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**Hedge Fund Self-Regulation
in the US and the UK**

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I. INTRODUCTION

The phrase “regulation of hedge funds” is a contradiction in terms. Hedge funds are designed to avoid regulation, allowing flexibility in investment for both the hedge fund managers and investors in the fund.¹ Hedge funds are structured so as to fall through the cracks, and any attempt by governments to regulate them has resulted and will likely result in funds squirming to find a way to avoid such regulation. Recently, however, the hedge funds themselves have taken steps towards regulation — with serious self-regulatory proposals being developed in both the US and the UK — countries responsible for over four-fifths of global hedge fund activity.² This Paper considers the reasons and motivations for the regulation of hedge funds and analyzes the recent proposals of the President’s Working Group in the US and the Hedge Fund Working Group in the UK. Many commentators, including fund managers, investors, regulators and academics have argued that self-regulatory proposals will revolutionize the hedge fund sector by finding the most efficient point at which to regulate. This Paper, however, argues that self-regulation will not necessarily result in any efficiency gains as government regulators will remain the ultimate drivers of any regulation. However, self-regulation may still bring other benefits, including international scope and flexibility and thus should not be dismissed.

Part II begins by briefly attempting to define and categorize hedge funds. Part III considers the justifications for regulating hedge funds, assessing the various goals of investor protection, systemic risk prevention and corporate governance. Parts IV and V analyze the current regulatory structure and recent self-regulatory proposals in the US and UK respectively. Part VI contrasts the theoretical costs and benefits of government regulation and self-regulation

¹ See, e.g., Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 327 (“Hedge funds are simply pooled investments designed to avoid regulatory constraints that might inhibit profit for the investors and the investment managers. By avoiding regulation, the funds may adopt investment strategies that involve greater risk of loss than mutual funds.”)

² As measured by location of manager. See *infra* notes 326–327 and accompanying text.

with regard to hedge funds. Part VII considers recent self-regulatory proposals and whether they will achieve all the benefits that commentators suggest they will. Part VIII concludes.

II. DEFINITION AND HISTORY OF HEDGE FUNDS

Hedge funds are notoriously hard to define and categorize. By design they institutional investors that purposefully live in the margins and fall through the cracks. This Part will briefly recount the history of hedge funds, consider what they have in common and describe the global market of hedge funds today.

A. *What is a Hedge Fund?*

The first hedge funds came into existence in the US in the 1940s. The funds were designed to avoid Securities and Exchange Commission (“SEC”) regulation and achieve versatility in their investments.³ This versatility means that, when attempting to categorize hedge funds, for each area of general commonality there are almost certainly funds that do not exhibit that characteristic at all.⁴ Nevertheless, it is helpful to try to distinguish hedge funds from other kinds of institutional investor.

Short-selling — A defining characteristic of many hedge funds (particularly as compared to mutual funds, which in the US are generally not allowed to short sell⁵) is that they take both long and short positions in stocks. This goal of this strategy is to enable funds to mitigate market risk, allowing absolute returns whatever the state of the market.⁶ Alfred Winslow Jones, credited with inventing the hedge fund, had the novel idea of taking as many short positions as long

³ J.W. Verret, *Dr Jones and the Raiders of Lost Capital; Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L 799, 803 (2007).

⁴ See HEDGE FUND WORKING GROUP (“HFWG”), HEDGE FUND STANDARDS: CONSULTATION PAPER, PART I, at 33 (Oct. 2007), available at <http://www.hfwg.co.uk/files/HFWG%20Paper%20Part%201%20Final.pdf> (“Not all [hedge funds] use leverage. Not all engage in short selling. And a few are now even quoted and open to retail investors.”); see also Verret, *supra* note 3, at 803 (giving examples of the diverse activities of hedge funds, including “trad[ing] commodities or currency swaps based on macroeconomic data, or trad[ing] on expected results of a merger or acquisition between two companies.”)

⁵ See *infra* Part III.C.2.a.

⁶ “Going short of stock to generate returns and/or hedge market exposure . . . involves borrowing stock and then selling it in order to profit from the value of the security falling.” HFWG, *supra* note 4, at 33.

positions, thus meaning his fund could always make money, as long as he picked the correct stocks!⁷

Leverage — Many hedge funds buy securities using borrowed money, or most often, by purchasing derivatives in which positions are maintained by posting a margin, rather than supporting the full economic position.⁸ This results in magnified returns, if successful, but also increased exposure. In the classic trade-off between risk and return, hedge funds generally inhabit the “risk” side of the spectrum.⁹

Activity Level — Hedge funds are generally much more active — for some funds, a “long-term” investment is keeping securities for a whole day!¹⁰

Fee Structure — One area of certainty among hedge funds is the fee structure that a fund charges its investors: it will be much higher than other institutional investments. Typically, funds charge a management fee of 1-2% per year and a performance fee of 20%.¹¹ Coupled with the fact that a hedge fund manager will often have a lot of personal wealth invested in his fund, this means that the manager is highly incentivized to generate high returns, and that absolute returns must be very good for it be worth investing in the fund.

Many commentators have attempted to categorize hedge funds based upon their investment strategies. René Stulz, for example, has identified four main types: 1) long-short equity;¹² 2) event-driven;¹³ 3) macro;¹⁴ 4) fixed-income arbitrage,¹⁵ which together account for

⁷ *Id.*

⁸ *See, e.g., Verret, supra note 3, at 826.*

⁹ This risk may not only be to the fund and its investors. There are systemic risks concerns if the fund cannot cover its margin positions. *See infra* Part III.B.

¹⁰ *See* Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021, 1083 (2007); HFWG, *supra* note 4, at 33.

¹¹ HFWG, *supra* note 4, at 33.

¹² Those that take both long and short position (as with Mr. Jones’s first hedge fund). René M. Stulz, *Hedge Funds: Past, Present and Future* 13 (Dice Center Working Paper 2007-3, Feb. 2007), *available at* <http://www.ssrn.com/abstract=939629>.

87% of funds.¹⁶ One of the leading hedge fund indices reports separately for nine different strategies;¹⁷ the Wall Street Journal recently distinguished between only “simple strategies” and “complex strategies.”¹⁸

Along with high fees, then, the only real point of agreement amongst all those analyzing hedge funds is recognition of the fact that it is almost impossible to define and characterize them!¹⁹

B. *Growth of the Hedge Fund Industry*

Fortune magazine published an article about Jones’ invention in 1966, and his ideas soon caught on.²⁰ It is in the last 15 years, however, that the hedge fund industry has really grown. In 1993, just over \$50 billion was invested in hedge funds, 4 percent of the amount invested in mutual funds.²¹ By 2006 this proportion had grown to more than 10 percent, with over \$1 trillion invested in hedge funds globally.²²

In fact, simply attempting to quantify the amount invested in hedge funds perfectly illuminates the difficulties found in defining and characterizing hedge funds. In a perfect world,

¹³ *Id.* (“attempt to take advantage of opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, reorganizations, bankruptcies, and other extraordinary corporate transactions.”).

¹⁴ *Id.* at 14 (“attempt to identify mispriced valuations in stock markets, interest rates, foreign exchange rates and physical commodities, and make leveraged bets on the anticipated price movements in these markets.”)

¹⁵ *Id.* (“attempt to find arbitrage opportunities in the fixed income markets”).

¹⁶ *Id.*

¹⁷ Hedge Fund Research, HFRX Strategy Definitions, <https://www.hedgefundresearch.com/index.php?fuse=hfrx-str&1206408023> (last visited Mar. 30, 2008) (defining separate indices for Convertible Arbitrage, Event Driven, Distressed Securities, Macro, Equity Hedge, Merger Arbitrage, Equity Market Neutral, Relative Value Arbitrage and Volatility).

¹⁸ Gregory Zuckerman, *Hedge Funds Feel New Heat*, WALL ST. J., Feb. 23, 2008, at A1 (citing Hedge Fund Research).

¹⁹ See generally Stulz, *supra* note 12, at 5–15 (attempting distinguish hedge funds from other institutional investors). In the D.C. Circuit decision of *Goldstein v. SEC*, the Court described hedge funds as “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.” *Goldstein v. SEC*, 451 F.3d 873, 875 (D.C. Cir. 2006) (quoting PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999) (hereinafter PWG 1999 REPORT), available at <http://www.treas.gov/press/releases/reports/hedgefund.pdf>) (internal quotation marks omitted).

²⁰ Carol J. Loomis, *The Jones Nobody Keeps Up With*, FORTUNE, Apr. 1966, at 237.

²¹ Stulz, *supra* note 12, at 3.

²² *Id.*

to find the global assets under management of hedge funds, one would simply take the assets under management of each hedge fund at a given time, and sum across the set of all hedge funds at that time. In June 2007, three respected industry index providers reported their estimates of the size of the global hedge-fund market: \$1.25, \$1.74 and \$2.48 trillion dollars.²³ Issues with both elements of the sum help to explain this wide variation.

First, it is hard to define what entities are classified as “hedge funds,” because the boundaries with other investment activities are blurred and because there is no requirement that funds report their holdings. Second, and perhaps more surprising and concerning, the level of variation among the index providers of the measurement of one fund is remarkable. After all, for any hedge fund, size matters. If a fund has attracted a lot of money from other investors, that is a big factor in favor of choosing that fund, as there are few other metrics with which to compare funds.²⁴ Apart from outright fraud,²⁵ the primary method by which funds inflate their size is to include borrowed money when reporting. In October 2007, the Fairfield Greenwich Group was describing itself as a fund with \$15 billion under management, and these figures were reported to some industry watchdogs. That number, however, included \$2 billion of borrowed money.²⁶ Other hedge fund managers count assets twice if they run a fund of funds which invests in their own funds.²⁷

The ostensibly simple task, then, of measuring the size of the hedge fund industry illuminates the possible need for regulation. It is difficult for investors to compare the size of

²³ “As of the end of June, Chicago-based Hedge Fund Research Inc. put the total assets managed by hedge funds at \$1.74 trillion, while London-based HedgeFund Intelligence put it at \$2.48 trillion. Credit Suisse Tremont, which also tracks the industry, puts it at \$1.25 trillion.” Alistair MacDonald & Margot Patrick, *Hedge Funds: Leveraging the Numbers — Size Can Be Deceiving When Borrowed Money Is Added to Calculation*, WALL ST. J., Nov. 24, 2007, at B1.

²⁴ *Id.*

²⁵ See *infra* Part III.A.2 for a discussion of managers obtaining funds by fraudulently reporting their funds’ size.

²⁶ *Id.*

²⁷ *Id.*

different hedge funds and evaluate possible investments if the managers use different measurement and valuation techniques.²⁸

Hedge funds have been the shining light of Wall Street in the last ten years.²⁹ Since the credit crunch of late 2007, however, hedge funds as a group have begun to struggle for the first time — the average fund lost over 5% in the first two months of 2008,³⁰ provoking newspaper columns, for example, entitled: *Death of the Hedge Fund?*³¹ Some funds were hit by the knock-on effects of the credit crunch, and even “simple” funds that continued to perform well through the first few months of 2008 have suffered recently, apparently in part because of the bailout of Bear Stearns.³² Given this market turmoil, and the ever-increasing magnitude of assets under hedge fund management, there has never been a more important time to consider hedge fund regulation.

III. WHY REGULATE HEDGE FUNDS?

There are a number of groups in the market who may be harmed by the activities of hedge funds, and to whose benefit regulation may be directed:

Entity Regulation Intended to Protect	Area of Regulation
Protection of Investor	Investor Protection
Protection of Public and Markets Generally	Systemic Risk
Protection of Companies Invested in by Hedge Funds	Corporate Governance

These regulatory areas are mostly distinct, and regulation that is designed to affect one area may have unintended and unwanted effects on other areas of regulation.

²⁸ See *infra* note 251 and accompanying text.

²⁹ See Zuckerman, *supra* note 18 (“The past decade has been the era of the hedge fund Fortress Investment Group LLC . . . became the symbol of hedge-fund success when it went public last February”)

³⁰ Svea Herbst-Bayliss, *Hedge Funds Worldwide Show More Losses in February*, REUTERS, Mar. 6, 2008, available at <http://www.reuters.com/article/fundsFundsNews/idUSN0649219120080307>.

³¹ Stephen Foley & Nick Clark, *Death of the Hedge Fund?*, THE INDEPENDENT, Mar. 14, 2008.

³² See Zuckerman, *supra* note 18 (noting that “complex” funds were struggling, but long-short funds were still performing well through January); Laurence Fletcher, *Hedge Funds Hit by Bear Bailout*, REUTERS.COM, Mar. 28, 2008, available at <http://uk.reuters.com/article/fundsNews/idUKNOA83916620080328> (“Long-short equity hedge funds are set to post poor performance for March as the bailout of Bear Stearns and commodity price falls hit recently profitable trades, according to HSBC Alternative Investments.”). For more details of the failure of Bear Stearns, see *infra* notes 74–77 and accompanying text.

Before considering the negative implications of hedge funds, it is worth noting that commentators are in agreement that hedge funds do have beneficial effects on the global economy (independently of making a small set of hedge fund managers very rich!).³³ Summarized neatly by the UK Economic Secretary to the Treasury, Ed Balls, hedge funds “provid[e] liquidity, help[] markets price assets more accurately and driv[e] financial innovation.”³⁴ Alan Greenspan has expressed concern that the over-regulation of hedge funds may reduce liquidity, which would have a large negative effect on the markets.³⁵

A. *Investor Protection*

In both the US and the UK, the linchpins of the current regulatory structure of hedge funds are provisions that an investor must be in some way “sophisticated.”³⁶ The rationale behind this is simple: a sophisticated investor can “fend for himself.”³⁷ He is able to afford the high fees and should understand the riskiness and complexity of his investment. He does not need external regulation to protect him; if he wanted that, he could invest in instruments he knows *are* stringently regulated. Two main arguments, however, are made in favor of increased

³³ See, e.g., Timothy F. Geithner, President and Chief Executive Office of the Federal Reserve Bank of New York, Keynote Address at the National Conference on the Securities Industry: Hedge Funds and their Implications for the Financial System (Nov. 17, 2004), available at <http://www.ny.frb.org/newsevents/speeches/2004/gei041117.html> (“Hedge funds play a valuable arbitrage role in reducing or eliminating mispricing in financial markets. They are an important source of liquidity, both in periods of calm and stress. They add depth and breadth to our capital markets.”)

³⁴ Ed Balls, MP, Economic Secretary to the Treasury, Speech at the FSA Principles-based Regulation Conference (Apr. 23, 2007), available at http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_48_07.cfm. Justifying the recent loosening of hedge-fund investor rules in the UK, “Dan Waters, FSA director of retail policy and asset management sector leader, said allowing customers access to a wider range of investment strategies gives ‘better opportunity for risk diversification.’” Margot Patrick, *U.K. to Loosen Hedge-Fund Investor Rules*, WALL ST. J., Feb. 23, 2008, at B2. Many institutional investors are prohibited from short-selling. See Dale A. Oesterle, *Regulating Hedge Funds* 13 (Ohio State Pub. Law Working Paper No. 71, 2006), available at <http://ssrn.com/abstract=913045> (describing restrictions in the US and noting that mutual funds must cover any open short positions it carries with liquid assets). This provision is even more stringent as mutual funds are subject to shorter redemption requirements.

³⁵ Alan Greenspan: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 108th Cong., available at <http://www.federalreserve.gov/boarddocs/testimony/2004/20040420/default.htm>; see also Verret, *supra* note 3, at 825.

³⁶ See *infra* Part IV.A.1.e and notes 227–228 and accompanying text.

³⁷ Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, at 991 n.62.

regulation with regard to investor protection. First, in recent years, the increasing “retailization” of hedge funds has blurred the “sophisticated investor” distinction, so the justification may no longer hold firm. Second, the general lack of disclosure from hedge funds enables funds to engage in fraud and can cause even sophisticated investors to suffer from information asymmetries.

1. The Blurring of the “Sophisticated Investor” Distinction

Regulators have expressed concern at the increasing ability of individual, unsophisticated investors to be exposed to investments in hedge funds, sometimes without their knowledge.³⁸ First, the proportion of investments by institutional investors has increased greatly. For example, the global investment in hedge funds by pension funds increased from a 5% share of capital, to a 15% share between 1996 and 2004.³⁹ Presumably pension fund managers are not “unsophisticated,” but the *beneficiaries* of the funds they manage likely are; and they are the people who are ultimately taking on the risk of the investments. For example, in 2006 the San Diego County Employees Retirement Association had \$175 million of its \$7.7 billion of assets invested in the hedge fund Amaranth.⁴⁰ In the September 2006, a series of increasingly risky bets on natural gas futures led one trader to lose \$5 billion in one week, causing the value of the fund to drop by over 65 percent: One month later, it was liquidated.⁴¹ The San Diego fund lost \$80 million in the subsequent collapse.⁴² Nevertheless, in March 2007, a survey of public pension funds in the US found that 42% were planning to “significantly increase” their current hedge-

³⁸ See, e.g., FSA, DISCUSSION PAPER 05/4, HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT ¶¶ 2.9–2.12 (June 2005), available at www.fsa.gov.uk/pubs/discussion/dp05_04.pdf

³⁹ *Id.* at 13.

⁴⁰ Craig Karmin, *Pension Managers Rethink Their Love of Hedge Funds*, WALL ST. J., Aug. 27, 2007, at C1.

⁴¹ Ann Davis, *How Giant Bets on Natural Gas Sank Brash Hedge-Fund Trader*, WALL. ST. J., Sept. 19, 2006, at A1.

