatory approach to hedge funds. However, the FSA has focused its inquiry on the right concerns, market risk, liquidity risk, capital requirements, and limits on economic leverage, rather than simply on investor fraud and protection.