⁴² Karmin, *supra* note 40.

fund holdings.⁴³

Second, it has become much easier for individual investors to invest in hedge-fund-like entities themselves. In both the US and the UK, an odd quirk is that “funds of funds” are treated differently to individual funds; they have lower buy-ins and are available to less-well accredited investors.⁴⁴ In the US, the “accredited investor” definition is not linked to inflation, and has not been adjusted since 1982, meaning millions of individuals now qualify.⁴⁵ Funds of funds, consisting of investments in two or more hedge funds (which does not necessarily reduce risk and increases fees) have grown recently, now accounting for over 20% of the global investment in individual hedge funds.⁴⁶ Another method of individual investment is via indexes that “clone” hedge fund strategies.⁴⁷ Merrill Lynch, Goldman Sachs, State Street and Deutsche Bank have each launched products that attempt to do just that. They benefit from not having the exorbitant performance fees, but can suffer from the same lack of transparency that hedge funds do. Goldman Sachs, the first bank to launch such a replication index, keeps its “Absolute Return Tracker” proprietary; investors know little of the strategy that they are investing in.⁴⁸

These developments have led some commentators to suggest that hedge funds must be regulated more closely, as the “sophisticated investors” justification no longer holds firm.⁴⁹

⁴³ Douglas Appell, *Tipping Point Seen in Asset Allocations*, PIONLINE.COM, Apr. 2, 2007, available at <http://www.pionline.com/apps/pbcs.dll/article?AID=/20070402/PRINTSUB/70330041/1031/TOC>.

⁴⁴ See generally Sean M. Donahue, Note, *Hedge Fund Regulation: The Amended Investment Advisers Act Does Not Protect Investors from the Problems Created by Hedge Funds*, 55 CLEV. ST. L. REV. 235, 239–40, 255–56, 264–65 (2007) (arguing that average investors should be restricted from investment in funds of funds in the US); FSA, *supra* note 38, at ¶ 2.12 (noting that “that UK retail investors are becoming more interested in hedge fund investing,” particularly fund of funds).

⁴⁵ See Donahue, *supra* note 44, at 246–247. A joint adjusted gross income of \$200,000 qualifies someone as an accredited investor, not far above the gross income of a first-year associate at a large NY law firm.

⁴⁶ FSA, *supra* note 38, at 13.

⁴⁷ Steve Johnson & Ellen Kelleher, ‘Cloned’ Strategies Offer Investors Better Options, FIN. TIMES (LONDON), Mar. 22, 2008, at 15.

⁴⁸ *Id.*; Steve Johnson, *Goldman Launches Art to Shake Up Hedge Fund Industry*, FIN. TIMES (LONDON), Dec. 4, 2006, at 19.

⁴⁹ See, e.g., Edward Pekarek, *Pruning the Hedge: Who is a “Client” and Whom Does an Adviser Advise?*, 12 FORDHAM J. CORP. & FIN. L. 913, 952–53 (2007); Donahue, *supra* note 44, at 263–65.

Others, however, argue that such concerns are unfounded. The San Diego pension fund had investments in 12 hedge funds, and even including its losses in Amaranth (less than 1% of its assets), the fund returned 16% for the year-ended in June 2007.⁵⁰ Many pension funds consider hedge funds as one small part of their diversified portfolio and will only invest up to 10% of the value of the fund in hedge funds.⁵¹ By August 2007, many pension funds had responded to turbulence in the financial markets and had become more conservative regarding their approach to hedge fund investments.⁵²

2. Lack of Disclosure Leads to Fraud and Harmful Information Asymmetries

The secretive nature of hedge funds means they do not have to disclose information regarding their holdings. As such, they can diverge from stated investment strategies without investor knowledge, or simply engage in fraud. There have been numerous examples of fund managers falsifying their fund's performance figures in order to attract investors while misappropriating funds. Daniel Marino, the former CFO of the hedge fund Bayou Management was recently sentenced to 20 years in prison after defrauding investors of over \$400 million.⁵³ A few months earlier, John Whittier, the former head of Wood River Capital Management was forced to give up \$5.5 million personally and sentenced to three years after investors lost at least \$88 million through his fraud.⁵⁴ Both funds collapsed in 2005, but there are no signs of such fraud abating: In February 2008, the Commodity Futures Trading Commission brought an action against Lake Short Asset Management alleging the fund had fraudulently solicited \$300

⁵⁰ See Karmin, *supra* note 40.

⁵¹ See *id.*

⁵² *Id.* But see Tomoko Yamazaki, *Hedge Funds Attracting Pensions, College Endowments*, BLOOMBERG.COM, Mar. 12, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601101&sid=amFYeqZXT70g> ("Hedge funds globally are attracting more pension funds, foundations and college endowments that seek to diversify assets and boost returns . . .").

⁵³ Chad Bray, *Bayou's Ex-Finance Chief Sentenced to 20 Years*, WALL ST. J., Jan. 30, 2008, at B13.

⁵⁴ Chad Bray, *Former Head of Wood River Is Sentenced*, WALL ST. J., Oct. 16, 2007, at C3.

million.⁵⁵ In March 2008, the SEC brought an enforcement action against Thompson Consulting for defrauding investors of \$60 million.⁵⁶

A lack of disclosure may also lead an investor to not fully understand what their hedge fund investment really entails. Consider two investors. The first investor “knows not, and knows that she knows not.”⁵⁷ She has two options, she can either invest in the fund, knowing the risk she is undertaking, perhaps because she trusts the fund manager. Alternatively, she can insist upon further disclosure before she will invest.⁵⁸ The second investor “knows not, and knows not that he knows not.” It is with this investor that the real concern lies — he really might not be able to fend for himself, and may invest blindly and irrationally.

The increased retailization of hedge funds may both relieve and aggravate this problem.⁵⁹ On the one hand, as the proportion of institutional investors investing in hedge funds increases, it is likely that those investors will demand better information and fund managers will be forced to provide it, to the benefit of all investors.⁶⁰ Some pension fund managers do months of research and meet with scores of hedge fund managers before finally investing with only one or two.⁶¹ On the other hand, as individual “average-Joe” investors increasingly have the capacity to invest in hedge-fund-like entities, they may rely solely on past performance as an indicator of future success. Consider a hedge fund that, through a complex series of undisclosed derivatives, has a

⁵⁵ Press Release, CFTC, CFTC Alleges that the Lake Shore Common Enterprise Fraudulently Solicited At Least \$300 Million and Misappropriated More Than \$11 Million (Feb. 20, 2008), <http://www.cftc.gov/newsroom/enforcementpressreleases/2008/pr5459-08.html>.

⁵⁶ Press Release, SEC, SEC Charges Hedge Fund Adviser and Principals in \$60 Million Investment Fraud (Mar. 3, 2008), <http://www.sec.gov/news/press/2008/2008-28.htm>.

⁵⁷ Ancient Chinese Proverb, attrib. Confucius. See, e.g., Ralph Kenyon, Knows and Knows Not, <http://www.xenodochy.org/ex/quotes/knowsnot.html> (last visited Mar. 31, 2008).

⁵⁸ See Paredes, *supra* note 37, at 990.

⁵⁹ See generally Brad R. Balter, *Gatekeepers in the Hedge Fund Industry: The Good, the Bad and the Ugly*, AIMA J., Autumn 2007 (arguing that “good” investors can act as gatekeepers in ensuring market discipline).

⁶⁰ See Paredes, *supra* note 37, at 990–98.

⁶¹ *Id.* at 993.

strategy that effectively replicates “earthquake insurance.”⁶² For years the fund may make a tidy profit, and Joe may be very happy with steady, strong returns. But then one year an earthquake strikes, and Joe will be surprised to lose all of his investment. This example is not so far-fetched. The San Diego pension fund brought suit after the collapse of Amaranth citing unexpected, “excessive and unbridled speculation in natural gas futures.”⁶³

B. *Systemic Risk*

Systemic risk captures the possibility of the “knock-on” effect — i.e., that the failure of one hedge fund could cause problems elsewhere in the financial markets: “the possibility of a series of correlated defaults among financial institutions—typically banks—that occurs over a short period of time, often caused by a single major event.”⁶⁴ The paradigm example of the threat systemic risk poses to the global financial markets with regard to hedge funds is the failure of the Long Term Capital Management (“LTCM”) fund in 1998.⁶⁵ Simply put, LTCM took a very large gamble that risky debt would increase in value across the globe.⁶⁶ Two coincident and dramatic world events, however, caused the opposite to happen.⁶⁷ At the time of its collapse, LTCM had \$125 billion in total assets, a leverage ratio of 25:1 and notional derivative positions of over \$1.5 trillion.⁶⁸ When the fund had only \$2 billion of cash-on-hand remaining, it had to be bailed out to the tune of \$3.5 billion by a consortium organized by the Federal Reserve Bank of New York⁶⁹ Consensus at the time, and since, was that, had LTCM fully defaulted on its positions, the

⁶² See Stulz, *supra* note 12, at 17–18.

⁶³ Ann Davis, *San Diego Pension Fund Sues Amaranth Advisors*, WALL ST. J., Mar. 31, 2007, at A7; see also *supra* note 41 and accompanying text.

⁶⁴ Nicholas T. Chan et al., *Systemic Risk and Hedge Funds 1* (MIT Sloan Sch. of Mgmt., Working Paper 4535-05, Feb. 2005), available at <http://ssrn.com/abstract=671443>.

⁶⁵ See, e.g., Paredes, *supra* note 37, at 984; Pekarek, *supra* note 49, at 949.

⁶⁶ See Paredes, *supra* note 37, at 984.

⁶⁷ “Russia devalued the ruble and declared a debt moratorium in 1998, while, at the same time, the Asian financial crisis persisted.” Paredes, *supra* note 37, at 984.

⁶⁸ *Id.*

⁶⁹ Gretchen Morgenson, *Hedge Fund Bailout Rattles Investors and Markets*, N.Y. TIMES, Sept. 25, 1998, at A1.

domino effect “might have led to a series of dramatic and punishing events for LTCM’s trading counterparties and the markets themselves in the event of a default.”⁷⁰

Systemic risk is particularly relevant when considering possible regulation of hedge funds as it is likely that funds will not internalize the risk of catastrophic harm to the markets when considering an investment — i.e., when considering the risk that the a particular investment may fail, managers will not factor the knock-on effect of such failure into their calculus.⁷¹ This effect is amplified by the weighting that “long-tail” events receive in any such calculus. “Long-tail” events are those that have a very small probability of occurring (such as the convergence of the Russian devaluation and the Asian financial crisis), but that have a very large impact when they do occur.⁷² Very unlikely but very severe events will be discounted almost entirely by managers, but present the greatest threat to the global financial system if they happen.

As the hedge fund sector has grown, it has become more and more and integrated with the banking sector.⁷³ Given the highly-leveraged nature and ever-increasing returns of many hedge funds, a large element of the success of many banks in recent years has been attributable to the success of their hedge fund clients. Banks provide many lucrative services as prime brokers, from lending money to advice on finding office space.⁷⁴ Of all the investment banks, Bear Stearns was the most aggressive, with a market-leading 34.6% share of prime brokerage services for funds managed from the US.⁷⁵ As well as being Bear Stearns’ strongest investment

⁷⁰ PWG 1999 REPORT, *supra* note 19, at 18.

⁷¹ Lartese Tiffith, *Hedge Fund Regulation: What the FSA is Doing Right and Why the SEC Should Follow the FSA’s Lead*, 27 NW. J. INT’L L. & BUS. 497, 523 (2007); *see also* FSA, *supra* note 38, at 18–22.

⁷² *See* FSA, *supra* note 38, at 21–22; Chan et al., *supra* note 64, at 6–12.

⁷³ Chan et al., *supra* note 64, at 1 (“[T]he hedge fund industry has a symbiotic relationship with the banking sector, providing an attractive outlet for bank capital, investment management services for banking clients, and fees for brokerage services, credit, and other banking functions.”)

⁷⁴ Gregory Zuckerman, *Hedge Funds, Once a Windfall, Contribute to Bear’s Downfall*, WALL ST. J., Mar. 17, 2008, at C1.

⁷⁵ Lipper HedgeWorld, Service Provider League Table Guide, at Prime Brokerage–1 (2007), *available at* http://www.hedgeworld.com/research/reports/protected/hedgeworld_spltg.pdf.

in recent years, however, hedge funds contributed to its eventual downfall.⁷⁶ First, the number of shares of the bank that were sold short steadily increased from March 2007, doubling over the summer, and eventually reaching 25% of outstanding stock at the time of the collapse.⁷⁷ Most of this stock was likely borrowed by hedge funds whose managers, some argue, may have been privy to some of the troubles Bear Stearns was in.⁷⁸ Second, in the week prior to its collapse, a “wave of nervous [hedge] funds” pulled their prime brokerage accounts from the firm.⁷⁹ Although prime brokerage accounts are completely separate from the bank’s own accounts (which were crippled because of the credit crunch), hedge funds evidently were nervous of having their securities lodged as collateral for their loans from the bank.⁸⁰ This vote of no confidence was enough to finish the bank off.

The oft-cited LTCM example of the threat of systemic risk is from 1998. Other hedge funds have imploded since then, for example Amaranth lost \$5 billion in less than a week in 2006.⁸¹ At that time, there was no knock-on effect whatsoever: only Amaranth and its investors lost money.⁸² Many commentators see this as an indication that the systemic risk from hedge funds is limited; that the market learned its lesson after LTCM, as there have been no problems for ten years. However, the global financial markets were particularly buoyant at the time of Amaranth’s collapse, there was plenty of liquidity, tight credit margins, and no other funds were

⁷⁶ Zuckerman, *supra* note 74. Bear Stearns’ stock dropped 94% between January 1 and March 20, 2008. Gregory Zuckerman et al., *Stocks Tumble Again, but Some Traders Win Big*, WALL ST. J., Mar. 20, 2008, at C1.

⁷⁷ Zuckerman et al., *supra* note 76.

⁷⁸ *Id.* (“Some analysts who follow the moves of short sellers . . . say a big spike in short positions in recent months suggests that some investors might have been privy to information about the brokerage firm’s growing difficulties.”) *Contra id.* (“There is no indication that those betting against Bear Stearns knew something that the rest of the world wasn’t aware of.”).

⁷⁹ Zuckerman, *supra* note 74.

⁸⁰ *Id.*

⁸¹ See *supra* note 41 and accompanying text.

⁸² Annette L. Nazareth, Comm’r, SEC, Remarks Before the PLI Hedge Fund Conference (June 6, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch060607aln.htm>.

in trouble.⁸³ In today's market there is no such certainty. Furthermore, as hedge funds become larger and more complex, it becomes harder for their creditors to judge their strength, particularly as it is now very common for funds to have multiple prime brokers.⁸⁴ Just because hedge funds have not caused a global financial crisis for ten years does not mean their activities pose no systemic risk to the global financial markets.

C. *Corporate Governance*

The final group of entities that regulation of hedge funds could affect are the companies that the hedge funds invest in.⁸⁵ Hedge funds have been both much criticized and much lauded for their governance actions as shareholder activists in recent years.⁸⁶ They have been described, on the one hand, as the “newest version of Wall Street wolves, always poised to attack new companies while claiming to be acting in shareholder's best interests by operating under a cloak of shareholder clothing.”⁸⁷ On the other hand, some commentators believe activist hedge funds are well “positioned to approach corporate governance's theoretical ideal of a vigorous outside monitor.”⁸⁸ Given the amorphous definition of “hedge fund,”⁸⁹ it is worth stressing that currently only a small number of such funds are in fact “activist.”⁹⁰ An estimated \$50 billion of assets under management is in activist hedge funds: less than 5% of total hedge fund portfolios.⁹¹ Furthermore, activist hedge funds are still on a much smaller monetary scale than the private

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ For a detailed discussion of corporate governance and hedge funds, see generally Kahan & Rock, *supra* note 10.

⁸⁶ Compare Andrew M. Kulpa & Butzel Long, *The Wolf in Shareholder's Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures to Exploit Corporate Control and Governance*, 6 U.C. DAVIS BUS. L.J. 4, 4 (2005), <http://blj.ucdavis.edu/article.asp?id=582>, with Oesterle, *supra* note 34, and William W. Bratton, *Hedge Funds and Governance Targets* (Georgetown Law and Economics Research Paper No. 928689 2007), available at <http://ssrn.com/abstract=928689>.

⁸⁷ Kulpa, *supra* note 86.

⁸⁸ Bratton, *supra* note 86, at 54.

⁸⁹ See *supra* Part II.B.

⁹⁰ See Kahan & Rock, *supra* note 10, at 1046.

⁹¹ HEDGE FUND WORKING GROUP (“HFWG”), HEDGE FUND STANDARDS: FINAL REPORT 13 (Jan. 2008), available at <http://www.pellin.co.uk/HFWG/Final-Report.pdf>.

equity buyouts, which totaled over \$160 billion in the US and Europe in 2006.⁹²

As the vast majority of hedge funds are non-activist, any regulation intended to target the corporate governance activities of hedge funds may have disproportionate side-effects on the industry as a whole. This Section will consider how activist hedge funds are able to exert influence over corporate governance, compare these hedge funds with mutual funds and finally consider the costs and benefits of the power these activist hedge funds exert.

1. How Do Hedge Funds Succeed as Corporate Governance Activists?

Activist hedge funds often appear to exert great power even when they have a relatively small share in a company in their portfolio. All the methods have one thing in common — the ability to quickly and quietly amass a significant share in a company, with the credible threat of further action. For example, the hedge fund Third Point quietly obtained 6% stake in Star Gas. Once it achieved its stake, it attacked the company's management and the CEO personally, suggesting that it was not good corporate governance for the CEO's 78-year old mother to serve on the company's board of directors.⁹³ Shortly after, the CEO resigned.⁹⁴ Hedge funds are also successful in often encouraging other investors to follow their activist strategies. This is sometimes because the other investors analyze the strategy and believe it to be good corporate governance (even though they themselves did not have the resources to discover it). Sometimes other investors will simply trust that the hedge fund would only take the action if it would result in an increase in the value of its investment. For example, even though the fund Barington Capital Group held only a 3.1% stake in Nautica Enterprises, it persuaded the proxy voting group ISS to support the fund's nominations of directors, and the nomination was successful.⁹⁵ Finally,

⁹² *Id.* at 13.

⁹³ See Kahan & Rock, *supra* note 10, at 1029.

⁹⁴ *Id.*

⁹⁵ *Id.* at 1030.

hedge funds will often work together with other funds, “hunt[ing] in packs.”⁹⁶

2. Why Do Hedge Funds Differ from Mutual Funds as Activists?

Hedge funds differ in their approach and the scope of activism from the largest institutional investor, mutual funds. Mutual funds engage in less activism, and of a different kind. Their proposals tend to relate to corporate governance rules, rather than specific aspects of corporate policy.⁹⁷ One of the main reasons for the difference in the US, is the differing regulatory structures.

a. US Regulation

There are four primary reasons why, from a regulatory perspective, hedge funds are more likely to be active in corporate governance. The main spheres of regulation affect disclosure, diversification, redemption provisions and fund fee structures.

First, mutual funds are subject to stringent disclosure requirements. Under the Investment Company Act, a fund must disclose the amounts and value of securities it owns every six months, and the way in which it voted those securities.⁹⁸ Hedge funds have much less strict disclosure requirements.⁹⁹ As with any investor, they are covered under section 13(d) of the 1934 Act; any person who owns more than 5% of the equity securities of a public company must disclose.¹⁰⁰ As “institutional investment managers,” hedge funds are also covered by section 13(f) of the act, which requires disclosure of all securities and options traded on public exchanges, if the fund is larger than \$100 million.¹⁰¹ Thus “small” hedge funds are not covered at all. Larger hedge funds can (and do) escape 13(f) disclosures by not buying securities or options

⁹⁶ Emily Thornton, *The New Raiders*, BUS. WK., Feb. 28, 2005, at 32.

⁹⁷ Kahan & Rock, *supra* note 10, at 1043. The authors summarize mutual fund activism as “designed to achieve small changes in multiple companies at little expense,” where as hedge fund aim to “result in big changes in specific companies.”

⁹⁸ Investment Company Act of 1940, § 29(e), 15 U.S.C. §80a-29(e) (2000), 17 C.F.R. § 270.30b1-4 (2006).

⁹⁹ See *infra* Part IV.A.1.

¹⁰⁰ Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2000).

¹⁰¹ Securities Exchange Act of 1934 § 13(f), 15 U.S.C. § 78m(f) (2000).

traded on public exchanges — instead they trade off-exchange derivatives with the same economic effect. Thus it is much easier for hedge funds to achieve the element of surprise which is often necessary in corporate governance situations.¹⁰²

Second, mutual funds are subject to diversification requirements if they are to receive tax benefits.¹⁰³ A certain percentage of the fund's assets are limited such that the fund "may own no more than 10% of the outstanding securities of a portfolio company, and that the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund."¹⁰⁴ The percentage of the fund's assets this applies to is at least 50%, under the diversification requirements in subchapter M of the Internal Revenue Code, and as much as 75% if the fund wishes to obtain the preferred "diversified" label under the Investment Company Act.¹⁰⁵ Given, these limitations, mutual funds are restricted in the use of their funds. As 25% of the assets, however, may be invested however the fund pleases, and there is no inherent limitation on the size of a fund, it is possible a fund could be large enough to make any investment. Hedge funds are subject to no such restrictions, but are generally smaller than mutual funds. The median size of US hedge funds is estimated to be \$25 million, whereas this figure is closer to \$1 billion for US mutual funds.¹⁰⁶ Hedge funds are much more highly leveraged, however, and given their flexibility in focusing their investments, the mere size of mutual funds does not give them more power with regard to corporate governance.

Third, open-end mutual funds have mandated liquidity provisions. At the request of any shareholder, shares are redeemable based on the fund's current net asset value.¹⁰⁷ Clearly, this

¹⁰² Kahan & Rock, *supra* note 10, at 1049, 1063.

¹⁰³ See, e.g., Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 20–22 (1991).

¹⁰⁴ Kahan & Rock, *supra* note 10, at 1049.

¹⁰⁵ Investment Company Act of 1940 § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (2000).

¹⁰⁶ Kahan & Rock, *supra* note 10, at 1048, 1062.

¹⁰⁷ See Investment Company Act of 1940 § 5(a)(1), 15 U.S.C. § 80a-5(a)(1) (2000).

limits the amount of a mutual fund's assets that can be invested in illiquid investments.¹⁰⁸ Hedge funds are subject to no such regulation and are free to include "lock-up" provisions. Investors are unable to withdraw money from the fund for a given period and thus the fund has fixed sum of money it can invest inflexibly. Indeed, the SEC 2004 rule-making attempt may have *caused* hedge fund lock-up period to increase to over two years, likely leading to more hedge fund activism!¹⁰⁹

Finally, mutual funds are limited in the fees they charge to investors. Most relevantly, performance fees must be based on a period of at least twelve months. Thus, after a particularly profitable month, fund investors are able to "cash out," and the full proportion of the performance fees relevant to that investment will not be charged to them — rather it will be spread over the next twelve months.¹¹⁰ Furthermore, this discourages potential investors from investing in the fund as they will be paying fees for returns they have not realized. There are not such regulatory restrictions on hedge funds — fees can be apportioned directly to the withdrawals from the fund.

b. *Other Factors*

Two other factors that help explain the different approaches to corporate governance taken by mutual funds and hedge funds are the incentives the funds have to monitor and the conflicts of interest present with the fund managers. Both factors are currently independent of the regulatory structure, and favor activism from hedge funds.

First, a hedge fund manager has a much higher stake in the financial success of his fund,

¹⁰⁸ The SEC has suggested that no more than 15% of a mutual fund's assets be in illiquid assets. Eleanor Laise, *Mutual Funds Delve into Private Equity*, WALL ST. J., Aug. 2, 2006, at D1.

¹⁰⁹ See *infra* notes 173–175 and accompanying text; see also Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, WALL ST. J., Nov. 10, 2005, at C1 (listing firms that had increased lock-up periods in order to avoid SEC registration).

¹¹⁰ See Kahan & Rock, *supra* note 10, at 1050.

particularly if the manager has a lot of his own personal wealth invested.¹¹¹ Contrary to this, over 90% of mutual funds charge flat-rate fees, which depend on the *size* of the fund, but not its *performance*.¹¹² Mutual funds are measured not by absolute returns, but by their ability to hit certain index return targets, and performance as measured against their competitors. Engaging in activism is costly and risky, and if a mutual fund has a low share in a particular governance target compared to competitor funds, it may actually be disincentivized from activism, as it would not benefit as much as its competitors do from any gains!¹¹³

Second, mutual fund managers are often presented with conflicts of interest that discourage activism.¹¹⁴ Many mutual funds are controlled by large financial institutions, such as investment banks or insurance companies, or the mutual funds themselves control large corporate investment funds.¹¹⁵ These relationships mean the mutual fund managers are discouraged from engaging in activist activities. To do so would not please the clients of their parent firm, or the clients of the fund itself if it is managing a large corporate account.¹¹⁶ Activist hedge funds are much smaller and are independent of these pressures.¹¹⁷

3. Possible Problems of Hedge Fund Activism

Marty Lipton states the issue simply in his memorandum to clients, entitled *Be Prepared for Attacks by Hedge Funds*, when he calls hedge fund managers “self-seeking, short-term speculators looking for a quick profit at the expense of the company and its long-term value.”¹¹⁸ A tripartite of reasons has brought about the increasing focus on hedge fund activism and its

¹¹¹ See *supra* note 11 and accompanying text; see also Kahan & Rock, *supra* note 10, at 1064.

¹¹² Kahan & Rock, *supra* note 10, at 1051.

¹¹³ *Id.* at 1051–54

¹¹⁴ *Id.* at 1051–54, 1066–70.

¹¹⁵ *Id.* at 1054.

¹¹⁶ *Id.* at 1054–55.

¹¹⁷ *Id.* at 1066–68.

¹¹⁸ Memorandum from Martin Lipton, Partner, Wachtell, Lipton, Rosen & Katz, to Clients, *Be Prepared for Attacks by Hedge Funds* (Dec. 21, 2005), available at <http://www.realcorporatelawyer.com/pdfs/wlrk122205-02.pdf>.

relationship to corporate governance.¹¹⁹ First, in order to remain competitive and justify their high-fees, hedge funds have developed increasingly novel methods to make money as the hedge fund market has become saturated.¹²⁰ Second, the benefits of shareholder (and hence hedge fund) activism have become more accepted and realized in recent years — particularly since Enron. Third, as the previous Part demonstrates, the current regulatory structure enables it.¹²¹ As activist hedge funds demonstrate the success of their strategies, the proportion of activist funds will undoubtedly increase.¹²² It is helpful to consider briefly the problems that hedge fund activism may raise and that regulators may consequently wish to tackle.¹²³

First, the prototypical hedge fund is, by definition, hedged — and thus will short certain stocks.¹²⁴ If it votes stock it does not own, the fund is engaging in “empty voting,” effectively betting *against* the price of some stock it “holds.” The fund may get the stock by borrowing it or through some other, more complex, financial structure. It is possible that some “corporate governance activity,” say the blockage of a merger, would then be diametrically opposed to the wishes of the investee firm and its other shareholders.¹²⁵ There are a number of examples of hedge funds engaging in such “activism,” to the certain detriment of other shareholders.¹²⁶

Second, in light of the power that hedge funds have as shareholder activists, we might expect to

¹¹⁹ Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 684 (2007).

¹²⁰ See Kulpa, *supra* note 86.

¹²¹ See *infra* Part III.C.2.a.

¹²² See generally Bratton, *supra* note 86 (conducting empirical studies of shareholder activism by hedge funds).

¹²³ A full analysis of the costs and benefits of hedge fund activism is beyond the scope of this Paper. See Kahan & Rock, *supra* note 10, at 1070–91 for a thorough investigation.

¹²⁴ See *supra* notes 6–7 and accompanying text.

¹²⁵ See Kahan & Rock, *supra* note 10, at 1072–77.

¹²⁶ *Id.* at 1073–74. The hedge fund, Highfields, held just less than 5% of MONY, a life-insurance firm that was being acquired by AXA. As a substantial shareholder it argued against the acquisition and convinced other investors to follow its lead. Highfields, however, was secretly holding certain instruments created by AXA that would be very valuable if the merger did not go through (regardless of the effect on MONY). While apparently acting as an “activist” in favor of MONY, Highfields was likely acting against MONY’s best interests. *Id.*

see investee companies paying funds off, emulating the problems of 1980's "greenmail."¹²⁷ To date, however, this has not been a problem, at least not publicly. Third, and most concerning for many commentators, is the possible problem of "short-termism."¹²⁸ It is unlikely that hedge funds will be investing in the same company for years, and so firms may be incentivized to bring about short-term gains in their investee companies, even if such gains harm the companies in the long run.¹²⁹ This criticism of activist hedge-funds is controversial, as it rests on the assumption that markets are short-sighted.¹³⁰ In a perfect market, any long-term benefits or harms would be factored into the current stock price; and as Commissioner Campos has noted "[e]ven if a hedge fund is looking for short-term gains, it is possible that their strategies will improve a company's long-term prospects as well."¹³¹

The costs and benefits of hedge fund activism are not well understood, and commentators disagree as to how the balance of regulation should be struck.¹³² The benefits of accountability and the ability of hedge funds to prompt other investors' beneficial corporate governance activities should not be underestimated.¹³³ Marty Lipton, the fiercest critic of hedge fund activism, unwittingly demonstrates one possible benefit in his memo to clients, *Attack by Activist Hedge Funds*.¹³⁴ He presented a checklist of advice, one item of which is to "[r]eview basic strategy and evaluation of portfolio of businesses with the board [of directors] in light of possible arguments for spinoffs, share buybacks, special dividends, sale of the company or other

¹²⁷ Kahan & Rock, *supra* note 10, at 1082.

¹²⁸ *Id.* at 1083.

¹²⁹ *Id.*

¹³⁰ *Id.* at 1083–86.

¹³¹ Roel C. Campos, Comm'r, SEC, Remarks Before the SIA Hedge Funds & Alternative Investments Conference (June 14, 2006), available at <http://www.sec.gov/news/speech/2006/spch061406rcc.htm>.

¹³² See, e.g., Briggs, *supra* note 119, at 722 ("It is too early to say whether hedge fund activism is profitable for the funds, value-maximizing for other public shareholders, or good for corporate governance in the United States generally."); see also *supra* note 86.

¹³³ Bratton, *supra* note 86, at 24.

¹³⁴ Memorandum from Martin Lipton, Partner, Wachtell, Lipton, Rosen & Katz, to Clients, Attacks by Activist Hedge Funds (Mar. 7, 2006), available at http://online.wsj.com/documents/wsj-law_act-Hfunds.pdf.

structural changes.”¹³⁵ If the presence of activist hedge funds in the market ensures that companies take such action, perhaps it should not be discouraged! The few empirical studies that have considered hedge fund activism have generally found positive results.¹³⁶

IV. HEDGE FUND REGULATION IN THE US

A. *History of Hedge Fund Regulation in the US*

1. Legislative Structure

Before analyzing recent proposals, it is helpful to understand the historic legislative regulatory structure. In the United States, there are four key pieces of legislation under which entities similar to hedge funds *could* be regulated, were they not subject to various exceptions. Hedge funds are structured specifically to avoid the more stringent regulation under each piece of legislation. The various pieces of legislation have overlapping requirements, primarily covering the number of investors, the “type” of investors, and the way investors are solicited.¹³⁷

a. *Securities Act of 1933*

Regulation under the 1933 Act is intended ensure investors receive material information concerning securities that are available for public sale, and hence to prohibit fraud and deceit in the sale of securities. Hedge funds are structured to fall within section 4(2) of the Act, which exempts the highly detailed disclosure requirements for “transactions by an issuer not involving any public offering.”¹³⁸ Rule 506 of Regulation D further defines the “safe harbor” requirements to fall within this exemption.¹³⁹ Hedge funds must not sell to more than 35 investors who are not

¹³⁵ *Id.*

¹³⁶ See Bratton, *supra* note 86, at 53–54; Briggs, *supra* note 119, at 721.

¹³⁷ Much scholarship discusses this legislation and the applicability of the various exemptions in depth. A cursory analysis is all that is necessary for purposes of this paper. When the legislation overlaps, only the most limiting instances are considered. For further details, see, for example, Tiffith, *supra* note 71, at 509–14; Donahue, *supra* note 44, at 249–52; Sargon Daniel, *Hedge Fund Registration: Yesterday’s Regulatory Schemes for Today’s Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247, 257–66.

¹³⁸ 15 U.S.C. § 77d(2) (2000).

¹³⁹ 17 C.F.R. § 230.506.

accredited.¹⁴⁰ Accredited investors under the 1933 Act are those whose net worth is greater than \$1 million or whose income is greater than \$200,000.¹⁴¹ Hedge funds, also must not advertise or solicit the purchase of interests in the fund, and must take reasonable steps to ensure that their investors do not plan to sell their interests.¹⁴²

b. *Securities Exchange Act of 1934*

The 1934 Act contains stringent registration and disclosure requirements for dealers in securities, and so hedge fund managers seek to avoid being registered as “broker-dealers” under Section 15 of the Act. They aim to fall within the “trader exception,” such that they are deemed to trade securities for their own accounts, not as part of a business.¹⁴³ Furthermore, to avoid regulation under Section 12 of the Act, hedge funds must ensure they have less than 500 interest holders or less than \$10 million of assets.¹⁴⁴

Hedge funds are subject to other regulation under the 1934 Act, regarding the investments the funds make, including the short-swing profits provision in Section 16 and the periodic reporting requirements of Section 13(f).¹⁴⁵ With regard to the latter, however, many hedge funds are successful in avoiding disclosure.¹⁴⁶

c. *Investment Company Act of 1940*

The Investment Company Act requires entities that fall within its remit to register with the SEC and comply with the regulatory and disclosure requirements therein.¹⁴⁷ There are two exceptions that may apply to hedge funds. Under section 3(c) of the Act, an entity is excluded if it either has less than 100 private investors or the investments are owned only by “qualified

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at § 230.215.

¹⁴² See 17 C.F.R. §§ 230.501, 230.502, 230.506; see also Tiffith, *supra* note 71, at 509–10.

¹⁴³ Willa E. Gibson, *Is Hedge Fund Regulation Necessary*, 73 TEMP. L. REV. 681, 692 (2000).

¹⁴⁴ 15 U.S.C. § 78(l)(g) (2000).

¹⁴⁵ See, e.g., Tiffith, *supra* note 71, at 511–12; Gibson, *supra* note 143, at 692–93.

¹⁴⁶ See *supra* notes 100–102 and accompanying text.

¹⁴⁷ See *supra* note 98 and accompanying text.

purchasers.”¹⁴⁸ A qualified purchaser is an individual with more than \$5 million of investments.¹⁴⁹

d. *Investment Advisers Act of 1940*

Under the Act, investment advisers are subject to unannounced searches by the SEC of books and records, limits on the performance fees that may be charged and further filings and disclosure.¹⁵⁰ Hedge fund managers fall within the broad scope of the Act, as they advise clients regarding investment opportunities.¹⁵¹ However, the Act contains a “private advisor exemption,” exempting hedge fund managers if they (1) “had fewer than fifteen clients” in the proceeding 12 months; (2) do not hold themselves “out generally to the public as an investment adviser” and (3) do not act as an “investment adviser to any [registered] investment company.”¹⁵² Crucially for purposes of this test, the clients of the investment manager for purposes of the Act are deemed to be the individual hedge funds. The funds are organized as a limited partnership, with each investor investing as limited partners, and the fund manager serving as the general partner.¹⁵³

e. *Summary of Historic Legislation*

In order to summarize the kinds of hedge fund that may exist in the US, consider the following three “kinds” of investor:

Non-Accredited Investor — an individual investor who earns less than \$200,000 and has assets worth less than \$1,000,000;

Accredited Investor — an individual who earns \$200,000 or more or has assets worth \$1,000,000

¹⁴⁸ 15 U.S.C. § 80a-3(c)(1), (7) (2000).

¹⁴⁹ *Id.* at § 80a-2(a)(51).

¹⁵⁰ *E.g., id.* at § 80b-4; *see* Pekarek, *supra* note 49, at 926.

¹⁵¹ Recent Development in Hedge Funds: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs, 108th Cong. 35 (2003) (prepared statement of William H. Donaldson, Chairman, SEC), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_senate_hearings&docid=f:92703.pdf (“Managers of hedge funds meet the definition of ‘investment adviser’ under the Investment Advisers Act of 1940 because they are in the business of providing investment advice about securities to others.”).

¹⁵² 15 U.S.C. § 80b-3(b)(3) (2000).

¹⁵³ 17 C.F.R. §§ 275.203(b)(3)-1(a), (b)(3); *see* Gibson, *supra* note 143, at 698.

or more and certain other entities; and

Super-Accredited Investor — an individual who owns \$5,000,000 worth of investments and certain entities that own \$25,000,000 of investments.

There are two “kinds” of hedge fund that satisfy all of the above provisions:¹⁵⁴

A “3(c)(1)-type hedge fund” — which has up to 100 investors, provided that no more than 35 investors are non-accredited investors.

A “3(c)(7)-type hedge fund” — which has up to 500 super-accredited investors.¹⁵⁵

In molding themselves to fit all of these exceptions, hedge fund managers are able to operate with little US regulatory oversight.¹⁵⁶

2. The SEC’s 2004 Rule-making and *Goldstein*

In 2004, the SEC revised the rules applying to the Investment Advisers Act of 1940 that effectively brought all hedge fund managers within the remit of the Act.¹⁵⁷ Soon afterwards, however, the rule was struck down by the U.S. Court of Appeals for the District of Columbia, as an invalid exertion of administrative power.¹⁵⁸ The regulatory approach the SEC took appeared rushed, was generally unpopular, and appears to represent the high-water market of regulatory efforts by the SEC to date.

a. *SEC Rulemaking*

In 2002, the SEC undertook an investigation of the fast-growing hedge fund industry.¹⁵⁹ In the resulting Report and rule-making, the Commission identified three primary reasons for its concern: (1) that “the number and size of hedge funds were rapidly growing and that this growth

¹⁵⁴ This summary is taken from Hedge Fund Tour, <http://www.moneymanagerservices.com/tour/sales.cfm> (last visited Mar. 31, 2008).

¹⁵⁵ In these titles, “3(c)(1)” and “3(c)(7)” refer to

¹⁵⁶ Pekarek, *supra* note 49, at 924.

¹⁵⁷ See *supra* Part IV.A.1.d.

¹⁵⁸ *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

¹⁵⁹ STAFF REPORT TO THE SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

could have broad consequences for the securities markets for which we are responsible;” (2) that there were an increasing number of cases of fraud being brought against hedge fund managers; and (3) that less advanced investors were beginning to be affected by the industry.¹⁶⁰

In order to bring hedge fund managers within the scope of the Investment Advisers Act, the SEC closed the “loop-hole” that allowed each individual hedge fund to be counted as a “client” for purposes of the Act. Now, managers would have to count each individual investor in the hedge fund as a client.¹⁶¹ The limit of 15 “clients” before the Act applied would now be prohibitively small, and the presumption was that most hedge funds would fall within the Act.

The SEC rulemaking, though apparently only changing one small definition applying to one of the four relevant Acts, would have had a very large effect on the regulatory structure applied to hedge funds. Funds would have been subject to the full provisions of the Investment Advisers Act. This would subject them to the SEC’s regular inspections and examinations program, and would force funds to disclose significant amounts of information to investors.¹⁶² Specific aspects of registration included “the designation of a chief compliance officer; the presence of written policies and procedures; a code of ethics; and retention of books and records”¹⁶³

Some commentators suggested that the SEC hurried into the rulemaking, prompted by recent controversy surrounding hedge funds and the timing of the purchase of mutual fund

¹⁶⁰ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 n.15 (Dec. 10, 2004), available at <http://a257.g.akamaitech.net/7/257/2422/06jun20041800/edocket.access.gpo.gov/2004/pdf/04-26879.pdf>; see also Pekarek, *supra* note 49, at 924.

¹⁶¹ “Our actions today withdraw that safe harbor and require advisers to “private funds”— which will include most hedge funds—to “look through” the funds to count the number of investors as “clients” for purposes of the private adviser exemption.” Investment Adviser Registration Final Rule, *supra* note 160, at 72,065.

¹⁶² See Tiffith, *supra* note 71, at 518.

¹⁶³ David M. Katz, *Lawmakers: Hedge-Fund Risk Hits Pensions*, CFO.COM, Mar. 13, 2007 (quoting Kenneth Brody, founder of Taconic Capital Advisors).

shares.¹⁶⁴ It was perhaps a little embarrassing to the SEC that, using a New York state law, Eliot Spitzer (then the State Attorney General) had reached a \$40 million settlement with Canary Capital Partners, including \$30 million of restitution of illegal profits from mutual fund trading schemes.¹⁶⁵

b. *Response to the Amended Rule*

There was much disagreement and resistance to the revised rule, unsurprisingly from the hedge fund industry, but also from within the SEC and other prominent figures in the financial markets. The rule was promulgated when William Donaldson was Chairman of the SEC. The other four commissioners who voted were split, with Cynthia Glassman and Paul Atkins publishing their dissents along with the final rule.¹⁶⁶ The dissent gave three key reasons for its dissatisfaction with the rule: (1) that alternatives to the rulemaking should have been considered, including better enforcement of current applicable provisions and other less stringent possible rules; (2) that the Commission's findings of fraud were possibly overstated, and the new registration requirements would not have prevented many of the instances of fraud cited in support of the rule; and (3) that the Commission's already limited resources would be too far stretched.¹⁶⁷ Atkins noted that the institutionalization of hedge fund investors had already led to greater self-regulatory oversight, as investors "require funds to complete voluminous questionnaires about management, investment procedures, and operational and risk controls."¹⁶⁸

When the proposed rule was first published, over 150 comment letters were received,

¹⁶⁴ "Most disturbing is that hedge fund advisers have been key participants in the recent scandals involving late trading and inappropriate market timing of mutual fund shares." Investment Adviser Registration Final Rule, *supra* note 160, at 72,056.

¹⁶⁵ Press Release, New York State Attorney General, State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html. When promulgating the new rule, although the text in the Federal Register mentions Canary Partners, there is no mention of Spitzer's settlement.

¹⁶⁶ Investment Adviser Registration Final Rule, *supra* note 160, at 72,089–98.

¹⁶⁷ *See id.* at 72,089–90

¹⁶⁸ *Id.* at 72,094 n.58 (quoting Comment Letter of Schulte, Roth & Zabel LLP (Sept. 15, 2004)).

only 30 of which were in support of the rule.¹⁶⁹ Then Chairman of the Federal Reserve, Alan Greenspan was quoted as warning that “the initiative cannot accomplish what it seeks to accomplish.”¹⁷⁰ The President’s Working Group was not consulted.¹⁷¹ Hedge fund managers faced with the new rule had three options. First, they could comply with the new provisions and register. Second, they could attempt to find another loophole. Third, they could disregard the new rule and carry on as before. A number of funds managers did take the first option and registered. Each of the other two options, however, were also taken, and have led to more interesting results.

The loophole many hedge funds found was through a provision in the new Rule which was included by the SEC drafters to prevent venture capital and private equity funds from being covered by the Act.¹⁷² Rule 203(b)(3)-1 was amended such that the definition of “private funds” regulated by the Act only included funds that permit their owners “to redeem any portion of their ownership interests within two years of the purchase.”¹⁷³ This once again demonstrates the chameleon nature of hedge funds; the only distinction the SEC could find between private equity and most types hedge funds was the difference in lock-up provisions.¹⁷⁴ Prior to the change, however, many hedge funds actually did have lock-up provisions of up to a year, and the inevitable result of the rule-making was that many hedge fund managers increased lock-up period to two years or more — once against fitting themselves in the cracks!¹⁷⁵

¹⁶⁹ Paul S. Atkins, Comm’r, SEC, Speech at Open Meeting to Consider the Registration of Hedge Fund Advisers (Oct. 26, 2004) (transcript available at <http://www.sec.gov/news/speech/spch102604psa.htm>).

¹⁷⁰ *Id.*; see also Lee Conrad, Compliance: Hedge Fund Registration Sparks Broad Criticism, *US BANKER*, Dec. 2004, available at <http://www.us-banker.com/article.html?id=20041201J3Q4VGSK> (last visited Mar. 31, 2008).

¹⁷¹ Atkins, *supra* note 169; see *infra* Part IV.B.

¹⁷² See, Paredes, *supra* note 37, at 1016.

¹⁷³ Investment Adviser Registration Final Rule, *supra* note 160, at 72,088.

¹⁷⁴ See Ordower, *supra* note 1, at 324 (“Promoters of hedge funds design their funds to fit these regulatory exceptions. As exceptions change, hedge funds adjust in structure in order to remain unregulated.”)

¹⁷⁵ See, e.g., Pekarek, *supra* note 49, at 933 n.76; Paredes, *supra* note 37, at 1017 n.157.

c. *The Goldstein Decision and its Aftermath*

Philip Goldstein, manager of the *Bulldog Investors* group of hedge funds took the third option. He disregarded the rule and brought suit in Federal court in the District of Columbia, alleging that the SEC had abused its agency rulemaking powers in changing the definition of “client”.¹⁷⁶ The D.C. Circuit looked to the legislative history of the Investment Advisers Act and the SEC’s prior interpretation of the term and unanimously agreed with Goldstein’s position, finding the agency’s rulemaking to be “arbitrary”.¹⁷⁷ The logic of the court’s decision is debatable and a number of commentators attacked it from an administrative law perspective, particularly given the stated underlying objectives of the Investment Advisers Act.¹⁷⁸

The immediate legislative response to *Goldstein* was dramatic. Six days after the Court of Appeal decision, handed down on June 23, 2006, Rep. Barney Frank introduced a bill, The Securities and Exchange Commission Authority Restoration Act of 2006,¹⁷⁹ to the House. Though the Bill never made it out of committee, the proposal was to enable the SEC to re-promulgate the exact same Rule that was thrown out by the Court.

Not to be outdone, the SEC also came out swinging. The new Chairman, Christopher Cox testified before U.S. Senate Committee on Banking, Housing and Urban Affairs on July 25, 2006.¹⁸⁰ The level of rhetoric was as high as that found in the earlier rulemaking — Cox pointed to recent examples of fraud and instability caused by hedge funds. Cox stressed that,

notwithstanding the *Goldstein* decision, hedge funds today remain subject to SEC regulations and enforcement under the antifraud, civil liability, and other

¹⁷⁶ This discussion simplifies the arguments brought by both sides in the case. For a more expansive discussion, see generally Pekarek, *supra* note 49, at 933–55.

¹⁷⁷ *Goldstein v. SEC*, 451 F.3d 873, 883–84 (D.C. Cir. 2006).; *see also* Pekarek, *supra* note 49, at 940.

¹⁷⁸ *See, e.g.,* Recent Case, *District of Columbia Circuit Vacates Securities and Exchange Commission’s “Hedge Fund Rule”*, 210 HARV. L. REV. 1394, 1401 (2007).

¹⁷⁹ H.R. 5712, 109th Cong. (2d Sess. 2006) (introduced on June 29, 2006); *see also* Pekarek, *supra* note 49, at 959–60.

¹⁸⁰ Testimony Concerning the Regulation of Hedge Funds, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 25, 2006), *available at* <http://sec.gov/news/testimony/2006/ts072506cc.htm>

provisions of the federal securities laws. We will continue to vigorously enforce the federal securities laws against hedge funds and hedge fund advisers who violate those laws. Hedge funds are not, should not be, and will not be unregulated. The challenge for the SEC and the President's Working Group going forward is, rather, to what extent to add new regulations, particularly in light of the recent Court of Appeals ruling.¹⁸¹

Chairman Cox also announced two new proposals, one to “expand the Commission’s authority to hold hedge fund advisers accountable for fraud against individual hedge fund investors,” and one to “update protections for unsophisticated investors by raising the thresholds to qualify for sophisticated investor status.”¹⁸² The proposed rules were issued on January 4, 2007.¹⁸³

Over the course of 2007, however, it became apparent that the SEC was not going to pursue as tenaciously the course of direct regulation of hedge funds that the Commission had followed under Chairman Donaldson.¹⁸⁴ The Commission decided not to appeal the *Goldstein* decision to the Supreme Court.¹⁸⁵ Furthermore, only the first of the two proposed rules was adopted, on August 3, 2007¹⁸⁶ and its scope was not as wide as first anticipated. It explicitly served only to reinstate and reinforce powers that the Commission (and everyone else) believed it already had prior to *Goldstein*.¹⁸⁷ Consideration of the second proposal has been postponed while the Commission considers more broad regulation of the “accredited investor” standard

¹⁸¹ *Id.*

¹⁸² Press Release, SEC, State of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in *Phillip Goldstein, et al. v. SEC* (Aug. 7, 2006), <http://sec.gov/news/press/2006/2006-135.htm>.

¹⁸³ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400 (Jan. 4, 2007).

¹⁸⁴ See, e.g., Verret, *supra* note 3, at 812.

¹⁸⁵ Press Release, *supra* note 182 (noting that “the appellate court’s decision was based on multiple grounds and was unanimous”)

¹⁸⁶ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756 (Aug. 9, 2007).

¹⁸⁷ “As a result [of *Goldstein*], it was unclear whether the Commission could continue to rely on sections 206(1) and (2) of the Advisers Act to bring enforcement actions in certain cases where investors in a pool are defrauded by an investment adviser to that pool.” *Id.* at 44,757. See also David M. Mahle, Jones Day Commentaries, SEC Adopts Rule on Fraud by Advisers to Pooled Investment Vehicles; Defers on Standards for Accredited Investors in Certain Private Investment Vehicles (Aug. 2007), http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4524.

under Regulation D.¹⁸⁸

B. *Current Developments in Hedge Fund Regulation in the US*

1. The Move Towards Self-Regulation

A number of prominent figures close to the Commission have expressed support for a self-regulatory scheme. Of the five Commissioners who voted on the earlier Rule, only one, Paul Atkins, remains on the Commission.¹⁸⁹ Speaking in May 2006 (just prior to the *Goldstein* decision), he said

[T]he Commission erred in requiring hedge fund advisors to register. Investors lose out. . . . All hedge fund investors will end up paying for something that some of them did not want. . . . One-size-fits-all regulatory mandates, although generally well-intentioned, deprive investors of decision-making power that is rightfully theirs and may impose costs on investors that do not produce a proportionate return. Investors are best able to make this determination. If SEC-registration were perceived to be uniformly desirable, the market — meaning investors — would eventually lead all hedge fund advisers to register.¹⁹⁰

The first SEC Chairman appointed by President Bush, Harvey Pitt, who preceded Donaldson,¹⁹¹ has explicitly spoken in favor of self-regulation for hedge funds, saying “If the hedge fund industry is able to realize that the benefits of self-regulation outweigh their costs, for a few dollars more the industry can protect itself from unwelcome government intervention. . . . Absent any concrete suggestions from hedge funds . . . legislators and regulators will be happy to propose their own solutions, no matter how impractical.”¹⁹²

Chairman Cox has also expressed support of self-regulatory approach, particularly with

¹⁸⁸ See, e.g., Mahle, *supra* note 187. Interestingly, the proposed rule affecting the definition of “accredited investor” does not consider the effect of such a change on hedge funds. Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. 45,116 (Aug. 10, 2007).

¹⁸⁹ SEC, Historical Summary of Chairman and Commissioners, <http://www.sec.gov/about/sechistoricalsummary.htm> (last visited Mar. 31, 2008).

¹⁹⁰ Paul S. Atkins, Comm’r, SEC, Remarks Before the N.Y. City Bar Assoc. (May 5, 2006), available at <http://www.sec.gov/news/speech/2006/spch050506psa.htm>.

¹⁹¹ Pitt was Chairman from August 2001 to February 2003. Donaldson was Chairman from February 2003 to June 2005. Cox has been Chairman since August 2005. SEC, *supra* note 189.

¹⁹² Emily Chasan, *Former SEC Head Urges Hedge Funds to Self-Regulate*, REUTERS, May 16, 2007, <http://www.reuters.com/article/ousiv/idUSN1626114020070517?sp=true>.

regard to investor protection. Discussing the announcement of the formation of FINRA from the combination of NASD and the regulatory arm of the New York Stock Exchange (“NYSE”), he said the merger would “simplify and strengthen the current self-regulatory structure in the United States,” and enthused about the benefits of self-regulation.¹⁹³ When discussing direct regulation of hedge funds, Chairman Cox has focused recently only on insider trading fraud prevention and systemic risk.¹⁹⁴ The Commissioners have also indicated their willingness to instead following the lead of a larger group on which the Commission is represented, the President’s Working Group.¹⁹⁵

2. The President’s Working Group

The President’s Working Group on Financial Markets (“PWG”) was formed in 1988 by President Reagan, and consists of the Secretary of the Treasury and the Chairmen of the SEC, the Federal Reserve and the Commodity Futures Trading Commission, or their representatives.¹⁹⁶

The initial purpose of the PWG was to investigate the causes of the 1987 Wall Street crash, and

¹⁹³ Christopher Cox, Chairman, SEC, Statement at News Conference Announcing NYSE-NASD Regulatory Merger (Nov. 28, 2006), available at <http://www.sec.gov/news/speech/2006/spch112806cc.htm>. “Self regulation has played a key role in protecting investors for a very long time. Most observers agree that the SRO system has functioned effectively, and has served the government, the securities industry, and investors well. But despite this general agreement, one feature of the system in particular has increasingly drawn the attention of reformers — and that is its reliance on multiple, redundant regulators.” *Id.*

¹⁹⁴ Christopher Cox, Chairman, SEC, Remarks to the *SEC Speaks in 2008* Program of the Practising Law Institute (Feb. 8, 2008), available at <http://www.sec.gov/news/speech/2008/spch020808cc.htm> (“Any hedge fund or other large investor who thinks they’ll get away with dishonest and unfair dealing in our markets will face the concentrated resources of a relentless SEC.”); Christopher Cox, Chairman, SEC, Address to the 39th Annual Rocky Mountain Securities Conference (May 11, 2007), available at <http://www.sec.gov/news/speech/2007/spch051107cc.htm> (“Only with the active assistance of our colleagues abroad will we be able to fully confront the challenge of enforcement in a global environment. The same is true of our concern with the systemic risk posed by over 9,000 hedge funds in both our national and the world’s economy. We want to maintain the advantages of market liquidity while preserving the safety and security of world markets.”)

¹⁹⁵ See, e.g., Andrew J. Donohue, Comm’r, SEC, Keynote Address at the 9th Annual International Conference on Private Investment Funds (Mar. 10, 2008), available at <http://www.sec.gov/news/speech/2008/spch031008ajd.htm> (“My staff and I will continue to work with the industry to encourage compliance by private funds and their advisers with all regulatory requirements and with the industry’s own best-practice standards.”); Interview by EDHEC-Risk with Paul S. Atkins, Comm’r, SEC (Jan. 14, 2008), available at <http://www.edhec-risk.com/Interview/RISKArticle.2008-01-14.5808> (“Chairman [Cox] has been an active participant in the important work of the President’s Working Group . . . Last February, the PWG put out a policy statement regarding private pools of capital that supported a market-based approach with government regulation as the exception.”); see also Verret, *supra* note 3 at 812 n.74.

¹⁹⁶ Exec. Order No. 12,631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

to make recommendations based on “the goals of enhancing the integrity, efficiency, orderliness, and competitiveness of [the U.S.] financial markets and maintaining investor confidence” for the future.¹⁹⁷ The stated goals of the PWG remain the same, though its scope has expanded to cover all aspects of financial regulation.¹⁹⁸

In 1999, the PWG published a major report on Hedge Funds, focusing on the concerns of excessive leverage that were abound in the aftermath of the collapse of Long Term Capital Management.¹⁹⁹ The Report explicitly noted that the PWG was not recommending anything more than “indirect regulation.”²⁰⁰ The next publication of the PWG on the subject of hedge funds was in February 2007, entitled *Agreement among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*.²⁰¹ The Agreement made it clear that the PWG still believed that the “current regulatory structure . . . [was] working well,” and quoted the 1999 Report: “[I]n our market-based economy, market discipline of risk-taking is the rule and government regulation is the exception.”²⁰²

3. Self-Regulatory Committees in 2007–08

In June 2007, Treasury Secretary Henry Paulson announced the “next steps of his capital

¹⁹⁷ *Id.*

¹⁹⁸ Press Release, President’s Working Group Releases Common Approach to Private Pools of Capital Guidance on Hedge Fund Issues Focuses on Systemic Risk, Investor Protection (Feb. 22, 2007), <http://www.treasury.gov/press/releases/hp272.htm>.

¹⁹⁹ PWG 1999 REPORT, *supra* note 19. The Report was published primarily in response to the collapse of LTCM the year before, and the effects that that had on the financial markets. *Id.* at viii. For more details on LTCM and its effects see *supra* Part III.B.

²⁰⁰ *Id.* at ix (“If further evidence emerges that indirect regulation of currently unregulated market participants is not effective in constraining excessive leverage, there are several matters that could be given further consideration; however, the Working Group is not recommending any of them at this time.”).

²⁰¹ PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL 1 (2007) (hereinafter PWG PRINCIPLES & GUIDELINES), *available at* http://www.treasury.gov/press/releases/reports/hp272_principles.pdf (“Since we last made a statement on these issues in 1999, the market has matured and expanded considerably . . .”).

²⁰² *Id.* (quoting PWG 1999 REPORT, *supra* note 19, at 26).

markets competitiveness action plan.”²⁰³ The overarching goal was a “rationalized regulatory structure with improved oversight, increased efficiency, reduced overlap and the ability to adapt to market participants’ constantly-changing strategies and tools.”²⁰⁴ This was the first time that the US regulators had announced a plan with the focus so heavily on self-regulation with regard to hedge-funds. Paulson introduced a two-part initiative: The PWG would work separately with asset managers and investors to “define separate sets of best practices that address investor protection, enhance market discipline and mitigate systemic risk,” in line with the PWG *Principles and Guidelines* released earlier in the year.²⁰⁵ In September 2007 the details of the plan were announced. Chairing the Investors’ Committee was Russell Read, chief investment officer of CalPERS: “one of the most influential jobs in US capital markets.”²⁰⁶ The chair of the Asset Managers’ Committee was Eric Mindich, the chief executive officer of hedge fund Eton Park.²⁰⁷ The original plan was to publish reports for public comment by the end of 2007, but this date slipped until the reports were finally published on April 15, 2008.²⁰⁸ At the Managed Funds Association’s *Network 2008* conference in, Mr. Read presented the “Highlights of Recommendations” of the Investors’ Committee Report.²⁰⁹ When considering investing in hedge funds, the Committee has different advice for fiduciary investors and individual investors.

The report recommends that fiduciary investors should 1) not feel forced to invest in

²⁰³ Press Release, Paulson Announces Next Steps to Bolster U.S. Markets’ Global Competitiveness (June 27, 2007), <http://www.treas.gov/press/releases/hp476.htm>.

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ Anuj Gangahar, *Duo to Draw Up Best Practice for Hedge Funds*, FIN. TIMES (USA), Sept. 25, 2007, at World News.

²⁰⁷ There was some surprise at the appointment of Mindich. Although appointed by Paulson (Bush’s treasury secretary), “Mindich is a top-level Democratic fund-raiser.” Editorial, Robert Novak, *Bush’s Treasury Chief Lacks Strong GOP Ties*, Oct. 1, 2007, CHI. SUN TIMES, at 35. A treasury spokesman noted that “[they] were looking for somebody who is well-respected in the industry’ to fill what is ‘not really a political position.’” *Id.*

²⁰⁸ Press Release, PWG Private-Sector Committees Release Best Practices for Hedge Fund Participants (Apr. 14, 2008), <http://www.ustreas.gov/press/releases/hp927.htm>.

²⁰⁹ Russell Read, Chairman, PWG Investors’ Committee, Presentation on Principles and Practices for Hedge Fund Investors 10 (Feb. 12, 2008), *available at* <http://www.managedfunds.org/downloads/Russell%20Read%20presentation.ppt>.

hedge funds; 2) consider the role of the hedge fund investment in their investment program; and 3) consider the appropriateness of the investment, which depends “upon the goals of the plan, [the] sophistication of the investor/plan,” the ability to determine whether the fund has a “compelling role in the portfolio, and [the] ability to identify compelling hedge funds”.²¹⁰ Recommendations for individual investors are that they 1) have a detailed investment policy, with performance and risk expectations and parameters; 2) perform effective due diligence, needed to “effectively evaluate managers and the expected impact on portfolio risk/returns typically using customized due diligence questionnaires”; and 3) have adequate risk measurement procedures.²¹¹ Both fiduciary and individual investors should also have the expertise to sufficiently evaluate, monitor, hire and fire hedge fund managers.²¹² Mr Reed also noted that the new committees are standing committees, and will “continue to address areas of concern to the hedge fund industry and investors as they arise,” with the intention of fostering “a healthy long-term environment for the hedge fund industry and investors.”²¹³

The findings of the PWG Investors’ Committee reflect a recent trend that a large part of the onus of investment assessment should rest with the investors themselves, rather than with direct regulation of the funds.²¹⁴ In line with this, in January 2008, a trade organization, the Alternative Investment Management Association (“AIMA”) announced the creation of an Investor Steering Committee: “the first global effort between investors and the hedge fund

²¹⁰ *Id.* at 15.

²¹¹ *Id.* at 16. Risk measurement procedures should include measurement of “market, business, process, style, model, leverage, liquidity, legal and tax needs.” *Id.*

²¹² *Id.* at 15, 16.

²¹³ *Id.* at 17.

²¹⁴ *See supra* note 60. As part of recent PWG report investigating the effects of the recent credit crunch, the PWG said “financial regulators should require investors to seek more information about credit risk before investing. As one example, the group said the US Department of Labor could require investors in private pension funds to do more research about investment risks.” Pete Kasperowicz, *US Seeks More Regulations for Mortgage Brokers, Financial Institutions*, FORBES, Mar. 13, 2008, available at <http://www.forbes.com/markets/feeds/afx/2008/03/13/afx4768716.html>.

industry.”²¹⁵ Its goal is to “provide access to meaningful and practical information on the nature and activities of the hedge fund industry — including information on hedge fund strategies, performance data, investment processes, and industry and business dynamics.”²¹⁶ There is much overlap between the AIMA Committee and the PWG Investors’ Committee, and Russell Read has noted that the work will “complement” the work of the PWG Committee.²¹⁷

V. HEDGE FUND REGULATION IN THE UK

A. *History of Hedge Fund Regulation in the UK*

1. Current Regulation and the FSA Approach

In the UK, the primary regulatory organization for hedge funds and “most financial services markets, exchanges and firms” is the Financial Services Authority (“FSA”).²¹⁸ The FSA was formed in October 1997 as part of the new Labour government’s proposals to centralize regulation.²¹⁹ The FSA resulted from the merger of a multitude of previously independent regulatory groups.²²⁰ Since its formation, the FSA has been more vocal than the US regulatory authorities in the debate regarding the regulation of hedge funds. In the past six years there has been a clear progression from a very positive stance by the FSA towards hedge funds to a much more cautious one. In many of its publications, however, the FSA still stresses the benefits that

²¹⁵ Press Release, AIMA, AIMA Investor Steering Committee to Publish First Global Collaborative Guide for Investors (Jan. 31, 2008), <http://www.aima.org/uploads/AIMAISCtolaunchworldsfirstinvestorhedgefundguideJan08.pdf>.

²¹⁶ *Id.*; see also Emma Mugridge, *Hedge Fund Guide from the Horses’ Mouths*, FIN. TIMES (LONDON), Mar 17, 2008, at 6.

²¹⁷ Press Release, *supra* note 215.

²¹⁸ “The Financial Services Authority (FSA) is an independent organisation responsible for regulating financial services in the UK. The FSA’s aim is to promote efficient, orderly and fair financial markets and help retail financial service consumers get a fair deal. The FSA was set up by government. The government is responsible for the overall scope of the FSA’s regulatory activities and for its powers. . . . It sets the standards that they must meet and can take action against firms if they fail to meet the required standards. FSA, Who We Regulate, <http://www.fsa.gov.uk/pages/About/What/Who/index.shtml> (last visited Mar. 31, 2008).

²¹⁹ FSA, History, <http://www.fsa.gov.uk/Pages/About/Who/History/index.shtml> (last visited Mar. 31, 2008).

²²⁰ *Id.*

hedge funds bring to the UK economy.²²¹

In 2002, it released a discussion paper entitled *Hedge Funds and the FSA* (the “2002 Report”) that set out the regulatory approach the FSA took to hedge funds, and requesting comments on a number of possible developments.²²² Hedge funds are treated very differently in the UK. One reason is that no hedge funds are physically based in the UK, for tax reasons.²²³ In the US, the converse is true, tax considerations make it beneficial for US investors to invest in funds that are based in the US.²²⁴ The FSA has a two-fold approach to the regulation of hedge funds.

First, the FSA oversees the marketing of hedge fund products in the UK.²²⁵ Hedge funds are classified as “unregulated collective investment schemes,” and as such they may not be marketed to the general public and only to private customers in limited circumstances.²²⁶ Only individuals or firms that are classified by the FSA as “eligible counterparties” or “professional clients” may be marketed to by hedge funds.²²⁷ The definition of “professional clients” includes

²²¹ See, e.g., FSA, FEEDBACK STATEMENT 06/2, HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT, FEEDBACK ON DP05/4 ¶ 1.1. (Mar. 2006), available at http://www.fsa.gov.uk/pubs/discussion/fs06_02.pdf.

We are committed to playing our part to ensure the UK remains an attractive location for hedge fund managers to be based. Over recent years prime brokerage business has grown in tandem with hedge fund manager activity, making it very big business for London-based investment banks. In addition institutional investors, including many pension funds, are increasingly investing in hedge funds. They are a major source of liquidity and can significantly enhance market efficiency. Increasingly, they are fundamental to the efficient reallocation of capital and risk and provide a mechanism for increasing investment portfolio diversification. So it is unsurprising that hedge fund managers are receiving increased attention from regulators.

Id.

²²² FSA, DISCUSSION PAPER 16, HEDGE FUNDS AND THE FSA (Aug. 2002), available at <http://www.fsa.gov.uk/pubs/discussion/dp16.pdf>.

²²³ “A UK-domiciled hedge fund would be liable for corporation tax on income and capital gains.” *Id.* at ¶ 4.2. The administration of most hedge funds also occurs offshore. *Id.*

²²⁴ HAL SCOTT, INTERNATIONAL FINANCE, Chp 16, p. 41 (working draft 2007, on file with author).

²²⁵ See generally FSA, *supra* note 222, at ¶¶ 4.5–4.15.

²²⁶ *Id.* at ¶¶ 4.5–4.6.

²²⁷ FSA, New Conduct of Business Sourcebook R. 4.12.1(4), available at <http://fsahandbook.info/FSA/html/handbook/COBS/4/12> (defining a “category 7 person”).

individuals with financial expertise, and high net worth.²²⁸

Second, the FSA regulates the UK-based hedge fund managers themselves.²²⁹ Under the Financial Services and Markets Act 2000, UK based hedge fund managers engage in “regulated activities,” and must seek authorization to do so.²³⁰ The FSA stresses that it is not territorially able to regulate the “systems and controls of the underlying hedge fund[s]”.²³¹ Rather, the regulation is directed at the managers, with the FSA focusing on:

[a firm’s] resources and competence to manage the assets of funds in line with its mandates from the operators of the underlying fund. This will include the need to have adequate interfaces with the Prime Broker and Administrator of the fund for reconciliation purposes, and appropriate information feeds for pricing and other market information. Also, a firm would need to show adequate internal accounting systems to ensure ongoing compliance with its financial resources requirement.²³²

In the 2002 Report, the FSA noted that “[h]edge fund managers (as distinct from hedge funds) tend to have a relatively low impact on both retail consumers and UK financial markets,” and thus were subject to very limited oversight, classified as “low-impact” in the risk-based approach to regulation the FSA takes.²³³ Even then, the FSA recognized that the low regulatory burden, coupled with the fact that so many “wholesale investors” are based in London, attracted managers to be based in the UK, and that their presence benefited the strength of the UK markets.²³⁴ Indeed the FSA was considering relaxing the rules regarding the marketing of hedge funds to retail customers and was open to input from the industry on modifications to the way

²²⁸ *Id.* at R. 3.5.3, available at <http://fsahandbook.info/FSA/html/handbook/COBS/3/5#D182>.

²²⁹ FSA, *supra* note 222, at ¶ 4.4.

²³⁰ *Id.* at ¶ 4.20. Regulated activities include: “(a) managing assets belonging to another person which are, or which may include, securities or contractually based investments; or (b) advising on the merits of buying, selling, subscribing for or underwriting a particular investment which is a security or contractually based investment.” *Id.*

²³¹ *Id.* at ¶ 4.22.

²³² *Id.* at ¶ 4.21.

²³³ *Id.* at ¶ 4.24.

²³⁴ *Id.* at ¶ 6.35.

hedge fund managers were regulated.²³⁵ After the consultation, however, the FSA decided that it believed the regime provided “the right balance of consumer protection and access” and did not make any changes to the regulatory structure.²³⁶ Very recently, the FSA has reopened this consultation, and has indicated that it will modify the tax regime to allow authorized funds of funds to be marketed directly to retail investors from within the UK.²³⁷

In 2005, the FSA began to look more closely at hedge funds, in June releasing a report entitled: *Hedge Funds: A Discussion of Risk and Regulatory Engagement* (the “2005 Report”).²³⁸ There were two key reasons for its burgeoning interest. First, the market had grown rapidly, particularly in Europe (from under \$100 billion in 2002 to over \$250 billion in 2005), and was perceived as being a much more important element of the economy than in 2002.²³⁹ Second, the FSA recognized that underlying investor base had grown as pension funds exposure to hedge funds had increased, and a “growing number of investment managers intend[ed] to launch onshore regulated products using some of the investment techniques typically employed by hedge fund managers.”²⁴⁰ The 2005 Report identified a wide variety of “potential risks” and requested comment on their magnitude and impact, but noted that the FSA did not then “see significant risks to UK retail consumers arising in the hedge funds sector.”²⁴¹

In October 2005, the FSA set up a dedicated centre “for hedge fund expertise,” the Hedge

²³⁵ *Id.* at ¶¶ 1.5–1.6.

²³⁶ Press Release, FSA, FSA Publishes Update on Regulation of Hedge Funds (Mar. 26, 2003), <http://www.fsa.gov.uk/pages/library/communication/pr/2003/038.shtml>.

²³⁷ See FSA, CONSULTATION PAPER 07/6, FUNDS OF ALTERNATIVE INVESTMENT FUNDS ¶ 1.09, (Mar. 2007), available at http://www.fsa.gov.uk/pubs/cp/cp07_06.pdf; FSA, CONSULTATION PAPER 08/4: FUNDS OF ALTERNATIVE INVESTMENT FUNDS, FEEDBACK ON CONSULTATION PAPER 07/6, at ¶ 2.4 (Feb. 2008), available at http://www.fsa.gov.uk/pubs/cp/cp08_04.pdf.

²³⁸ FSA, *supra* note 38.

²³⁹ *Id.* at ¶¶ 1.2, 2.6.

²⁴⁰ *Id.* at ¶ 1.2.

²⁴¹ *Id.* at ¶ 1.9.

Fund Managers Supervision Team.²⁴² The Team is responsible working directly with the largest hedge funds managed in the UK: “assessing the risks posed individually by these firms and developing the individual risk mitigation plans for them to follow.”²⁴³ The funds were regulated by the FSA beforehand — but this was the first time that a dedicated group of individuals was assigned to look after them.

In March 2006, the FSA released the Feedback on the 2005 Report (the “2006 Feedback”).²⁴⁴ The 2006 Feedback focused on two very specific aspects of hedge fund activity. The first was regarding valuation — the FSA was concerned of the valuation by managers of their own instruments, particularly when they were highly complex.²⁴⁵ The second was the practice of issuing “side-letters” (where investors in funds are treated differently based on the size of their investment).²⁴⁶ Beyond these issues, however, the general tenor of the Feedback was that the FSA would continue to closely monitor the developments in the industry, without further regulation being necessary. For the first time, the FSA noted that it “welcomed” the development of a global “industry-led . . . Code of Conduct.”²⁴⁷

The FSA has a very principles-based approach to regulation, and all entities that it regulates must follow the “Principles for Business.”²⁴⁸ In the 2006 Feedback, the FSA discussed, for the first time, the application of the Principles to hedge fund managers.²⁴⁹ The Principles are so broad that the FSA would be able to change its approach to the regulation of hedge funds

²⁴² Rebecca Jones, Capital Markets Sector Manager, FSA, Speech Discussing the Results of the Initial Consultation on ‘Hedge Funds: A Discussion of Risk and Regulatory Engagement’ (Nov. 15, 2005), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/1115_rj.shtml; *see* FSA, *supra* note 221, at ¶ 4.2.

²⁴³ *Id.*

²⁴⁴ FSA, *supra* note 221.

²⁴⁵ *Id.* at ¶ 4.3.

²⁴⁶ *Id.* at ¶ 4.4.

²⁴⁷ *Id.* at ¶ 2.9.

²⁴⁸ *Id.* at ¶ 2.3. For a list of the FSA Principles, *see* FSA, The Principles, R. 2.1.1, *available at* <http://fsahandbook.info/FSA/html/handbook/PRIN/2/1>.

²⁴⁹ FSA, *supra* note 221, at ¶ 2.3 (“Principles are a statement of the fundamental obligations of firms and apply to all firms, including hedge fund managers.”); *see also* HFWG, *supra* note 91, at ¶ 3.5.

without having to enact any legislation, or even change its rules. This is very different to the circumstance the SEC was faced with prior to enactment of its rule in 2005.²⁵⁰

2. Recent FSA Actions

Since the 2006 Feedback, the FSA has continued to focus on hedge funds, not with broad-sweeping regulatory changes, but with small, incremental proposals. Following up on the issue of valuation raised in the Feedback, the FSA has supported the International Organization of Securities Commissions (IOSCO) in its development of *Principles for The Valuation of Hedge Fund Portfolios*.²⁵¹ Similarly, in response to the issue of side letters, the FSA made it clear that “a failure by a UK based hedge fund manager to make adequate disclosures of material side letters would amount to a breach of Principle 1 of our Principles for Businesses.”²⁵²

During 2007, the FSA “visited” a number of hedge fund managers, in order “to review the controls they had in place to mitigate the risk of market abuse.”²⁵³ In October 2007, the FSA launched a “formal assessment of the systems hedge fund managers use to prevent market abuse

²⁵⁰ Much has been written about the difference between the SEC’s rule-based approach and the FSA’s principles-based approach. SEC commissioners often argue the systems are not that different — apparently wishing to be seen to be closer to the FSA’s system than they are seen. *See, e.g.*, Roel C. Campos, Comm’r, SEC, Speech: Principles vs. Rules (June 14, 2007), available at <http://www.sec.gov/news/speech/2007/spch061407rcc.htm>.

²⁵¹ Press Release, FSA, FSA supports IOSCO Principles for the valuation of Hedge Fund Portfolios (Mar. 14 2007), <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/034.shtml>

Hedge funds are playing an increasingly important role in the international capital markets and we are pleased to support IOSCO in promulgating valuation principles which are applicable across all national boundaries. The paper addresses the issues of how effective controls may be placed around the valuation process to mitigate conflicts of interest, increase independence in sourcing and review of the resulting valuations.

Developing the Principles alongside practitioners with extensive involvement in the hedge fund industry proved to be a very productive process for IOSCO. We very much appreciated the generous time and commitment given by industry experts. Their insight into effective valuation processes and open dialogue with regulators was invaluable.

Id.; see IOSCO, PRINCIPLES FOR THE VALUATION OF HEDGE FUND PORTFOLIOS (2007), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf>.

²⁵² Dan Walters, Speech on FSA Regulation of Alternative Investments (Mar. 12 2007), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0313_dw.shtml.

²⁵³ FSA Newsletter, *Markets Division: Newsletter on Market Conduct and Transaction Reporting Issues* 1, MARKET WATCH (Oct. 2007), available at http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter24.pdf.

after being “disappointed” by the quality of controls at some firms it visited.”²⁵⁴ For the reserved British regulator to express “disappointment” is serious.²⁵⁵ Given the high-profile case of market abuse at French bank Société Générale in January 2008, where one trader lost over \$7 billion by engaging in risky trades and covering his tracks, this assessment will likely remain at the forefront of the FSA’s regulatory goals.²⁵⁶

Finally, in November 2007, the FSA launched a consultation entitled *Disclosure of Contracts for Difference*.²⁵⁷ A contract for difference is a “derivative product that gives the holder an economic exposure . . . to the change in price of a specific share.”²⁵⁸ Such contracts enable hedge funds to gain large economic exposure to the price of stock without having to disclose their interest. Current disclosure laws in the UK are tied to voting interests, but hedge funds have proven able to exert power over investee companies without such voting interests.²⁵⁹

During the summer of 2007, the credit crunch hit the global financial markets. The FSA had much to worry about, including the collapse of Northern Rock, one of the top five mortgage lenders in the UK.²⁶⁰ Hedge funds were not seen as part of the problem. In November 2007, Hector Sants, the Chief Executive of the FSA, said that “hedge funds were not the catalyst or the drivers of the summer’s events and their subsequent behaviour was broadly in line with the

²⁵⁴ Andrew Hill, *Disappointed FSA Must Act To Prevent Disaster*, FIN. TIMES (LONDON), Oct. 30, 2007, at 20.

²⁵⁵ *Id.*

²⁵⁶ See David Gauthier-Villars & Carrick Mollenkamp, *How to Lose \$7.2 Billion: A Trader’s Tale*, WALL ST. J., Feb. 2, 2008, at A1.

²⁵⁷ FSA, CONSULTATION PAPER 07/20, DISCLOSURE OF CONTRACTS FOR DIFFERENCE (Nov. 2007), available at http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf

²⁵⁸ *Id.* at ¶ 2.2.

²⁵⁹ *Id.* at ¶¶ 1.10, 1.20–21. For an extensive analysis of the effect of contracts for difference in the US, see generally Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007).

²⁶⁰ The collapse of Northern Rock had a very large impact on the UK financial markets and likely future approach to regulation therein which is beyond the scope of this paper. At the FSA in particular, “[o]f the seven FSA supervisors working closely on the bank before its implosion last August, five have left.” Patrick Hosking, *Five FSA Officials who Oversaw Northern Rock Have Resigned*, TIMES (LONDON), Mar. 10, 2008, at 38; see also Press Release, FSA, FSA Moves to Enhance Supervision in Wake of Northern Rock (Mar. 26, 2008), <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/028.shtml>.

assumptions which underpin [the FSA's] regulatory approach."²⁶¹ Most relevantly, Sants noted that the FSA "remain[ed] broadly content with its approach to the regulation of hedge funds and that recent events, in our view, support rather than detract from the overall philosophy of principles and outcome focused regulation, which seeks to foster innovation and competition."²⁶² In a joint report on the credit crunch released by the Bank of England, the Treasury and the FSA in January 2008, hedge funds were hardly mentioned, which also indicates the UK government's position that hedge funds were not part of the problem.²⁶³ The report noted that, as part of "proposals for reform," "the Authorities will consider the implications for investors in structured products of the recommendations of the advisory groups established in September 2007 by the US President's Working Group on Financial Markets to improve best practice in the operation of hedge funds and the hedge fund working group in the UK chaired by Sir Andrew Large."²⁶⁴ Thus, hedge funds may temporarily be off the top of the FSA's list of priorities, but the FSA will undoubtedly return to them with ever-increasing vigor in the coming months.

3. The Hedge Fund Working Group Consultation

In July 2007, 14 UK-based hedge funds formed an ad hoc group to establish a set of best practice standards for the hedge fund industry, the Hedge Fund Working Group ("HFWG"). The HFWG was headed by Sir Andrew Large, former Chairman of the Bank of England and comprised of 14 hedge fund managers, 12 of whom are based in the UK.²⁶⁵ In October 2007 the

²⁶¹ Hector Sants, Chief Executive, FSA, Speech on Hedge Funds — Lessons from the Recent Market Turmoil, A Supervisor's Perspective (Nov. 20, 2007), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/1120_hs.shtml.

²⁶² *Id.*

²⁶³ FSA, HM TREASURY & THE BANK OF ENGLAND, FINANCIAL STABILITY AND DEPOSITOR PROTECTION: STRENGTHENING THE FRAMEWORK (Jan. 2008), *available at* http://www.fsa.gov.uk/pubs/cp/JointCP_banking_stability.pdf.

²⁶⁴ *Id.* at ¶ C.6.

²⁶⁵ HFWG, *supra* note 91, at 82.

HFWG published a two-part Consultation Document seeking input from the industry.²⁶⁶ The document contained at its core a set of 15 “issues” and proposed Standards addressing each of these issues. Written comments were received from 75 interested parties, and on January 22, 2008, the Final Report of the HFWG was published.²⁶⁷ The Final Report updated the standards based on the feedback and established a new Hedge Fund Standards Board (“HFSB”). The HFSB will be responsible for maintaining and updating the standards, as well enabling hedge funds to sign up to the standards.²⁶⁸ The motivation behind the publication of the HFWG Final Report was the acceptance in the industry of “the premise that the hedge fund industry is maturing and that to enhance confidence in the industry in the longer term it had to accept the responsibilities consistent with its standing.”²⁶⁹

B. *The Hedge Fund Working Group Standards*

No matter where a hedge fund is itself located, the Principles of the Financial Services Authority (FSA Principles) apply to the 21% of global hedge fund managers that are located in the UK.²⁷⁰ The HFWG Final Report noted that regulation of hedge funds in the US is “less embracing” and that there is no such “set of statutory principles.”²⁷¹ The FSA Principles comprise eleven very general points (e.g., “Customers’ interests — A firm must pay due regard to the interests of its customers and treat them fairly”).²⁷² They are not intended specifically for hedge funds, but rather cover any entity regulated by the FSA. One of the primary goals of the HFWG, then, was to illuminate what the FSA Principles should mean for hedge fund

²⁶⁶ HFWG, *supra* note 4; HEDGE FUND WORKING GROUP (“HFWG”), HEDGE FUND STANDARDS: CONSULTATION PAPER, PART II (Oct. 2007), available at <http://www.hfwg.co.uk/files/HFWG%20Paper%20Part%202%20Final.pdf>

²⁶⁷ HFWG, *supra* note 91, at 82.

²⁶⁸ *Id.* at 10.

²⁶⁹ *Id.* at 16.

²⁷⁰ See *infra* note 326.

²⁷¹ HFWG, *supra* note 91, at 12.

²⁷² FSA, *supra* note 248.

managers.²⁷³ The Final Report contains 28 Standards, each covering a different area of hedge fund regulation.

1. The Structure and Operation of the HFWG Standards

The HFWG Standards are intended to be best-practice standards for hedge fund managers to follow. Managers will be able to sign-up to become signatories to the Standards, after which they must adopt a “comply or explain approach.”²⁷⁴ This approach is a very distinctive part of the HFWG Standards — none of the Standards are mandatory for any of the signatories. The HFWG gives a number of reasons for such a regime. First, a “comply only” regime would require Standards to be very complex in order to cater to all different kinds of hedge funds. Second, the Standards are predominantly intended to encourage disclosure, and an “explain” option encourages this, even if the manager cannot follow the particular Standard precisely. Third, the “explain” option “accommodates the dynamism of firms without needing constantly to change the Standards . . . important for such a fast moving industry.”²⁷⁵ One final reason not enunciated by the HFWG — an “explain” option will allow managers to become signatories and get the labeling benefit that brings, while not having to follow all or indeed any of the Standards in their totality. This is undoubtedly an effort on the part of the HFWG to encourage funds to become signatories — the measure by which it will be judged as a voluntary self-regulatory organization (“SRO”).

HFWG gives reasons why managers will be incentivized to conform — all the “Standards are based on enlightened self-interest.”²⁷⁶ Conformity will add value to the confirming managers, as other parties, including potential investors, will have more confidence

²⁷³ HFWG, *supra* note 91, at 11.

²⁷⁴ *Id.* at 25.

²⁷⁵ *Id.* at 26.

²⁷⁶ *Id.* Confirming means either comply with the Standards or sufficiently explaining deviation from the Standards. *Id.*

in the individual managers and sector as a whole. This will, in theory, lead to pressure from the market on those managers who have not yet become signatories to do so.

In order for the Standards to remain relevant and up-to-date in the rapidly changing market, the HFWG Final Report envisions the HFSB as acting as the guardian of the Standards.²⁷⁷ Confusingly, the HFSB is explicitly *not* going to be a “trade association,” even though its members will all be members of the industry. Rather the HFSB will work very closely with the Alternative Investment Management Association (“AIMA”), the trade association that was most involved in the development of the Standards (indeed AIMA’s chairman is serving as an interim Trustee of the HFWB).²⁷⁸

2. The Legal and Regulatory Status of the Standards

The HFWG Standards have not yet been reviewed or commented upon by the FSA, though it has acknowledged their existence.²⁷⁹ The FSA does have a procedure whereby it can “confirm” industry guidance, meaning it is accorded “sturdy breakwater” status — the “FSA will not take action against any regulated firm that has adhered to confirmed industry guidance in force at the relevant time.”²⁸⁰ The HFWG Standards are “unconfirmed,” and the Group is not seeking for the Standard to be accorded “confirmed” status. Thus, even full compliance with the Standards does not guarantee the FSA would find no violation of its Principles. The HFWG gives reasons for not seeking “confirmed” status. The FSA Principles are “minimum standards,” whereas the HFWG Standards are seen as best-practice policies. Although stronger standards would likely not lead to the FSA rejecting them, the “comply or explain” process that is

²⁷⁷ *Id.* at 29.

²⁷⁸ *Id.* at 29, 34–35.

²⁷⁹ FSA, *supra* note 257, at ¶ 5.53 (citing HFWG, *supra* note 91, at 80) (noting the position of the HFWG with regard to Contracts for Difference); *see also* Cassell Bryan-Low, *European Hedge Funds Issue Disclosure Guides*, WALL ST. J., Jan, 23, 2008, at C6 (“[A] spokeswoman for the [FSA] declined to comment on how the standards might affect future regulation.”).

²⁸⁰ HFWG, *supra* note 91, at 98.

necessary given such aspirational standards will likely not “lend itself to the FSA confirmation process.”²⁸¹ After all, even a good explanation for why a manager is not complying with some of the Standards may not be satisfactory and the FSA may still consider the relevant Principles to be violated.

3. Overview of the Standards

In the Final Report there are 28 Standards. Each Standard covers a different aspect of possible hedge fund regulation, and most Standards have multiple parts. This Paper shall briefly consider the main elements of each Standard as they relate to investor protection, systemic risk and corporate governance.

a. *Investor Protection*

The vast majority of the HFWG standards appear to be aimed at investor protection — even those that may have an impact on other areas of regulation are often based on disclosure, which will aid investor protection goals. It is unsurprising that many of the Standards involve disclosure. On the one hand, a large amount of the criticism leveled against hedge funds is at the “secretive” nature of the investments — disclosure is a direct way to redress such criticism. On the other hand, disclosure is relatively easy for managers to implement. There are provisions in the Standards concerning the disclosure of:²⁸²

- 1) a firm’s general investment policy or strategy and the associated risks;
- 2) the commercial terms, such as the fee structure and termination rights;
- 3) the details of how assets are valued — in particular methodology for hard-to-value assets;
- 4) the fund’s valuation procedures and controls, including specific disclosure of whether anyone whose compensation is linked to fund performance is involved in valuation;

²⁸¹ *Id.* at 28.

²⁸² *See generally id.* at 40–81.

5) the amount of a fund's portfolio invested in hard-to-value assets, and the amount invested in "side-pockets" — investments to which not all investors will have access;

6) the general approach of the manager to managing portfolio risks, possibly including providing access to data on volatility, Value-at-Risk amounts, leverage, etc.²⁸³

7) the sources of and mechanisms for tackling operation and outsourcing risk.

8) the manager's proxy voting policy and instances in which the policy is not followed.²⁸⁴

In addition to disclosure, a number of the Standards contain specific "Governance Standards." These include ensuring that:²⁸⁵

1) valuation arrangements are in place aimed at addressing and mitigating conflicts of interest in relation to asset valuation;

2) hard-to-value assets, when valued in house, are valued fairly and consistently;

3) a risk framework is in place which sets out the "governance structure for its risk management activities and specifies the respective reporting lines, responsibilities and control mechanisms intended to ensure that risks remain within the [] manager's risk tolerance as conveyed to and discussed with the fund governing body."²⁸⁶

4) the fund manager has a risk management framework in place and regularly tests the fund's position against possible outcomes. Such frameworks should exist for liquidity risk, market risk, counterparty credit risk, portfolio risk and operational risk.

5) the fund "has internal compliance arrangements which are designed to identify, detect and prevent breaches of market abuse laws and regulations."²⁸⁷

²⁸³ *Id.* at 55, 63

²⁸⁴ *Id.* at 79–80.

²⁸⁵ *See generally id.* at 40–81.

²⁸⁶ *Id.* at 55.

²⁸⁷ *Id.* at 77.

b. *Systemic Risk*

Many of the Standards directed towards investor protection would have an impact on protecting against systemic risk. In Part III.B, we saw that many of the systemic risk concerns arise from problems of valuation and risk assessment and disclosure. Had LTCM, for example, been able to adequately value the risk of the Russian devaluation, or had disclosed its high leverage, it is possible that their counterparties would have more fully appreciated the risk of their investments.

A number of the Standards appear directed towards combating systemic risk in a more direct way. Discussing disclosure to lenders, prime brokers and dealers, the Final Report notes that “when determining how much information to provide on a confidential basis to their counterparties, market participants should recognise that provision of relevant credit data increases the level of counterparties’ comfort and improves the likelihood that access to credit will continue during periods of systemic and institutional stress.”²⁸⁸ The language of the consequent Standard, however, is quite vague: “A hedge fund manager should . . . provide . . . any agreed information reports to the fund’s counterparties in a timely manner.”²⁸⁹

c. *Corporate Governance*

The Standards do little to regulate the activities of hedge funds specifically with regard to activism and corporate governance. Two target market abuse: the Standards require “internal compliance arrangements which are designed to identify, detect and prevent breaches of market abuse laws and regulations” — which includes insider trading.²⁹⁰ A further two Standards consider the issue of proxy voting, requiring the managers have a policy that investors may use to evaluate the general approach the fund takes towards proxy voting of its stock. Even these

²⁸⁸ *See id.* at 45.

²⁸⁹ *Id.* at 45.

²⁹⁰ *Id.* at 78

Standards relate to investor protection, however, and not directly to the protection of investee companies. Indeed, at the time of the Group's formation, Sir Andrew Large noted that, "Activist hedge fund attacks on underperforming companies . . . [were] unlikely to feature in recommendations."²⁹¹ Only the final Standard: "A hedge fund manager should not borrow stock in order to vote" appears to relate directly to corporate governance.²⁹² There is no further guidance given, however, and this provision is rather simplistic. It does not cover the "greenmail" or short-termism problems, or even complex hedging structures such as the Highfields fund situation.²⁹³

VI. GOVERNMENT REGULATION VS. SELF-REGULATION

Having seen the approaches of government regulators in the US and the UK and recent moves towards self-regulation, the two methods of regulation appear to be very different in their approach to the same issues. This Section will consider the theoretical advantages and disadvantages of each.²⁹⁴

A. *Benefits of Self-Regulation*

1. Speed and Flexibility

One of the main arguments in favor of self-regulation is its capacity to react to industry changes quickly.²⁹⁵ This is particularly relevant in the hedge fund market: hedge funds are designed to fit in regulatory cracks — for example in the US they are structured to avoid heavy

²⁹¹ James Mackintosh, *Facing Down the Threat of Tighter Rules*, FIN. TIMES (LONDON), June 20, 2007, at 21.

²⁹² *Id.* at 81.

²⁹³ See *supra* Part III.C.3; note 126.

²⁹⁴ Other regulatory possibilities have been proposed which are beyond the scope of this Paper. These include the regulation of investors themselves. See, e.g., Tony A. Paredes, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation*, in CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW, VOL. 5 (forthcoming 2008) (International Monetary Fund seminar on current developments in monetary and financial law), available at <http://ssrn.com/abstract=984450>. One other suggestion is the relaxation of mutual fund regulation to narrow the gap between hedge funds and mutual funds. See Oesterle, *supra* note 34, at 33

²⁹⁵ See, e.g., Verret, *supra* note 3, at 818 ("the self-regulatory can escape the bureaucratic morass of the administrative process").

regulation under any of the four relevant Acts.²⁹⁶ The SEC's 2004 attempt to amend the Investment Advisers Act well-demonstrates this problem.²⁹⁷ The rule took years of discussion and notice and comment proceedings before it was finally passed. The SEC wanted to avoid new regulation of private equity and venture capital funds, so it inserted the two-year lockup provision in an attempt to distinguish those entities from hedge funds.²⁹⁸ Almost immediately, many hedge funds changed their structures to include such two-year lock-ups (so they once again fitted in the cracks).²⁹⁹ Two possible harms of government regulation may be drawn from this example. First, the consequences of government regulation may be hard to recognize *ex ante* — increasing the length of time investors must remain invested in hedge funds is not exactly congruent with the SEC's "investor protection" goals. When including the provision to distinguish private equity, the legislative drafters most likely did not realize that they would precipitate a big change in what a hedge fund is! Second, once a rule is in place, it is not easy to amend it *ex post* — doing so requires another round of notice and comment.³⁰⁰ Perhaps, then, the SEC is better for having had the rule abrogated by the *Goldstein* Court.

The possible flexibility of a self-regulatory scheme can be observed by looking at the governance of hostile takeovers in the US and UK. The methods of governance differ greatly, both substantively and procedurally.³⁰¹ In the US, takeovers are governed by statute and, most often, in the Delaware courts.³⁰² In the UK, however, a totally self-regulatory system is in place. Takeovers are administered by the Panel on Takeovers and Mergers ("Takeover Panel") which authors the relevant rules and is staffed "by personnel on secondment from the professional

²⁹⁶ See *supra* Part IV.A.1.

²⁹⁷ See *supra* Part IV.A.2.

²⁹⁸ See *supra* notes 173–175 and accompanying text.

²⁹⁹ Zuckerman & Ian McDonald, *supra* note 109.

³⁰⁰ See, e.g., *Air Trans. Asso'c v. Dep't of Trans.*, 900 F.2d 369 (D.D.C 1990).

³⁰¹ See generally, John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO L.J. 1727 (2007).

³⁰² *Id.* at 1729.

community that it regulates.”³⁰³ In the course of an ongoing takeover bid, the Takeover Panel will decide issues as they arise, almost immediately (for example by instructing a bidder to provide additional disclosure).³⁰⁴ In the US, the Delaware courts respond quickly relative to normal judicial process, but decisions are still made *ex post*, months after the event.

In a rapidly changing marketplace, the UK’s Takeover Panel is also able to update the relevant rules quickly. Indeed, in its recent publication, *Contracts for Difference*, the FSA approved of the Takeover Panel’s handling of the issue of such contracts when considering making changes to the regulatory structure with regard hedge funds.³⁰⁵ In their recent analysis, Armour and Skeel demonstrate that self-regulation is the primary cause of the more flexible and fair system in the UK.³⁰⁶

2. Efficiency

When considering the efficiency of any possible proposed regulation, it is always necessary to balance its estimated costs and benefits. In the hedge fund context, costs include (1) the cost of the affected hedge funds complying with the regulation, (2) the opportunity cost of trades not undertaken due to an artificial dampening of risk appetite, (3) the consequent legal and enforcement costs.³⁰⁷ A number of commentators have suggested that a government regulator would be likely to over-regulate, as it would be less likely to factor the opportunity costs of lost trades into its calculus.³⁰⁸ This is exacerbated by the fact that it takes a long time for government regulators to “unwind” any inefficient regulation and, should hedge funds wish to remain in the

³⁰³ *Id.*

³⁰⁴ *Id.* at 1744–45.

³⁰⁵ FSA, *supra* note 257, at ¶ 1.22 (“[T]he changes the Takeover Panel introduced in 2005 appear to have addressed disclosure concerns for the most important time period.”).

³⁰⁶ *Id.* at 1763.

³⁰⁷ Verret, *supra* note 3, at 815.

³⁰⁸ See, e.g., Paredes, *supra* note 37, at 1034–35; Verret, *supra* note 3, at 816. For an empirical analysis of the effect of regulation on hedge fund performance, see generally Douglas J. Cumming & Li Que, *Capital Flows and Hedge Fund Regulation* (Oct. 31, 2007) (unpublished manuscript, available at <http://ssrn.com/abstract=1026683>).

corresponding jurisdiction, they have no choice but to abide by it.³⁰⁹ Even just the estimation of the various costs can consume a large amount of a government regulator's resources.

The SEC has recently demonstrated an approval of the efficiencies that coordinated self-regulation can offer. Until recently, NASD was the SRO that regulated securities brokers in the US. NASD had survived a number of scandals in the last fifteen years, including failure to detect price-fixing and conflicts of interest in equity research.³¹⁰ A number of commentators suggested that self-regulation was failing. Under recent leadership of Mary Schapiro and with the support of the SEC, however, the NASD demonstrated that self-regulation could succeed.³¹¹ In late 2006, the SEC pushed for the merger of NASD with the self-regulatory arm of the NYSE.³¹² Chairman Cox argued that the merged entity would be "more efficient and more robust from an investor protection standpoint," further noting that "regulation of the markets works best when the front-line regulator is close to the markets."³¹³ The new entity, the Financial Industry Regulatory Authority ("FINRA") was formed in July 2007.³¹⁴

The complexity of the hedge fund industry makes it hard to regulate. Hedge funds are growing in size and importance, but are still a relatively small element within the financial markets,³¹⁵ and it would take a large amount of any government regulator's resources to regulate them fully, even if the regulator could find the optimal point of regulation. The SEC and, even more so, the FSA are reeling from the effects of the late-2007 credit crunch, and would likely not

³⁰⁹ Paredes, *supra* note 37, at 1034–35.

³¹⁰ Brooke A. Masters, *NASD Appoints Top Enforcer Schapiro as Its Chief Executive*, WASH. POST, Jan. 13, 2006, at D1.

³¹¹ *Id.* Schapiro was herself the youngest-ever appointed SEC Commissioner. *Id.*

³¹² Cox, *supra* note 193 ("As Chairman of the SEC, I've strongly supported the effort to fold the member regulation functions of both the NASD and the NYSE into one regulatory body"); *see also* Judith Burns & Randall Smith, *SEC Chairman Backs Creation Of One Regulator for Brokerages*, WALL ST. J., Nov. 11, 2006, at B3.

³¹³ Cox, *supra* note 193.

³¹⁴ FINRA, About FINRA, <http://www.finra.org/AboutFINRA/CorporateInformation/index.htm> (last visited Mar. 31, 2008).

³¹⁵ *See supra* Part II.B

have the resources to commit to a full regulatory program of hedge funds at this time.³¹⁶

3. International Effect

The most important benefit of a self-regulatory system is its capacity to be cross-boarder. In the US, the PWG noted in its 2007 *Principles and Guidelines*, that “[b]ecause key creditors and counterparties to [hedge funds] are organized in various jurisdictions, international policy collaboration and coordination are essential.”³¹⁷ In the UK, the HFWG devoted a whole section of its Final Report to the “global dimension,” noting: “The hedge fund industry operates worldwide and one of the purposes of this exercise is to encourage global convergence of standards governing the industry.”³¹⁸ It is clear that any single government regulatory scheme would suffer jurisdictional problems.³¹⁹ Administration of the SEC’s ill-fated 2004 rule would have required complex registration procedures for foreign hedge funds that would have had more than 14 US investors.³²⁰

Hedge funds tend to require relatively few human resources, and little fixed assets.³²¹ Thus, it would be easy for hedge funds to physically move location if necessary to avoid stringent regulation. During the notice and comment period to the 2004 rule-making, a number of hedge funds did threaten to leave the country altogether.³²² The complete flight of hedge funds from a country would likely harm its financial markets, given the accepted benefits they bring.³²³

Even in the face of increasingly stringent regulation, however, neither hedge funds nor

³¹⁶ See, e.g., Cox, *supra* note 193; Christine Seib, *Credit Crunch Rebuke for FSA and Bank of England*, TIMES (LONDON), Mar. 3, 2008, at 38.

³¹⁷ PWG PRINCIPLES & GUIDELINES, *supra* note 201, at ¶ 10.

³¹⁸ HFWG, *supra* note 91, at § 9, pg. 32.

³¹⁹ The FSA goes to great length in its materials to stress that it only regulates hedge fund *managers* present in the UK, not the funds that those managers manage (which are usually organized overseas for tax purposes).

³²⁰ See generally, Alex R. McClean, Note, *The Extraterritorial Implications of the SEC’s New Rule Change to Regulate Hedge Funds*, 38 CASE W. RES. J. INT’L L. 105, 123–26 (2006).

³²¹ Jeff Sommer, *Bermuda Isn’t Far, Hedge Funds Warn*, N.Y. TIMES, May 18, 2003, at § 3, p. 8. The then vice-Chairman of Goldman Sachs was quoted as saying “The most portable asset in the world is cash” at a meeting at the SEC. *Id.*

³²² *Id.*

³²³ See *supra* note 34–35 and accompanying text.

their managers are likely to flee developed financial markets altogether. First, the physical location of the fund is irrelevant. The US is well within its territorial rights to regulate funds globally if they wish to attract investment from US entities.³²⁴ Similarly, the UK is well within its territorial rights to regulate fund managers based in the UK — it does not matter where the fund itself is. Second, even though the hedge funds themselves may easily move, hedge funds need prime brokers and other services which are unlikely to be setting up large offices in Bermuda any time soon! Third, and most importantly, hedge funds need investors; the growth of the hedge fund market has led to immense competition for investment. Investors, particularly desirable institutional investors such as pension funds, will not be willing to blindly invest in a hedge fund based in a jurisdiction with no regulatory oversight at all — investors will likely always require minimum anti-fraud provisions, for example.³²⁵

It is interesting to consider the breakdown of the global hedge fund market. As of the end of 2006, the US had a 63% share of assets under management based on manager location, London had 21%, the rest of Europe had 5% and Asia had 8% .³²⁶ This dominance by London and the US is due to the need for a developed financial market, and particularly prohibitive regulation in otherwise suitable countries, such as France and Germany.³²⁷

There is still, however, the possibility of harmful regulatory competition between developed markets, such as the UK and US.³²⁸ Discussing the regulation of securities, Chairman Cox has recognized the benefits of international regulators working together:

³²⁴ McClean, *supra* note 320, at 134.

³²⁵ *Id.* at 135–37.

³²⁶ INTERNATIONAL FINANCIAL SERVICES LONDON, HEDGE FUNDS 1 (Apr. 2007), *available at* http://www.ifsl.org.uk/uploads/CBS_Hedge_Funds_2007.pdf and accompanying data, *available at* http://www.ifsl.org.uk/uploads/data/Hedge_Funds_2007.xls.

³²⁷ *See, e.g.,* McClean, *supra* note 320, at 128–31.

³²⁸ *But see* Paredes, *supra* note 37, at 1034 (“[T]here is no meaningful opportunity for parties to use arbitrage to escape the federal securities laws”)

[I]nstead of competitors, we've got to see one another as partners, working together to ensure the sound regulation of efficient global markets. There is much that we can do to better serve investors, by reducing duplicative and overlapping regulation and ensuring that regulators have access to the information they need — whether it's located domestically or abroad — in order to effectively regulate and enforce cross-border market operations.³²⁹

In its 2005 Report, the FSA concluded by noting that “it would not be beneficial if regulatory action caused the hedge fund industry to move to more lightly regulated jurisdictions.”³³⁰ Clearly, a globally effective self-regulatory scheme, supported by the US, Europe and the large financial centers in Asia would prevent a regulatory “race-to-the-bottom” among developed markets. Speaking recently in London, SEC Commissioner Donohue discussed the work of the HFWG and the PWG private-sector Committees and commended the “coordination and cooperation” between the groups, adding that it “serves as an excellent model for the way in which industry can work together with regulators around the globe to develop smart and sensible solutions to hedge fund regulatory issues and to strengthen and enhance confidence in all of our markets.”³³¹

One fund manager has suggested that, at least regarding the issue of valuation “[t]he only way to give the market confidence . . . is for the processes to be of a recognised international standard.”³³² Neither the PWG nor the HFWG go so far as to suggest a totally contiguous global SRO, but they do recognize the importance of the capacity for international cooperation, and the benefits that a self-regulatory system can bring.³³³

³²⁹ Christopher Cox, Chairman, SEC, Keynote Address to the Columbia Law and Business Schools Cross Border Securities Market Mergers Conference (Dec. 19, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch121907cc.htm>.

³³⁰ FSA, *supra* note 38, at ¶ 8.2.

³³¹ Donohue, *supra* note 195.

³³² Jerome de Lavenere Lussan, *Valuation Problems Need In-House Solution*, FIN. TIMES (LONDON), Jan. 21, 2008, at 8.

³³³ *E.g.*, James Mackintosh, *Hedge Funds Agree Greater Disclosure*, FIN. TIMES (LONDON), Jan. 23, 2008, at 18. (“The working group hopes the British standards could form the basis of an international regime for funds.”).

B. *Costs of Self-Regulation*

1. Misaligned Incentives

The incentives of SROs are not necessarily aligned with all the parties the regulation is trying to protect. Chairman Cox summarized the issue when discussing self-regulation of securities exchanges:

Today there are new risks and new strains on the self-regulatory system. The most obvious of these is the inherent tension between an SRO's role as a business, on the one hand, and as a regulator, on the other. A for-profit shareholder-owned SRO will always be tempted to fund the business side of its operations at the expense of regulation.³³⁴

Historically, the only source of regulation for the exchanges, prior to the formation of the SEC, was the rules written by the exchanges themselves. Obviously those who ran the exchange and wrote the rules were incentivized to ensure the market functioned well: that there was continuous, liquid trading. It became apparent, however, that the exchange had little interest in enforcing strict corporate governance controls, leading to the enactment of the 1933 and 1934 Acts — indeed traders may benefit from “opacity” as this “enhance[d] the importance of their role and create[d] more opportunities for profitable trading,” effectively taking advantage of other members of the markets.³³⁵

The incentives of hedge fund managers are aligned with the market in certain ways. For example, with regard to “investor protection,” hedge fund managers will be incentivized to disclose if doing so encourages investment. Issues such as better valuation techniques and market abuse processes presumably benefit all parties. In many aspects, however, the incentives of hedge fund managers may conflict with the market's goals. By definition, systemic risk is aggravated because fund managers only factor the harm of their fund collapsing into their

³³⁴ Cox, *supra* note 329.

³³⁵ Armour & Skeel, *supra* note 301, at 1785 n.272.

calculus, not the possible harm of knock-on effects on the markets. There can also be clear conflicts between hedge funds and their investee companies, depending on the type of investment. Armour and Skeel, who approved of a self-regulatory structure for takeovers,³³⁶ explicitly noted that “proposals for self-regulation by the [hedge fund] industry itself as a substitute for formal regulation need to be viewed with caution.”³³⁷

The problems of misalignment can be countered somewhat by modifying the composition of the SROs. For example, the HFWG has been criticized for not having any investor representation,³³⁸ whereas the PWG set up two separate committees, one of investors and one of asset managers, each of which published its own set of recommendations. The best solution is likely for the SRO to have some detailed governmental regulatory oversight that enables the monitoring of the standards and regulations and suggests areas that need further protection.³³⁹

2. Ineffectiveness of Voluntary Schemes

Any self-regulatory scheme that is voluntary and does not have an enforcement mechanism will always suffer from the appearance that it may be ineffectual. SROs that are set up with a “comply or explain” model such as the HFWB are very far removed from strict SEC rules backed up by the SEC’s enormous enforcement teams. The primary criticism of the HFWG Final Report when it was issued was that the Standards were too vague.³⁴⁰ Large investor Albourne Partners said “more detailed standards were needed to ensure that hedge funds complied with the spirit of the voluntary rules.”³⁴¹ The head of hedge fund advisory at KPMG also noted that “one bad apple [could] spoil the whole thing. If someone self-certifies to say that

³³⁶ See *supra* notes 301–306 and accompanying text.

³³⁷ Armour & Skeel, *supra* note 301, at 1786.

³³⁸ See Mackintosh, *supra* note 333.

³³⁹ See generally Verret, *supra* note 3, at 817–20, 833–34, 839.

³⁴⁰ See, e.g., James Mackintosh, *Adviser Says Hedge Fund Code Needs To Be Tougher*, FIN. TIMES (LONDON), Jan. 3, 2008, at 15.

³⁴¹ *Id.*

they have been complying and it turns out they haven't . . . it will damage the whole reputation of the standards.”³⁴² Speaking of the PWG’s *Principles and Guidelines* the Attorney General of Connecticut, Richard Blumenthal said: “[t]hese vague recommendations lack substance and specifics, making them unenforceable,” before suggesting that state action may be required.³⁴³

Finally, in order to be at all successful, an SRO must have members! The HFSB does not become effective until the end of this year, and it already has the 14 funds that helped to draft the standards as signatories.³⁴⁴ The HFWG has said that it “expects more to sign up,”³⁴⁵ but so far there have been no indications in the press that funds are rushing to sign up. It is likely that many other funds are waiting to see how investors, the FSA and other regulators respond to the Standards. A survey of pension funds conducted by KPMG shortly after the publication of the standards was promising — indicating that “eight out of 10 pension funds said they would favor a hedge fund manager who had complied with the HFWG’s standards.”³⁴⁶ If there is no response from the FSA, however, the HFSB may go the way of other attempts at “best-practice” materials by trade organizations, which have had “limited success.”³⁴⁷ In order to be a true success, the Standards likely require a seal of approval, even if unofficial, from the FSA.

VII. ANALYSIS OF RECENT MOVES TOWARDS “SELF-REGULATION”

In both the US and UK, responsible for over four-fifths of the hedge fund industry, there has been a move towards self-regulation in recent years. In the UK, the Hedge Fund Working Group was set-up by market participants, as was the AIMA Investor Steering Committee in the

³⁴² James Mackintosh, *Big Hedge Funds Agree Voluntary Code of Practice*, FIN. TIMES (LONDON), Jan. 3, 2008, at 20 (quoting Tom Brown, Head of Hedge Fund Advisory, KPMG Europe).

³⁴³ Deborah Solomon, *Regulators’ Hedge-Fund Approach: Hands Off*, WALL ST. J., Feb. 23, 2007, at C1.

³⁴⁴ HFWB, *Who Has Signed Up Already?*, <http://www.hfsb.org/?section=10567> (last visited Mar. 31, 2008).

³⁴⁵ James Mackintosh, *Hedge Funds In Disclosure Move*, FIN. TIMES (USA), Jan. 23, 2008, at 18.

³⁴⁶ Laurence Fletcher, *Pension Funds Welcome Hedge Fund Standards-Survey*, REUTERS.COM, Apr. 14, 2008, <http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSL1470184820080414?sp=true>.

³⁴⁷ Alistair MacDonald & Deborah Solomon, *Hedge Funds From Europe Take a Crack at Self-Policing*, WALL ST. J., Oct. 11, 2007, at C1 (“Trade groups have tried to implement voluntary standards on hedge funds with limited success.”).

US. The President's Working Group may have initiated the Investors' and Advisors' Committees, but those groups comprise private industry members only. In both the US and the UK the groups that have been formed will continue to monitor the industry and propose modification to their standards and regulations.³⁴⁸ Given this, it is important to consider whether this form "self-regulation" will really be different to government regulation, and if not, whether the recent self-regulatory proposals may do more harm than good.

A. *Will Self-Regulation be Different to Government Regulation?*

One of the key benefits of self-regulation is efficiency: the ability of the market to discover the correct level of regulation.³⁴⁹ It is possible, however, that SROs act only in response to the threat of government regulation — i.e., they fill the vacuum that they believe would otherwise be filled by direct government regulation. The recent behavior of the SROs provides evidence for this theory. First, the SROs are often formed as a result of the behavior of government regulators, whether direct or indirect, and second, the areas SRO regulate are colored by government regulatory priorities.

1. Self-Regulation as a Direct Response to Government Action

There is strong evidence that the recent self-regulatory drives come about as a direct response to an increasing government regulatory focus, rather than as a response to market forces. In some instances the government regulator set up the SRO. In other, such evidence can be read directly from the SRO's materials, or can be inferred from timing and the content of the reports.

In the US, the self-regulatory Asset Managers' and Investors' Committees were set up by the government regulatory organization — the President's Working Group. The reports will be

³⁴⁸ See *supra* notes 213, 277 and accompanying text.

³⁴⁹ See *supra* Part VI.A.2.

published by the Committees, the members of the which are all private members of the industry — though the senior members were political appointees.³⁵⁰ The creation of the Committees came after failed and aborted attempts at regulation by Congress and the SEC. In this way, the government regulators are directly responsible for the instigation of the “self-regulation.”

The AIMA Investor Steering Committee was not created directly by government regulators. However, the Director of AIMA has made it abundantly clear that the Committee’s work is intended to fulfill “the Financial Stability Forum’s Highly-Leveraged Report (2007) recommendation that industry and investors work more closely to develop positive initiatives.”³⁵¹ The Financial Stability Forum is a group of senior representatives of financial authorities, including government regulators from twelve countries and international financial institutions such as the World Bank and the European Central Bank.³⁵² In 2000, the FSF published a Report on Highly-Leveraged Institutions, which was updated in May 2007 to recommend “action by financial authorities, counterparties, investors and hedge fund managers to strengthen protection against potential systemic risks relating to hedge funds.”³⁵³ The FSA explicitly supported this Report in its 2008–09 Business Plan.³⁵⁴

In the UK, the HFWG Final Report, makes it explicitly clear that one of the primary motivations for the formation of the Group was the threat of government regulation. The introduction to the Report notes that the HFWG is “publishing the Report because hedge funds

³⁵⁰ See *supra* notes 206–207 and accompanying text.

³⁵¹ Press Release, *supra* note 215, at 2 (quoting Emma Mugridge, Director of AIMA).

³⁵² Financial Stability Forum, Who We Are, http://www.fsforum.org/about/who_we_are.html (last visited Mar. 31, 2008). The Forum includes representatives from Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, Switzerland, the United Kingdom (Bank of England, FSA and the Treasury), and the United States (Treasury, SEC, Federal Reserve). *Id.*

³⁵³ Press Release, FSF, FSF Makes Recommendations to Address Potential Financial System Risks Relating to Hedge Funds (May 19, 2007), http://www.fsforum.org/press/PressRelease-FSF_HLI_Update-final19May07-2.pdf.

³⁵⁴ FSA, BUSINESS PLAN 2008/09, at 20 (2008), available at http://www.fsa.gov.uk/pubs/plan/pb2008_09.pdf (“We will continue our international cooperation and our work with the [FSF] designed to ensure the potential risks to financial stability posed by the failure of one or more hedge funds . . .”).

are increasingly in the public eye,” and that “[t]he HFWG has sought to draw a baseline of best practices to strengthen the confidence of investors, lenders, regulators and other market participants.”³⁵⁵ When summarizing the responses received to the HFWG consultation paper, the Report adds:

Respondents also agreed that an industry-led market discipline regime could reduce the possibility of unsatisfactory regulatory intervention or legislation. On the one hand, if the regime is successful, regulators are less likely to introduce external regulation of the industry. On the other hand, should regulators feel the need to step in, the Standards could well be a realistic blueprint for external regulation and reduce the chances of a regulatory regime being imposed which the industry considers unpalatable.³⁵⁶

There is yet more evidence that the HFWG was set up to combat the tide which had turned, albeit slowly, in favor of regulation. Many politicians in Germany have long cast a wary eye over hedge funds: in April 2005, the Chairman of the then-ruling SPD, Franz Müntefering described them as financial “locusts.”³⁵⁷ In 2007, Germany became the host country of the Group of Eight (G8) international forum of governments.³⁵⁸ As the host, Germany was able to set the agenda — and one of the items high on it was transparency and hedge funds.³⁵⁹

Although Germany did not make much progress at the G8,³⁶⁰ the threat of heightened regulatory scrutiny, especially on a global level was enough to bring about the formation of the HFWG.³⁶¹ Paul Marshall, a member of the Group and Chairman of Marshall Wace, one of the

³⁵⁵ HFWG, *supra* note 91, at 7.

³⁵⁶ *Id.* at 16

³⁵⁷ Edward Taylor, *German Official Wants to Put Hedge Funds on G-8's Agenda*, WALL ST. J., Sept. 1, 2006, at C4.

³⁵⁸ The Federal German Government, G8 Summit 2007 Heiligenhamm, <http://www.g-8.de/Webs/G8/EN/Homepage/home.html> (last visited Mar. 31, 2008).

³⁵⁹ See Angela Merkel, Chancellor of the Federal Republic of Germany, Opening Address at the World Economic Forum (Jan. 24, 2007), *available at* <http://www.g-8.de/Content/EN/Reden/2007/01/2007-01-24-rede-bkin-davos.html>.

³⁶⁰ James Mackintosh, *Facing Down the Threat of Tighter Rules*, FIN. TIMES (LONDON), June 20, 2007, at 21 (“Germany’s G8 move was shot down by other countries, particularly the UK and US, which argued against more government interference in the booming sector.”).

³⁶¹ *Id.* (“When Germany unsuccessfully tried to push the Group of Eight to tighten oversight of the industry — already regulated in Europe, but only lightly regulated in the US — that prompted Marshall Wace, one of London’s biggest funds, to start calling rivals.”)

ten biggest hedge funds in Europe, wrote in September 2007:

[T]he industry needs to take its responsibilities for self-regulation seriously. There have been warning signals about what could happen if the industry does not take up this challenge. Nicolas Sarkozy, France's president, has attacked "predator" hedge funds and called for a European tax on "speculative movements" by financial groups. A range of continental politicians, particularly in Germany, have been in favour of a statutory code of practice. There are even calls for more regulation in the US. . . . The hedge fund industry must be seen to be taking its responsibilities seriously. If not, others will fill the vacuum.³⁶²

Another member of the Group went so far as to admit that "[i]t is difficult to produce something other than motherhood and apple pie, so whether it gets there or just takes the heat off until the German presidency (of the G8) has rotated, we don't know yet."³⁶³

The self-regulatory efforts appear to have achieved the goal of taking the pressure off direct regulation, at least from Germany. In September 2007, the German finance minister, Peter Steinbrück said that, in light of the recent credit crunch, he would push for a "voluntary code of conduct" for hedge funds at the next G8 meeting.³⁶⁴

2. Regulatory Areas Covered by Recent Proposals

It is notable that the HFWG Report appears to pay particular attention to areas of hedge fund regulation that government regulators have recently focused on. Consider the specific areas of hedge fund activity that the FSA has discussed recently, discussed in Part V.A.2. First, two Standards in the Final Report directly relate to the prevention of market abuse.³⁶⁵ Second, another Standard states that a "hedge fund manager should disclose the existence of side letters

³⁶² Paul Marshall, *Why Hedge Funds Have to Address the Critics' Concerns*, FIN. TIMES (LONDON), Sep 25, 2007, at 13.

³⁶³ James Mackintosh, *Big Hedge Funds Look at Code of Practice*, FIN. TIMES (LONDON), June 19, 2007, at 1.

³⁶⁴ Rainer Buergin, *Steinbrueck Says Hedge Funds Should Police Themselves (Update4)*, Sept. 4, 2007, BLOOMBERG.COM, available at <http://www.bloomberg.com/apps/news?pid=20601085&sid=aE93VQRIOMtA&refer=europe> (last visited Mar. 31, 2008).

³⁶⁵ See HFWG, *supra* note 91, at 76–78 ("Prevention of market abuse – Governance Standards and Guidance [23] . . . Disclosure Standards and Guidance [24]")

which contain ‘material terms’, and the nature of such terms.”³⁶⁶ Third, five of the Standards cover valuation, and the Report explicitly cites the IOSCO Principles that the FSA supports.³⁶⁷ Thus, over one quarter of the Standards cover specific issues that had been on the FSA’s regulatory radar in the twelve months prior to their publication. Finally, the Final Report defers consideration of Contracts for Difference until the FSA has completed its investigation.³⁶⁸

a. *Investor Protection and Systemic Risk*

Of the three areas of regulation, international government regulators have consistently expressed concern regarding investor protection and systemic risk. For example, in the US, Robert Steel, Treasury undersecretary for domestic finance approved of the PWG’s Principles and Guidance, hoping that the industry committees would address “investor protection, enhance market discipline and mitigate systemic risk.”³⁶⁹ In Germany, Chancellor Angela Merkel in her opening address at the 2007 World Economic Forum said: “We want to minimize the international capital market’s systemic risks while increasing their transparency. Let me make it very clear that I see much room for improvement, especially regarding hedge funds.”³⁷⁰ In 2007 a “trilateral review” was begun between the SEC, the FSA and the New York Federal Reserve Bank, which focused all aspects of credit risk in financial markets, and paid particular attention to hedge funds.³⁷¹ Finally, in the its 2005 Report, the primary risk identified by the FSA was “serious market disruption and erosion of confidence.”³⁷² The majority of the self-regulatory

³⁶⁶ HFWG, *supra* note 91, at 43.

³⁶⁷ *Id.* at 46–53. “Hedge fund managers should refer to . . . IOSCO’s Principles for the Valuation of Hedge Fund Portfolios (2007) for further guidance in this area.” *Id.* at 48.

³⁶⁸ *Id.* at 8 (“The proposed Standard relating to the disclosure of positions held via Contracts for Difference [is] pending the outcome of the FSA’s consultation on this issue.”)

³⁶⁹ Simon Hildrey, *SEC Plans Hedge Fund Anti-Fraud Regulation*, FIN. TIMES (LONDON), July 12, 2007, at 13.

³⁷⁰ Merket, *supra* note 359.

³⁷¹ Nazareth, *supra* note 82 (“[S]upervisory staff from the three bodies [met] with business personnel and risk managers at firms to discuss and review practices related to prime brokerage and credit risk management of OTC derivatives counterparties.”).

³⁷² FSA, *supra* note 38, at 6.

proposals and standards, as seen above, relate to investor protection or combating systemic risk.

b. *Corporate Governance*

In May 2006, when stories of activist hedge funds first arose, regulators in Europe began to investigate “short term profit-oriented foreign investors.”³⁷³ The following month, SEC Commissioner Campos spoke about the “role of hedge funds in the corporate democracy,” noting that “as their strength increases . . . hedge funds’ ability to wreck havoc on issuers and the market grows.”³⁷⁴ In recent months, however, the government regulators have not discussed activist hedge funds, aside from the FSA’s general concerns regarding contracts for difference and empty voting.³⁷⁵ The FSA has specifically noted that “shareholder activism is not peculiar to the hedge fund sector” and so should be addressed in a broader context.³⁷⁶ As expected, recent self-regulatory efforts pay little attention to corporate governance and activist hedge funds.³⁷⁷

B. *Does It Matter if Self-Regulation Responds Only to Government Pressure?*

It is apparent that recent self-regulatory proposals shadow government proposals. This could be because government regulators have successfully highlighted all areas in which hedge funds might need to be regulated. It is more likely, however, especially given the rhetoric of the proposals, that the aim of the SROs was to discover the government regulators’ concerns, and regulate accordingly to assuage those concerns and prevent direct regulation.

Consequently, some of the proposed benefits of self-regulation may be lost. If SROs rely on government regulators finding and pointing areas that need regulation out, the regulation may be no quicker than government regulation. Furthermore, self-regulators may choose to regulate in an area even if they believe doing so is inefficient — because they prefer to regulate

³⁷³ Edward Taylor & Alistair MacDonald, *Hedge Funds Face Europe’s Clippers*, WALL. ST. J., May 26, 2006, at C1.

³⁷⁴ Campos, *supra* note 131.

³⁷⁵ See FSA, *supra* note 257, ann. 2, at 6.

³⁷⁶ FSA, *supra* note 38, at ¶ 1.8.

³⁷⁷ See *supra* Part V.B.3.c.

themselves than incur government intervention. Conversely, government regulators may come to over-rely on the self-regulatory groups. If they do not continue to investigate hedge funds with the rigor they have, new issues, or dormant issues such as corporate governance, may arise and be missed. This problem may be aggravated if the self-regulatory standards are ill-defined or ill-enforced, and the market fails to recognize that fact until it is too late.

Many of the benefits of self-regulation are not lost, however. The two most important remain: 1) the ability to modify regulation if it does not work or has unintended consequences; and 2) the possibility of a truly international regulatory standard. As noted above, any self-regulatory system will likely need close government oversight to ensure the standards are aligned with the incentives of all interested parties. Thus, even if the hypothesis is correct, that self-regulation only covers areas that would otherwise be regulated by governments, it does not mean a government regulatory system would be preferable. And, should government regulators decide to step in, they may be able use the self-regulatory materials as a “blueprint.”³⁷⁸

VIII. CONCLUSION

Hedge funds have always been the least regulated of all institutional investors. This has enabled them to try a wide variety of investment strategies at which they have been largely successful over the last ten years. Sophisticated investors have benefited from being allowed to share in the hedge fund managers’ gains, causing other institutions and individuals to want to share the benefits. As the sector has grown, however, hedge funds have increasingly attracted the attention of the government regulators. Several high-profile instances of fraud and the increasing exposure of less-sophisticated individuals to hedge funds have sparked the interest of the media. This, coupled with the ever-present fear of system risk and the lack of clarity regarding the corporate governance effects of hedge funds, has led to calls for hedge fund regulation from

³⁷⁸ See *supra* note 356 and accompanying text.

across the globe.

In an effort to thwart possible government regulation, investors and managers in the hedge fund sector have formed self-regulatory groups to propose possible regulatory solutions. This has received support from many commentators, partly because they believe self-regulation will be more efficient than government regulation. This Paper has shown, however, that recent proposals simply reflect the areas of regulation that government regulators would otherwise engage in. Consequently, a self-regulatory scheme may not be optimally efficient and may not respond as quickly as it could. Other benefits, however, likely make self-regulation worth pursuing. With the coordination of government regulators, trade groups and investors, a global best-practice scheme could be developed.